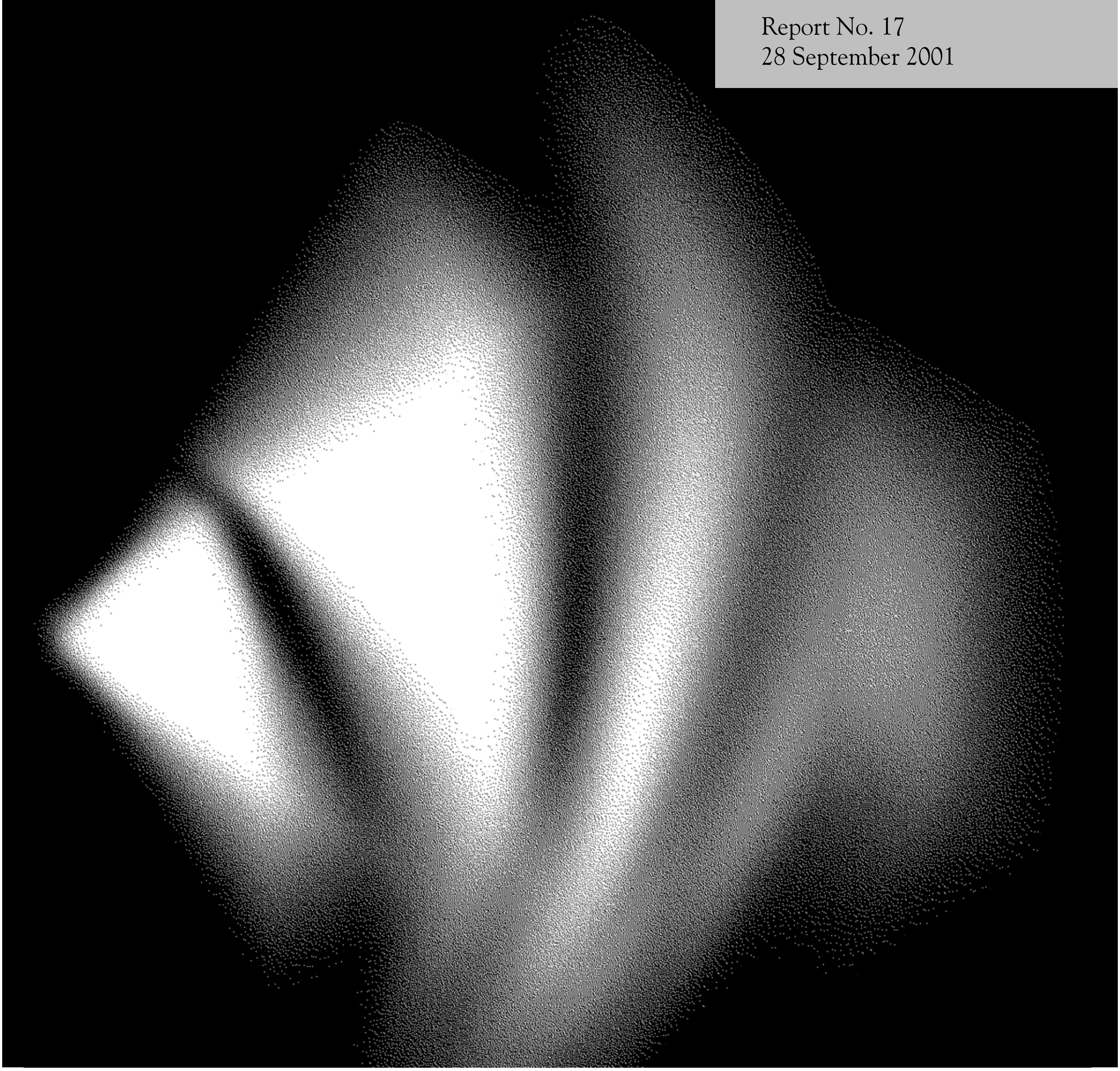
Review of the National Access Regime

Inquiry Report



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The Productivity Commission, an independent Commonwealth agency, is the Government’s principal review and advisory body on microeconomic policy and regulation. It conducts public inquiries and research into a broad range of economic and social issues affecting the welfare of Australians.

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PRODUCTIVITY COMMISSION

28 September 2001

Senator the Hon. Rod Kemp
Assistant Treasurer
Parliament House
CANBERRA ACT 2600

Dear Assistant Treasurer

In accordance with Section 11 of the *Productivity Commission Act 1998*, we have pleasure in submitting to you the Commission's final report for its *Review of the National Access Regime*.

Yours sincerely

Gary Banks	John Cosgrove
Chairman	Commissioner

Terms of Reference

I, ROD KEMP, Assistant Treasurer, pursuant to Parts 2 & 3 of the *Productivity Commission Act 1998*, hereby refer Clause 6 of the Competition Principles Agreement (CPA) and Part IIIA of the *Trade Practices Act 1974* (TPA) to the Commission for inquiry and report within twelve months of receipt of this reference. The Commission is to focus on those parts of the legislation that restrict competition, or that impose costs or confer benefits on business. The Commission is to hold hearings for the purpose of the inquiry.

Background

2. In April 1995 the Commonwealth, States and Territories signed three Inter-governmental Agreements, including the CPA, which established the framework for competition policy reforms. The CPA requires that its own terms and operation be reviewed after five years of operation. Terms of Reference for that review specify that the review of Clause 6 of the CPA be incorporated into the competition policy review of Part IIIA of the TPA.

3. Clause 6 requires the Commonwealth to establish an access regime with certain characteristics, explains the circumstances in which this regime will be utilised, and details the principles to which an effective State/Territory access regime must conform. Part IIIA of the TPA discharges the Commonwealth's obligation under Clause 6. There is no intention that the review lead to reconsideration of existing or pending certifications, declarations or undertakings agreed or accepted under Part IIIA.

Scope of Inquiry

4. The Commission is to report on current arrangements established by Clause 6 and Part IIIA for regulation of access to significant infrastructure facilities, and ways of improving them, taking into account the following:

(a) legislation or regulation that restricts competition or that may be costly to business should be retained only if the benefits to the community as a whole outweigh the costs; and if the objectives of the legislation or regulation can be achieved only by restricting competition or by imposing costs on business;

(b) where relevant, the effects of Clause 6 and Part IIIA on the environment, welfare and equity, occupational health and safety, economic and regional development, consumer interests, the competitiveness of business (including small business), investment and efficient resource allocation;

(c) the need to promote consistency between regulatory regimes and efficient regulatory administration through improved coordination to eliminate unnecessary duplication; and

(d) mechanisms that may improve Clause 6 and/or Part IIIA processes for achieving third party access to essential infrastructure, or that may engender greater certainty, transparency and accountability in the decision making process in Clause 6 and Part IIIA.

5. In making assessments in relation to the matters in 4, the Commission is to have regard to the analytical requirements for regulation assessment by the Commonwealth, including those set out in the CPA. The report of the Commission should:

(a) identify the nature and magnitude of the problem(s) that Clause 6 and Part IIIA seek to address;

(b) clarify the objectives of Clause 6 and Part IIIA;

(c) identify whether, and to what extent, Clause 6 and Part IIIA restrict competition or impose costs on businesses;

(d) consider any alternative means of achieving the objectives of Clause 6 and Part IIIA, including non-legislative approaches;

(e) analyse and, as far as reasonably practical, quantify the benefits, costs and overall effects of Clause 6 and Part IIIA and alternatives identified in (d), including the impact of Clause 6 and Part IIIA on investment in infrastructure;

(f) identify the different groups likely to be affected by Clause 6 and Part IIIA and each of the alternatives in (d) above;

(g) list the individuals and groups consulted during the review and outline their views;

(h) determine a preferred option for regulation, if any, in the light of the objectives set out in (b);

(i) examine measures to engender greater certainty, transparency and accountability in the decision making processes in Clause 6 and Part IIIA;

(j) examine mechanisms for improving Clause 6 and Part IIIA processes for achieving third party access to significant infrastructure facilities, including measures to improve flexibility, reduce complexity, costs and time for all participants and, where the mechanisms differ, determine a preferred mechanism; and

(k) examine the roles of the National Competition Council, the Australian Competition and Consumer Commission and the Australian Competition Tribunal in the administration of the access provisions of Clause 6 and Part IIIA, and the relationship between the institutions.

6. The Commission is to take into account any recent relevant studies undertaken.

7. In undertaking the review, the Commission is to advertise nationally, consult with key interest groups and affected parties, and produce a report.

8. The Government will consider the Commission's recommendations and consult as appropriate, and the Government's response to matters affecting Part IIIA, and the response of parties to the CPA to matters affecting Clause 6 of the CPA, will be announced as soon as possible after the receipt of the Commission's report.

ROD KEMP

[Reference received 11 October 2000]

Contents

OVERVIEW

Key messages

- Access regulation provides a means for businesses to use the services of ‘essential’ infrastructure, such as gas pipelines, that is uneconomic to duplicate. Without such regulation, service providers might deny access to their facilities or charge monopoly prices for their services. This could be costly for the community.
- Given these potential costs, the limited experience in Australia with access regimes and ongoing structural change in a number of infrastructure sectors, it would be inappropriate to abandon access regulation at this stage.
- The present national access regime, operating in tandem with industry access regimes, has important advantages. But it also has significant deficiencies.
- The paramount concern is the potential for access regulation to deter investment in essential infrastructure. To lessen this risk, the Commission has proposed that new measures be incorporated into the national access regime to facilitate efficient investment.
- In addition, the Commission has proposed a range of modifications to the architecture of Part IIIA to ensure that access regulation is better targeted and more workable. These include:
  - inserting an objects clause and pricing principles to guide regulators and industry and to discourage unwarranted divergence across industry-specific regimes;
  - strengthening the coverage criteria to ensure that mandated access would only occur where it would promote a *substantial* increase in competition. This would guard against the inappropriate declaration of essential facilities;
  - streamlining the coverage criteria applying across the regime’s different access routes to reduce the scope for inconsistent determinations;
  - enhancing the prospects for negotiated outcomes and ultimately effective arbitrations, through modifications to the negotiate-arbitrate framework; and
  - improving administrative efficiency and transparency to address the currently cumbersome and protracted arrangements.
- Given the importance of essential infrastructure services and the scale of investment involved, the benefits from improving the effectiveness of Part IIIA and reducing the potential for its inappropriate application are likely to be substantial.

Overview

In 1995, the Commonwealth and State and Territory Governments agreed to implement a National Competition Policy package. The package contained a range of measures to increase competition across the economy and thereby to enhance economic performance.

This inquiry has examined the operation of one of those measures — the national access regime for 'essential' infrastructure services. Under the regime, businesses can seek access to these services on 'reasonable' terms and conditions in cases where replicating the infrastructure concerned would not be economically feasible.

Among other things, the terms of reference for the inquiry ask the Commission to:

- clarify the objectives of the regime;
- analyse its benefits and costs and ways to improve it;
- consider other ways of achieving the regime's objectives; and
- examine the roles of the various bodies involved in administering the regime.

The Commission has concluded that retention of a national access regime is warranted.

However, some significant changes to the current arrangements are required. In particular, the regime needs to give greater emphasis to ensuring that there are appropriate incentives to invest in essential infrastructure.

How does the national access regime operate?

The focus of the national access regime is on infrastructure facilities such as gas pipelines that occupy a strategic position in the service delivery chain (see box 1). These are often referred to as 'essential' or 'bottleneck' facilities.

Box 1 Key features of Australia's infrastructure access arrangements

The arrangements for firms to gain access to essential infrastructure services are complex. They involve the generic national regime — commonly referred to as Part IIIA — and a host of industry regimes. Many of these industry regimes are governed by State and Territory legislation. There are also Commonwealth regimes applying in sectors such as telecommunications and airports, as well as an access code for the national electricity market. Some of the industry regimes operate under the Part IIIA umbrella, while others are outside it.

The focus of the national access regime is on infrastructure services that are essential inputs to services provided in other (upstream or downstream) markets and which involve a 'natural monopoly' technology. The latter characteristic means that it is unlikely to be profitable or efficient for more than one firm to provide the service.

The national regime provides three access routes:

- Having a service *declared*: To be declared, a service must satisfy a number of criteria, including that: access would promote competition in another market; it would be uneconomic to develop another facility to provide the service; the facility is nationally significant; and the service is not already covered by an effective access regime. Declaration gives the access seeker the right to negotiate with the service provider, with provision for arbitration if those negotiations are unsuccessful;
- Seeking access through an *effective* access regime: Part IIIA provides for the 'certification' of existing regimes as effective. Clause 6 of the Competition Principles Agreement sets out principles for an effective State or Territory access regime. A service covered by a certified regime cannot be declared; and
- Seeking access under the provisions of an *undertaking* from the service provider which has been accepted and registered by the Australian Competition and Consumer Commission (ACCC). Undertakings can apply either to an individual service, or provide the basis for an industry access code. Services covered by undertakings cannot be declared.

There are several decision makers:

- The National Competition Council (NCC) is responsible for assessing declaration and certification applications.
- Final responsibility for declaring services resides with the State Premier/Chief Minister, or the Commonwealth Treasurer — depending on the ownership of the infrastructure. The Commonwealth Treasurer is also responsible for certifying existing access regimes as effective.
- As well as assessing proposed undertakings, the ACCC is involved in arbitrating disputes for declared services.
- Part IIIA provides appeal rights for most steps in the process, mainly involving the Australian Competition Tribunal.
- Various State and Territory regulators and the ACCC are responsible for administering industry access regimes operating under the Part IIIA umbrella.

The regime is not intended to replace commercial negotiations between facility owners and access seekers. Rather, it seeks to enhance the incentives for negotiation and provide a means of access on reasonable terms and conditions if negotiations fail.

Under the regime, there are three regulatory ways for a business to gain access to an essential service:

- having the service *declared*: this gives an access seeker the right to negotiate with the service provider, and to use arbitration if those negotiations are unsuccessful;
- seeking access through an industry-specific regime applying to the service which has been deemed to be *effective*; and
- seeking access under the terms and conditions specified in a registered *undertaking* from the service provider.

The legislative and institutional arrangements giving effect to the national access regime are complex:

- A range of legislative instruments are involved, including: Part IIIA of the Trade Practices Act (which sets out the regime's architecture); Clause 6 of the Competition Principles Agreement (CPA) which sets out principles for testing the effectiveness of State and Territory access regimes; and various pieces of regulation governing industry access regimes that operate under the Part IIIA umbrella.
- Responsibility for administering the arrangements is divided among the NCC, the ACCC, the Australian Competition Tribunal and various State regulators.

Why this review?

Since its introduction in 1995, the national access regime has proved to be an innovative, but often controversial, piece of economic regulation.

Although determinations under Part IIIA have been relatively few in number (see box 2), the regime influences the framework for the provision of access in most of Australia's essential infrastructure sectors. The value of infrastructure assets affected by the regime is well over $50 billion, and the services they provide are important inputs for most Australian businesses. Those services are also vital to the quality of life enjoyed by Australians generally.

Box 2 Use and impact of the national access regime to date

To date, there have been few access arrangements arising directly from the Part IIIA declaration and undertaking provisions:

- There have been only two declarations — covering certain cargo handling services at Sydney and Melbourne airports. Moreover, the latter was only an interim measure, while the former has yet to lead to a specific access agreement. (There have, however, been a number of recommendations by the NCC for declaration of particular rail services that were rejected by State Ministers.)
- The only undertaking so far accepted by the ACCC has been for the code covering the National Electricity Market.

Use of the certification mechanism has been somewhat more widespread. So far, 9 regimes have been certified as effective. While most of these have been gas regimes developed under the Gas Code, two rail regimes and a regime covering Victorian shipping channels have also been certified.

One declaration application and three certification applications are currently under consideration by the NCC.

However, the influence of the national access regime cannot be judged simply by reference to the number of determinations made:

- The threat of declaration under Part IIIA has helped to shape State and Territory access regimes, even where certification has not been sought.
- Access agreements have been negotiated for a number of rail services which were the subject of unsuccessful declaration applications.

Not surprisingly, therefore, the inquiry generated considerable interest. While there was widespread support for a national access regime, there were also substantial concerns about aspects of the current arrangements (see box 3).

What is the rationale for access regulation?

In most circumstances, competition between suppliers of goods and services will result in lower prices, a wider range of products and better service for consumers.

However, the transmission and distribution networks involved in the delivery of some infrastructure services use ‘natural monopoly’ technologies. This means that one firm can meet total demand for this type of service more cheaply than two or more firms. In an unregulated situation, and in the absence of competition from substitute services, an incumbent provider might thus enjoy substantial and enduring market power.

Box 3 **Participants' views on the national access regime**

Most participants agreed that there is a case for access regulation and merit in having a national access regime.

Many, however, raised concerns about the current arrangements in general and Part IIIA in particular. For example, the Western Australian Government argued:

> Western Australia recognises the importance of access regulation in promoting economic activity and increasing efficiency of production. Accepting the merits of both the generic Part IIIA access framework and the various industry-specific regimes, Western Australia suggests that there is some scope to improve the framework so as to provide greater certainty in its application and ensure that incentives to invest in key infrastructure industries are not distorted. (sub. 38, p. 1)

More forcefully, the Australian Council for Infrastructure Development contended that:

> … the current industry specific and generic access regimes are highly prescriptive and intrusive and are not consistent with incentive regulation or productivity improvements in infrastructure development. The current regime provides an excessive focus on short term consumer cost savings without proper regard to the adequacy of investment and the costs that will have in the long term. (sub. DR80, p. 3)

The Network Economics Consulting Group emphasised the important framework role of Part IIIA, but argued that the current regime is deficient in this regard:

> NECG and the parties that have endorsed this submission have significant concerns about the adequacy of Part IIIA, as currently drafted, to fulfil its role as the framework for access regulation in Australia. (sub. 39, p. 3)

In contrast, users of essential infrastructure services and access regulators viewed the current arrangements more favourably. Thus, BHP Billiton stated:

> The National Access Regime has delivered considerable benefits to the Australian Economy and our international competitiveness. Competition has been fostered, new markets are developing and prices for users of natural monopoly energy infrastructure have reduced as some monopoly rents have been removed. (sub. 48, p. 5)

And, looking to the future, the NCC remarked:

> Despite their significant achievements, the provisions that embody the national access regime are relatively new. It is not apparent that there are serious deficiencies that, at this stage, would make a compelling case for altering the major features of the regime. Rather, it appears that progress has been made in clarifying the nature and implications of the regime. (sub. 43, p. 17)

However, user interests such as the National Farmers' Federation saw a need for greater efforts to reduce monopoly pricing of essential infrastructure services.

The incumbent provider could exercise such market power in two main ways:

- it could charge access prices that were significantly above costs; or
- it could deny access to the essential service.

Denial of access could be a particular problem where the access provider was also involved in supplying services in the final market. In effect, denial of access to the essential input would be a way of preventing competition in the downstream market. Indeed, this was the situation that the architects of the national access regime mainly had in mind.

Whichever way market power was manifested, output of the final service would, in most cases, be lower than desirable, resulting in an economic loss for the community. Over the longer term, excessive prices for essential infrastructure services could impede investment in downstream (and upstream) markets. In addition, there might occasionally be wasteful investment to bypass an essential facility that was overpricing its services.

The potential to earn monopoly profits could also adversely affect the timing of investment in essential infrastructure. For instance, an incumbent provider might seek to delay expenditure to upgrade a congested facility beyond the time at which consumers' willingness to pay for an expanded facility exceeded the cost.

Access regimes aim to curb the market power attaching to some essential facilities. While their precise configuration varies, in broad terms they are designed to:

- give businesses operating in downstream (or upstream) markets a mechanism for securing access to the essential services concerned; and
- provide regulators with the power to vary the terms and conditions of access that service providers would offer voluntarily to access seekers. Under the national access regime, this power is exercised via the arbitration of disputes. However, in some industry regimes, regulators set access prices directly.

Apart from lower prices and increased use of services, the provision of access can be an important stimulus to innovation and other so-called 'dynamic efficiency' gains. The explosion of product offerings in the telecommunications market in recent years highlights the role that new entrants can play in this regard.

What are its potential costs?

Access regulation can intrude significantly on property rights and give rise to a range of costs that must be set against its benefits. These include:

- administrative costs for government and compliance costs for business;
- constraints on the scope for access providers to deliver and price their services efficiently;

- reduced incentives to invest in facilities to provide new essential services or to maintain existing facilities;
- inefficient investment in downstream markets; and
- wasteful strategic behaviour by both service providers and access seekers.

The potential 'chilling' effect of access regulation on investment in essential infrastructure services is the main concern. Investment may be deterred for two reasons.

- Potential exposure to access regulation is likely to increase the general level of risk attaching to investment in essential facilities. The inevitable regulatory discretion involved in the implementation of such regulation, and perceptions that regulatory decisions are likely to be biased in favour of service users, are among the factors that contribute to regulatory risk. These sorts of risks attach to investment in any regulated activity. However, the scale of investment in essential infrastructure, and the fact that, once in place, the assets are 'sunk' with few alternative uses, mean that regulatory risk can be a more critical factor in the investment decision and may sometimes deter projects.
- Investments in essential infrastructure will also be deterred if regulated terms and conditions are not expected to provide a sufficient return. A particular problem here is that the possibility of earning higher than normal profits if a project proves to be very successful may be required to balance the possibility that the project will fail. However, once a facility is operating, it will generally be impossible for regulators to delineate any upside returns from genuine monopoly rent — that is, returns in excess of those necessary to justify the investment. Regulatory pricing arrangements that (inadvertently) appropriate upside returns (so called 'regulatory truncation') can be a significant source of inefficiency arising from access regulation.

Third party access and the resulting benefits to service users are only possible over the longer term if there is continuing investment in the essential infrastructure services themselves. On the other hand, while denial or monopoly pricing of access imposes costs on the community, such behaviour cannot threaten the continued availability of the services concerned. This asymmetry in potential outcomes highlights the priority that access regulation must give to ensuring that there are appropriate incentives for efficient investment.

Retention of a *modified* national access regime is warranted

Quantifying the benefits of well applied access regulation, or the costs of unwarranted or inappropriate intervention, is extremely difficult. In part, this reflects the difficulty of establishing the investment levels and conditions of access that would otherwise have prevailed. Separating the effects of access regulation from the myriad of market and other government influences on the infrastructure sectors is an additional complication.

The fact that the national access regime is still in its infancy further constrains assessments of its efficacy. As well as the limited case history, a number of the regime's key concepts and processes have yet to be fully bedded down. Also, many of Australia's infrastructure sectors are still undergoing significant structural change. At this juncture, it is difficult to judge what implications such changes will have for access regulation in general and Part IIIA in particular.

Nonetheless, the Commission's assessment — supported by virtually all participants — is that abandoning access regulation at this stage would be inappropriate. In its view, the natural monopoly characteristics of a number of essential infrastructure services mean that an explicit mechanism for facilitating efficient third party access is likely to be desirable. Moreover, the efficacy of the policy alternatives in this area is questionable. In particular, the Commission concurs with the widespread view that reliance on the competitive conduct provisions in Part IV of the Trade Practices Act would not be a viable stand-alone mechanism for facilitating access to essential facilities.

The Commission further considers that the current approach of the Part IIIA regime operating in tandem with industry access regimes has significant advantages. Industry regimes provide the flexibility to tailor access arrangements to the characteristics of particular infrastructure sectors. Equally, however, it is important that the requirements of industry regimes do not diverge unnecessarily. This is where a well-functioning national regime comes into play. Thus, the threat of declaration under Part IIIA has helped to shape State and Territory access regimes, even where certification has not been sought. Indeed, the framework provided by Part IIIA in conjunction with Clause 6 of the CPA is almost certainly more important than its role as a 'residual' access route.

However, this is *not* an endorsement of the status quo. The present national access regime is deficient in a number of important respects:

- It contains no overarching objective or pricing principles to guide negotiations between access providers and seekers and to underpin regulatory determinations. This has increased uncertainty for service providers and access seekers alike, as well as raising the spectre of inappropriate determinations.
- The criteria applying to the different access routes vary unnecessarily. For example, the coverage tests embodied in the Part IIIA declaration criteria are somewhat different from the corresponding tests in the CPA for determining whether an existing State or Territory regime is effective. Similarly, the factors

that the ACCC must take into account when arbitrating a dispute for a service declared under Part IIIA are more tightly prescribed than the factors it has to consider when assessing a proposed undertaking. Such divergences give rise to the possibility of inconsistent determinations.

- The arrangements have not been particularly successful in preventing unwarranted differences in the requirements of industry access regimes. This was of concern to service providers and access seekers alike.
- The institutional arrangements are cumbersome and the administrative processes very time consuming. Indeed, some determinations have been several years in the making.

But most importantly, the national access regime does not do enough to guard against the possibility that investment in essential infrastructure will be deterred. So-called 'regulatory risk' under the regime is greater than it need be. There is a danger that the regime could be applied to projects that should not be regulated at all. As outlined above, there is a significant risk that arbitrated determinations under the regime could go beyond appropriating genuine monopoly rent. Furthermore, the fact that coverage and other determinations are generally made after a facility is in place gives rise to the possibility of regulatory 'moral hazard'. That is, decision makers operate in the knowledge that the availability of the services concerned is unlikely to be threatened by determinations which are unduly favourable to access seekers.

Thus, significant modifications to the regime are required.

What changes are required?

In framing its recommendations to improve the national access regime, the Commission has had particular regard to the significant information problems confronting access regulators, and the imperfect regulatory instruments at their disposal. There are significant constraints on what even the best resourced and well intentioned regulator can achieve.

A number of other considerations have also been influential in the Commission's thinking:

- The recent decision by the Australian Competition Tribunal that the Eastern Gas Pipeline should not be covered under the Gas Code has clarified some aspects of the Part IIIA declaration criteria — those criteria are almost identical to the coverage criteria under the Code. The Tribunal's decision has eased some, though by no means all, of the concerns that were evident during the early stages of the inquiry.

- Changes to the wording of legislation will inevitably invite legal debate about what was intended by those changes. Thus, efforts to fine tune legislative provisions to give better intent to objectives is not without risk. The implication is that changes to current provisions in Part IIIA should focus on those aspects of the regime that are manifestly deficient.
- Clause 6 of the CPA is an integral part of the national access framework. Changes to Part IIIA which had the effect of downgrading the role of Clause 6 and, by implication, the role of certified industry regimes, could weaken the 'access compact' between the various Australian governments. This would be an undesirable outcome given that the compact is a vehicle for progressing a number of necessary reforms to the national access framework.

Against this backdrop, and in the light of the problems with the current arrangements identified above, the Commission has made a range of recommendations to improve Part IIIA. Some of these would involve relatively minor changes to the current arrangements. Others are intended to change the emphasis of the regime significantly.

A full list of the Commission's recommendations and findings follows this overview. Some of the more important recommendations are discussed below, with a more detailed explanation provided in the relevant sections of the report.

Inclusion of an objects clause and pricing principles in Part IIIA

Clear specification of objectives is fundamental to all regulation. Currently, Part IIIA contains no specific objects clause. While the Trade Practices Act contains an objects clause referring to enhancing welfare by the 'promotion of competition and fair trading and provision for consumer welfare', this is very general. Also, it gives no signals about the need to provide appropriate incentives for investment.

Inclusion of an objects clause in Part IIIA would be highly desirable to:

- provide greater certainty to service providers and access seekers about the circumstances in which intervention may be warranted;
- emphasise, as a threshold issue, the need for the application of the regime to give proper regard to investment issues;
- promote consistency in the application of the regime by the various decision makers; and
- help to ensure that decision makers are accountable for their actions.

Also, in keeping with the broader framework role of Part IIIA, an objects clause would help to condition the objectives and application of industry access regimes.

The Commission is therefore recommending that an objects clause be included in Part IIIA referring to the need to promote the efficient use of, and investment in, essential infrastructure facilities and to recognise the regime's role in discouraging unwarranted divergence in industry regimes. Part IIIA decision makers would be required to have regard to this objects clause in all of their coverage decisions and determinations.

The Commission is also proposing that pricing principles be embodied in the regime. Amongst other things, these principles would:

- condition negotiations between service providers and access seekers and thereby increase the likelihood of negotiated outcomes;
- indicate how the broad objectives of Part IIIA should be reflected in regulatory determinations under the regime; and
- assist the development of pricing frameworks in industry regimes.

A key requirement in the Commission's suggested principles is that pricing determinations under Part IIIA provide a sufficient return to service providers to justify continuing investment in the infrastructure concerned. The principles also endorse the use of multi-part pricing arrangements and the provision of incentives within pricing determinations for service providers to improve the efficiency of their operations.

Strengthening the declaration criteria

For some, the recent Eastern Gas Pipeline decision has largely addressed concerns that application of the Part IIIA declaration criteria could lead to the regulation of essential facilities that do not have substantial market power.

However, the Commission still has some concerns in this regard. In its view, the interpretation of natural monopoly and market power issues is not fully settled. More case history will be required before a definitive judgement can be made about the adequacy of the current criteria.

To provide some immediate assurance against the still present possibility of inappropriate declarations, the Commission is recommending that the first of the declaration criteria be strengthened. Specifically, declaration would have to promote a *substantial* increase in competition in another market, rather than simply promoting competition in that other market. This should help to guard against the possibility of declarations where there would be little prospect of a gain in efficiency, given the likely costs of intervention.

The Commission is also proposing that subsequent declaration decisions be examined in the next review of Part IIIA, with a view to determining whether further strengthening of the criteria is required. Were there to be inappropriate declarations, an overhaul of the criteria to focus more explicitly on market power and efficiency issues would be warranted. To this end, the Commission has set out in the report features that an alternative set of declaration criteria should embody.

Modifications to the negotiate-arbitrate framework

There is general acceptance that the Part IIIA negotiate-arbitrate framework is broadly appropriate.

However, the Commission sees the opportunity to facilitate more effective negotiations on access to declared services through the introduction of mandatory information disclosure requirements. These should be two-sided, placing an onus on the access seeker as well as the service provider to furnish information to the other party.

Further, while the regime's arbitration provisions have yet to be tested, there is also a case for some pre-emptive changes to improve their effectiveness and limit the possibility of inappropriate intervention. Amongst other things, the Commission is recommending that:

- when arbitrating a dispute for a declared service, the ACCC generally limit its involvement to matters in dispute between the parties;
- the scope for the ACCC to require a service provider to allow interconnection to the facility in question be made explicit; and
- there be provision for the ACCC to conduct multilateral arbitrations in some circumstances.

Improving the certification and undertaking framework

As noted, while the dual approach of Part IIIA operating in tandem with industry access regimes has important advantages, it has not prevented unnecessary divergences in the requirements of individual access regimes. To help address these divergences, the Commission is recommending a two-pronged strategy, namely:

- that the Commonwealth, States and Territories negotiate changes to Clause 6 of the CPA with a view to aligning (as far as practicable) the principles for assessing the effectiveness of State and Territory access regimes with the modified Part IIIA; and

- that immunity for Commonwealth industry regimes from Part IIIA be removed and that any new Commonwealth regimes be vetted by the NCC against the effectiveness principles in Clause 6.

To promote consistency across the various access routes, the Commission is also recommending that the criteria for assessing proposed undertakings be aligned more closely with the arbitration criteria and the Clause 6 effectiveness principles. Its other recommendations on undertakings entail:

- provision for facility owners to lodge undertakings after a service has been declared; and
- changes to rule out 'forum shopping' via the lodgement of undertakings for services subject to a certified industry regime.

Introduction of new measures to facilitate efficient investment

A number of these recommendations would help to facilitate investment in essential infrastructure services. Indeed, the emphasis in the proposed objects clause and pricing principles is very much on preserving incentives for investment, while the strengthening of the declaration criteria is intended to reduce the prospect of unwarranted coverage of services.

By themselves, however, these measures are not enough.

As noted, for firms contemplating an investment in a new facility, scope to earn higher than normal profits if the facility proves to be quite successful will often be needed to offset the possibility that the investment will fail. In such situations, the prospect of regulatory 'truncation' of upside returns if a favourable scenario eventuates may be sufficient to deter investment.

It is very difficult to address this problem by modifications to the sort of coverage tests used in Part IIIA and some industry access regimes. This is because these tests do not determine exposure on the basis of the *expected* profitability of a facility at the time of construction. Rather, they address whether an *incumbent* service provider might have the scope to exercise market power, even if the facility concerned was constructed with the expectation of providing only a normal risk-adjusted return.

For this reason, 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.

The Commission is recommending that two new mechanisms be introduced to Part IIIA as soon as possible:

- *Provision for binding rulings*: This would allow investors in a proposed essential facility that is unlikely to enjoy substantial market power to seek a ruling from the Minister (on the recommendation of the NCC) that the Part IIIA declaration criteria are not met. Bringing forward a (negative) coverage determination would greatly reduce regulatory risk and obviate the need for investors to adopt more expensive risk reduction strategies. For some marginal projects, this reduction in cost could be the deciding factor in allowing worthwhile investment to proceed.
- *Exemptions for government-sponsored infrastructure projects awarded by competitive tender*: Where the right to construct and operate an essential facility is determined on the basis of the most favourable access terms and conditions offered in a competitive tender, the intent of access regulation will have been achieved. It is therefore unnecessary to expose such projects to the Part IIIA regime.

However, these two mechanisms would only be relevant in a limited range of circumstances. Thus, a more general mechanism (or mechanisms) will be required to facilitate efficient investment in other situations.

In its Position Paper, the Commission floated the idea of an 'access holiday' — that is, a time-limited exemption from exposure to Part IIIA for eligible investments. While this approach, or the intent underlying it, was widely supported, some participants suggested different approaches, including:

- framework undertakings or access compacts, whereby a project proponent and the regulator would agree *prior to investment* on the cost of capital and other key parameters that would govern regulated access arrangements for the life of the project;
- exemption for new facilities from Part IIIA until such time as they returned their cost of capital — or became 'net present value (NPV) positive' — after which profit sharing arrangements would apply; and
- provision for a 'truncation' premium which would be added to the 'weighted average cost of capital' agreed for a proposed facility by the regulator and the project proponent. In essence, inclusion of such a premium would allow investors to retain higher than normal profits if a facility proved to be successful.

As outlined in box 4, each of these approaches has advantages and disadvantages. Importantly, there is likely to be a trade-off between precision on the one hand and administrative simplicity and avoiding disputation on the other.

Box 4 Some generally applicable approaches for facilitating efficient investment in regulated essential infrastructure

A number of approaches could be employed to address regulatory truncation of returns accruing to successful essential facilities and to lessen regulatory risk attaching to investments in these facilities more generally. Significantly, all involve specifying key aspects of the regulatory environment *prior to investment*.

Submissions from industry groups saw an important role for ex ante agreements between project proponents and the access regulator setting out the basis for any future regulated access determinations. Such ‘framework undertakings’ or ‘access compacts’ would clearly increase certainty for investors. But they would not, by themselves, address the truncation problem. This would require some other instrument within the framework undertaking.

One such instrument would be a case-specific truncation premium that would be added to the regulated cost of capital determined for a proposed project. A somewhat simpler variant would be to specify a standard truncation premium, rather than determining it on a case-by-case basis. Yet a further refinement would be to differentiate the standard premium across sectors to reflect their differing investment characteristics. All of these permutations could operate within the current Part IIIA architecture.

Alternatively, some form of access holiday arrangement could be used. Most participants favoured an approach which would exempt a new project from exposure to an access regime until it had returned the cost of capital agreed in advance with the regulator. Once a project had become ‘NPV positive’, any additional profits would be shared by the facility owner and the regulator (on behalf of service users).

The approach, which has parallels with a resource rent tax, would have important advantages. For example, it would provide certainty to investors and avoid the need to define the period of the holiday, or eligibility for it. That is, any new project could qualify.

However, both this approach and a truncation premium arrangement would be information intensive and prone to disputation. Given the imperfect information available to the regulator, they could also be open to ‘gaming’. In effect, both approaches would give rise to similar problems as the current arrangements for regulating access prices once facilities are in place.

Alternatively, the access holiday could be for a fixed term of sufficient duration to provide scope for investors in a successful project to recoup some upside returns. Like a standard truncation premium, the term of the fixed holiday could vary across sectors to reflect the differences in typical pay back periods for investments. This approach, which the Commission advocated in the Position Paper, would be much less complex. However, it would provide less certainty to participants than the tailored access holiday approach and would not address regulatory arrangements after expiry of the holiday. Moreover, eligibility criteria would have to be specified, again giving rise to the possibility of gaming.

Nonetheless, adoption of any of the approaches outlined above in Part IIIA (and in industry regimes) would, in the Commission's view, constitute an improvement on the current situation.

On balance, the Commission has some leaning towards making provision for a standard 'truncation premium' to be added to the regulated cost of capital agreed on prior to investment for a proposed essential facility. The total allowable rate of return could then be specified as part of a framework undertaking agreed with the ACCC.

Significantly, this sort of arrangement could operate within the current Part IIIA architecture rather than requiring the implementation of a new approach. Indeed, in some respects, it would be an extension of the direction in which access regulators profess to be moving. Moreover, in contrast to a fixed-term access holiday, it would provide greater certainty about regulated access terms and conditions over the life of a facility.

However, the Commission is not recommending that a particular approach be adopted in Part IIIA at this stage. In its view, further analysis and consultations are required before specific measures could be introduced.

The Commission has therefore recommended that the Commonwealth, through the Council of Australian Governments, initiate a process directed at further refining mechanisms to help ensure that new infrastructure investments are not deterred by exposure to access regulation. Given the imperative for such mechanisms, the process should be undertaken with a view to incorporating generally applicable mechanisms within the Part IIIA regime no later than 2003.

Institutional and administrative arrangements

The Commission is not proposing any changes to Part IIIA's broad institutional arrangements. Given the significant property right issues involved, it is appropriate that Ministers continue to be responsible for making decisions on applications for declaration of services and the certification of industry regimes as effective. Similarly, there are sound public policy arguments for retaining the current separation of responsibility for assessments of whether the regime should apply (the NCC), from responsibility for the regulation of services that are covered (the ACCC). Under a single regulator model, conflicts of interest might emerge, since the body with the power to shape an activity would also have the power to determine whether it should be placed in the position to do so.

The Commission is, however, proposing a range of changes to streamline the administrative arrangements and enhance their transparency, including:

- the introduction of merit review for decisions on proposed undertakings;
- indicative time limits for the various steps in the Part IIIA process;
- a requirement for all Part IIIA decision makers to publish reasons for their recommendations and determinations; and
- provisions to expedite extensions of certifications and undertakings.

Review of the revised arrangements

Given the complexity of the access problem and the imperfect nature of the solutions to it, ongoing monitoring and periodic review of the national access regime is essential. The Commission is recommending that the NCC be charged with reporting annually on the operation and effects of the revised arrangements and that there be a further independent review of the regime five years after the first group of changes emerging from this inquiry is put in place.

How would these changes benefit the community?

Adoption of the Commission's recommendations would deliver:

- more efficient outcomes, particularly in relation to new investment in essential infrastructure;
- greater certainty for market players about the situations in which access regulation might apply and the likely outcomes;
- more timely and less costly regulatory procedures; and
- greater regulatory accountability.

Realisation of these benefits would, of course, require an effective implementation process. Cooperation between the Commonwealth and States and Territories would be paramount in this regard. This is particularly the case as many of the potential benefits would come from parallel changes to industry-specific regimes.

Just as it is very difficult to quantify the impacts of the current arrangements, so too is it difficult to estimate the magnitude of the benefits likely to result from the proposed changes to the regime. Nonetheless, given the importance of essential infrastructure services to the economy and wider community, and the scale of investment involved, the benefits from improving the effectiveness of Part IIIA and reducing the potential for its inappropriate application are likely to be substantial.

Recommendations and findings

The future role of the national access arrangements

FINDING 4.1

Given the in principle case for some curbs on the exercise of monopoly power in the provision of essential infrastructure services, the limited experience in Australia with access regimes, and ongoing structural change in a number of infrastructure sectors, abandoning access regulation at this stage would be inappropriate.

Access regulation in the broader policy context

FINDING 5.1

There is no reason for a significant change in the balance between the use of access regulation and other policy instruments available for promoting efficient access to essential infrastructure. Any such change would increase uncertainty for market participants without any guarantee of improved outcomes. However, the balance should be reviewed periodically in the light of emerging evidence of the effectiveness of particular instruments.

FINDING 5.2

The current approach of a national access regime operating in tandem with industry-specific regimes has significant advantages. In effect, it draws on the strengths of both the generic and specific approaches, while avoiding some of the pitfalls of a one-dimensional solution.

Some changes to both Part IIIA and Clause 6 of the Competition Principles Agreement are nonetheless required to strengthen the access framework and to discourage unwarranted divergence across industry-specific regimes.

Objectives and coverage of Part IIIA

RECOMMENDATION 6.1

The following objects clause should be incorporated in Part IIIA of the Trade Practices Act 1974:

'The object of this Part is to:

(a) promote economically efficient use of, and investment in, essential infrastructure services; and

(b) provide a framework and guiding principles to discourage unwarranted divergence in industry-specific access regimes.'

FINDING 6.1

The national access regime is not an appropriate vehicle for pursuing distributional outcomes.

RECOMMENDATION 6.2

For all coverage decisions and determinations under Part IIIA, the relevant decision maker should be required to have regard to the objects clause.

RECOMMENDATION 6.3

Pricing principles should be included in Part IIIA with specific application to arbitrations for declared services, assessments of undertakings and evaluations of whether existing access regimes are effective (see recommendation 9.2).

FINDING 6.2

Part IIIA should continue to cover eligible services provided by both vertically integrated and non-integrated facilities.

FINDING 6.3

Part IIIA should continue to focus on addressing market power arising from natural monopoly that leads to the denial or monopoly pricing of access to essential infrastructure services. In sectors such as telecommunications, however, it may be appropriate for industry regimes to address additional sources of market power impinging on the provision of access to the essential services concerned.

RECOMMENDATION 6.4

While the current exclusions from the coverage of Part IIIA should be retained, developments in relation to the 'production facility' exemption should be monitored by the National Competition Council. Should judicial interpretation of that exemption lead to outcomes that detract from efficiency, it may be necessary to remove the provision or clarify its intent.

FINDING 6.4

The current emphasis of Part IIIA on the services provided by essential infrastructure facilities is broadly appropriate.

Part IIIA declaration criteria

RECOMMENDATION 7.1

Clause 44G(2)(a) of the Trade Practices Act should be amended such that access (or increased access) to the service would promote a <u>substantial</u> increase in competition in at least one market (whether or not in Australia), other than the market for the service.

If it is considered that the inclusion of the word 'substantial' carries a concomitant requirement for greater certainty of the outcome, an explicit concept of likelihood may need to be embodied in the revised criterion.

RECOMMENDATION 7.2

The next scheduled review of Part IIIA (see recommendation 16.2) should examine the interpretation of the declaration (coverage) criteria, modified in accordance with recommendation 7.1, to assess whether further strengthening of particular criteria or recasting of the criteria to focus explicitly on market power and efficiency considerations is required.

Negotiation and arbitration

RECOMMENDATION 8.1

The arbitration provisions of Part IIIA should be amended to provide for 'two-sided' information disclosure requirements involving both the access provider and the access seeker. The access seeker should be required to provide sufficient information, including technical and commercial requirements, to enable the access provider to respond to the request for access. The provider of the declared

service should be required to provide sufficient information to an access seeker to facilitate effective negotiation on the terms and conditions of access. This should include:

- ***information on the availability of the service, including any reasons why the service is not available on the conditions sought by the access seeker;***
- ***an offer of the terms and conditions of access to the service; and***
- ***sufficient information (such as the costs of operating the facility and providing the service) to enable the access seeker to make a reasonable judgement of the basis on which the terms and conditions of access were determined.***

This information should be provided within 28 days of the access seeker submitting its request for access to the service provider.

RECOMMENDATION 8.2

The Australian Competition and Consumer Commission, in arbitrating terms and conditions for declared services, should generally limit its involvement to matters in dispute between the parties. Where matters agreed between the parties are subjected to re-assessment, the Commission should be required to explain its reasons for doing so in the post-arbitration report (see recommendation 15.6).

RECOMMENDATION 8.3

Where the Australian Competition and Consumer Commission introduces considerations other than efficiency when arbitrating disputes for declared services or assessing proposed undertakings, it should be required to make this explicit and explain its reasons for doing so.

RECOMMENDATION 8.4

Section 44V of the Trade Practices Act should make explicit that when arbitrating a dispute for a declared service, the Australian Competition and Consumer Commission can require a service provider to permit interconnection to its facility by an access seeker.

RECOMMENDATION 8 5

The Part IIIA arbitration provisions should be amended to provide the Australian Competition and Consumer Commission with the discretion to conduct multilateral arbitrations following consultation with the parties to the dispute. If the Commission rejects the wishes of the parties as to whether or not to engage in multilateral negotiations, it should explain its reasons for doing so.

Certification

RECOMMENDATION 9.1

To discourage unwarranted divergence from the national access framework:

- ***Immunity from Part IIIA afforded to Commonwealth access regimes should be removed and such immunity should not be conferred on new Commonwealth regimes;***
- ***Clause 6 of the Competition Principles Agreement should make provision for the Commonwealth Government to seek certification of its access regimes; and***
- ***prior to enactment, any new Commonwealth access regimes should be submitted to the National Competition Council for comment on their consistency with Part IIIA.***

FINDING 9.1

Principles for assessing the effectiveness of industry access regimes should continue to be located within the Competition Principles Agreement.

FINDING 9.2

Ideally an 'effective' access regime should include the following:

- *an objects clause (specifying that the objective of the regime is to promote the efficient use of, and investment in, the essential infrastructure facilities concerned);*
- *coverage arrangements that focus mainly on services for which it would be uneconomic to develop another facility to provide the service;*
- *clearly specified dispute resolution arrangements and provisions to establish the terms and conditions of access;*
- *clearly specified criteria and pricing principles applying to regulated terms and conditions;*
- *effective appeal and enforcement provisions;*
- *revocation and review requirements for all determinations;*
- *where relevant, provisions to facilitate consistency across multiple State and Territory access regimes applying to a particular service; and*
- *where relevant, provision for measures to facilitate efficient new investment.*

The degree of reliance on negotiation, relative to arbitration and regulation, to set terms and conditions of access should be a matter for individual regimes and not be a part of the effectiveness test.

RECOMMENDATION 9.2

The parties to the Competition Principles Agreement should negotiate changes to Clause 6 with a view to aligning it, as far as practicable, with the modified Part IIIA. In doing so, the parties should have regard to the effectiveness criteria spelt out in finding 9.2.

RECOMMENDATION 9.3

The parties to the Competition Principles Agreement and the National Competition Council should investigate how best to provide for 'interim' and 'conditional' certifications, including whether such provisions would need to be reflected formally in Clause 6 of the Agreement.

Undertakings

RECOMMENDATION 10.1

There should be provision in Part IIIA for an access provider to lodge an undertaking after a service has been declared.

RECOMMENDATION 10.2

Criteria for assessing proposed undertakings under Part IIIA should be aligned, as closely as practicable, with those applying to arbitrations for declared services and the Clause 6 principles for certification. Specifically, the criteria should incorporate the recommended pricing principles.

FINDING 10.1

The inability of those who do not own infrastructure facilities to submit undertakings is not a sufficiently general problem to warrant changing the current provisions in Part IIIA. The difficulties encountered in relation to the development of an undertaking to cover the entire interstate network should be resolved, preferably through cooperative means, at the State and Territory government level. If this is not possible, the Commonwealth Government should pursue the foreshadowed alternative institutional arrangements for rail.

RECOMMENDATION 10.3

The Gas Code should be amended to provide that, where a pipeline owner potentially covered by the Code lodges a Part IIIA undertaking, this should trigger an assessment by the National Competition Council to determine whether the pipeline meets the requirements for coverage under the Code. The Australian

Competition and Consumer Commission's assessment of the Part IIIA undertaking should be held over pending the outcome of the Council's inquiry.

RECOMMENDATION 10.4

Part IIIA should be amended to make it explicit that the Australian Competition and Consumer Commission cannot accept an undertaking if the service concerned is subject to a certified access regime.

Facilitating efficient investment

RECOMMENDATION 11.1

Part IIIA should make provision for the proponent of a proposed investment in an essential infrastructure facility to seek a binding ruling on whether the services provided by that facility would meet the declaration criteria. Where the Minister, after receiving advice from the National Competition Council, determines that they would not, the services concerned would be exempt from declaration.

A binding ruling should apply in perpetuity, unless revoked by the Minister on advice from the Council on the grounds of a material change in circumstances. Such a revocation should be appellable to the Australian Competition Tribunal.

RECOMMENDATION 11.2

Where the licence to construct and operate a government sponsored essential infrastructure facility is to be awarded by an appropriately constituted competitive tendering process, there should be provision in Part IIIA to provide the services concerned with immunity from declaration.

Specifically, the Australian Competition and Consumer Commission should be able to issue an immunity for the term of the tender where the government concerned can demonstrate that:

- ***the licence to construct and operate the facility is to be awarded through a competitive process; and***
- ***favourable terms and conditions of access will be a key consideration in selecting the preferred tenderer.***

Provision should also be made to revoke the exemption if it transpires that the conduct of the tender does not conform with the arrangements on which the Commission's decision was based. Such a revocation should be appellable to the Australian Competition Tribunal. The Commission's initial decision should not, however, be appellable.

RECOMMENDATION 11.3

The Commonwealth Government should, through the Council of Australian Governments, initiate a process to refine mechanisms (additional to those provided for in recommendations 11.1 and 11.2) to facilitate efficient investment within the Part IIIA regime in particular and access regimes generally. The mechanisms to be considered should include:

- ***fixed-term access holidays available to any proposed investment in essential infrastructure which is determined to be contestable; and***
- ***provision for a 'truncation' premium to be added to the cost of capital that has been agreed between a project proponent and the regulator prior to investment.***

This process should be completed in sufficient time to enable legislative implementation within Part IIIA no later than 2003.

Access pricing principles

RECOMMENDATION 12.1

The Australian Competition and Consumer Commission, in seeking to reduce access prices that are inefficiently high, must also have regard to the following principles:

(a) that regulated access prices should:

(i) be set so as to generate expected revenue across a facility's regulated services that is at least sufficient to meet the efficient long-run costs of providing access to these services;

(ii) include a return on investment commensurate with the regulatory and commercial risks involved;

(iii) generate revenue from each service that at least covers the directly attributable or incremental costs of providing the service.

(b) that the access price structures should:

(i) allow multi-part pricing and price discrimination when it aids efficiency;

(ii) not allow a vertically integrated access provider to set terms and conditions that discriminate in favour of its downstream operations, except to the extent that the cost of providing access to other operators is higher.

(c) that access pricing regimes should provide incentives to reduce costs or otherwise improve productivity.

RECOMMENDATION 12.2

The Commonwealth, States and Territories, through the Council of Australian Governments, should initiate a process to develop further the productivity measurement and benchmarking techniques necessary for regulators to make greater use of productivity-based approaches to setting access prices.

The measurement of capital costs

RECOMMENDATION 13.1

When arbitrating a dispute for a service declared under Part IIIA, the Australian Competition and Consumer Commission should outline the reasons for its choice of asset valuation methodology in the post-arbitration report (see recommendations 15.6).

Institutional arrangements

FINDING 14.1

Ministers should continue to be responsible for making decisions on applications under Part IIIA to have services declared or existing access regimes certified as effective.

FINDING 14.2

The current division of administrative responsibility in Part IIIA between the National Competition Council and the Australian Competition and Consumer Commission is appropriate.

Procedural and administrative matters

RECOMMENDATION 15.1

Part IIIA should include provision for merit review by the Australian Competition Tribunal of decisions by the Australian Competition and Consumer Commission on proposed undertakings.

FINDING 15.1

The current rights of appeal attaching to Part IIIA declaration decisions should be retained.

FINDING 15.2

The 60 day limit on Ministerial decisions on declaration recommendations from the National Competition Council should be retained.

RECOMMENDATION 15.2

A 60 day limit should be introduced for decisions by the Commonwealth Minister on certification recommendations from the National Competition Council.

RECOMMENDATION 15.3

In addition to a 60 day limit for Ministerial decisions on declaration and certification applications (see recommendation 15.2), target time limits should apply to the other steps in the Part IIIA process:

- ***For assessments by the National Competition Council of declaration applications, the target time limit should be four months.***
- ***For assessments by the Council of certification applications and by the Australian Competition and Consumer Commission of undertaking applications, the target time limit should be six months.***
- ***For arbitrations for declared services by the Commission, the target time limit should be six months.***
- ***For the processing of appeals on any of these matters by the Australian Competition Tribunal, the target time limit should be four months.***

These targets should be specified legislatively, along with a provision that if the Council, the Commission or the Tribunal wishes to extend a target limit in a particular case, they be required to publish notification to that effect in a national newspaper. The annual reports of the Council and the Commission should contain information on the actual time taken to deal with matters subject to these time limits.

RECOMMENDATION 15.4

Part IIIA should make legislative provision for public input on declaration and certification applications, and proposed access undertakings, where it is 'reasonable and practical' to do so.

RECOMMENDATION 15.5

Ministers, the National Competition Council and the Australian Competition and Consumer Commission should be required to publish reasons for their decisions or recommendations relating to applications for declarations and certifications and proposed undertakings.

If Ministers fail to make a decision on a declaration or certification recommendation within the 60 day time limit, this should be deemed as acceptance of the National Competition Council's recommendation.

RECOMMENDATION 15.6

The Australian Competition and Consumer Commission should be required to publish reports on completed arbitrations for services declared under Part IIIA. Subject to the proviso that any information disclosed does not unduly harm the legitimate business interests of parties to the dispute, these reports should generally include the following:

- ***an outline of the decision making framework and methodologies underpinning the arbitrated outcome, including the reasons for the choice of asset valuation methodology (see recommendation 13.1);***
- ***any non-confidential information provided by the parties to the dispute which has implications for the framework and methodologies adopted; and***
- ***discussion of any implications of the determination for parties seeking access to the service, or a similar service, in the future.***

The reports should also include justification for any of the following actions taken by the Commission as part of the arbitration process:

- ***reassessment of matters agreed between the parties to the dispute (recommendation 8.2);***
- ***the introduction of non-efficiency considerations (recommendation 8.3); and***
- ***decisions on whether or not to engage in multilateral arbitrations which are against the wishes of the parties to the dispute (recommendation 8.5).***

RECOMMENDATION 15.7

Part IIIA should include explicit provision to expedite extensions of certifications and undertakings as follows:

- ***Six months prior to the expiry of a certification or undertaking, the National Competition Council or the Australian Competition and Consumer***

Commission would be required to seek public comment on the need for any change to the existing arrangements.

- ***On the basis of that input and other relevant information, the Council or the Commission would have the option of making a case for change.***
- ***If the Council or Commission did not do so, and the service provider did not wish to make changes, extension of the arrangement in question would be automatic.***
- ***For certifications, the duration of the extension would be determined by the Minister on advice from the Council. For undertakings, the duration would be determined by the Australian Competition and Consumer Commission. Standard appeal rights would apply to these determinations.***

FINDING 15.3

The materiality of any problems arising from the current overlap between Parts IIIA and IV of the Trade Practices Act is not clear. The issue might usefully be the subject of further investigation and discussions between the National Competition Council, the Australian Competition and Consumer Commission and the legal profession. Those investigations and discussions should also help to clarify what is the most appropriate way of addressing the overlap, if a consensus emerges that action is required.

Monitoring and review

RECOMMENDATION 16.1

The National Competition Council should be required to report annually on the operation and effects of the national access regime. Reporting by the Council should contain information and commentary on:

- ***statutory and judicial interpretation of the (strengthened) declaration criteria;***
- ***any factors that have impeded the regime's capacity to deliver efficient access outcomes;***
- ***evidence of benefits arising from access determinations under the regime;***
- ***evidence of associated costs, including any evidence of disincentives created for investment in essential infrastructure; and***
- ***implications for the national access framework in the future.***

RECOMMENDATION 16.2

There should be a further independent review of the national access regime five years after the first group of changes to Part IIIA resulting from this inquiry is put in place.

1 Introduction

In April 1995, the Commonwealth and State and Territory governments agreed to implement the National Competition Policy (NCP) package. The package comprises three inter-governmental agreements that seek to facilitate effective competition in the delivery of goods and services so as to improve economic performance. One of these agreements — the Competition Principles Agreement (CPA) — provides for a national access regime for 'nationally significant' infrastructure.

Under this regime, introduced later in 1995, businesses can seek access to certain publicly and privately owned infrastructure services on 'reasonable' terms and conditions and 'fair' prices. The regime sits alongside industry-specific access regimes (State, Territory and Commonwealth) applying to a range of infrastructure services. It is in keeping with, though does not exactly mirror, proposals in the Hilmer Committee report (1993).

1.1 The inquiry

As part of the NCP, the Commonwealth and State and Territories agreed to review the national access arrangements after five years of operation. This inquiry gives effect to that commitment in respect of:

- Clause 6 of the CPA, which requires the Commonwealth to establish a national access regime, explains the relationship between that regime and State and Territory access regimes, and details the principles with which an effective State or Territory regime must comply.
- Part IIIA of the *Trade Practices Act 1974* (TPA), which discharges the Commonwealth's obligation under Clause 6. The national access regime is therefore commonly referred to as the Part IIIA regime — see box 1.1.

Amongst other things, the reference asks the Commission to:

- clarify the objectives of Clause 6 and Part IIIA;
- analyse their benefits and costs and ways to improve them;

Box 1.1 **Some key terms used in the report**

Access undertaking: An undertaking to the Australian Competition and Consumer Commission from an infrastructure provider setting out terms and conditions for third party access.

Certified access regime: A legislated access regime that is determined to be effective for the purposes of Part IIIA. For State and Territory regimes, principles for establishing effectiveness are set out in Clause 6 of the CPA.

Declared service: Infrastructure service for which third parties have legislative rights to negotiate access under Part IIIA, with provision for arbitration if negotiation is unsuccessful.

Essential or bottleneck infrastructure: Infrastructure which is the source of intermediate services essential to upstream or downstream service provision. Such infrastructure almost invariably relies on a 'natural monopoly technology'. Examples include transmission and distribution networks for gas and electricity and certain railway lines.

Market foreclosure: Denial of access by a provider of essential infrastructure services to some or all third parties.

Monopoly rent: Returns to a service provider in excess of those necessary to have justified the investment in the facility providing the services in question.

Natural monopoly technology: A production technology which means that one provider can meet total demand for a particular good or service more cheaply than two or more providers. (Chapter 3 discusses this concept in some detail.)

Negotiate-arbitrate: Process underpinning many access regimes which seeks to encourage commercially negotiated agreements between a service provider and an access seeker, with provision for arbitration only when such negotiation is unsuccessful — see chapter 8.

Non-integrated or vertically separate provider: Provider of an essential infrastructure service which is not involved in providing services in upstream or downstream markets.

Part IIIA: The section of the Trade Practices Act which provides the legislative underpinning for the national access regime. It is commonly used as a descriptor for the regime, including in this report.

Reference tariff: An 'indicative', regulated price for access to a particular infrastructure service. Often a reference tariff is established as an upper bound price, with the service provider and access seeker free to negotiate a lower price.

Vertically integrated provider: Provider of an essential infrastructure service which also provides services in upstream or downstream markets — for example, an electricity authority responsible for generation, transmission, and distribution. Such providers are often regarded as the primary targets of access regulation (see chapter 3).

- consider other ways of achieving underlying objectives;
- examine measures to engender greater certainty, transparency and accountability in Part IIIA decision making, and increase flexibility and reduce complexity and costs for participants; and
- examine the roles of the National Competition Council (NCC), the Australian Competition and Consumer Commission (ACCC) and the Australian Competition Tribunal (the Tribunal) in administering the arrangements, and the relationships between them.

The reference also specifies that there is no intention for the inquiry to lead to reconsideration of existing or pending access arrangements under Part IIIA. The full text of the reference is reproduced at the front of this report.

The inquiry sparked considerable interest. While the broad rationale for a mechanism facilitating third party access to the services of so-called ‘essential’ or ‘bottleneck’ infrastructure was generally acknowledged, the merits of the current arrangements were widely debated (see box 1.2). Amongst service providers, concerns about the intrusiveness and complexity of the arrangements, and their potentially adverse impacts on investment, loomed large. Users of essential infrastructure services questioned whether the regime is doing enough to prevent service providers from misusing their market power. The differences in the requirements of industry access regimes operating under the Part IIIA umbrella and the lack of timeliness in Part IIIA decision making were other areas of concern. Moreover, there was still some debate about whether Part IIIA is necessary at all, given the more general remedies to address anti-competitive conduct elsewhere in the Trade Practices Act.

1.2 The Commission’s approach

In examining the national access regime and developing a number of proposals for change, the Commission has taken an economy wide view. That is, it has looked beyond the concerns of access providers and seekers, important though these are, and asked what is best for the community as a whole. This approach is in keeping with requirements in both the Commission’s enabling legislation and the reference.

Further, the Commission has not presumed that a national access regime is necessary. Rather, it has looked at the underlying goals of the regime and assessed which of these continue to be relevant given the many changes in the infrastructure sector since Part IIIA was enacted. It then has examined how relevant goals might be best pursued. Again, this approach is in keeping with the requirement in the reference for the Commission to consider alternative instruments, including non-legislative approaches.

Box 1.2 **Some general views on the national access regime**

While most participants acknowledged a case for access regulation and saw merit in having a national access regime, many raised concerns about the current arrangements. For example, the Western Australian Government argued:

> Western Australia recognises the importance of access regulation in promoting economic activity and increasing efficiency of production. Accepting the merits of both the generic Part IIIA access framework and the various industry-specific regimes, Western Australia suggests that there is some scope to improve the framework so as to provide greater certainty in its application and ensure that incentives to invest in key infrastructure industries are not distorted. (sub. 38, p. 1)

The Australian Council for Infrastructure Development raised concerns that:

> … the current industry specific and generic access regimes are highly prescriptive and intrusive and are not consistent with incentive regulation or productivity improvements in infrastructure development. The current regime provides an excessive focus on short term consumer cost savings without proper regard to the adequacy of investment and the costs that will have in the long term. (sub. DR80, p. 3)

Mr I. A. Tonking said that:

> It is important that Part IIIA should operate in a way which addresses serious bottlenecks in the economy without at the same time tying up scarce resources in pointless disputes which may interfere with the productive use of infrastructure without being conducive to any appreciable improvement in efficiency. (sub. 5, p. 2)

Even more forcefully, the Law Council of Australia contended:

> Third party access regulation is a very intrusive form of regulation. It may have a serious impact on the dynamic efficiency of an industry, because it lessens the incentive to innovate and invest, and permits free riding on existing infrastructure. Regulation is also costly in itself. Because of this:
>
> – compulsory access to infrastructure should be granted sparingly, and only in cases where there is acknowledged to be a serious problem;
>
> – there should be no unnecessary delay in the process by which access is granted;
>
> – there should be some guidance as early as possible in the process as to the likely terms and conditions of access (including pricing).
>
> The existing Part IIIA does not achieve these aims. (sub. 37, pp. 1-2)

The Network Economics Consulting Group emphasised the important framework role of Part IIIA, but argued that the current regime is deficient in this regard:

> NECG and the parties that have endorsed this submission have significant concerns about the adequacy of Part IIIA, as currently drafted, to fulfil its role as the framework for access regulation in Australia. (sub. 39, p. 3)

(continued next page)

Box 1.2 **continued**

In contrast, users of essential infrastructure services and access regulators viewed the current arrangements more favourably. Thus, BHP Billiton stated:

> The National Access Regime has delivered considerable benefits to the Australian Economy and our international competitiveness. Competition has been fostered, new markets are developing and prices for users of natural monopoly energy infrastructure have reduced as some monopoly rents have been removed. (sub. 48, p. 5)

In a similar vein, the New South Wales Minerals Council said:

> The impression that we have drawn from our experiences is that the use of Part IIIA by a consumer of monopoly services is a long, difficult and costly process. … Despite this, the changes that have occurred in rail freight of coal in NSW through the application of Part IIIA have been of great benefit to the NSW coal industry and the cause of economic efficiency. Without the avenues provided by Part IIIA much of this progress would not have been possible. (sub. 22, p. 1)

And, looking to the future, the National Competition Council remarked:

> Despite their significant achievements, the provisions that embody the national access regime are relatively new. It is not apparent that there are serious deficiencies that, at this stage, would make a compelling case for altering the major features of the regime. Rather, it appears that progress has been made in clarifying the nature and implications of the regime. (sub. 43, p. 17)

That said, some user interests saw a need to push harder on the access front. Most forcefully, the National Farmers Federation argued:

> The Productivity Commission should not lend intellectual legitimacy to the imposition of hidden taxes on Australian industry in the form of specious charges for access to essential infrastructure. Marginal cost pricing is the rule for economic efficiency and we expect the Commission to defend that rule against the vested interests of infrastructure owners. (sub. 26, p. 2)

More broadly, some participants questioned the need for specific access regulation, given other mechanisms available to facilitate access. For example, the Australian Petroleum Production and Exploration Association stated:

> APPEA believes that economic outcomes are normally best achieved through commercial negotiations, subject to general competition laws such as the provisions of the Trade Practices Act 1974 relating to anti-competitive practices. If there is a need for regulation, self-regulation is preferred. Government regulation is only warranted where there has been a demonstrated market failure and in such circumstances it should be 'light-handed' regulation. (sub. 35, p. 1)

While the Commission was asked to look at the principles for an effective State or Territory access regime in Clause 6 of the CPA, this did not necessitate a detailed examination of individual regimes. Rather, the Commission has sought to map out a broad framework that would help guide these regimes in the future and identify the implications that framework would have for Clause 6 and its relationship with Part IIIA.

In framing its recommendations, the Commission recognises that, to some extent, the limited practical experience with Part IIIA is an argument against making major changes to the regime at this stage. It is also conscious of concerns about any move away from the current emphasis on promoting competition — rather than economic efficiency — that permeates Part IIIA and the TPA more generally. (As discussed later in this report, the promotion of competition is seen by many as a well understood and legally tested proxy for enhancing efficiency.)

Further, the Commission is cognisant of the overlaps between this inquiry and its inquiries into:

- *Telecommunications competition regulation* (TCR) which includes an assessment of the industry access regime in place for those services;
- the *Prices Surveillance Act (PSA),* which examines oversight of prices charged by certain industries with the potential to exercise market power; and
- *Price regulation of airport services*, which occurs via the PSA.

Indeed, the desirability of releasing the preliminary findings and recommendations for this inquiry at the same time as those for the TCR and PSA inquiries, which had commenced some months earlier, led the Commission to prepare a Position Paper rather than a fully developed draft report. As discussed below, this had important implications for both the nature of the Commission's preliminary findings and proposals and the development of the recommendations contained in this final report.

1.3 Inquiry processes

The Commission provided the opportunity for a wide range of interested parties to contribute to its deliberations. To this end, the Commission advertised the commencement of the inquiry in the national press and invited public submissions. To help those preparing submissions, it released an issues paper (PC 2000). It also established a website (at www.pc.gov.au/inquiry/access) on which it placed relevant legislation, inquiry material and submissions from interested parties.

Informal discussions

The Commission commenced informal discussions with interested parties soon after it received the reference. During the inquiry, the Commission spoke to more than 60 groups and individuals representing a wide range of interests (see appendix A). It also took the opportunity to attend a number of forums and conferences discussing issues connected to the inquiry.

Roundtables

Early in the inquiry, the Commission held two roundtables — one in Melbourne and one in Sydney — to elicit views on the efficacy of the national access regime and possible modifications to it. A number of regulators, lawyers, economists, facility owners, access seekers and end user/consumer groups attended (see appendix A).

Position Paper

In March 2001, the Commission released a Position Paper outlining its preliminary views, findings and proposals. As noted, this timing reflected a desire to align the release of the paper with two other Commission draft reports bearing on closely related issues — one on the Price Surveillance Act and the other on telecommunications competition regulation.

One consequence of the release of the Position Paper relatively early in the inquiry was that the Commission did not have the opportunity to hold an initial round of public hearings. This meant that its capacity to test propositions and possible policy modifications was constrained.

Accordingly, the Commission grouped its proposals in the Position Paper into two tiers:

- Tier 1 proposals which it considered would clearly be beneficial.
- Tier 2 proposals which it considered would have the potential to deliver further gains, but which would involve more substantial changes to the architecture of the national access regime. It was therefore uncertain whether the likely gains would be sufficient to warrant the implementation costs.

This two-tiered structure performed some of the role of an initial public hearing. That is, while eliciting detailed comments on the 'core' tier 1 proposals, it also provided the opportunity for feedback on the issues involved in moving beyond incremental change to the national access regime. Not surprisingly, this approach has involved a greater degree of change in the Commission's recommendations than would normally be evident in the transition from a fully developed draft report to a final report.

Public hearings

To elicit views on the Position Paper, the Commission held public hearings in Melbourne, Sydney, Brisbane and Perth during May and June, 2001. Some 28 participants attended the hearings (see appendix A).

Submissions

In addition to input provided through informal discussions, roundtables and public hearings, the Commission also had the benefit of commentary on the issues via a significant number of often comprehensive written submissions.

Prior to the release of the Position Paper, the Commission received some 54 submissions. A further 72 submissions were lodged in response to the Position Paper. These submissions came from a wide cross-section of interests including: State governments; private owners or operators of infrastructure facilities; access seekers; those involved in administering access regulation; the legal profession; and academics. A full list of those who made submissions is contained in appendix A. Submissions received after the release of the Position Paper are denoted in this report by the prefix 'DR'.

The Commission wishes to thank those who made submissions, participated in informal discussions and roundtables or attended public hearings, or in other ways contributed to the inquiry.

1.4 Structure of the report

The remainder of this report is in four parts:

- The first describes the current regulatory framework and use of Part IIIA to date, and briefly comments on some overseas approaches to access issues (chapter 2). (These matters are canvassed further in appendices B, C and D.)
- The second looks at the nature of the access 'problem' and possible responses to it. Specifically, chapter 3 examines the rationales for government regulation of access to essential infrastructure services and the significance of the underlying problem, while chapter 4 examines some of the costs of access regulation. Chapter 5 looks at the merits of access regulation relative to alternative policy approaches, and at some of the considerations in choosing between generic and industry-specific access regulation.
- The third part looks at ways to improve the national access regime:
  - Chapter 6 outlines the Commission's views on appropriate objectives for the regime and the sorts of services it should cover;
  - Chapter 7 canvasses modifications to the declaration process and criteria in Part IIIA;
  - Chapter 8 considers modifications to the Part IIIA negotiation and arbitration provisions that ensue from the declaration process;

- Chapter 9 puts forward changes to improve the operation of the certification arrangements;
- Chapter 10 addresses the scope to improve the undertaking arrangements;
- Chapter 11 examines specific measures that could be introduced to facilitate efficient investment within the national access regime;
- Chapter 12 spells out pricing principles that should apply to assessments of access terms and conditions under the regime;
- Chapter 13 examines capital cost issues, including the efficacy of different methods of asset valuation;
- Chapter 14 discusses Part IIIA's institutional arrangements, focussing on the role of Ministers in the Part IIIA decision making process and whether both the NCC and ACCC should continue to be involved in administering the regime; and
- Chapter 15 examines various process issues, including Part IIIA appeal rights, the scope to impose time limits on Part IIIA decision making and ways to enhance the transparency of that decision making. It also looks briefly at the relationship between Part IIIA and other parts of the Trade Practices Act and at the role of consumers in access decision making.

• The final chapter of the report discusses some of the issues that would arise in implementing the Commission's recommendations, including the implications for Clause 6 of the CPA and industry access regimes.

2 Current access arrangements

2.1 Introduction

The national access regime is a regulatory framework which provides an avenue for firms to use certain infrastructure services owned and operated by others when commercial negotiations regarding access are unsuccessful. Its regulatory provisions are set out in Part IIIA of the *Trade Practices Act 1974* (TPA) and Clause 6 of the Competition Principles Agreement (CPA). (The latter contains the principles against which State or Territory access regimes are assessed to determine whether they are ‘effective’ for the purposes of Part IIIA.)

The resulting access arrangements are complex. They involve both the generic access regime — commonly referred to as Part IIIA — and a host of industry regimes. Most of the industry regimes are governed by State and Territory legislation. However, there are Commonwealth regimes for telecommunications and airports, as well as an industry code for the national electricity market. Some of the industry regimes operate under the Part IIIA umbrella, while others are outside it. Part IIIA alone provides three different routes to gain access. A variety of Commonwealth and State and Territory bodies are responsible for administering the arrangements, applying criteria which vary from regime to regime.

Such complexity and diversity is partly a reflection of the range of infrastructure services which these access arrangements cover. Australia’s federal system has also played a role, with access regimes differing not only between different classes of infrastructure, but often for the same class of infrastructure across jurisdictions. The scope to rationalise or make these arrangements more consistent is an important issue for this review.

This chapter details the various components of the national access regime and the key features of the main industry-specific regimes operating under the Part IIIA umbrella. It also briefly outlines overseas approaches to access issues.

Background to the regulatory requirements of the national access regime

In 1992, the Council of Australian Governments commissioned an independent committee of inquiry into a national competition policy. This Committee, known as the Hilmer Committee, conducted its inquiry in the context of an infrastructure sector dominated by public providers, typically operating at all levels of the production chain. Many of the transmission and distribution networks involved in service provision displayed natural monopoly characteristics. In areas where competition was feasible, there were often legislative restrictions creating statutory monopolies.

The Committee gave particular emphasis to incentives for vertically integrated providers of essential services to deny access to competitors in related markets and considered that this could be a serious impediment to competition in those markets, even if legislative restrictions on competition were removed. Its preferred solution was to vertically separate such entities. However, it recognised that structural separation would not always be feasible or efficient. (The restructuring of public monopolies is discussed in box 2.1.)

The Hilmer Committee also considered that the provisions in Part IV of the TPA, which regulate anti-competitive behaviour, would be inadequate to deal with access to essential infrastructure. For example, it considered that the courts would have difficulties in determining the terms and conditions of access (see chapter 5). Consequently, it proposed the introduction of a national access regime to address the denial of access by vertically integrated service providers (Hilmer Committee 1993). The current national access regime — introduced in 1995 — draws heavily on the Committee's recommendations.

While the introduction of this regime represented a major new plank in Australian competition policy, access arrangements had existed before then. For example, in the early 1960s, the Western Australian Government and Hamersley Iron reached an agreement (*Iron Ore (Hamersley Range) Agreement Act 1963*) requiring the company to carry the freight of the Western Australian Government and third parties on its rail line. Moreover, some of the current industry-specific arrangements had their genesis prior to the Hilmer Committee's report.

2.2 Part IIIA of the *Trade Practices Act 1974*

Part IIIA sets out mechanisms for: permitting third party access to the services supplied by eligible facilities or infrastructure; the arbitration of access disputes; and the roles and responsibilities of the institutions which administer the arrangements. Part IIIA is not intended to replace commercial negotiations between facility owners and third parties, but rather to provide a means of access if those negotiations fail. Unlike some other parts of the TPA, Part IIIA contains no separate statement of the objectives which it is meant to serve.

Box 2.1 **Restructuring of public monopolies**

At the time of the Hilmer Committee report, most infrastructure services were provided by government owned monopolies. Many of these providers were vertically integrated, operating in regulated State markets. They were charged with a range of commercial, social and regulatory objectives which were frequently in conflict.

However, since then, there have been major changes to the nature of infrastructure provision. Most of the publicly owned monopolies have been privatised or corporatised and subjected to competition. Commercial objectives have been given primacy and many regulatory functions have been transferred to non-trading agencies. Many of the previously vertically integrated entities have been separated into competing businesses either on an activity basis or on regional lines. For example:

- In electricity, the NSW Electricity Commission previously operated the State's generation and transmission network. New South Wales now has three separate generation entities and an independent transmission business, with the previous 25 distributors consolidated into six new distribution utilities. The Hydro Electric Corporation in Tasmania has been separated into three entities responsible for generation and system control, transmission and retail/distribution.
- Similar restructuring has occurred in rail. In Victoria, the vertically integrated Public Transportation Corporation — which previously provided passenger and freight services — was separated, with service provision subsequently privatised or franchised. Access to interstate track is controlled by the Australian Rail Track Corporation. Suburban track in Melbourne is leased to private entities with the leases providing for access by freight and intrastate passenger services. Non-urban track is owned by the Victorian Rail Access Corporation and leased to Freight Australia. In South Australia, the planning and regulatory functions of the State Transit Authority's passenger services have been transferred to the Passenger Transport Board and passenger services to a corporatised TransAdelaide. Freight services are now provided by Australian National.
- Government owned gas utilities have been corporatised and, in some cases, sold (eg the Victorian gas utilities) or prepared for privatisation. This has involved the separation of vertically integrated transmission and distribution networks. Private sector gas utilities in most jurisdictions have completed 'ring fencing' of their transmission and distribution activities.
- Most port authorities have been corporatised and several ports in Victoria privatised. In addition, the majority of port authorities have moved to a 'landlord model' where the authority is only involved in the provision of core activities and the more contestable elements such as pilotage, dredging and stevedoring are provided by private contractors.

As result of this restructuring, many of the transmission/network services no longer operate as part of vertically integrated entities. This has potential ramifications for the scope of any access regulation (see chapter 3).

Sources: PC (1999a, 1999c)

Part IIIA has various links to the rest of the Act. In particular, there are links to, and overlaps with sections which deal with anti-competitive behaviour (see section 2.5). In a more general sense, established interpretations of like terminology in other parts of the Act are likely to have a bearing on how Part IIIA will apply if access disputes require the involvement of the regulator or the courts.

Part IIIA provides three ways for a third party to gain access to an eligible infrastructure service:

- having a service *declared*;
- using an existing access regime which has been deemed to be *'effective'*; and
- seeking access under the terms and conditions specified in an *undertaking* given by the service provider and accepted by the Australian Competition and Consumer Commission (ACCC).

Services covered by effective access regimes or by undertakings accepted by the ACCC cannot be declared.

(Figure 2.1 provides a summary of the different avenues for gaining access.)

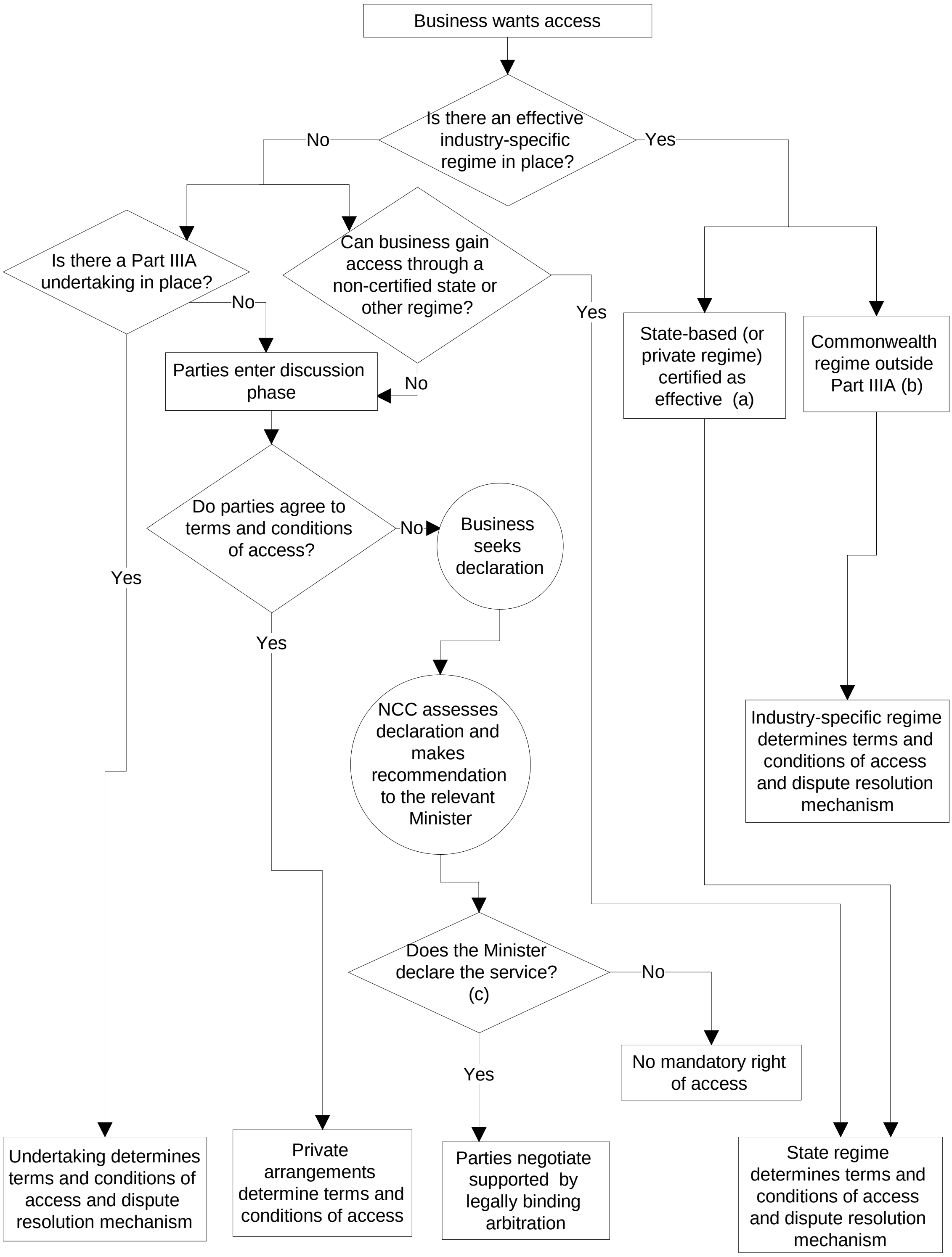
As discussed below, the second route — involving access via 'certified' State and Territory regimes — has been the most important to date. However, the declaration provisions have had a significant impact on the access process. In particular, the threat of declaration has provided an incentive for States and Territories to seek to have their regimes certified as effective. The National Competition Council (NCC) said:

> The declaration/arbitration process is often regarded as the national access regime in total ... This characterisation fails to recognise that all those [other] regimes fall within the Part IIIA umbrella, with the declaration process acting as a discipline on [them]. (sub. 43, p. 70)

Moreover, even where States and Territories have not sought certification of particular regimes, a concern to avoid the potential for declaration is likely to have helped shape those regimes. As the Queensland Minerals Council commented:

> … we see the national access regime as performing a very important role in acting as the potential default regime that will apply in the event that effective State arrangements cannot be put in place … (transcript, p. 398)

Figure 2.1 Alternative ways of achieving access



[a] While a private regime could in theory be found to be effective, the NCC has questioned whether, in practice, a non-statutory regime could be certified. [b] For example, Part XIC of the *Trade Practices Act 1974* (governing telecommunications access). [c] The provider or the applicant can appeal against the decision to the Australian Competition Tribunal.

In this context, some have argued that the primary role of the national access regime is to provide a framework for, and discipline on, industry regimes, with its role as an avenue for resolving specific access disputes being of much less importance. The Network Economics Consulting Group (NECG) said:

> The importance of Part IIIA lies less in *ad hoc* declaration decisions, such as the Sydney Airport case, than in the fact that the State and Territory access regimes that have been certified under Part IIIA or the undertakings that have been given under it are now the primary vehicle for regulating access to assets conservatively estimated to be well in excess of $50 billion. (sub. 39, p. 3)

The Australian Gas Association (sub. 29) said that gas infrastructure assets falling within the scope of the national access arrangements are worth some $24 billion (compared with the NECG estimate of $13 billion). Similarly, Associate Professor Phillip Laird (sub. DR 83) estimated the value of the national rail track network to be in excess of $12 billion compared with the NECG estimate of $7 billion.

Declaration of a service

The declaration of a service does not provide an access seeker with an automatic right to use that service. Rather, it provides for a right of negotiation and for legally binding arbitration if negotiations fail.

Coverage

Under the declaration process, access is provided only to services produced by the infrastructure facility and *not* to the facility itself. This is because some facilities may provide a range of services, only some of which may be eligible to be declared.

The legislation defines the term ‘service’ via illustrations and specified exclusions:

- It provides examples of services that are covered — for instance, the use of an infrastructure facility such as a railway line or road and the handling or transporting of goods or people.
- It also states that a service does *not* include the supply of goods, the use of intellectual property (eg copyrights and patents) or the use of a production process (eg plant and equipment). However, if these are an ‘integral but subsidiary part of the service’, they may still be declared.

The declaration process

An individual or business refused access to an essential infrastructure service, or unable to reach agreement on the terms and conditions of access, can request the

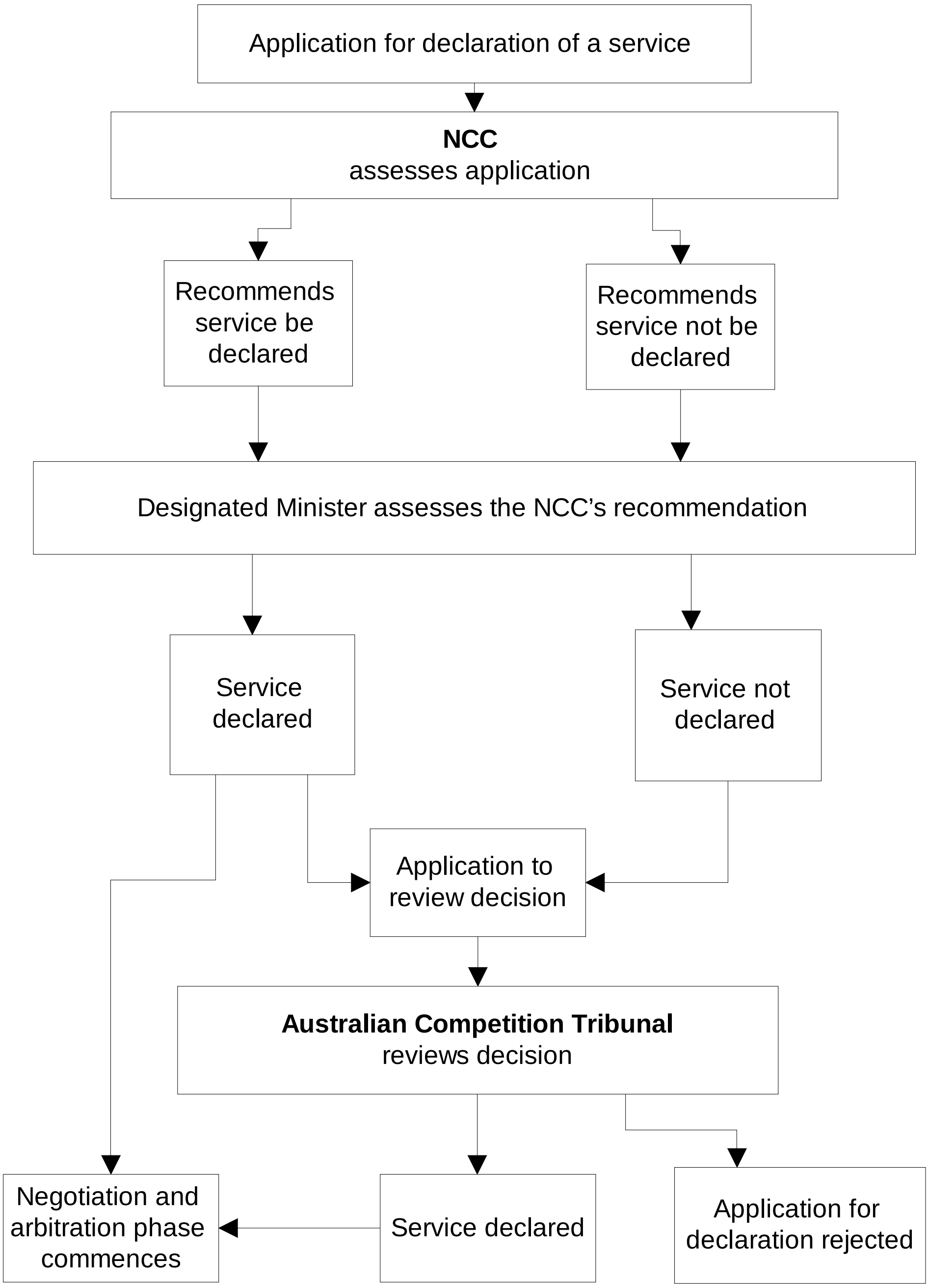
NCC to declare the service. The NCC assesses the request and makes a recommendation to the relevant Minister who, in turn, makes a decision on whether or not to declare the service (see figure 2.2). For infrastructure owned by a State or Territory, the responsible Minister is the State Premier or Chief Minister. For all other infrastructure, responsibility for declaring services lies with the Commonwealth Treasurer.

The NCC can recommend that the service be declared and the relevant Minister can act on that recommendation only if *all* of the following criteria are met:

- 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;
- it would be uneconomical for anyone to develop another facility to provide the service;
- the facility is of national significance, having regard to:
  - the size of the facility; or
  - the importance of the facility to constitutional trade or commerce; or
  - the importance of the facility to the national economy;
- access to the service can be provided without undue risk to human health or safety;
- access to the service is not already the subject of an effective access regime; and
- access (or increased access) to the service would not be contrary to the public interest (TPA, s.44G(2)). (Chapter 7 discusses how these criteria have been interpreted in relation to specific declaration applications.)

On receiving the NCC’s recommendation, the responsible Minister has 60 days to make a decision on whether to declare the service. The Minister must publish the declaration, or the decision not to declare the service, and provide a copy of the decision and the reasons for it to the infrastructure owner and the access seeker. However, non-declaration can occur by default — where a decision has not been made after 60 days, the Minister is deemed not to have declared the service. This has occurred for a number of recommendations from the NCC for declaration of infrastructure owned by a State government (see below).

Figure 2.2 **The Part IIIA declaration process**



Source: NCC (1996a)

The applicant or the infrastructure owner/operator can appeal against the Minister's decision to the Australian Competition Tribunal (the Tribunal). For the purposes of the appeal, the Tribunal has the same powers as the designated Minister and is required to reconsider the matter entirely. Matters of law raised in Tribunal judgements are, in turn, subject to judicial review.

Box 2.2 provides an example of how these processes worked in relation to a particular declaration application.

Box 2.2 **Assessing an application for declaration of a service**

In 1996, the NCC received an application from the Australian Union of Students (AUS) to have the Austudy payroll deduction service, operated by the Commonwealth Department of Education, Employment, Training and Youth Affairs, declared.

The NCC assessed the application against the criteria in s.44G(2) of Part IIIA and found that:

- access to the payroll deduction service would promote competition in the Student Representation Services market;
- it would not be uneconomical for anyone to develop another facility to provide the service and other institutions did provide direct deduction services;
- the facility was not of national significance;
- access to the service could be provided without undue risks to health and safety and that the service was not already covered by an effective access regime; and
- access to the service would be contrary to the public interest. The NCC said that the increased revenue for the AUS resulting from access to the payroll deduction service would allow the union to provide better and more services to students and would lead to greater competition for student representation. However, it judged that these benefits would be outweighed by the costs imposed on Austudy recipients in terms of equity and compulsion in declaring the service.

As all the criteria were not met, the Minister, acting on the NCC's recommendation, did not declare the service. The decision was upheld on appeal to the Tribunal.

Source: NCC (1996b)

Arbitration

The provision under the Part IIIA legislation for legally binding arbitration can involve the use of a private arbitrator or the ACCC.

Where a private arbitrator hears the dispute, the parties may subsequently enter into a contract for access to the service. The parties can then seek to have the contract *registered* by the ACCC. Registration makes the contract enforceable through the Federal Court under Part IIIA. In deciding whether to register a contract, the ACCC is required to take into account the public interest and the interests of those with rights to use the service, including the service provider. A decision not to register a contract can be subject to appeal to the Tribunal. Where registration is not sought, normal contractual principles apply.

Alternatively, either the access provider or seeker can notify the ACCC that a dispute exists over access to the declared service. The ACCC then arbitrates on the dispute and makes a *determination* on the terms and conditions of access taking into account:

- the legitimate interests of the provider and the provider's investment in the facility;
- the public interest, including the public interest in having competition in markets (whether or not in Australia);
- the interests of all persons who have rights to use the service;
- the direct costs of providing access to the service;
- the value to the provider of extensions whose cost is borne by someone else;
- the operational and technical requirements necessary for the safe and reliable operation of the facility;
- the economically efficient operation of the facility; and
- any other matters that the ACCC thinks are relevant (TPA, s.44X).

The determination by the ACCC need not be confined to matters in dispute. It may deal with any matters relating to access by the third party to the service. For instance, in its determination the ACCC can:

- require the provider to provide access to the service to the third party;
- require the third party to accept, and pay, for access to the service;
- specify the terms and conditions of the third party's access to the service;
- require the provider to extend the facility; and
- specify the extent to which the determination overrides an earlier determination relating to access to the service by the third party (TPA, s.44V).

However, a determination by the ACCC does *not* have to require the owner/operator to provide access to the service. Moreover, the ACCC may *not* make a determination which:

- prevents an existing user from obtaining a sufficient amount of the service to be able to meet the user's reasonably anticipated requirements, measured at the time the dispute was notified;
- prevents a person from obtaining, by the exercise of a pre-notification right, a sufficient amount of the service to be able to meet the person's actual requirements;
- deprives any person of a pre-contractual right;

- results in the third party becoming an owner (or one of the owners) of any part of the facility or of extensions of the facility without the consent of the provider; or
- requires the provider to bear some or all of the costs of extending the facility, or maintaining extensions of the facility (TPA, s.44W).

Either party to the ACCC arbitration can appeal against the determination to the Tribunal. This review of the determination may uphold or vary the ACCC's determination. On issues of law, the Tribunal's decision can be subject to appeal to the Federal Court.

Access under an effective regime

Effective access regimes already in existence provide a second avenue for third party access under Part IIIA.

The focus of this access route was intended to be on regimes established by State and Territory governments for particular infrastructure services. Indeed, all of the regimes so far certified as effective have been State or Territory regimes (see section 2.4). The criteria for establishing the effectiveness of State and Territory regimes are set out in Clause 6 the CPA (see box 2.3).

There are no parallel criteria for assessing the effectiveness of Commonwealth (or private) access regimes. However, the NCC has indicated that it would apply the same principles as for State and Territory regimes. That said, it has questioned whether a non-statutory private regime could be certified.

State and Territory regimes

Certification of a State or Territory access regime may occur as a result of an application by a jurisdiction to the NCC, or in response to an application for declaration by an access seeker.

In essence, the requirements for certification of an access regime are:

- appropriate coverage of services;
- appropriate treatment of interstate issues;
- an effective regulatory framework to facilitate access and competition, including scope for commercial negotiation underpinned by an appropriate regulatory design (as distinct from a mechanism to detail actual terms and conditions);
- an independent and binding dispute resolution framework;

- appropriate guidance to the arbitrator and the regulator; and
- terms and conditions of access that deliver competitive outcomes.

Box 2.3 **Clause 6 of the CPA**

In brief, Clause 6 contains the following:

- Clause 6(1) is historical in that it states that the Commonwealth will establish an access regime;
- 6(2) indicates the broad circumstances in which the national regime, rather than a State or Territory regime, should apply to infrastructure services;
- 6(3) addresses the type of infrastructure services for which a State or Territory regime should apply, focussing on the issues of whether:
  - it would be economically feasible to duplicate the facility;
  - provision of access to the service is necessary to permit effective competition in upstream and downstream markets; and
  - the provision of access would affect the safe use of the facility; and
- 6(4) identifies the features an access regime must exhibit to be effective, including a negotiate-arbitrate framework, a dispute resolution mechanism and the principles which the dispute resolution body should take into account, as well as consistency in the treatment of cross-border issues.

The annex to chapter 9 sets out these requirements in greater detail.

While the CPA does not define ‘services’, the coverage of the certification arrangements is effectively the same as for the declaration process. This is because the incentive to seek certification applies primarily to services which might otherwise be declared.

Clause 6 also specifies a range of matters which the dispute resolution body must take into account. For the most part, these are similar to the requirements imposed on the ACCC when arbitrating terms and conditions for declared services. However, in contrast to the Part IIIA arbitration requirements, some guidance is provided on ‘appropriate’ access prices. For example, Clause 6 (4)(i)(ii) specifies that the dispute resolution body should take into account:

> The costs to the owner of providing access, including any costs of extending the facility but not costs associated with losses arising from increased competition in upstream or downstream markets.

On receiving the NCC’s recommendation on the effectiveness of a State or Territory regime and the period for which a certification should apply, the Commonwealth Minister decides whether or not to certify the regime (see box 2.4 for an example). The State or Territory concerned can appeal against the Minister’s decision to the Tribunal. A State or Territory access regime may cease to be effective where, because of changes to the regime or to the CPA itself, it no longer conforms with the relevant clauses of the CPA.

The certification process can apply to regimes for proposed investments in facilities providing eligible services, as well as to existing infrastructure. For example, the South Australian and Northern Territory Governments used the certification process to develop an access regime for the proposed Tarcoola to Darwin rail line. As discussed later in the report, the capacity of access regimes to address prospective investments is a crucial consideration in assessing the efficacy of those regimes.

Box 2.4 **Assessment of an application for certification of a State access regime: an example**

The Western Australian Government applied for certification of its rail regime in 1999. The regime embodies:

- a negotiate-arbitrate framework, with parties seeking access required to make a proposal to the service provider;
- a requirement for the service provider to respond with a range of information, including floor and ceiling prices for the route over which access is sought. (Under the regime, the floor price is the incremental cost of making access available, while the ceiling price is equal to stand-alone costs — calculated with regard to the revenue received on a defined rail line section); and
- a requirement that the parties negotiate a price for access in this price range.

The regime also contains provisions to encourage a fair negotiation process with Westrail, the vertically integrated operator. In particular, it establishes 'ring fencing' requirements for Westrail and provides for a regulator charged with monitoring and enforcing compliance by Westrail with the regime's requirements. Westrail's freight business was sold to WestNet Rail in December 2000.

Public submissions and the discussion between the NCC and the Western Australian Government on certification of the regime focussed on a number of issues, such as the need for an independent rail access regulator with broad powers to enforce compliance with the regime. After amendments were made by the Western Australian Government, the NCC's draft recommendation was that the amended regime would meet the criteria of being an effective regime under the principles set out in Clause 6 of the CPA. However, following public submissions on the draft recommendation, the NCC raised a number of additional concerns with the Western Australian Government. Agreement was reached with the Government to rectify all of these issues, except for the treatment of interstate rail operations. The NCC has indicated that it cannot recommend certification of the regime until this issue is addressed. The Western Australian Government has withdrawn its application to have the regime certified.

Sources: Cope (2000), NCC (1999), PC (1999c), Western Australian Government (sub. 38).

Undertakings

Under Part IIIA, owners of significant infrastructure have the option of providing an undertaking to the ACCC setting out the terms and conditions of access for third parties. Also, industry bodies can adopt an industry code and have the access provisions of that code accepted as an undertaking by the ACCC. If an undertaking is accepted, access seekers must negotiate with the service provider according to the terms and conditions in the undertaking.

An undertaking is an alternative to declaration. If an undertaking is accepted by the ACCC, the service in question cannot be declared. Conversely, an undertaking cannot be accepted for a service which has been declared. Notably, the submission of an undertaking by a facility owner covered by a certified regime is not precluded in the legislation. However, in assessing such an undertaking, the ACCC would need to have regard to the requirements of the certified regime (see below).

The aim of the undertaking arrangements is to provide owners/operators of infrastructure facilities — particularly those not covered by legislated industry regimes — with an opportunity to remove any uncertainty as to the access conditions which will apply to the services in question. Like the certification process, it can be used to settle access arrangements prior to investment in a new piece of infrastructure (ACCC, sub. 25).

On receiving a proposed undertaking, the ACCC first seeks public submissions on it. It then assesses the proposed access arrangements against a number of criteria, including:

- the legitimate business interests of the provider;
- the public interest, including the public interest in having competition in markets (whether or not in Australia);
- the interests of persons who might want access to the service;
- whether the service is already the subject of an existing access regime;
- whether the undertaking is in accordance with an access code that applies to that service; and
- any other matters the ACCC thinks are relevant (TPA, s.44ZZA).

These criteria are similar to, but not identical with, those that would apply were the ACCC to make an arbitrated determination on the terms and conditions of access for a declared service. Significantly, and in contrast to the declaration process, the ACCC is not formally required to consider the application against each criterion. The ACCC has stated, however, that its overriding objective is to ensure that the access arrangements provided for by the undertaking promote competition and economic efficiency consistent with the objectives of Part IIIA (ACCC, 1999).

If the ACCC accepts an undertaking, it is placed on a public register. There is no right of appeal against the ACCC's decision to accept or reject an undertaking.

An undertaking may include details on dispute resolution mechanisms which may (but need not) require the ACCC to arbitrate. Undertakings can be withdrawn or varied with the ACCC's consent. Where an undertaking is withdrawn or expires, the service in question is no longer exempt from declaration.

2.3 Industry-specific regimes

As noted, there are a host of industry-specific access regimes covering a range of infrastructure services. Many of these are State and Territory regimes, some of which have been certified as effective under Part IIIA. Others operate under specific Commonwealth legislation outside Part IIIA.

These regimes differ in a number of ways. A few — such as the recently expired New South Wales rail access regime — rely primarily on negotiations to establish access prices with regulatory involvement generally limited to the arbitration of disputes. (Some may limit negotiations on price within broad floor and ceiling bands.) At the other extreme are regimes where regulators are much more heavily involved in setting terms and conditions of access. For example, regimes in the gas sector incorporate reference tariffs approved by a regulator establishing the price of access for specific services.

Such differences are evident not only between regimes for different types of infrastructure, but also between jurisdictions for the same class of infrastructure. Indeed, no two regimes are the same. The Law Council of Australia said:

> The increasing number of State regimes and State regulators is a cause for concern, where there is no specific consistency in regimes for the same industry between states … (sub. 37, p. 26)

Box 2.5 summarises key features of the main industry regimes. A more detailed discussion of each regime is provided in appendix B. That appendix also discusses a generic access regime operating in Queensland which is modelled on Part IIIA. The regime contains most of the features of Part IIIA, including an independent arbitrator and regulator, and provision for undertakings. It also embodies declaration criteria similar to those in Part IIIA, but without a 'national significance' test.

Box 2.5 Industry-specific regimes

Industry-specific access regimes apply to both vertically integrated and non-integrated service providers (see table 2.1). The following is a brief summary of the main features of, and differences between, the regimes applying in individual sectors. A more detailed treatment is provided in appendix B.

Airport services: Access to the 'core' privatised airports is covered by the declaration criteria in the Airports Act as part of a wide regulatory regime which also includes a price cap on various services provided by these airports.

Under the Act, the ACCC can declare services or accept undertakings for the purpose of Part IIIA. Importantly, the criteria for declaration potentially pick up some services that might not meet the declaration criteria under Part IIIA. Once declared, the services are subject to the Part IIIA provisions to determine terms and conditions of access. Services at other airports, including Sydney airport, are subject to the Part IIIA declaration criteria.

Channels: Access to certain Victorian shipping channels is provided for under a State regime that has been certified as effective. The regime covers commercial shipping channels for the ports of Melbourne, Geelong, Hastings and Portland.

A negotiate-arbitrate approach is used to determine terms and conditions of access. Charges for the use of channels are regulated and must be posted by channel owners. However, these effectively constitute 'posted ceiling prices' as lower prices can be negotiated.

Electricity: The national electricity market covering the southern and eastern States, the ACT and, with the construction of Basslink, Tasmania, is governed by the National Electricity Code (NEC).

The code includes a set of arrangements for access to transmission and distribution networks. Notably, regulators are responsible for setting terms and conditions of access in certain areas, including determining the annual revenue requirements of the relevant infrastructure and approving prices for the use of electricity networks by third parties in accordance with the code.

The NEC is administered jointly by the ACCC, the NEC administrator and State regulators.

Western Australia and the Northern Territory — which do not currently participate in the national electricity market — have developed separate access arrangements.

Gas: The National Gas Access Code was approved by the Commonwealth and the States and Territories in November 1997. It provides for right of access to natural gas pipelines under terms and conditions approved by an independent regulator, and binding arbitration to resolve disputes. It also requires that regimes include reference tariffs approved by the regulator for access to specific services at a known price.

The code is being implemented by the States and Territories through their access regimes. Each jurisdiction's supporting legislation — known as Gas Pipelines Access Law (GPAL) — incorporates key elements of the code to provide consistency across jurisdictions.

(continued next page)

Box 2.5 **continued**

The code also provides for the coverage of additional or new pipelines and for the revocation of existing coverage decisions. Such changes are made by the relevant Minister on receipt of a recommendation from the NCC. The ACCC is the regulator for all transmission pipelines, except in Western Australia, and for distribution pipelines in the Northern Territory. State regulators are responsible for remaining pipelines.

Postal services: The *Australian Postal Corporation Act 1989* exempts postal services from the Part IIIA regime and establishes specific access arrangements for a limited number of these services.

In early 2000, the Government, tabled in Parliament the *Postal Services Amendment Bill 2000* which would create a new section in the TPA (Part XID). Under the proposed legislation, the ACCC would have the power to declare postal services and arbitrate the terms and conditions of access to such services if negotiations between Australia Post and an access seeker fail. The Bill further provides that, within 6 months of commencement, bulk mail services and post office boxes would be determined by the Minister to be declared services. The Bill also includes provision for undertakings for other postal services to be submitted to the ACCC. The Bill was rejected in the Senate in late 2000.

Rail: A process is under way to develop a mechanism for rail operators to gain access to the interstate network through the Australian Rail Track Corporation. An undertaking for the interstate network setting out terms and conditions is to be lodged with the ACCC. At the State level, all jurisdictions except the ACT and Tasmania have developed, or are developing, rail access regimes — although certification may not be sought in every case. To date, only the Tarcoola to Darwin rail line, which covers interstate track, and the New South Wales regime have been certified as effective. Moreover, the certification of the New South Wales regime expired at the end of 2000.

In general, rail access regimes rely on a negotiate-arbitrate approach, in most cases conditioned by floor and ceiling prices. There is variation across the regimes in the independence of the arbitrator, the transparency of the arbitrator’s decisions and the scope to appeal against decisions.

Telecommunications: The telecommunications access regime is set out in Part XIC of the TPA. It is administered by the ACCC. Like Part IIIA, Part XIC involves a declaration process and uses a negotiate-arbitrate approach to establish terms and conditions of access. However, Part XIC provides wider grounds for access than Part IIIA. The ACCC has declared a number of services under Part XIC.

Financial Payments Clearing System: The system allows institutions other than banks, building societies and credit unions to apply for exchange settlement accounts with the Reserve Bank of Australia (RBA). These arrangements allow eligible institutions to settle their own payments (ie cheques, consumer and bulk electronic payments) without relying on another institution that may be a competitor. These arrangements were implemented by the RBA following a recommendation from the Financial System Inquiry in 1997 to make RBA exchange settlement accounts more widely available. They operate quite separately from Part IIIA.

2.4 Use of Part IIIA

The facilitation of access under Part IIIA has mainly involved the certification mechanism. There have been only two declarations — covering certain cargo handling services at Sydney and Melbourne airports, with the latter being only an interim measure. The only undertaking accepted by the ACCC has been for the National Electricity Code.

However, the influence of the declaration process has been more pervasive than the limited number of declarations might indicate. As noted, even where certification applications have been rejected, or States and Territories have not sought certification for their regimes, the Part IIIA framework and threat of declaration have helped to shape those regimes. Moreover, according to the NCC, access has been achieved via negotiations for a number of rail services that it had recommended be declared, but which were not ultimately declared by the relevant State Minister.

Notably, Part IIIA has been used to provide access to both vertically integrated and vertically separate facilities (see table 2.1). As discussed later in the report, the efficacy of extending access regulation to vertically separate entities has been the subject of much debate.

Use of the declaration process

Since Part IIIA's inception, there have been 23 applications to have services declared. Grouped by sector, there have been 10 applications for rail services, 10 for airport services, one for gas services, one for electricity transmission and distribution services and one for payroll services.

Importantly, however, a number of the applications for rail and airport services involved an applicant seeking declaration of multiple services provided by a single infrastructure owner/operator. For example, Specialized Container Transport (SCT) submitted 5 applications to cover certain Western Australian Government rail services. Thus, there have only been 13 separate declaration applications, a number of which were withdrawn prior to the NCC making a recommendation to the relevant Minister.

Table 2.1 **Industries covered by Part IIIA access arrangements, by vertical structure, June 2001**

Industry		*Type of access arrangement*	*Jurisdiction*	*Vertically integrated*	*Vertically separate*
Airports		declaration[a]	Commonwealth		✓
Electricity		undertaking (industry code)			
	Transmission		New South Wales		✓
			Victoria		✓
			Queensland		✓
			South Australia		✓
			ACT		✓
	Distribution and retailing		New South Wales	✓	
			Victoria	✓	
			Queensland	✓	
			South Australia		✓
			ACT	✓	
Gas		certification			
	Transmission		South Australia		✓
			Western Australia		✓
			Victoria		✓
			New South Wales		✓
	Distribution and retailing		South Australia		✓
			Western Australia	✓	
			Victoria		✓
			New South Wales	✓	
			ACT	✓	
Railways			NT/South Australia[b]	✓	
Channels		certification	Victoria		✓

[a] Services provided by the core privatised airports are covered by the declaration provisions of the *Airports Act 1996.* The non-privatised airports (eg Sydney airport) are subject to the Part IIIA declaration provisions.
[b] Tarcoola to Darwin rail line.
Note: A certification for the New South Wales rail regime expired in December 2000.

Of the 23 services so far the subject of declaration applications, the NCC recommended declaration of 9 and non-declaration of 6. Five applications were withdrawn, and an application made by Robe River for access to Hamersley Iron's Pilbara railway was withdrawn following a Federal Court decision that it was not a service for the purposes of Part IIIA (see appendix D). An application has been made for declaration of transmission and distribution services provided by Western Power Corporation in the south west of Western Australia. However, Western Power is seeking a ruling in the Federal Court that the service subject to the application for declaration is not a service for the purposes of Part IIIA. Also, Freight Australia has sought declaration for a number of its own rail services provided as part of its role in operating the Victorian intra-state rail track network. Freight Australia has contended that, in contrast to Part IIIA, the Victorian Rail Access Regime will not provide it with a commercial return on its investment (NCC 2001a). The application is being assessed by the NCC.

Of those services recommended for declaration by the NCC, only cargo handling services at Sydney airport and, as an interim measure, at Melbourne airport, were declared by the relevant Minister. While the NCC recommended the declaration of some rail services, the relevant Ministers rejected these recommendations. Moreover, for the services so far declared, the process has not, as yet, extended to the arbitration phase. Box 2.6 provides further details on declaration applications and outcomes to date.

Use of the certification process

To date, there have been 14 applications for certification of State and Territory regimes. This has seen 9 regimes certified — the gas regimes in South Australia, Western Australia, the ACT, Victoria, New South Wales, a previous interim gas regime in New South Wales, the rail regime in New South Wales (since lapsed), and the regimes covering the Tarcoola to Darwin rail line and Victorian shipping channels.

Of the other applications, three are under consideration — the Queensland and Northern Territory gas regimes and the Northern Territory electricity regime. The Queensland and Western Australian Governments have withdrawn their applications to have their rail regimes certified.

Use of the undertaking process

To date, only the access arrangements in the NEC — which are registered as an industry code for the national electricity market — have been accepted as an undertaking by the ACCC. When a network service provider registers with the national electricity market, it is required to give an undertaking to the ACCC to provide access to its network in accordance with the code.

Box 2.6 **Declaration processes and outcomes**

Airport services

The applications for declaration of airport services were all lodged by Australian Cargo Terminal Operators:

- Four applications were made for access to Qantas and Ansett's ramp and cargo handling facilities at Sydney and Melbourne International Airports. These applications were subsequently withdrawn.
- A further 3 applications to have certain freight handling services at Sydney International Airport declared were accepted by the NCC and the Minister. Following an appeal to the Tribunal by the Sydney Airports Corporation, the services were declared for 5 years from March 2000.
- Another 3 applications to have certain freight handling services at Melbourne International Airport declared were also accepted by the NCC and the Minister. The services concerned were declared as an interim measure prior to being declared under the Airports Act.

Rail services

Of the applications to have rail services declared:

- An application by Carpenteria Transport to have certain Queensland Rail services declared was rejected by the NCC and the Minister. Carpenteria Transport applied for a review of the decision, but subsequently withdrew its application.
- An application by SCT to have the Sydney to Broken Hill track service declared was supported by the NCC. However, because the Minister had not made a decision within 60 days of receiving the declaration recommendation, the service was deemed not to be declared. An appeal was then lodged by SCT with the Tribunal. Access to the track service was negotiated following the withdrawal of the appeal.
- SCT also placed 5 applications to cover certain Western Australian rail services. The NCC recommended declaration of the rail track service, but not the other 4 services. The Minister decided not to declare any of the services. An appeal was then lodged by SCT with the Tribunal. Access was negotiated following the withdrawal of the appeal.
- The New South Wales Mineral Council's application for declaration of rail track services in the Hunter Valley was supported by the NCC. However, the service was deemed not to be declared when the Minister failed to make a decision on the NCC's recommendation for declaration within the 60 day limit. The applicant then appealed, but withdrew the appeal following the certification of the New South Wales rail access regime (see box 14.1 for more detail).

(continued next page)

Box 2.6 **continued**

- The application by Robe River for access to Hamersley Iron's railway in the Pilbara region of Western Australia was withdrawn following a Federal Court decision that the service was not encompassed by Part IIIA on the grounds that it was part of a production process. The NCC and Hope Downs — an interested third party — appealed against the decision to the Federal Court. The original applicant, Robe River, was not a party to the appeal and withdrew its application prior to the appeal commencing. In dismissing the appeal, the Federal Court secured an undertaking from Hamersley Iron that it would not use the 'production process' basis for the decision as a barrier to further applications for access to its rail services and, in particular, to any access application by Hope Downs. Since then, Rio Tinto, the owner of Hamersley, has acquired 53 per cent of the Robe River operation and announced that it has reached agreement with the remaining joint venture partners in Robe River to share Hamersley's rail infrastructure (see appendix D)
- Freight Australia, the operator of the Victorian intra-state network, has applied to have a number of its own rail freight services declared. The application is currently being assessed by the NCC.

Gas

An application by Futuris Corporation for access to the Western Australian gas distribution network was withdrawn prior to a decision being reached by the NCC.

Payroll services

The Australian Union of Students applied to have the Department of Employment, Education, Training and Youth Affairs' payroll deduction service declared. The NCC's recommendation against declaration of the service was supported by the Minister. An appeal to the Tribunal from the AUS was unsuccessful (see box 2.2).

Electricity transmission and distribution

An application has been lodged by Normandy Power, NP Kalgoorlie and Normandy Golden Grove to have the transmission and distribution services provided by Western Power Corporation in the south west of Western Australia declared. Western Power has taken the matter to the Federal Court to seek a ruling that the services subject to the declaration application are not services for the purposes of Part IIIA.

There have been other, unsuccessful, applications for undertakings:

- two applications for undertakings to provide access to airport services at Melbourne and Perth airports were placed with the ACCC. Processing of these applications was incomplete when the services concerned were declared under the provisions of the *Airports Act 1996*; and
- an application from Duke Energy International for the Eastern Gas Pipeline was rejected by the ACCC.

There were also discussions between the Northern Territory and South Australian Governments and the ACCC in regard to the use of an undertaking to provide for access to the proposed Tarcoola to Darwin rail line. However, as noted above, access arrangements for the line ultimately became the subject of a certified regime. In addition, the Australian Rail Track Corporation has provided the ACCC with a draft discussion paper for an undertaking dealing with access to the interstate rail network (sub. 28).

2.5 Part IIIA links with the rest of the Trade Practices Act

Part IIIA links or overlaps with a number of other sections of the TPA. As discussed in chapter 15, some have argued that this creates uncertainty for investors, service providers and access seekers.

The main overlap is with Part IV of the TPA. In particular, Part IIIA does not protect access arrangements from action under:

- Section 45 of Part IV which prohibits agreements that exclude or limit dealings with particular customers, or which fix, control or maintain prices;
- Section 46 which provides that a person with market power must not take advantage of that market power for the purpose of:
  - eliminating or substantially damaging a competitor;
  - preventing the entry of a person into a market; or
  - deterring or preventing a person from engaging in competitive conduct in a market; and
- Section 47 which prohibits exclusive dealings (ie restricting a party’s freedom to choose with whom, or in what, to deal).

The rationale for the overlap is that measures available in Part IV may be required to address any anti-competitive aspects of negotiated access agreements under Part IIIA.

Exposure to Part IV in turn brings into play Part VII of the TPA dealing with the authorisation of anti-competitive arrangements. Specifically, if an access arrangement could be considered as anti-competitive under Part IV, the parties to the arrangement have the option of applying for an authorisation from the ACCC to maintain it (ACCC 1999).

2.6 Overseas approaches

Two broad approaches are used overseas to facilitate access to essential infrastructure services:

- court-based regimes involving general competition legislation; and
- regulated access regimes applying to particular industries.

These approaches are used either singly or in tandem. For example, New Zealand has relied on using general competition laws — in particular, provisions of the Commerce Act which are similar to Section 46 of the Australian TPA. (However, the present Government has stated its intention to regulate certain infrastructure sectors.) In Europe, there is an emphasis on industry-specific access regulation, although a court-based essential facilities doctrine may also be invoked by an access seeker. Similarly, the United States uses both a court-based system and industry-specific regulation to facilitate access. Further details of overseas approaches and their outcomes are provided in appendix C.

Significantly, it appears that the Australian approach of a legislated 'generic' access regime operating in tandem with legislated industry regimes has not been used elsewhere.

3 The rationale for access regulation

The merits of access regulation have been the subject of much debate. This is not surprising given its potential ramifications for providers of essential infrastructure services, users of those services and investors in infrastructure.

In Australia, access regulation is still in its infancy. This is particularly true of the national access regime. For example, the arbitration provisions for declared services have yet to be invoked, and there has been only limited testing of the undertaking mechanism.

Consequently, some participants argued that it is premature to revisit the threshold question of whether a national access regime is warranted. The Energy Users Association of Australia commented that:

> … we believe that caution is needed in terms of any proposal for a radical departure from the existing national access regime at this time. (sub. DR94, pp. 38-9)

Also, BHP Billiton (sub. DR79) and the Australian Chamber of Commerce and Industry (sub. DR67) suggested that it is important not to lose sight of the fact that the national access regime is an element of a national competition policy package which has been of major benefit to the Australian economy. Similarly, in a paper prepared for BHP Billiton, Fitzgerald (2001, pp. 3-4) argued that, as part of this wider package, the regime has driven a range of beneficial reforms in energy markets.

However, other participants contended that, given the intrusive nature of access regulation and its potentially significant costs, this review of the national access regime should examine whether such regulation is warranted. For example, the Australian Gas Association commented:

> The AGA believes the current regime should not be regarded as immutable and therefore welcomes the opportunity of the Productivity Commission inquiry as a necessary precursor to legislative and policy adjustments. (sub. 29, p. 2)

The Institute of Public Affairs said:

> The competition authorities that have been expanded or created in the wake of the Hilmer Report have placed considerable emphasis on the promotion of rivalry as a means of enhancing output and living standards. But they have often been less cognisant of the importance of property secure from measures by government … that

> constitute expropriatory ‘takings’ and reduce the value of that property. IPA welcomes this inquiry, which we see as an opportunity to re-seat property rights with competition at the head of the efficiency table. (sub. 18, p. 2)

A broad ranging assessment of the current arrangements is in fact required by the terms of reference (see chapter 1). In the Commission’s view, there are good reasons for this. Whatever the merits of the current arrangements, a proper analysis of them must have regard to the basic problem that intervention seeks to address and its likely consequences — both intended and unintended. This is true even if such analysis supports the view that major changes to the current arrangements are not required. That is, even minor refinements to the national access regime must have regard to underlying objectives and to any adverse consequences that this sort of regulation can entail.

Accordingly, this and the following two chapters look at some key considerations in determining whether regulation to address access issues is warranted, and what form such a regulatory response should take:

- This chapter examines the rationale for, and the potential benefits of, access regulation. Specifically, it seeks to identify the characteristics of infrastructure markets that underpin the case for access regulation, and assess whether the associated inefficiencies are likely to be significant enough to require a regulatory response.
- The following chapter looks at some of the potential costs of access regulation, with particular emphasis on its likely impacts on investment in essential infrastructure. The likely significance of these costs relative to the benefits of access regulation is then assessed.
- Chapter 5 compares access regulation with other policy instruments for dealing with access issues. It also discusses the pros and cons of generic and industry-specific access regulation.

3.1 Some regulatory assessment principles

In addressing these matters (and in its subsequent discussion of the detailed provisions of Part IIIA), the Commission has drawn on a number of general assessment principles (see box 3.1). These principles embody the requirements for regulation assessment by the Commonwealth, including those in the Competition Principles Agreement (CPA). They are also compatible with principles put forward by participants. For example, the Network Economics Consulting Group (NECG) argued:

> … in designing efficient regulatory responses to access problems, policy makers need to (1) carefully define and assess the market failure(s) they are seeking to address and (2) assure themselves that any regulatory intervention can be sufficiently well calibrated so that the likely costs of intervention are not so great as to outweigh the likely benefits of ameliorating any identified market failure. Policy that is not based upon such careful assessment risks imposing upon society regulations the costs of which far exceed any potential costs from the market failure at issue. (sub. 39, p. 10)

Box 3.1 Regulatory assessment: some general principles

Objectives

What problem does the regulation seek to address?

Is the problem significant enough to warrant a regulatory response, having regard to the likely costs of intervention? In other words, are the benefits of regulation to the community as a whole likely to exceed the costs?

General efficacy

Does the regulation target the problem effectively?

Does it have any unintended consequences and costs?

Is it consistent with related regulations?

Can it readily accommodate expected changes to the nature of the regulated activity?

Would changes to the design and implementation of the regulation improve its effectiveness?

Would alternative regulatory approaches provide a superior outcome for the community?

Administrative efficiency and accountability

Are administrative processes timely and transparent?

Are there appropriate and effective monitoring and review provisions?

Are regulators accountable for their decisions?

Is there appropriate separation of policy making and regulatory functions?

Could changes be made to reduce administrative and compliance costs without undermining the regulation's effectiveness?

Energex stressed, amongst other things, the need for practical regulations, developed and implemented in a transparent fashion. It said that:

- regulators must be held accountable for the powers they yield over the revenues, costs and profits of companies;
- regulations must be predictable and certain for industries with long investment horizons;

- regulations must be comprehensive and emulate what happens in real world markets;
- regulators must apply the rules with fairness and balance; and
- all stakeholders should have the opportunity to participate in the decision making process. (sub. 14, p. 41)

The National Competition Council (NCC, sub. 43, pp. 59-61) emphasised the need to give access providers and seekers flexibility to negotiate terms and conditions; provide clear guidance to regulators about the objectives of regulation; limit regulation to genuinely essential facilities; and avoid unnecessary overlap between regulatory regimes.

Effective regulatory assessment and good regulatory design are particularly important in this area. As discussed in chapter 4, inappropriate access regulation has potentially significant costs. Also, regulators are often operating with highly imperfect information, meaning that the spectre of regulatory failure looms large. Further, some infrastructure sectors — notably telecommunications — are in a state of technological flux, putting a premium on flexible and responsive policies to address any significant market failure.

That said, assessing the benefits and costs of different regulatory approaches is far from easy. In the first instance, this is because of the difficulties of establishing what would have happened under different forms of regulation (or in the absence of regulation). For this reason, much of the debate about the impacts of access regulation necessarily occurs at the conceptual level.

3.2 What is the problem?

In most circumstances, competition between suppliers of goods and services will result in lower prices, a wider range of products, or better service for consumers. Not surprisingly, a desire to encourage competition has been a driving force behind the economic reforms of the last two decades.

This has been especially the case for infrastructure services where, in the past, competition was often muted or non-existent. Traditionally, government monopolies dominated service provision — usually providing the final services as well as operating the networks. However, as noted in chapter 2, many of these entities have now been split up to facilitate competition in the ‘contestable’ parts of service delivery. Governments have also removed legislative restrictions on competition and privatised those activities where public ownership was no longer seen as justified. As a result, new players have entered sectors such as telecommunications and energy, bringing with them new products and, often, lower prices.

But, as the NCC noted, the reform process has recognised that competition may not be feasible in some aspects of infrastructure service provision and that:

> … the shared use of some (so-called bottleneck) infrastructure may be necessary to facilitate competition in markets that rely on this infrastructure. (sub. 43, p. 10)

Access regulation aims to promote competition in markets that use the services of ‘bottleneck’ or ‘essential’ infrastructure facilities, without compromising incentives to develop and maintain such facilities.

The perceived need for access regulation stems from the market power that sometimes attaches to the transmission and distribution facilities involved in the delivery of infrastructure services. Particularly where owners of such facilities also operate in upstream or downstream markets, the concern is that they may deny potential competitors in these related markets access to their facilities. Thus, the Hilmer Committee (1993) argued that:

> Where the owner of the ‘essential facility’ is vertically-integrated with potentially competitive activities in upstream or downstream markets — as is commonly the case with traditional public monopolies such as telecommunications, electricity and rail — the potential to charge monopoly prices may be combined with an incentive to inhibit competitors’ access to the facility. For example, a business that owned an electricity transmission grid and was also participating in the electricity generation market could restrict access to the grid to prevent or limit competition in the generation market. Even the prospect of such behaviour may be sufficient to deter entry to, or limit rigorous competition in, markets that are dependent on access to an essential facility. (p. 241)

However, concerns about monopoly pricing of access, as distinct from denial of access, also underpin much of this regulation, as reflected in the following comments from participants:

> Access regulation seeks to address a perceived imbalance between the bargaining position of the facility provider and third-parties seeking access. Excessive pricing is considered to be as important to an access seeker as other exclusionary tactics. (Western Australian Government, sub. 38, p. 10)

> … access regulation needs to deal with both the denial of access to and monopoly pricing of essential services as effective differentiation between these issues may be difficult. (VENCorp, sub. 24, p. 1)

> The issue of denial of access and the price and non-price conditions of access are not separable and need to be addressed in tandem. (Specialised Container Transport, sub. DR85, p. 7)

> Part IIIA mechanisms are designed to prevent anti-competitive refusals to provide access to bottleneck facilities. High access prices can have the same practical effect as a

> refusal to provide access. In part, this is why regulation has tended to focus on reducing access prices. (NECG, sub. 39, p. 16)
>
> … the problems arising from the monopoly power of airports can only be addressed through a regulatory framework that addresses both pricing and access issues and recognises the interlinked nature of the problems. (Board of Airline Representatives of Australia, sub. 49, p. 4)

In effect, the presumption is that the exercise of monopoly power by owners of essential facilities — regardless of its particular manifestation — will be to the detriment of providers in related markets and ultimately to users of the final services (see below).

The source of the problem

Transitory market power is a feature of virtually all markets. That is, new products or cost-saving innovations will give firms an advantage over competitors and temporarily allow them to earn above normal profits. However, the competitive responses of rival firms will typically see that market power eroded. As the Institute of Public Affairs argued:

> … most … monopolies are short-lived since if they extract high prices this rapidly attracts competition. (sub. 18, p. 3)

Indeed, this process of innovation and competitive response underpins the dynamism of the market system. As recent experience in the telecommunications sector illustrates (PC 2001c), this process may be just as influential in infrastructure markets as in other parts of the economy.

Yet, at the same time, there is the concern that, unlike most other parts of the economy, demand and supply conditions for essential infrastructure services are such that providers may sometimes have enduring market power. In most analyses, such market power is seen to stem from ‘natural monopoly’. However, defining this widely recognised concept and translating it into workable regulation is not straightforward.

What is natural monopoly?

The classic text book natural monopoly refers to a situation where one provider is able to meet total market demand at a lower unit cost than could two or more providers. This usually (though not always) reflects the existence of unexhausted economies of scale or scope (see box 3.2).

Box 3.2 **What is natural monopoly?**

A ‘text book’ natural monopoly exists where one firm can meet total market demand at a lower cost than can two or more firms. The phenomenon derives from the relationship between market demand and the firm’s costs. Usually, it reflects the existence of unexhausted economies of scale and/or scope:

- (Policy-relevant) economies of scale exist where, at an output sufficient to meet total demand, marginal costs for a single firm are less than average costs. This means that average costs are declining at this level of output — the reason why prices would potentially be higher if the market was split between multiple suppliers.
- Economies of scope exist where one firm can produce a combination of outputs more cheaply than two or more firms each producing a sub-group of those outputs. Such economies reflect complementarities in the production of often similar goods or services — for example, national and local telephone calls.

However, natural monopoly can persist beyond the point at which economies of scale are exhausted and average costs begin to rise. This is because, up to a point, average costs when the market is split between two providers will still be higher than those for a single provider, even though the average costs of the latter are increasing.

The cost-based underpinning for economies of scale and scope has led some analysts to talk in terms of natural monopoly *technologies*.

Sometimes, high fixed costs which are not recoverable if a venture fails are argued to be a source of natural monopoly. But the capacity for high sunk costs to deter entry may extend beyond markets where there is only one provider, to both duopolies and oligopolies. Accordingly, high sunk costs do not by themselves define a natural monopoly. Nonetheless, as discussed in the text, high sunk costs are an important feature of most natural monopoly facilities. Indeed, it is these high sunk costs which are likely to deter entry and wasteful duplication of such facilities.

In practice, identifying *sustainable* natural monopolies can be problematic, particularly when account is taken of ongoing changes in markets. For instance:

- Increases in demand may render a market contestable even without changes in cost structures at the firm level. For example, the creation of the national electricity market through the interconnection of network facilities has made competition between State-based transmission entities feasible.
- Changes in production technologies may alter the cost-minimising number of firms at any given level of output.
- Changes in technology may also lead to old and new natural monopoly technologies co-existing in the market, thereby helping to offset the market power of each.

Perhaps most importantly, even where provision of a particular infrastructure service by a single firm is likely to be enduring, the provider may have little or no market power. As discussed in the text, this has led some analysts to argue that natural monopoly should be defined in relation to a market rather than in terms of a technology.

The existence of a *natural monopoly technology* implies that competitive supply of that technology would be wasteful from the community's point of view. As Professor Parry (2000) put it:

> Natural monopoly facilities are commonly thought of as those that are so expensive to duplicate in the context of the market for their services that a more efficient use of resources arises from third-party access to the primary infrastructure. The 'natural monopoly' essential facilities that are common in many of the utilities, therefore, require some arrangements for third-party access and, hence, some form of access regulation. (p. 129)

Similarly, the Law Council commented:

> … in a natural monopoly situation, it is generally economically efficient and socially desirable to allow one firm only to produce all the goods or services required. In these circumstances, competition is a less efficient market structure than monopoly, and would lead to the wasteful use of society's resources, rather than benefit consumer welfare. (sub. 37, p. 5)

But the question arises as to why 'wasteful' competitive entry would be likely in such circumstances. Infrastructure transmission and distribution facilities typically have high fixed costs — most of which will not be recoverable by investors if a venture fails. As the NECG observed:

> … infrastructure assets are generally very long-lived and highly specific to the uses and places for which they have been provided — ie. not fungible. … These characteristics mean that infrastructure investment, once made, is largely sunk. The parties making that investment therefore bear a high level of risk … (sub. 39, p. 19)

This makes competing supply very risky, particularly as the sunk costs incurred by the incumbent provider would provide it with considerable scope and incentive to reduce its prices to ward off competition from a new entrant. Indeed, sunk costs are the main source of any market power enjoyed by the incumbent.

This suggests that, in an unregulated environment, socially wasteful duplication of essential infrastructure will not be common. In turn, this implies that, from an access policy perspective, the key issues will relate mainly to any adverse consequences of ongoing supply of those services by a *single* entity.

However, this is not to argue that socially wasteful duplication resulting from failure to secure access at 'appropriate' terms and conditions will never be an issue. In this regard, a number of participants referred to the $28 million investment by Duke Energy International to by-pass a section of the existing gas pipeline network in Sydney. Commenting on this investment in a paper prepared for BHP Billiton, National Economic Research Associates (2000a, p. 10) stated that:

> Duke's pipeline will traverse almost exactly the same route as the bypassed portion of AGLGN's system, even to the point of using the same right-of-way in many places. Horsley Park's is the most blatantly 'uneconomic' bypass we have witnessed anywhere in the world.

Does market power automatically attach to a natural monopoly technology?

As noted in box 3.2, there can be considerable uncertainty about the extent to which a natural monopoly is likely to be sustainable over time. For example, changes in demand or costs may make a monopolised market contestable. Likewise, particularly in sectors such as telecommunications where technology is evolving rapidly, old and new natural monopoly technologies may exist side-by-side in the market.

Further, even if a particular infrastructure service passes the sustainable natural monopoly *technology* test, the provider will not necessarily have significant power in the relevant market. For example, if there is competition in the final market from goods or services that do not rely on the particular intermediate service, the provider of that service may have little scope to price above costs. This led the Law Council to conclude:

> 'Natural monopoly' should not be defined to mean 'natural monopoly technology' — for example, rail technology may be natural monopoly technology even though the owner of the technology may have no market power because road and planes are effective substitutes for rail. The owner of natural monopoly technology in this sense has no incentive to deny access, even if vertically integrated, because it has no market power to protect. (sub. 37, pp. 5-6)

In this context, the NECG (sub. DR116, pp. 34-5) pointed to a number of examples in Australian law where the existence of substitutes has been 'linked' to the concept of natural monopoly.

Moreover, in the example above, some of those using the railway line might sell their outputs in competitive world markets. In this case, even if there is no competition for the rail service from road or air transport, there may still be limited scope for the owner of the line to price as an unfettered monopolist. Were it to do so, it would run the risk of making the internationally traded output uncompetitive and, at the extreme, dry up demand for its service.

These examples serve to illustrate that the perceived policy significance of natural monopoly may depend crucially on the definition of the market. The narrower the market definition, the greater the number of services that will become targets for intervention — even if there is little or no market power attaching to most of them. In this regard, various participants raised concerns about the initial decision to cover the Eastern Gas Pipeline under the Gas Code — although this decision was subsequently reversed on appeal (see chapter 2).

By the same token, too broad a market definition would define the problem away — ultimately all goods and services are part of the global market for the consumer dollar and therefore substitutable to some extent. As Dwyer and Lim observed:

> … such semantic games cannot conceal the fact that there are natural monopolies protected by barriers to entry … (sub. 53, p. 6)

Another relevant consideration is the nature of the customer base for an essential infrastructure service. As discussed in more detail later in the chapter, where there is a small number of large users, those users may have considerable countervailing market power. In such circumstances, the scope for the service provider to charge monopoly prices may again be limited.

Some other dimensions to the natural monopoly concept

Some analysts have complicated matters even further by suggesting that the concept of natural monopoly should encapsulate demand side factors which might lead to monopoly provision of an essential infrastructure service. These factors include:

- network externalities. For services like telecommunications and post, the value of the network to a potential customer may depend on the number of people connected to it. Hence, the advantages enjoyed by a large incumbent provider might deter the entry of rival providers, even if duplication of networks is feasible on cost grounds alone; and
- the costs for consumers of switching suppliers. 'Switching costs' attach to many goods and services and would not normally warrant policy attention. For some infrastructure services, however, there are concerns that an incumbent provider may be able to reduce competition significantly by artificial inflation of switching costs. The Commission's report on telecommunications competition regulation (PC 2001c) considers this issue in the context of that sector.

The need for common sense

Because of these sorts of complexities, it can be difficult to establish whether a particular market accords neatly with a definition of a natural monopoly. In this regard, the NECG argued that:

> While the concept is simple to state, it is not easy to translate into an exact yet operationally relevant definition. Moreover, and perhaps more importantly, it is exceptionally difficult to demonstrate empirically that a particular industry is a natural monopoly. (sub. 54, p. 12)

And, in reflecting on the policy implications of these difficulties, the NCC commented that:

> … much of the debate surrounding access regulation involves the notion of bottleneck infrastructure, rather than natural monopoly, for two reasons:
>
> - firstly, identification and analysis of bottleneck infrastructure is less problematic, both in practical terms and in terms of the evidence necessary for the conduct of administrative processes within an access regime; and
> - secondly, natural monopolies which do not constitute a bottleneck to competition in dependent markets are not a problem from the point of view of the objectives of access regulation.
>
> However, the concept of natural monopoly remains fundamentally important to the identification of relevant infrastructure in the context of the design and coverage of access regulation. (sub. 43, pp. 55-6)

The upshot is that there will be a need for pragmatism and common sense in relating access regulation to the concept of natural monopoly (see chapter 7).

Consequences

Whatever the precise source of any market power enjoyed by the owner of an essential facility, the denial of access to competitors in related markets — either directly, or indirectly through ‘unreasonable’ terms and conditions — is likely to have adverse efficiency effects. So too will monopoly pricing of services, even if access is provided to all those seeking it. Such behaviour is also likely to affect income distribution — although whether such impacts will be material depends on the particular circumstances.

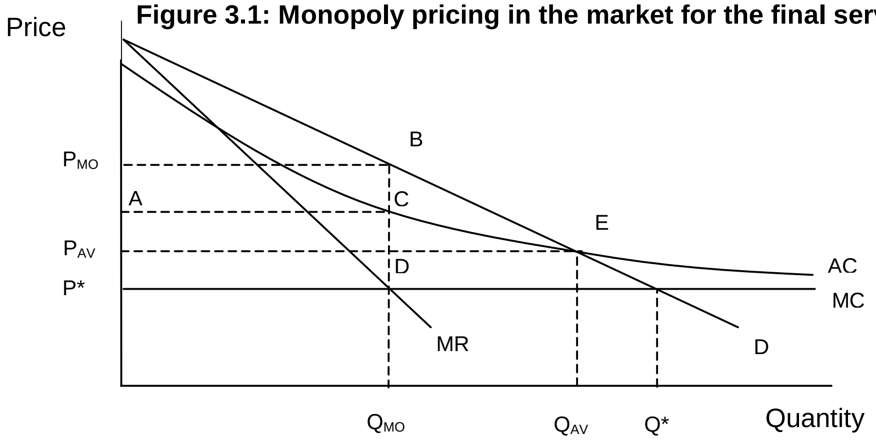
As the Australian Pipeline Industry Association (APIA, sub. DR70, pp. 10-1) pointed out, various approaches can be used to analyse the efficiency costs of market power in the delivery of essential services (and the costs of remedial intervention — see chapter 4). While some of these approaches involve significant abstractions from the real world, they can nonetheless provide useful insights. At the same time, however, it is important to recognise their limitations, particularly given the uncertainty and long investment horizons that characterise most infrastructure markets.

The starting point for most analyses of the efficiency costs of the denial of access, or monopoly pricing of that access, is to look at what such behaviour means for the pricing and use of an existing essential service (see box 3.3).

Box 3.3 Some impacts of monopoly pricing of essential infrastructure services: a stylised 'text book' model

As discussed in the text, the efficiency implications of denial of access, or monopoly pricing of access, can be considered in either a static or an inter-temporal framework. While the latter provides an additional element of reality and richness — as well as symmetry with the analysis of the costs of inappropriate access regulation (see chapter 4) — some useful insights can be gleaned from a simpler static treatment.

Figure 3.1: Monopoly pricing in the market for the final service



In the simple 'static' monopoly model, denial of access, or monopoly pricing of that access, results in higher prices for, and lower use of, the final service. To illustrate, consider the case where a vertically integrated facility owner denies access to the essential input. This leaves the facility owner as the sole provider of the final service.

As depicted in figure 3.1, free of competition in the final market, the facility owner (notionally) equates marginal revenue to marginal cost and supplies Q_{MO} units of the final service at a price P_{MO}. This compares with output of Q* at a price P*, were the retail price set on the basis of marginal cost to encourage efficient use.

Importantly, however, with declining average cost, the price/output combination Q*P* would not be profitable for the facility owner. The lowest single price the facility owner could sustain in the longer-term would be P_{AV}. Relative to the Q_{AV}/P_{AV} benchmark, the monopoly outcome is accompanied by a loss of consumer surplus of $P_{MO}BEP_{AV}$. The profits of the facility owner rise by $P_{MO}BCA$, meaning that the loss in allocative efficiency is equal to BDE plus $ACDP_{AV}$. (The latter reflects the higher average cost of delivering the service at the lower monopoly level of output.)

Notably, in this simple example, the outcome in the final market would be the same were a non-integrated facility owner to set a monopoly price for the essential input to downstream firms. That is, the facility owner would set a price for the input which raised the marginal cost for those firms to P_{MO}. This illustrates the more general point that outright denial of access and monopoly pricing of access are likely to have similar effects on the price and output of the final service.

(continued next page)

Box 3.3 **continued**

That said, real world outcomes are likely to be much more complex. For example, charges for both access to essential infrastructure inputs and the final services concerned can involve a two-part tariff comprising a connection or flagfall charge, and a charge per unit of use. Moreover, the connection charge may also differ between users according to the price sensitivity of their demand. Similarly, single charges can differentiate between users according to their perceived willingness to pay — so called 'Ramsey Prices'.

These sorts of charging regimes are likely to reduce the efficiency costs of monopoly pricing. For instance, suppose that under a two-part tariff approach, use charges are set at P* to encourage efficient use, with the service provider's fixed costs and any above normal profits recouped through the connection charge. If disconnection or connection to a substitute service is not an option for *most* users, then service use may differ little from the efficient level. This in turn implies that the allocative efficiency costs will be smaller than under the scenario outlined above. Indeed, the provider of an essential service will generally have an incentive to secure any above normal profit through charging regimes which minimise reductions in the use of the final service.

In reality, however, the information necessary to implement efficient 'price discrimination' will often be unavailable. Importantly, imperfect price discrimination may have significant and adverse impacts on service use and thereby on efficiency. (See for example, Schmalensee 1981, Tirole 1988, Baumol and Sidak 1994 and Daley 1997.) This led the Queensland Mining Council to conclude:

> … we seriously question the ability of any access provider to make the judgements about relative demand elasticities required to give proper effect to the Ramsey pricing concept, and of any regulator to guard against the misuse of such pricing latitude. (sub. 27. p. 14)

Also, from a policy perspective, it is crucial to distinguish between above normal profits earned on the provision of a particular infrastructure service and a true 'monopoly rent'. As discussed in chapter 4, investment in essential infrastructure services carries with it a range of risks. Thus, in an ex ante context, the expectation of above normal profits if an infrastructure project is successful may be required to balance the possibility of losses if the venture fails. In these circumstances, regulation which seeks to 'tax' such above normal profits *may* deter investment. The implication is that the above normal profit represented by the area P_{MO}BCA in figure 3.1 should not automatically be viewed as a genuine monopoly rent. More generally, this difference between the ex ante and ex post perspectives illustrates the limitations of the static monopoly model when applied to the infrastructure area.

In this 'static' framework, allocative efficiency costs arise from a higher price for, and lower use of the essential service, relative to a situation in which the price was set to encourage efficient use of the service. The higher price is also likely to involve an income transfer from users to the provider and its shareholders.

In practice, however, the impacts are likely to be much more complex. For example:

- More sophisticated charging regimes — particularly multi-part tariffs (see box 3.3) — can reduce the adverse impact of higher prices on service use and thereby lessen the associated efficiency costs.
- In addition to being significant household consumption items, infrastructure services are very important business inputs (see box 3.4). Hence, higher prices for these services will have implications for prices and outputs in a whole range of other markets. As the National Farmers Federation (NFF) commented:

  > Any monopoly rents levied by infrastructure owners represent a form of taxation of intermediate inputs to production or of consumers. For example, inflated electricity or gas network charges feed into the costs of energy users (eg. irrigators and rural processing industries) thereby reducing their competitiveness, and distort production and consumption patterns. (sub. 26, p. 6)

  In effect, the sort of welfare costs depicted in the simple diagram in box 3.3 as arising in the market for the final infrastructure service may flow-on to a range of downstream markets for goods and services.
- Where access is provided, the facility owner might seek to take some monopoly profits by reducing the quality or reliability of the service, rather than by increasing the price. In relation to (publicly-provided) electricity transmission services, Stanwell Corporation commented:

  > [Distribution Network Service Providers] have simply refused to accept responsibility for the quality and availability performance of their network service and for their emergency situation responsiveness. (sub. 3, p. 4)

Perhaps more importantly, the adverse efficiency effects of unregulated access to essential infrastructure facilities can also have dynamic dimensions. Indeed, these dimensions led APIA (sub. DR70, p. 10) to question the usefulness of an analytical framework ‘based upon instantaneous gratification, certainty and the absence of time or place utility’.

In particular, firms’ responses to the possibility of earning monopoly rents might influence the timing of new investments in essential infrastructure:

- In some cases, an incumbent service provider with market power might have an incentive to delay investments in new service capacity beyond the point at which such investment is socially desirable. For example, at the public hearings, the Energy Markets Reform Group suggested that delayed investment in interconnections between the New South Wales and Victorian electricity networks has been partly due to:

  > Preferences by some asset owners to have congestion pricing, create congestion, or perhaps interferences by State governments that wish to preserve the value in some of their businesses … (transcript, p. 275)

(However, TransGrid (sub. DR98, p. 2) rejected the suggestion that, as an asset owner, it had an incentive to delay interconnect investments. Among other things, it noted that most of its revenue is determined via a methodology which does not have regard to congestion.)

- Conversely, suppose that the provision of a new essential infrastructure service is contestable — that is, more than one firm could potentially make the investment. In these circumstances, competition between potential providers (or the threat of the emergence of a competitor) is likely to see investment take place as soon as the venture is expected to return a normal level of profits. Ordinarily, such an outcome would be both privately and socially efficient. However, in this instance, firms are effectively competing to build a facility which may have market power once on the ground. As discussed in section 4.3, there is an argument that competition to acquire such 'ex post' rents might sometimes lead to investment occurring prematurely from the community's point of view.

These sorts of investment timing impacts are of more than passing interest, given that the potential for access regulation to deter or delay socially worthwhile investment is one of its major drawbacks (see chapter 4).

Further, denial of access can prevent new players from entering the downstream market, and thereby limit innovation and the range of services available to users. In economic parlance, this may impede 'dynamic' efficiency. The explosion of product offerings in the telecommunications market in recent years highlights the role that new entrants can play in this regard. That said, as discussed in chapter 4, a wider product range in downstream markets will only be desirable from a community perspective if the terms and conditions of access provide a sufficient return to the facility owner to preserve appropriate incentives for future investment in the essential infrastructure services concerned.

More broadly, monopoly power might reduce the incentive for an incumbent facility owner to use its installed capacity efficiently and to invest in product improvement. Put another way, part of any monopoly rent attaching to extant infrastructure facilities could be dissipated in higher production costs and other inefficiencies.

However, in contrast to ex ante rent dissipation through competition to build (see above), such ex post dissipation appears to be more relevant to public than to private providers. Unregulated private monopolists will usually have stronger incentives to operate efficiently than public providers, so as to enhance the value of their position in the market. As the NECG argued:

> … an unregulated monopolist need not be technically inefficient. While complex arguments can be mounted as to why a monopolist might be less efficient in a static

productive efficiency sense than a competitive firm, powerful counter-arguments can be put pointing the other way. (sub. DR76, p. 35)

Indeed, some roundtable participants argued that a (transitional) rationale for access regulation is to help create the environment for more efficient private provision of essential infrastructure services.

Similarly, unregulated private monopolists will generally have commercial incentives to supply the service quality required by users (see, for example, Forsyth 2001). This implies that the sort of quality degradation referred to above is unlikely to constitute a generally applicable rationale for access regulation. That said, some forms of access price regulation may encourage cost padding or reductions in service quality irrespective of whether the service provider is publicly or privately owned — see chapter 4.

3.3 Significance of the problem

In assessing the need for access (or alternative) regulation, the extent of monopoly power in the delivery of essential infrastructure services, and the significance of the problems this creates, are clearly threshold considerations.

Are incentives to deny access likely to be widespread?

A common starting point for assessments of the significance of the access problem is to look at whether incentives for service providers to deny or inhibit access to *existing* essential facilities are likely to be widespread. These assessments, in turn, often draw attention to the differing incentives facing vertically integrated and vertically separate facilities.

There is general agreement that vertically integrated essential service providers will sometimes have incentives to inhibit access by downstream competitors to their facilities. While, in theory, an integrated entity could appropriate any available monopoly rents via the price charged for access, in practice, denying access may be a more effective way of pursuing this objective. For example, as Professor King (sub. 1) notes, the costs for an integrated provider of making access available, or constraints on it setting charges to extract above normal profits from competing downstream producers, may well provide incentives for denial of access.

In contrast, some argue that vertically separate providers will have little incentive to deny access to firms in related markets. This argument, which is based on the presumption that a vertically separate provider will maximise profits by maximising use of its service, underpinned the Hilmer Committee's view that the national access regime should only apply to integrated entities. It was also endorsed by a number of participants in this inquiry. For example, the Australian Council for Infrastructure Development (AusCID) stated:

> Infrastructure owners which control a single asset with no vertical integration upstream or downstream … have every incentive to increase the number of customers they provide services to and to maintain quality service delivery. (sub. 11, p. 11)

Similarly, APIA commented:

> Access is more certain in industries that have ring fencing (eg. gas pipelines) or a structure where owners and users of assets are separate (ie no vertical integration). In these industries it is not in the asset owner's interests to impede access. (sub. 32, p. 7)

Goldfields Gas Transmission (sub. DR104) and the Sydney Airports Corporation (sub. DR114) were among those vertically separate providers who said that they operate 'open' access arrangements. As noted in chapter 2, separation of essential infrastructure services from other parts of the delivery chain is more widespread than when the national access regime was promulgated.

However, in the Commission's view, attempts to delineate incentives to deny access on the basis of firm structures can be misleading. For example, even if providers of essential services operate in related markets, they may still have incentives to offer access to competitors. In this regard, the vertically integrated rail provider Freight Australia contended:

> … if a new operator sought access to rail from Freight Australia in order to participate in the freight market, providing access would then be a new business opportunity for Freight Australia… If the new operator sought to handle some freight that [Freight Australia] would otherwise handle itself, then it is to be expected that [Freight Australia] would take into account the potential loss of its own business in its negotiation with the new operator. …[However], there would be scope for [Freight Australia] and the new operator to successfully negotiate mutually beneficial terms. (sub. 19, p. 7)

Just as importantly, non-integrated providers — particularly publicly-owned entities that have been structurally separated — may have incentives to deny access. Commenting on this issue in general terms, the NECG said:

> It is important to note that [an access] problem can arise whether or not the owner of the bottleneck facility is vertically integrated, contrary to some recent suggestions. (sub. 39, p. 10)

More specifically, the NCC argued:

> … as further research has evolved in this area of regulation, it has become apparent that access can be just as substantial a problem for structurally separated essential facilities,

> as for those that are vertically integrated. This is largely because an essential facility owner will always face incentives to seek any rents available in upstream and downstream markets, and vertical integration is not the only means by which the facility owner may be able to capture these rents. For example, contractual arrangements can be used to achieve the same outcomes as vertical integration. (sub. 43, p. 58)

In effect, the argument is that if vertical integration is intrinsically more efficient, providers that have been vertically separated may seek to mimic the integrated outcome through a contractual arrangement with a single downstream supplier. The Queensland Mining Council saw this to be a particular problem where separated upstream and downstream entities remain in common ownership:

> There will … be a high risk of interference in the access process where the facility owner is a stand-alone entity, but is owned by an entity that also runs the upstream or downstream business. This is the case with electricity in Queensland where the state government owns generators, distributors/retailers and the transmission network provider. (sub. 27, p. 1)

Others have suggested that operators of publicly-owned, non-integrated, facilities still have considerable scope to pursue non-commercial objectives and might seek to deal on a selective basis with access seekers, even if an open access policy would maximise profits. In this regard, the Law Council said that the experience of some of its members is that:

> … there are non-vertically integrated natural monopolists in Australia who have denied in the past, and continue to deny, access to their essential facilities even though it would be profit-maximising to grant access. Reasons given for this denial include the long-entrenched culture of former State-owned natural monopolists, and a lack of incentives for these firms to achieve commercial returns. Examples given include various owners of rail facilities that are not vertically integrated. (sub. 37, p. 7)

Indeed, as previously noted, some commentators see access regulation as a vehicle for breaking down such legacies of public infrastructure provision. (The drawbacks of relying solely on structural or accounting separation to encourage publicly-owned providers to offer open access are considered further in chapter 5.)

More broadly, the Board of Airline Representatives (sub. 49, p. 3) provided a range of examples of economic linkages between airports and other airport businesses to illustrate that there can be varying degrees of integration into downstream markets. It went on to argue that, as a consequence, a simple delineation between integrated and non-integrated providers can be misleading.

In any event, even if operators of essential facilities do not have reasons to deny access, they will clearly have incentives to exploit any market power when setting prices and conditions for that access. As noted above, the impacts of monopoly pricing on users of the final service may be little different from those resulting from absolute denial of access. Indeed, in a commercial negotiating framework, the two may be linked. Thus, Specialised Container Transport claimed that the Australian Rail Track Corporation had:

> … unilaterally altered existing terms of access to the detriment of operators, with the threat of denying access if those terms were not agreed upon. (sub. DR85, p. 7)

Similar considerations are likely to influence access arrangements for *new* essential facilities. Sometimes, access terms and conditions for new facilities will be spelt out in contracts with 'foundation' customers (see chapter 4). Nonetheless, investors will take into account the scope to exercise market power in establishing these foundation contracts or in dealing with other access seekers once the facility is in place.

How big are the economic costs?

The implication of the preceding discussion is that, in the absence of regulation, denial of access to essential infrastructure services, or monopoly pricing of access, would be more than an isolated occurrence. As well as detracting from the efficient use of the services concerned, such behaviour would also compromise efficient investment in related markets. Moreover, the pursuit of monopoly rents might also have adverse consequences for the timing of investment to provide new essential services and to augment existing networks.

However, estimating the likely magnitude of these costs across the sweep of Australia's essential infrastructure sectors would be an extraordinarily difficult and time consuming exercise. Indeed, given the various assumptions about future demand and supply costs, pricing behaviour and the like that would be required, the reliability of any such estimates would be questionable.

Not surprisingly, therefore, the focus in submissions was on the benefits that users have derived from access regulation. For example:

- The Australian Wheat Board (sub. 16, p. 2) said that the open access rail regime in New South Wales has allowed it to introduce two additional rail operators in the south of the State leading to a freight cost saving of $4 a tonne in the region. The Board also noted that the Australian Rail Track Corporation's access regime has been partly responsible for a reduction in grain handling costs at the Dimboola Grain Centre of nearly 25 per cent.
- The New South Wales Minerals Council (sub. 22, p. 7) and Rio Tinto (sub. 15, pp. 9-10) said that access regulation has led to a reduction in rail charges for Hunter Valley coal exporters of up to 50 per cent, worth over $80 million a year.

- Specialised Container Transport (sub. DR85, p. 1) said that its entry into the rail freight market has contributed to a 30 per cent reduction in freight rates since 1995. (As noted in chapter 2, the company has successfully negotiated access to a number of rail services which it had sought to have declared under Part IIIA.)
- The Chamber of Commerce and Industry Western Australia (sub. 12, p. 4) noted that gas access regulation in Western Australia has led to significant price falls for 'contestable' customers, with further reductions anticipated as the demand threshold for contestability is reduced, and ultimately abolished.
- The Australian Petroleum and Production Exploration Association (sub. 35, p. 6) commented that, prior to the introduction of the gas access regime, facility owners offered uneconomic terms and conditions, or delayed negotiations for access to transmission pipelines and distribution systems. It went on to note that unnecessary costs are still being incurred, citing Duke Energy's Horsley Park bypass referred to above.
- The Northern Territory Government (sub. DR111, p. 7) said that the regime providing access to the Power and Water Authority's (PAWA) electricity network has enabled a private supplier — NT Power Generation — to enter the market in competition with PAWA. It went on to note that this has resulted in cost savings of around 15 per cent for larger electricity customers.
- The Australian Competition and Consumer Commission (ACCC, sub. 25, pp. 58-62) provided a range of data on price reductions and new investment in the electricity, gas and airports sectors.

However, separating the impacts of access regulation from those of other policy changes and market features is difficult. For instance, some roundtable participants suggested that the previously high rail charges imposed on Hunter Valley coal producers reflected the non-commercial pricing practices of a public rail authority, rather than the lack of access regulation as such. Similarly, the price reductions and new investment in key infrastructure sectors reported by the ACCC presumably reflect the combined effects of a sweep of policy reforms and general market developments. Commenting on such influences in relation to recent falls in rail freight costs, the Australian Rail Track Corporation acknowledged:

> It is probably fair to say that the vertical separation of a large part of the east-west interstate rail corridor, together with the presence of a highly efficient intermodal competitor, were largely responsible for the advent of … competition rather than access regulation per se. (sub. 28, p. 5)

It is also important to note that a, possibly large, component of the cost savings attributed above to access regulation is an income transfer between the parties rather than an efficiency gain. As is widely documented in the economic literature, 'transfer' calculations derived by multiplying service use by a fall in price are likely to exceed the true efficiency gain — the increase in the sum of producer and consumer surplus — by a considerable amount.

At a broader level, the importance of infrastructure services to the Australian economy might suggest that there will be significant costs from ineffective access arrangements. These services are major inputs for most Australian businesses (see box 3.4). Effective and accessible infrastructure services are also essential to provide for a basic quality of life in the wider community. The Western Australian Government summarised the role of access arrangements as follows:

> Western Australia recognises the importance to the Australian and State and Territory economies of administratively effective access regulation. With the lion's share of Australia's oil and gas reserves, Western Australia is well positioned to realise broadly based benefits from increased economic activity from the national gas pipelines access regime. Moreover, given the State's vast but isolated mineral endowments, effective and competitive rail freight, port services and other forms of transport will be of vital importance to the State's international competitiveness and economic well-being. (sub. 38, p. 5)

In relation to rural and regional Australia, the NFF said:

> Access to, and the adequacy of, competitively priced infrastructure is of vital concern to rural and regional Australia. The NFF sees the regulation of third party access to infrastructure as important in ensuring competition in the provision of services, thereby providing benefits such as lower prices, choice of service provider and more innovative and better quality services. In turn, this will increase the competitiveness of downstream industries from rural and regional Australia, such as dairy, rice growing, food processing and fertiliser plants, providing employment and underpinning regional development. (sub. 26, p. 2)

And, in relation to energy infrastructure, the Energy Users Association of Australia commented that:

> … energy networks are among the most important determinants of the international competitiveness of the Australian economy and Australian living standards, and engendering competition in upstream and downstream markets means lower prices, choice of provider, more innovation, better quality services and a more efficient utilisation of infrastructure. (sub. DR94, p. 38)

The importance of essential infrastructure services is further reinforced by the observation that the national access regime has been estimated to have a material impact on well in excess of $50 billion of assets (see chapter 2).

Box 3.4 The significance of infrastructure services

Access to, and investment in, infrastructure services are central to economic performance and living standards. As AusCID (sub. DR80, p. 3) remarked, Australia's size and dispersed population mean that infrastructure 'lies at the heart of the Australian economy'. More specifically:

- The services from economic infrastructure account for more than 10 per cent of Australia's GDP.
- Infrastructure services are major inputs for Australian industries and businesses. Power, water and sewerage, rail, pipelines and other transport and communication services together account for more than 9 per cent of total intermediate use by business. In turn, business use represents some 70 per cent of total demand for these services.
- Efficient infrastructure service provision is particularly important for Australia's traded goods sector. In this regard, Rio Tinto commented:

  > Access to efficient bulk freight rail systems is vital to maintaining the competitiveness of much of Australia's mining industry. In 1999–00 the five most important Australian mineral exports by value were, in order, coal, bauxite/alumina/aluminium, crude oil, gold and iron ore. The first, parts of the second and the fifth are bulk commodities whose cost structure is significantly affected by the cost of transport services. Energy is a major input into the refining of alumina and the smelting of aluminium. Burning coal frequently provides that energy. The cost of transporting that coal from mine to power station is a significant factor in the cost competitiveness of those industries. Taken together exports of these three groups of commodities earned Australia over $19b in 1999–00, accounting for over 26% of the value of Australia's commodity exports. (sub. 15, p. 2)

- Economic infrastructure services account for some 5 per cent of consumer spending. Moreover, in a broader sense, their significance to consumers extends beyond this accounting measure. Put simply, services such as power, water and communications are essential to basic quality of life.
- More efficient provision of infrastructure services can therefore be of major benefit to the economy and community more generally. For example, Industry Commission modelling (IC 1995) suggested that the infrastructure reforms, including access regulation, proposed by the Hilmer Committee could directly increase:
  - real GDP by nearly 2 per cent;
  - real consumption by more than 1.4 per cent; and
  - export volumes by nearly 5 per cent.

  Also, as the NFF (sub. 26, p. 7) noted, infrastructure investments can have 'spillover' benefits for productivity and growth more generally.

Source: ABS, *National Income, Expenditure and Product*, Catalogue no. 5206; *Australian National Accounts, Input-Output Tables*, Catalogue no. 5209; IC 1995b.

However, the *efficiency* costs of unregulated access are likely to be much less significant than might be inferred from the overall importance of infrastructure services:

- The most important consideration in this regard is the role of competition, even in an unregulated setting, in limiting an essential service provider's market power (see section 3.2).
- Further, as noted, non-integrated service providers will sometimes be dealing with a small number of large users with capacity to exercise countervailing market power. For example, in relation to gas pipelines, APIA said that:

  > Transmission pipeline customers are very small in number, are very informed buyers and often have (eg producers who are also owners and developers of pipeline assets) more market power than the pipeline companies themselves. (sub. DR70, p. 9)

  Similarly, in commenting on the ACCC's recent determination for the Moomba to Adelaide Pipeline system, Epic Energy (2001, p. 1) contended that:

  > The market will dictate the prices which are acceptable. The customers we are dealing with are large sophisticated buyers who have the ability to choose their source of supply and to negotiate suitable contracts …

  And, in an airports context, Sydney Airports Corporation (sub. DR114, p. 4) commented that scope for airlines to divert individual flights between airports can have a significant impact on airport profitability. It further contended that the influence of the airlines 'politically and in the media' is another source of countervailing power.

  There is a body of economic literature suggesting that, in these sorts of circumstances (and in the absence of collusion), negotiated prices and quantities *might* not diverge greatly from efficient levels. (See for example, Layard and Walters 1978, p. 244.) The Commission's draft report on Price Regulation of Airport Services (2001a) contains a discussion of the extent and impacts of countervailing power in that sector.
- Also, the efficiency impacts of the denial or monopoly pricing of access will depend on the nature of the charging regimes for the essential input and/or final services. For example, as noted in section 3.2, multi-part pricing regimes are likely to have lower efficiency costs than uniform single charges.

Of course, concerns about the costs of denial or monopoly pricing of access extend beyond efficiency. In particular, given that infrastructure services such as communications, power and water are essential for basic quality of life, there are distributional consequences to be considered. However, as discussed in chapter 6, access regulation is unlikely to be an effective or appropriate instrument for targeting distributional outcomes.

3.4 Summing up

The preceding discussion suggests that it is important not to overstate the extent of market power in the provision of essential infrastructure services. While delivery of a number of these services relies on natural monopoly technologies, various competitive pressures are likely to limit the scope for providers to restrict access and/or raise access prices unreasonably. This reinforces the need not to dismiss the ‘no regulation’ option, particularly given the likely costs of remedial intervention discussed in the following chapter.

Yet, at the same time, it would be foolish to dismiss the concerns and economic arguments underpinning access regulation. Clearly, there will be cases where providers of essential infrastructure services have both the incentive and capacity to behave in ways inimical to achieving efficient market outcomes.

Moreover, as a transitional mechanism, access (or similar) regulation may have a role to play in helping to overcome the legacy of public ownership and operation of many of Australia’s infrastructure networks. Evidence assembled in a range of Commission inquiries over a number of years indicates that public ownership, combined with lack of competition, led to substantial inefficiencies in service delivery and poor investment decisions, as well as stifling incentives to innovate. While the institutional and legislative reforms of the last decade or so are helping to create a more competitive market environment, the infrastructure sector is still in a transitional phase. Accordingly, the competitive forces that might be expected to constrain the exercise of market power in the delivery of these services might not yet be fully effective.

4 The costs of access regulation

In assessing the case for any regulation, the costs of intervention are an important consideration. Even if a regulation will have benefits, intervention will only be warranted if those benefits exceed the regulatory costs. As Rio Tinto commented in relation to Part IIIA:

> To achieve its objective, the [national access regime] must not simply deliver some benefits but sufficient benefits to outweigh the costs of obtaining them. … some aspects of the [regime] are proving relatively costly to operate, making this point more than academic. The point gains further weight when it is recognised, as the Hilmer report did, that there may be costs to the [regime] beyond those directly measurable like the cost of the legal process. (sub. 15, p. 4)

Access regulation can entail a significant attenuation of private property rights. This may give rise to a range of costs, particularly if access regulation is poorly specified, meaning that the implications for property rights are ill-defined. Uncertainty about the property right implications of changes to access regulation may also give rise to similar costs.

These costs can take a number of forms, including:

- administrative costs for government and compliance costs for business;
- constraints on the scope for infrastructure providers to deliver and price their services efficiently;
- reduced incentives to invest in infrastructure facilities;
- inefficient investment in related markets; and
- wasteful strategic behaviour by both service providers and access seekers.

The likely significance of these costs will obviously depend on the nature and use of an access regime. If a regime is used sparingly, the costs are likely to be small in aggregate terms. Perhaps more importantly, the costs (and the benefits) will depend crucially on the pricing rules that underpin access regulation — either explicitly, or implicitly via an arbitration process (see chapter 7). The significance of the costs will also depend on the extent of any 'regulatory failure'. Thus, as with the benefits of access regulation, establishing the materiality of the costs is fraught with difficulty.

4.1 Compliance and administrative costs

Access regimes entail administrative costs for government and compliance costs for business.

The Commission did not attempt to estimate the costs incurred by the Commonwealth Government in relation to Part IIIA, or by the States and Territories in administering their various industry access regimes. However, in an aggregate sense, these costs are unlikely to be all that large:

- BHP Billiton (sub. 48, pp. 72-3), while expressing concern about the proliferation of regulatory agencies in the energy area, suggested that the costs of funding a body like IPART are quite modest given the range of tasks it undertakes.
- The Western Australian Government (sub. DR69, p. 8) advised that the cost to the State of assessing gas access arrangements has averaged around $260 000, or less than 0.6 cents a GJ of regulated pipeline throughput. (These costs are in fact largely paid for by the industry.)

Moreover, in terms of affecting market outcomes, the costs of funding regulatory agencies are likely to be less of an issue than the compliance costs incurred by the parties to particular access disputes, or those seeking regulatory approval for specific access arrangements.

For both access seekers and service providers, compliance with access regulation can be costly. Decision making processes can often be protracted, particularly where a negotiate-arbitrate process is involved. For example:

- The experience to date with the Part IIIA regime suggests that an access seeker should expect that the declaration process could take several years, particularly if appeals to the Australian Competition Tribunal eventuate. While the arbitration process in Part IIIA has yet to be tested, it too is likely to be time consuming. For example, the experience to date with the telecommunications access regime is that arbitrations can take up to two years to complete (see PC 2001c).
- It took more than two years to achieve certification of the New South Wales rail access regime under Part IIIA (see box 15.1). Similarly, the Northern Territory Government (sub. DR111, p. ii) said that its application to have the Territory’s electricity access regime certified ‘has taken around eighteen months and is still to be completed’.
- Setting terms and conditions within the framework of a certified regime, or securing a Part IIIA undertaking, is also likely to be time consuming. For instance:

- The Australian Gas Association (sub. 29, p. 27) provided data showing that final approvals for access arrangements for gas transmission pipelines have generally taken between 12 and 20 months to secure.
- More specifically, Epic Energy referred to its experience with the access arrangement for the Moomba to Adelaide Pipeline, where it took the Australian Competition and Consumer Commission (ACCC) more than two years to make a final determination. It further noted that it had been waiting for 18 months for a draft determination on a proposed arrangement for the Dampier to Bunbury pipeline, resulting in a potential revenue loss of over $20 million. (transcript, p. 425)
- Box 4.1 outlines similar delays associated with the approval of an access arrangement for Australian Gas Light Gas Networks' (AGLGN) distribution network in New South Wales.

Duke Energy International (sub. DR95, p. 2) further noted that a need to seek prior approval for 'affiliate' contracts with foundation customers (and to disclose commercial contract information) 'can potentially result in the loss of business opportunities'.

The resource costs for firms of complying with the regulatory requirements can also be considerable. The Australian Gas Association commented:

> These costs include demands on the in-house senior management resources and the provision of external specialist legal/economic advice. In addition to these resources, many gas industry network businesses employ over 5 in-house specialists in the area of regulatory affairs. Estimates of the total costs of developing and negotiating Access Arrangements for small extensions to gas distribution networks range from $200 000 to $250 000. … Costs for development of Access Arrangements for transmission pipelines are even greater. So far, these Arrangements have been estimated to cost $10 million, with associated annual costs of $1-2 million. (sub. 29, p. 17)

In a subsequent submission responding to the Commission's Position Paper, (sub. DR84, p. 13), the Association updated its estimate of the cost of developing gas access arrangements to $13 million, noting that this figure excludes 'numerous' arrangements prepared by gas distribution networks. Goldfields Gas Transmission (sub. DR104, p. ii) said that compliance with the Gas Code costs it more than $1 million a year, 'with approximately half of this figure representing unavoidable fixed regulatory agency charges.' Similarly, Duke Energy International (sub. DR95, p. 3) said that the appeal against the initial decision to cover the Eastern Gas Pipeline under the Gas Code had cost the company in the order of $3 million.

Box 4.1 Delays and the compliance costs of access regulation: two participants' experiences

The Energy Markets Reform Forum

In its submission, the Forum quoted the following material from the Independent Pricing and Regulatory Tribunal's (IPART) foreword to the access arrangements for AGLGN's gas distribution network in New South Wales:

> The process for considering AGLGN's revised Access Arrangement has extended over some 18 months. This is far too long! This has reflected a variety of factors, including the particular requirements of the Code. …
>
> Following extensive further consultation and analysis since the release of its draft decision, the Tribunal still requires, inter alia, revision of the initial capital bases proposed by AGLGN; the rate of return underpinning the annual revenue requirement; and resultant prices proposed in AGLGN's revised Access Arrangement. The Tribunal will also require downward revision of AGLGN's non-capital cost projections and some of its expenditure items.
>
> There has also been considerable work undertaken on cost allocations and alternative tariff scenarios. Transportation charges represent a significant cost for customers and the Tribunal is concerned to ensure, inter alia, that customers pay no more than is appropriate for the use of the AGLGN distribution system. (IPART 2000, foreword).

The Energy Markets Reform Forum went on to say:

> Following further delays, the Tribunal finally approved AGLGN's revised Access Arrangement and Access Arrangement Information (which incorporated the amendments specified in the Tribunal's final decision) in September 2000 and the regime came into effect on 1 October 2000 — 22 months after AGLGN submitted its proposed Access Arrangement to the Tribunal in January 1999 and 14 months after the expected date for commencement of the access regime (July 1999). (sub. 7, p. 5)

Rio Tinto

In October 1998, Rio Tinto lodged an application in the Federal Court seeking a ruling that the Rail Track Service subject to a Part IIIA declaration application by Robe River Associates was not a service within the meaning of the national access regime (see appendix D). In its submission, Rio Tinto described the resources involved in pursuing this application:

> The formal process … stretched over some nine months and involved six days of Federal Court hearings. There were seven respondents in the case. While the case was proceeding, there was substantial activity associated with the processes of the NCC [National Competition Council]. Following receipt of the application the NCC issued a discussion paper in September 1998 and invited submissions from interested parties. HI [Hamersley Iron] and others, including Hope Downs Management Services and Wright Prospecting, both associated with other prospective mines in the Pilbara, as well as BHP Iron Ore and the Western Australian Government, filed submissions. The HI submission ran to some 235 pages and included four consultants' reports. Following further discussions with the parties, the NCC issued a further discussion paper in March 1999, and requested further submissions from interested parties. It also convened an economists' forum on the issues in May 1999, but this was subsequently cancelled. Overall a substantial volume of resources from a variety of sources was expended in resolving this matter. (sub. 15, p. 13)

High costs were also said to arise in gas and electricity distribution and retailing, with the Australian Council for Infrastructure Development (AusCID, sub. 11, p. 9) pointing to imposts from access and other regulation of $30 million a year in Victoria alone. And in the rail sector, Freight Australia (sub. DR82, p. 2) indicated that each application for access to its network would give rise to an initial cost to the company of at least $150 000, with ongoing 'information maintenance' expenditure of between $50 000 and $100 000 a year.

A number of participants also referred to the additional compliance costs for firms operating in more than one jurisdiction. The Australian Gas Association gave the example of a gas distribution business which has had to make different alterations to a draft access arrangement submitted to two State regulators. The Association went on to conclude that such inconsistency:

> … adds significantly to the cost of regulation under the Code, as it prevents gas network businesses taking full advantage of economies of scope and scale in responding to multiple regulatory authorities. (sub. DR84, p. 14)

Box 4.1 provides a further illustration of the compliance costs that access regulation can entail.

However, not *all* of the compliance costs referred to above can be attributed to access regulation. In an unregulated environment, commercial negotiations on access matters would not be costless. Also, the protracted nature of decision making to date is partly because access regulation in Australia is still very much in the development phase. As more decisions are made and precedents established, the general timeliness of decision making may well improve.

Further, it is important to consider the sort of dollar imposts reported above in the context of the overall value of the services being supplied. Thus, while emphasising that there are significant ongoing compliance costs for firms, the Australian Pipeline Industry Association (APIA, sub. DR70, p. 18) said that the cost of developing access arrangements for mature pipelines, expressed in per unit terms, 'does not appear to be excessive'. More specifically, BHP Billiton (sub. 48, p. 74) estimated that the total cash cost for service providers of gas access regulation in New South Wales is about $2.5 million a year or less than 3 cents/GJ. The latter represents only a very small fraction of the retail price of gas — although in a later submission (DR88, p. 1), BHP Billiton suggested that low compliance costs partly reflect the imprecise nature of the asset valuation methodology employed.

Nevertheless, a number of participants said that because there is a substantial fixed component in compliance costs, those costs can be proportionately significant for smaller facilities:

- The Australian Gas Association (sub. DR84, p. 13) said that the cost of an access arrangement for the 164 kilometre Palm Valley to Alice Springs transmission pipeline represents around 15 per cent of the final tariff to users.
- Parry (2000) reported that dealing with the access arrangement for Great Southern Energy's Wagga Wagga gas distribution network — servicing some 14 000 customers — involved the same procedures and efforts as the access arrangement for AGLGN's New South Wales distribution network servicing some 70 000 customers.
- The Northern Territory Government (sub. DR 111) said that for the Alice Springs gas distribution network, compliance with the Gas Code would have cost around $250 000 (not including costs to the regulator or the Territory Government). This figure equates to around $400 for each of the network's 625 residential, commercial and light industrial customers. While the network has been removed from coverage under the Code following a public inquiry by the National Competition Council (NCC), the Northern Territory Government concluded that:

  > Consideration should be given to having distribution networks covered by an alternative access regime that better suits the peculiarities of this form of investment. Experience indicates that the cost of compliance for distribution networks with the current Code is often out of proportion to the possible public benefit. This is especially true for networks servicing small regional centres where there is little possibility of growth in the market and the introduction of competitors is unlikely in the forseeable future. (p. 10)

4.2 Constraints on efficient pricing and service delivery

To reduce the efficiency costs of any monopoly profits attaching to the provision of an essential service, access regulation must necessarily constrain the service provider's operating and/or pricing practices.

Were access regulation to be purely a mechanism to appropriate any super profits or so-called 'monopoly rent' (see section 4.3), leaving untouched the provider's freedom to tailor access prices and conditions to market requirements, it *might* have few detrimental effects on operating or pricing efficiency.

However, developing mechanisms that target only genuine rents has proved to be very difficult. Indeed, as discussed in the next section, even identifying what part, if any, of a provider's profits is a true rent, can be highly problematic.

As a result, regulation of access prices and conditions — whether explicit or through a negotiate-arbitrate process — will almost always have some adverse impacts on pricing and operating efficiency. Such impacts will partly result from the imperfect information and instruments available to regulators and the trade-offs they face between competing interests. But they may also stem from other sorts of regulatory failure that are discussed later in the chapter.

These adverse effects may be manifest in a number of ways. For example:

- Efficient pricing structures may be proscribed, either explicitly in the legislation, or implicitly through regulatory precedent. In this regard, an issue yet to be fully clarified under the Part IIIA regime is the scope it currently provides for efficient price discrimination between users of essential services, based on their willingness to pay. As discussed in chapter 12, price discrimination can sometimes aid the socially efficient recovery of the fixed costs involved in service delivery.
- Conversely, regulated pricing structures may sometimes involve inefficient differentiation in charges. For example, Forsyth (2001, p. 13) argues that:

  > … where weight based charges are levied at busy, capacity constrained airports, an inefficient pattern of use is encouraged, because low value users are not rationed away in favour of high value users. This happens at Sydney and London Heathrow airports.

  Similarly, the submission from the Sydney Airports Corporation to this inquiry and to the Commission's companion inquiries into the Prices Surveillance Act and the Price Regulation of Airport Services (sub. DR114) discussed a range of potential inefficiencies in the current structure of regulated airport charges.
- As has been widely documented, many of the regulatory instruments available for reducing the profits earned by essential service providers will encourage cost-padding, or in other ways reduce incentives for efficient service delivery. In this regard, MIAB Technology (sub. DR56, p. 2) claimed that because regulated access prices are linked to costs, the incentives to invest in research into cost-saving pipeline technologies has been diminished.
- Many participants also expressed concern that the cost-based approach to price setting under some of the industry access regimes entails detailed regulatory involvement in firm management. Typifying these views, Energex stated:

  > Micro-management under current Australian regulation ranges from the regulator 'managing' capital outlays … down to the most forensic scrutiny of every aspect of a firm's activities and attempting to direct actions. (sub. 14, p. 33)

  The effects of regulated access prices on operating and pricing efficiency are explored in more detail in chapter 12.
- Access regulation may interfere unnecessarily with other aspects of service delivery. In particular, the criteria for invoking such regulation may make it difficult to rule out circumstances where denial of access might enhance

efficiency. An example is the declaration under Part IIIA of certain cargo handling services at Sydney Airport (see appendix D). This has effectively removed the option for the Sydney Airports Corporation to limit the number of cargo handlers operating at the airport. Arguably, however, and particularly if operating rights were allocated by an open tender process, such limitations might be compatible with making the best use of congested airport facilities.

4.3 Disincentives for investment

Access regulation — and the accompanying pricing approaches or rules — are likely to alter the incentives to invest in essential infrastructure. Arguments that these changes in incentives will generally be detrimental to investment have featured prominently in debates on the merits of access regulation.

The potential 'chilling' effect of access regulation on investment in essential facilities was an important theme in the Hilmer Committee (1993) report:

> The Committee is conscious of the need to carefully limit the circumstances in which one business is required by law to make its facilities available to another. Failure to provide appropriate protection to the owners of such facilities has the potential to undermine incentives for investment. (p. 248)

And:

> … when considering the declaration of an access right to facilities, any assessments of the public interest would need to place special emphasis on the need to ensure that access rights did not undermine the viability of long-term investment decisions, and hence risk deterring future investment in important infrastructure projects. (p. 251)

Such concerns were also prominent in many of the submissions to this inquiry. Typifying these concerns, the Network Economics Consulting Group (NECG) pointed to the serious consequences of failure to invest in infrastructure replacement and renewal:

> In infrastructural industries, the determination of efficient access prices is more difficult and the consequences of getting access prices wrong can be much greater than in other industries.
>
> Adequate levels of and incentives for investment are particularly important for infrastructure assets, which provide essential services to Australian consumers and businesses. These services must continue to be provided even after any particular asset or network has reached the end of its life. This means that infrastructure assets will need to be replaced, and their owners carry at least an implicit, and in many instances an explicit, obligation to renew or replace them.

> Failure to invest in timely renewal or replacement can have serious consequences. The continuity of key business and household inputs is often taken for granted, but rare failures are dramatic and widespread in their effects. (sub. 39, pp. 18-9)

For its part, Energex argued that Australia's current approach to access regulation stifles incentives for innovation:

> … there will be no dynamic efficiency or technical progress in the sorts of models currently employed in Australia. The Schumpeterian argument is that it is only the opportunity of higher returns than the perfectly competitive rate which will induce firms to undertake risky and uncertain investment and innovational activities that offer the prospects of enhanced services to customers at lower prices than otherwise. … This opportunity does not exist in the simple neo-classical perfectly competitive model applied by Australian regulators where ex post rates of return are imposed ex ante. (sub. DR81, p. 8)

And, in commenting on the ACCC's recent decision on the regulated rate of return for the Moomba to Adelaide pipeline, Epic Energy (2001, p. 1) contended:

> The downward trend in the allowed rate of return on investment and tariffs can only create uncertainty in the investment community. This, coupled with the micromanagement and the intrusive approach taken by the ACCC, will act to distort future decisions on whether to invest in future infrastructure.

However, not all participants shared these concerns. The ACCC, (subs. 25 and DR93), BHP Billiton (subs. 48 and DR79), Dwyer and Lim (subs. 53 and DR100) and the Energy Users Association of Australia (sub. DR94) were amongst those who disputed the contention that access regulation will necessarily be detrimental to efficient investment in essential infrastructure facilities.

As the discussion below indicates, determining the impacts of access regulation on investment is far from easy. There are conceptual arguments which suggest that access regulation could conceivably improve the efficiency of investment in essential infrastructure. However, these arguments rely on there being well informed regulators with access to regulatory instruments that permit clinical isolation of monopoly 'rents' accruing to successful projects through inefficient pricing or the denial of access. If this is not the case, then access regulation clearly has the potential to discourage investment. This implies that assessments of the impact of any particular access regime must have regard to actual investment outcomes. Yet, as the discussion below indicates, separating the impacts of access regulation from the myriad of other influences on observed investment is very difficult.

Nevertheless, in the Commission's view, the concerns about the *potential* for access regulation to deter investment appear to be well-founded. This in turn means that minimising the potential for such effects should be an important consideration in the design of access regimes.

Some conceptual considerations

The significance of regulatory risk

By their nature, infrastructure investments can be risky. A range of factors potentially contribute to that risk, including:

- the possibility of changes in economy-wide conditions;
- uncertainty about the future demand and prices obtainable for the services of a particular infrastructure facility;
- the possibility of unforeseen delays and costs during the construction phase;
- uncertainty about how an untried technology will perform, or the possible emergence of a superior competing technology; and
- exposure to government actions or regulation which could alter the viability of an investment down the track.

Submissions from the Chamber of Commerce and Industry Western Australia (sub. 12) and the Queensland Treasury (DR105) contain a useful discussion of the various sources of risk.

Such risks are not unique to investments in essential infrastructure. Indeed, all investments involve risks of some sort.

However, there is a widespread concern that the possibility of mandated access adds significantly to the risks facing investors in essential infrastructure. The NECG identified two discrete components to such 'regulatory' risk:

> - although market uncertainty arises from the normal interactions between buyers and sellers across all markets … it can have more severe impacts on regulated firms because of the constraints regulation imposes on their ability to respond. As a result, even when regulations are fully known and non-discretionary, regulated firms can be more exposed to the costs of normal market uncertainty than other firms; and
> - additional uncertainty can and almost invariably does arise from the exercise of regulatory discretion. In all regulatory systems, regulators have some non-trivial decisions to make. As a consequence, the outcomes from the future stream of regulatory decision making processes cannot be predicted with certainty. (sub. DR76, p. 9)

In this latter context, AGL (sub. DR86, p. 9) noted that the regulated cost of capital will not be known with certainty at the time of investment. The Australian Gas

Association (sub. DR84, p. 14) and the New South Wales Government (sub. DR109, p. 8) referred to the risk that, after the event, a regulator will judge that an investment was 'imprudent', based on information not available to the proponent at the time of investment, and 'optimise' it out of the asset base. And, in talking about its reasons for developing the now certified access regime for the Tarcoola to Darwin rail link despite its view that the risk of declaration would have been small, the Northern Territory Government stated that:

> … if an application were made, there is a possibility that the NCC may adopt a narrow definition of the market for the service (eg the market for rail freight services) and recommend declaration. (sub. DR111, p. 2)

The NECG (sub. DR76, pp. 9-10) further contended that dangers of bias in regulatory decision making can accentuate these effects. In this regard, it pointed to:

- biases in the sample of issues that proceed to regulatory determination — access disputes are mainly likely to arise for 'successful' developments; and
- wider public pressure on regulators to deliver reductions in prices for final consumers.

A number of participants went on to argue that concerns about regulatory risk are likely to have very significant ramifications for new investment given that, once made, most infrastructure investments are largely sunk. They also pointed out that the existence of regulatory risk will increase the cost of capital for infrastructure projects. In this context, the Queensland Treasury (sub. DR105, p. 14) observed that regulatory risk considerations are integral to the credit ratings given to utilities by agencies such as Standard and Poors. The implication of these arguments is that, without adequate compensation in regulated terms and conditions for such risk and the resulting higher cost of capital, willingness to invest will inevitably be compromised.

While not disputing the need to compensate investors for any additional risk arising from access regulation, some participants questioned the significance of that risk in the overall investment calculus. For example, at the public hearings to discuss the Commission's Position Paper, BHP Billiton commented that access regulation is only one influence on investment in energy infrastructure and that regulatory risk can be mitigated through 'foundation contracts':

> In gas pipelines, for example, most of the economics are dealt with by way of foundation shipper arrangements. … They will go to the most likely candidates … and say, 'Can you underwrite by way of forward commitment the cash flow required to cover the necessary parts of the investment?' Therefore when you have an access regime it's on top of, additional to, and in a different dimension to the foundation economics that underwrote the investment. (transcript, p. 24)

Similarly, in a paper prepared for BHP Billiton, Fitzgerald (2001, p. 11) contended that the main risks for 'greenfield' infrastructure projects 'relate to market risk and foundation shipping terms, not access pricing'.

However, as APIA noted, scope for third parties to secure regulated access to spare capacity in an infrastructure facility at a lower price than foundation contract members might undermine the viability of the contracting process:

> Regulation which exposes a contractual underwriter of a pipeline investment to competition from persons afforded access to that pipeline at a lower regulated price will act to frustrate pipeline investment by forcing pipeline investors, and/or foundation customers to accept untenable market risk. (sub. DR70, p. 12)

The Association also contended that if foundation customers seek to make provision in contracts for flow-on price reductions in such circumstances, this will 'erode the whole basis on the financials for the project in the first place'. (transcript, p. 185)

In sum, therefore, the mere existence of access regulation may well have some deleterious impacts on investment in essential infrastructure.

The impacts of regulated terms and conditions

Most of the discussion in submissions presumed that any significant constraints on the prices charged by owners of essential infrastructure are likely to harm investment. Underpinning this presumption was a view that the efficiency costs of monopoly pricing will, to a significant extent, be of a static allocative nature (see figure 3.1), whereas under-compensation will lead to deferred or non-investment in essential infrastructure. This sort of dichotomy was also implicit in some of the Commission's argumentation in the Position Paper.

At the same time, however, other elements of the Commission's analysis in the Position Paper indicated that the scope to charge monopoly prices for essential services is likely to affect investment outcomes — not only in related markets, but also in respect of the essential infrastructure concerned.

What these differing analytical perspectives illustrate is that the consequences of both monopoly pricing of essential services and of ill-judged or imperfect regulation to address such behaviour can be considered in either a static or a dynamic framework.

As noted, the sort of static framework outlined in box 3.3 has significant limitations. In particular, it fails to capture some of the important investment dynamics that are crucial in determining the efficacy of either regulated or unregulated market outcomes. However, the additional richness provided by a framework that takes account of these effects is accompanied by more ambiguity in possible outcomes.

In considering investment impacts, a key factor is that most investments in essential infrastructure are lumpy and long-lived. Thus, if demand for a particular service is growing over time, the profitability of an investment to provide that service is likely to depend on when the infrastructure is installed and/or replaced.

As discussed in box 4.2, this relationship between investment timing and profitability has a number of implications for the efficiency of unregulated investment in essential infrastructure. Relative to the socially efficient time of investment:

- incumbent service providers which face little or no competition may have incentives to delay expenditures to upgrade existing infrastructure; whereas
- the potential for competition between firms to provide some new infrastructure services, or to augment some existing infrastructure networks, could conceivably lead to premature investment.

While the first proposition is uncontroversial, the notion that competition between potential providers (or the threat of competition) could have deleterious efficiency effects may seem incongruous. In essence, the possibility arises because potential monopoly rents attaching to such investments can be dissipated in several ways.

Competition at the construction phase will sometimes occur against a back-drop of the potential for the successful investor to charge monopoly prices once it has become established as the incumbent provider. Thus, competition in this situation will be at least partly directed at acquiring a potential monopoly rent, rather than simply relating to the supply of a particular service.

As in other markets, the impact of ‘competition to construct’ will be to remove or reduce any such rents. However, for reasons spelt out in box 4.2, rent dissipation will not necessarily result in lower charges for users. Rather, it might sometimes lead to premature investment in capacity, but still with some degree of monopoly pricing of the services concerned.

An implication of the preceding discussion is that, at least in principle, regulated access pricing could be used to promote more efficient timing of investment in essential facilities. (See for example, Gans 2001, p. 4.)

In practice, however, a variety of factors will impinge upon investment timing. Some of these are likely to create incentives for providers to defer investments — including those that are contestable at the construction phase (see box 4.2).

Box 4.2 Unregulated investment in natural monopoly infrastructure

In the static analysis of monopoly provision of essential infrastructure (box 3.3), rents arise from the increases in prices that accompany the restriction of supply below efficient levels.

But this begs two important questions:

- What new investment will be required to sustain such rents beyond the life of the existing infrastructure? and
- Will there be any competitive forces operating to dissipate rents over time?

As the following discussion indicates, the timing of investment is a potentially significant consideration in addressing these questions. For the most part, investments in essential infrastructure are lumpy and long-lived. Thus, if demand for a particular service is growing over time, the profitability of an investment to provide that service is likely to depend on when the infrastructure is installed and/or replaced. This relationship between investment timing and profitability has a number of implications for the efficiency of unregulated investment in essential infrastructure.

Re-investment by incumbent service providers

As noted in chapter 3, the large sunk costs entailed in the provision of essential infrastructure services are likely to limit the scope for new entrants to undermine the market position of an incumbent provider. This may give the provider some control over when to refurbish or upgrade an existing piece of infrastructure.

As noted by Gans (2001, p. 2), if the incumbent provider had the capacity to set charges that discriminated perfectly between service users on the basis of their willingness to pay, it would (re)invest at the socially optimal time. This outcome is analogous to the outcome in the static model where perfect price discrimination eliminates the allocative efficiency costs of monopoly (see box 3.3).

However, in practice, with scope for at best only imperfect price discrimination, reinvestment by an incumbent may well be delayed relative to the social optimum. (While there is still some debate about what constitutes the 'socially optimal' time of investment, a reasonable view is that it is the time at which the net present value of an investment to the community — measured by the sum of producer and consumer surplus — is maximised.) In this context, chapter 3 noted that an incumbent provider might sometimes be able to increase its profits by delaying the upgrading of a congested facility.

The timing of ex ante contestable investments

Refurbishment and upgrading of facilities by incumbents is only one type of investment in essential infrastructure. There is also investment to provide new services, or to augment existing networks. As several participants pointed out, this type of investment is often 'contestable' at the construction phase — that is, more than one firm could *potentially* provide the service in question.

(continued next page)

Box 4.2 **continued**

It is important to note that, at least in principle, contestability does not require that there is actually more than one firm competing to build a particular facility. Rather, it simply requires that there are no barriers to entry which would rule out provision by all but one firm. This in turn means that the contestability concept centres on how the *threat* of competition affects the behaviour of firms.

Importantly, potential for competition at the construction phase will sometimes occur against a back-drop of the opportunity for the ‘successful’ investor to charge monopoly prices once it has become established as the incumbent provider. This in turn means that competition will at least partly be directed at capturing a potential monopoly rent.

In some cases, competition is likely to see those potential rents dissipated or reduced in the form of lower prices for service users. For instance, if the Government were to tender for the right to construct the infrastructure (see chapter 5), the successful tenderer would presumably be the firm offering the best price value combination for users.

But in other cases, rent dissipation through offers of lower prices to users may be more problematic. In particular, a private provider planning to offer lower prices might be undermined by a competing firm moving to build the infrastructure earlier and then charging higher prices once the facility was in place (assuming, of course, that customers had no option but to pay those higher prices). In such circumstances, rent dissipation would have occurred, at least in part, through bringing forward the timing of investment.

Just as delayed investment by an incumbent may be inefficient, so too may be any such pull forward of investment. That is, in the absence of regulation, investment could occur prematurely from the community’s point of view, but still with some degree of monopoly pricing of the services concerned. The NECG (sub. DR113) and Dwyer and Lim (sub. DR100) were among those participants who drew attention to this potential inefficiency.

Some qualifications and implications

The preceding analysis is of course subject to various qualifications. In particular, a range of other factors will impinge upon investment timing. Notable amongst these is uncertainty about the future market environment, which may sometimes counteract any ‘race to be first’. That is, over time, more information on factors impinging on the profitability of a proposed project will become available, thereby providing an incentive for delay. The credibility of the threat of pre-emptive construction of a facility by a rival will be another important consideration (see for example, Mills 1988).

Nonetheless, the discussion does reveal some important parallels between the potential for inefficient timing of new investment in the unregulated environment and deferred or precluded investment resulting from inappropriate access regulation (see text). In so doing, it illustrates the need for a more careful assessment of the *net* impacts of access regulation on investment in essential infrastructure than was evident in some submissions to the inquiry.

More importantly, the potential for access regulation to deliver more efficient investment outcomes depends crucially on regulators having the information and regulatory instruments to isolate genuine monopoly 'rents'. As Dwyer and Lim noted:

> The real issue is how to regulate without impeding *efficient* and *desirable* … infrastructure investment: in effect, how to allow a return to physical capital investment without conferring monopoly rents … (sub. DR100, p. 4)

In this context, rents can be defined as returns in excess of those needed by investors to have justified a project proceeding. Thus, they do not include any above normal returns on successful projects that were factored into the investment calculus as a balance to losses that would have been incurred under less favourable market outcomes. As a number of participants noted, if access regulation extends beyond appropriating genuine monopoly rents and truncates balancing 'upside' returns, it may render some projects *ex ante* unprofitable. Thus the NECG commented that:

> … the bulk of the regulation carried out under Part IIIA and other Australian access regimes — operates by limiting the economic income that can accrue to regulated suppliers. This effectively truncates the distribution of returns investors can hope for. When the attractiveness of investment depends on the possibility of significant 'up-side' — that is, on the likelihood, however slight, that investors will secure some 'clear blue sky' profits — truncating the distribution of earnings can be sufficient to prevent socially desirable investments from going ahead. (sub. 39, pp. 24-5)

And, using the example of a proposed investment in a new pipeline, the Institute of Public Affairs observed:

> The owner of the pipeline will usually have considered a spectrum of alternative market projections (and perhaps a spectrum of cost projections). There is uncertainty and, implicitly or explicitly, the owner will weight each scenario in making his investment decision. If his threshold is a rate of return of 15% and he is considering scenarios that might yield rates ranging from 25% to 5% but provide a weighted average rate of 15%, cutting off the potential to earn the higher rates will reduce the weighted average to something less than the threshold. The regulatory action would then eliminate the commerciality of the project. (sub. 18, p. 6)

As AGL (sub. DR86, p. 10) and Duke Energy International (sub. DR95, p. 2) noted, the problem is one of regulatory asymmetry. In this regard, the latter commented that:

> … access regulation effectively provides a cap or upper limit on the returns that a service provider may achieve while failing to provide an offsetting guarantee that returns will not fall below the regulated target. This asymmetry creates an extreme disincentive to entrepreneurial investment especially as it applies to marginal greenfields projects.

Significantly, the ACCC (sub. DR93, pp. 33-4) acknowledged the validity of the truncation argument, although it noted that there are various pricing approaches to address the problem, at least in part. These are explored further in chapter 11.

While discussion in submissions of the likely impacts of regulatory truncation of profits was usually couched in terms of deterring investment, those impacts could be manifested in other ways. In particular, the prospect of truncation (or simply the desire to reduce regulatory risk) may provide an incentive for firms to build smaller than optimal facilities to create a capacity constraint, and thereby minimise or remove the threat of regulated access. In this regard, APIA referred to current indications that the operation of the Gas Code:

> … will lead to pipelines sized to accommodate foundation contracts negotiated with customers, rather than the creation of the 'spare' capacity needed to meet longer term growth. (sub. DR70, p. 20)

Though not as damaging as non-investment, such outcomes will still be socially inefficient. For example, a number of participants said that it is more efficient to cater for future growth in demand for gas pipeline services by constructing over-sized pipes than by 'compressing' or 'looping' smaller pipes. In this regard, Epic Energy (2001, p. 1) recently argued:

> … we potentially face a situation in the future of 'spaghetti pipelines' across the country where pipelines are only built based on what the market will contract for today.
>
> The current regulatory regime offers no incentive to build a pipeline with spare capacity which takes a risk on the future market growth, and yet this is a time when it is most critical for the development of the Australian gas industry.

What is the evidence?

The preceding discussion implies that the impact of access regulation on investment in essential infrastructure needs to be assessed on a case-by-case basis. The more successful regulators are in limiting the purview of access regulation to appropriating genuine monopoly rents, the smaller are likely to be the associated investment costs and the greater the possibility of some improved investment outcomes.

However, establishing the success or otherwise of regulators in this regard is extremely difficult. In the first instance, this is because of the problem of establishing the 'no regulation' counterfactual. Indeed, the NECG (sub. DR76, p. 10) commented that the problem of determining the counterfactual 'makes it impossible to demonstrate conclusively the impact of regulatory risk on investment levels in Australian infrastructure'.

The infrequent and lumpy nature of infrastructure investments compounds such assessment problems. For instance, the absence of new investment in a sector for a period could reflect the stage of the investment cycle rather than investment disincentives arising from access or other regulation. In this regard, in its recent determination on the application of the Gas Code to the Eastern Gas Pipeline, the Australian Competition Tribunal (2001, para. 99) noted:

> The Tribunal concludes that spare pipeline capacity will continue to exist over the next 10 to 15 years, initially without the need to physically alter the pipelines and later with relatively low cost capacity increases …

Conversely, the long-lived nature of most essential infrastructure means that any adverse impacts of regulated access pricing on investment may not be apparent in the short to medium term. As the NECG observed:

> … it can take many years before the full consequences of revenue inadequacy become apparent … what typically happens when regulated revenues are driven below costs is that service continues — but maintenance is cut back, new investments are deferred, the quality of service suffers, and it is only once the impacts of each of these has cumulated that the full extent of the problems becomes apparent …
>
> This slow nature of adjustment in infrastructure industries means that it may be difficult to ascertain that prices have been set too low. (sub. 39, p. 20)

Such evidentiary problems are particularly pertinent in the Australian context where access regulation is still in its infancy.

For these sorts of reasons, much of the commentary from participants on the adverse impacts of access regulation on investment in essential infrastructure was expressed in very general terms. Thus AusCID claimed:

> The current National Access Regime is unclear, uncertain and biased towards access seekers. As a result it is having a substantial disincentive on investment in sectors where it applies such as gas pipelines, electricity transmission and telecommunications, and in sectors where it may potentially apply such as airports, rail and shipping channels. (sub. 11, p. 6)

Nonetheless, the Commission received some specific examples of apparent negative investment impacts of access (and related) regulation. For example:

- Australian Pacific Airports Corporation (sub. 10, p. 5) commented that the ACCC's intervention in a commercial arrangement with Impulse Airlines for access to Melbourne Airport's new Domestic Express Terminal had made airport operators more wary about new investment. The Corporation went on to say that:

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

available. This will have the effect of delaying delivery of new services for many months when compared to a situation where we could invest with pricing certainty.

- TransGrid (sub. 17, p. 1) said that low regulated rates of return for electricity transmission facilities have contributed to insufficient investment in network inter-connections. By expanding the size of transmission networks, such inter-connections can play an important role in reducing the market power of particular electricity generators.
- The NECG (subs. 39, p. 18 and DR76, pp. 10-1) referred to previous public comments by AMP and Deustche Asset Management about their decisions to suspend investment in regulated firms because of the associated uncertainty.
- The Australian Gas Association (sub. DR84, p. 15) said that regulatory uncertainty was one factor contributing to the deferral of the Central Ranges pipeline from Dubbo to Tamworth.
- Epic Energy said that the proposed Darwin to Moomba pipeline would be built to meet the requirements of foundation shippers so as to reduce the threat of regulated access. It also said that 'looping' arrangements for the Moomba to Adelaide pipeline and an enhancement to the Dampier to Bunbury pipeline had been constructed solely to meet the needs of incremental contract volume (transcript, p. 437). Yet, as noted above, building pipelines with spare capacity may sometimes be the most efficient way of catering for future demand growth.
- TXU Networks (sub. DR89, pp. 2-3) said that it had deferred plans to extend gas reticulation to Barwon Heads following failure to agree with the Office of the Regulator-General, Victoria on a number of matters relating to the rate of return on the capital expenditure involved. According to the Australian Gas Association (sub. DR84, p. 15) this deferral has denied Barwon Head residents savings in power costs of $1000 per household a year. The Association went on to provide examples of the benefits for regional Australia that have followed from connection to the gas network.
- Freight Australia (sub. DR82, p. 3) commented on the implications of the Victorian Government's decision to declare open access to the State's intrastate, non-urban rail network. (Freight Australia manages the network under what is effectively a 45 year lease and also operates its own freight services.) The company said that, in the light of the pricing rules applying under the regime, its owners have resolved to suspend discretionary investment in the network, other than that 'required for Freight Australia to meet its contractual requirements with passenger operators on the network'.

  (However, the Victorian Department of Infrastructure (sub. DR97, p. 4) said that the pricing principles to apply under the access regime were made known to bidders as part of the tender process. It also suggested that Freight Australia may be operating on the incorrect premise that investment undertaken during the lease will be treated as sunk for pricing purposes.)

- The New South Wales Minerals Council (sub. DR63, p. 5) argued that the asset valuation methodology specified in the New South Wales rail access regime is discouraging investment in track infrastructure.
- Similarly, the Railway Technical Society of Australasia commented that:

  … failure to devise an 'acceptable' access regime which is fair to track owners has been used to deny much needed interstate track investment. The longest standing failure has been that of the NSW and Federal Government authorities to agree on access arrangements for NSW mainline interstate track. (sub. DR91, p. 2)

- The Queensland Treasury (sub. DR105, p. 11) said that a number of tenders to purchase or lease government-owned infrastructure, or to construct and operate new infrastructure, had been affected by investor uncertainty about access regulation, including tenders for:
  - the sale of three central Queensland water pipelines;
  - the construction and operation of the Brisbane Light Rail;
  - the proposed construction and operation of the Nathan Dam in the Dawson Valley; and
  - the lease of the Dalrymple Bay Coal Terminal.

And, in its response to the draft report issued by the Commission for its companion inquiry into telecommunications competition regulation — including the industry access regime applying in that sector — Telstra (2001, pp. 20-1) indicated that:

> Unless the [telecommunications] regulatory environment is changed so as to significantly reduce its distorting impacts, it is difficult to see any commercial incentive for Telstra to incur the substantial outlays involved in upgrading the [Customer Access Network].

In contrast, users of essential infrastructure and the ACCC argued that current access arrangements are providing a healthy investment environment. To support this contention, the ACCC (subs. 25 and DR93) noted that:

- a recent report prepared for it by National Economic Research Associates (NERA, 2001a) had found that average regulated rates of return for gas and electricity transmission and distribution businesses in Australia have been above those in both North America and the United Kingdom;
- its regulatory determinations in the energy sector have provided average rates of return to service providers above average stock market returns in recent years; and

- it had made provision for an additional risk premium in the regulated return for the Central West gas pipeline in New South Wales in recognition of the project's greenfield status.

The ACCC went on to conclude that:

> Together with the substantial new investments being undertaken or planned for Australia, including more than $8 billion worth of new gas pipeline investments, the returns achieved lend support to the [ACCC's] view that current regulated returns provide a solid base for future investment in electricity and gas transmission. (sub. 25, pp. 64-5)

Similarly, BHP Billiton contended that there is no evidence that access regulation is inhibiting investment in gas pipelines. Indeed, it said that some new pipeline investment has been encouraged:

> BHP developed the Eastern Gas Pipeline project on the basis that access would be available to the existing NSW gas distribution system. The pipeline would not have been built without access. Thus the Eastern Gas Pipeline is a $450m project that has been directly facilitated by the [Gas] Code.

BHP Billiton went on to say that:

> The fact that access has had no negative impact on pipeline investment in Australia should be no surprise. This is consistent with experience in the USA and in Canada, where pipeline investment has thrived notwithstanding in a more rigorous and onerous regulatory environment. (sub. 48, p. 62)

The Australian Petroleum Production and Exploration Association (sub. 32, p. 5), WMC Resources (sub. DR71, p. 3) and the Energy Users Association of Australia (sub. DR94, pp. 22-5) also pointed to the significant new investment in gas transmission pipelines that has occurred since the inception of the Gas Code. The Commission also notes that Duke Energy (2001a, b) has signalled a desire to invest an additional $1.5 billion in infrastructure projects in Australia over the next few years, including $250 million in the Southern Gas Pipeline and $400 million in the Bass Strait Pipeline from Longford to Bell Bay.

More generally, in a paper prepared for BHP Billiton looking at, amongst other things, the impact of regulation on investment in other countries, NERA (2001b, p. 38) concluded:

> We have analysed sections of the [Gas] Code and demonstrated that it is, in fact, based upon the tenets of sound regulation, and thus should not hamper infrastructure investment. We have supported this point with an evaluation of North American experience, demonstrating how apt regulation in the US, Canada and Mexico has facilitated a healthy investment environment in these countries.

> Thus, we conclude that any worries that the Commission may have about access regulation deterring infrastructure investment are unwarranted, with respect to the gas pipeline industry.

Summarising these views, the Energy Users Association of Australia concluded that:

> … insufficient information has been advanced to substantiate claims of inadequate regulated returns and their deterrence of investments. On the contrary, the evidence is that new investments in existing businesses and in greenfields projects are occurring. The introduction of access regimes has also resulted in new investments benefiting competition in downstream markets. (sub. DR94, p. 26)

However, many of these claims are subject to the same sort of caveats as contentions about the negative investment impacts of access regulation. For instance, the issue is not whether significant new investments are planned, but whether socially worthwhile investment has been precluded or undesirably delayed.

Moreover, without consideration of differences in regulatory and other risks, asset valuation methodologies and the like, comparisons between regulated returns on infrastructure investments in different countries can be problematic. As Epic Energy commented:

> … there are no grounds for a simple or straight comparison. Australia is a very undeveloped market with a relatively recent regulatory history. Its overall economy is quite different from those other countries. (transcript, p. 427)

More specifically, in commenting on the NERA analysis, the NECG argued:

> We emphasise that very simplistic comparisons across industries and across countries are unlikely to be particularly informative or helpful, unless the full range of explanatory variables are given careful consideration and adjustments made accordingly. As such, any moves to effectively benchmark the returns that Australian regulators set for Australian companies against international comparisons of this kind are dangerous. (sub. DR107, p. 2)

The NECG went on to argue (p. 15) that a number of features of the Australian regulatory regime expose investors to risks that do not usually arise in the USA or the UK, including:

- the immaturity of the Australian regime, and the uncertainty that this creates;
- the limited guidance on access pricing principles in Part IIIA;
- the very limited protection provided against variations in uncontrollable operating costs; and
- the methodology used to calculate the regulated asset base at periodic reviews.

Further, as noted by APIA (transcript, p. 187), some of the new investments that have occurred after the inception of access regulation in Australia were well in train when those regimes were introduced.

The messages emerging from such ex post studies and observations will inevitably be the subject of debate. Thus, in responding to the NECG's critique of its study, NERA, commented that:

> Whilst we would be the first to agree that reasonable assurance of cost recovery is fundamentally important for investors in long lived assets, in the case of the energy sector, the significantly greater risks NECG cites in Australia are more imagined that real. (sub. DR120, p. 3)

(This submission elicited a further response from the NECG (sub. DR123) relating to NERA's criticisms.)

But what is harder to dispute is that the adequacy of regulated rates of return for particular projects ultimately can only be assessed with reference to the various rate of return scenarios factored into the decision to invest. Thus, if the possibility of earning say a 40 per cent rate of return under a particular market scenario was necessary to get a proposed investment 'over the line', the prospect of a lower regulated return — even if higher than the normal (risk-adjusted) level for that sector — may be sufficient to deter investment. Further, even successful infrastructure projects will not usually generate revenues in their early years sufficient to cover costs. Thus, early losses must be covered by above normal profits in later years as demand for the services concerned increases. However, if returns in each year are capped at the risk-adjusted rate of return, the possibility of earning these 'covering' higher profits will be removed, again with adverse implications for incentives to invest.

These observations, in turn, mean that regulated rates of return for successful infrastructure projects which are higher than the stock market average do not of themselves signify that incentives for new investment are adequate. This led the NECG to argue:

> The NERA analysis does not, and cannot, offer any justification for moving away from detailed and rigorous analysis of the individual cost of capital parameters in future access price reviews. (sub. DR107, p. 2)

(The relationship between ex post returns and the ex ante cost of capital is considered further in chapter 11, as part of the assessment of various options for facilitating new investment within the national access regime.)

In the light of these sorts of complexities, it is significant that the Office of the Regulator General, Victoria was somewhat more guarded than the ACCC in commenting on the efficacy of the investment environment under current access arrangements. It noted that current regulatory arrangements provide regulators with scope to use a range of approaches in dealing with greenfield investments — including higher regulated rates of return, longer 'reset' periods and provision for facility investors to 'capitalise losses incurred early in the economic life of an investment and/or to backload the recovery of capital invested until the market for the facility's services has been established'. However, it went on to comment that there is nevertheless scope:

> … for further development of both the regulatory frameworks and the decision-making approaches of regulators in relation to this important issue. … the development of improved regulatory approaches and incentives for efficient new infrastructure investments is complex and is not simply a matter of approving access prices that incorporate a higher return. (sub. DR112, p. 9)

Some implications

The difficulty of verifying the impacts of access regulation on investment in essential infrastructure means that judgements about likely effects must be based largely on conceptual considerations. Yet, as the earlier discussion indicates, economic theory does not provide unambiguous answers.

However, by overlaying the theory with recognition of the practical difficulties that regulators face in determining access prices and conditions, some important messages emerge on both likely investment impacts and appropriate policy settings.

Asymmetry in the consequences of regulatory pricing errors

Regulators must operate with limited information and imperfect regulatory tools. This implies that precise delineation after the event between genuine monopoly rents and balancing upside profits on successful projects will be well nigh impossible. Accordingly, even an 'unbiased' regulator could sometimes allow a service provider to retain an element of rent, and sometimes truncate balancing upside profits. (As discussed in section 4.5, service providers argued that a range of factors are likely to encourage regulators to err on the side of users.)

Some participants, including the NECG, argued that there is an asymmetry in the consequences of the two types of error, with under-compensation for service providers likely to be more costly for the community than over-compensation. In essence, the underlying proposition was that the cost conditions for natural monopoly facilities are such that the prospect of under-compensation can lead to non-provision of services. In contrast, over-compensation reduces, but does not eliminate, use of those services. Specifically, the NECG commented that:

> In using their discretion, regulators effectively face a choice between (i) erring on the side of lower access prices and seeking to ensure they remove any potential for monopoly rents and the consequent allocative inefficiencies from the system; or (ii) allowing higher access prices so as to ensure that sufficient incentives for efficient investment are retained, with the consequent productive and dynamic efficiencies such investment engenders.
>
> There are strong economic reasons in many regulated industries to place particular emphasis on ensuring the incentives are maintained for efficient investment and for continued productivity increases. The dynamic and productive efficiency costs associated with distorted investment incentives and with slower growth in productivity are almost always likely to outweigh any allocative efficiency losses associated with above-cost pricing. (sub. 39, p. 16)

For the reasons outlined above, the Commission does not subscribe to the view that, in a regulated environment, the community faces a choice between incurring the allocative efficiency costs of over-compensation and (more serious) dynamic costs of under-compensation. Both types of error are likely to influence investment outcomes and therefore have dynamic efficiency implications.

Nonetheless, the Commission accepts that there is a potential asymmetry in effects:

- Over-compensation may sometimes result in inefficiencies in the timing of new investment in essential infrastructure (with flow-ons to investment in related markets), and occasionally lead to inefficient investment to by-pass parts of a network. However, it will never preclude socially worthwhile investments from proceeding.
- On the other hand, if the truncation of balancing upside profits is expected to be substantial, major investments of considerable benefit to the community could be forgone, again with flow-on effects for investment in related markets.

In the Commission's view, the latter is likely to be a worse outcome. Accordingly, it concurs with the argument that access regulators should be circumspect in their attempts to remove monopoly rents perceived to attach to successful infrastructure projects.

The implications of contestability for investment impacts

The previous discussion might further suggest that the greater the level of monopoly rent expected to attach to a project at the time of construction, the less likely it will be that exposure to imperfect access regulation will have a deterrent effect. That is, there will be potentially some 'fat' for the regulator to appropriate before curbs on returns start biting into balancing upside profits.

There are a number of circumstances in which significant monopoly rents might be expected to attach to a proposed project, rendering it 'infra-marginal'. In particular, as noted earlier, the barriers to entry that incumbency together with a natural monopoly technology create might allow established essential service providers to manipulate the timing of refurbishments and augmentations to their networks.

Conversely, the more marginal a proposed infrastructure project, the greater is the likelihood that the possibility of regulatory truncation of balancing upside profits after the event will deter investment.

In the Commission's view, the 'contestability' of a new investment provides an important guide to its likely marginality. As noted, there will often be situations where it is potentially open to more than one firm or consortia to provide a new piece of infrastructure or extend an existing network. Indeed, as discussed in box 4.2, contestability does not require that there is actually more than one firm competing to build a particular facility. Rather, it simply requires that there are no barriers to entry which would rule out provision by all but one firm, meaning that the threat of competition is present.

The implication of such contestability is that, in the absence of regulation, investment is likely to occur close to the time that expected demand and prices are sufficient to render a project marginally profitable. In this regard, APIA commented that gas transmission is:

> … a competitive environment where the only rent available to the pipeline developer is a return on those of its skills which are not readily available in the market. There is no basis for regulating the provision of such competitively provided services and, provided entry of new investors is not constrained, such regulation will be distortionary. (sub. DR70, p. 11)

Similarly, the Australian Gas Association commented:

> … most network expansion or new pipeline projects can be argued to be contestable at the construction phase. That is, it will be unlikely that given the competitive process for determining the new service provider, that the prices to end-users will contain any element of monopoly rent. (sub. DR84, p. 16)

Some of these projects might turn out to be highly profitable for the firm making the investment. But, as discussed above, the possibility of such high profits would most probably have been necessary to have justified the project proceeding, if there was also a possibility that it would fail.

Thus, the Commission considers that it is those projects which are ex ante contestable — and which therefore have little 'fat' to remove — that are most likely to be permanently deterred by the prospect of regulatory truncation of upside returns. With this in mind, an 'access holiday' mechanism floated by the Commission at the public hearings (see chapter 11) was built around the contestability concept.

The Dwyer and Lim critique

The basic thrust of the preceding conceptual analysis was endorsed or at least not challenged by most participants.

However, Dwyer and Lim (subs. 53 and DR100) argued that the analysis ignores a range of relevant factors — in particular:

- the potential for the exclusive right to use easements to create monopoly rents; and
- the relationship between the price charged for easements or land on which essential infrastructure is sited and the truncation of ex post returns.

As discussed in box 4.3, some of the matters raised by Dwyer and Lim are helpful in embellishing the conceptual analysis presented above. But in the Commission's view, they do not alter the basic conclusions emerging from it:

- Making easements (or any other input) available free of charge will, other things equal, bring forward the time at which a proposed infrastructure project becomes marginally profitable.

  If that project is contestable, and in the absence of access regulation, construction might therefore commence earlier. However, if an access regime is in place which operates to remove all above normal profits after the event if the project is successful, and if there is some possibility that the project will fail, it will still be ex ante unprofitable, notwithstanding the free provision of the easement.
- If the project is not contestable, then the provision of a free easement will increase any monopoly profits potentially on offer to the service provider. Similarly, exclusive access to an easement may help to protect an incumbent service provider from competition and allow it to earn monopoly profits on refurbishment and augmentation of its facilities. As noted, the application of access regulation to infra-marginal investments need not distort, and might even improve, investment decisions.

In effect, the arguments of Dwyer and Lim serve to reinforce two of the key points emerging from the Commission's analysis:

Box 4.3 **The Dwyer and Lim critique**

In their two submissions (no. 53 and DR100), Dwyer and Lim raised a range of criticisms about analyses which suggest that access regulation will discourage investment in essential infrastructure. Some of these criticisms are of a philosophical nature. However, two have a direct bearing on the analysis presented in this chapter.

First, Dwyer and Lim contended that the provision by government of exclusive rights to use easements may allow essential infrastructure providers to earn monopoly rents:

> Where by Crown grant or State action, a utility has privileged rights, such as easements or rights of way over the property of others and any other would-be service provider does not enjoy similar rights, questions naturally arise about lack of equality of access and lack of competition, inevitably raising in turn the questions of monopoly rents being charged to the public. (sub. 53, p. 11)

Second, they raised the issue of the relationship between the price charged for easements or land on which essential infrastructure is sited and the regulated truncation of ex post returns. In effect, their argument was that subsidised access to easements or land helps to offset any regulated truncation of returns and may even justify such truncation:

> 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? If the conditions attached to the franchise rights are onerous, an infrastructure provider is free to offer less for them (and if he has paid nothing to the Crown for them he can hardly be heard to complain). (sub. 53, pp. 11-2)

In this context, Dwyer and Lim drew parallels between access regulation and a resource rent tax:

> Just as a resource rent tax is argued to have no disincentive effects upon investment because physical capital investment is allowed a tax free internal rate of return, so a tax or regulation of infrastructure access which allows a market rate of return on funds employed in the construction of physical infrastructure capital should not deter investment. One can conceive of access regulation as a form of RRT which rebates monopoly rents back to users. (sub. DR100, pp. 7-8)

Taken at face value, these arguments challenge a number of the propositions in the text — and, in particular, the notion that regulatory truncation of returns on successful projects is likely to deter investment. But, on closer examination, they simply serve to augment the analysis, without substantially altering its conclusions.

Consider first the issue of access to free easements (or land). This will reduce costs and, other things equal, bring forward the time at which a project becomes marginally profitable. If that project is contestable, and in the absence of access regulation, construction might therefore commence earlier.

(continued next page)

Box 4.3 **continued**

However, if an access regime operates to remove all above normal profits after the event if the project is successful, *and if there is some possibility that the project will fail*, it will still be ex ante unprofitable, notwithstanding the free provision of the easement. In effect, the access regime would remove all of the benefit to the service provider of the free easement.

Conversely, if the project is non-contestable, then free provision of an easement will increase any monopoly profit expected to attach to it. In these circumstances, and consistent with the Commission's analysis in the text, the application of access regulation to remove genuine monopoly profits need not distort, and might even improve, investment decisions. Intervention may similarly be appropriate where exclusive access to an easement protects an incumbent service provider from competition and allows it to earn monopoly rents on refurbishment or augmentation of its facilities.

In effect, the arguments of Dwyer and Lim serve to reinforce two of the key points emerging from the Commission's analysis:

- The appropriation of genuine monopoly rents via access regulation is not a concern from an investment perspective. Where problems arise is when access regulation extends to removing 'upside' profits that were factored into an investment calculus to balance possible losses under less favourable market scenarios (or that are necessary to cover losses early in the life of a project). This remains the case almost irrespective of policies concerning access to, and the price of, easements and land.
- The contestability of an investment is an important consideration in assessing whether genuine monopoly rents are likely to attach to that investment and therefore whether the application of access regulation is warranted.

Dwyer and Lim also raised concerns that the potential to earn monopoly rents on the provision of essential infrastructure services could lead to wasteful investment 'races' (see box 4.2). More broadly, they further suggested that the capital costs of essential infrastructure should be at least partly funded by taxing the increases in adjacent land values that sometimes result from new developments.

This wider 'beneficiary pays' approach has some conceptual validity and, in particular circumstances, has been used to fund or contribute to the cost of new infrastructure developments. However, practical considerations have often limited the scope for its application. For example, estimating increases in land values attributable to a new infrastructure project can be difficult. Moreover, there is the perennial question of how widely the beneficiary pays concept should extend.

- The appropriation of genuine monopoly rents via access regulation is not a concern from an investment perspective. Where problems arise is when access regulation extends to removing above normal profits that were factored into an investment calculus to balance possible losses under less favourable market scenarios (or that are necessary to cover losses early in the life of a project).

- The contestability of an investment is an important consideration in assessing whether genuine monopoly rents are likely to attach to that investment and therefore whether the application of access regulation is warranted.

Investment in related markets

Various user interests stressed that, in examining the impact of access regulation on investment, it is important to take account of investment encouraged in upstream and downstream markets. At a general level, Dwyer and Lim commented that:

> If the price of attracting capital into infrastructure investment is the destruction of profitability and investment in downstream or upstream industries, the price is too high … It is precisely by removing monopoly rents that good regulation promotes upstream and downstream investment. (sub. DR100, p. 5)

More specifically, BHP Billiton (sub. 48, p. 61) said that improved access arrangements following the implementation of the Gas Code had been accompanied by increased investment in gas production. While noting that it would be premature to draw firm conclusions given the short period of the Code's operation, it provided data showing that the number of upstream concessions held in Victoria by companies other than BHP Billiton or ExxonMobil increased 'over a period when oil prices were flat or declining'. It went on to say that there has also been increased activity on a number of potential gas field developments in or adjacent to Victoria.

Equally, however, there were contentions that access regulation might sometimes reduce rather than increase investment in a related market. For example, Tap Oil — a gas producer and pipeline owner — commented on the implications for upstream investment of open access to its pipeline:

> Open access in the current format, means that the certainty of the available capacity in our pipeline is removed. There will be considerably less incentive to explore for new gas or develop smaller approximate discoveries.
>
> … There is effectively no risk for third parties once infrastructure is constructed. The consequence is that economically marginal projects will be underwritten by infrastructure holders at the expense of finding and developing approximate resources. (sub. DR59, p. 3)

More generally, whether or not any increased investment in related markets is desirable from the community's point of view will depend on the efficacy of the regulated access price and conditions. Consider, for example, a situation where access to the services of a vertically integrated provider is encouraged by an artificially low access price. This could lead to investment by other businesses to deliver the downstream service, even though they are less efficient at doing so than the access provider.

This highlights the important point that increased investment in related markets based on inappropriate access prices and conditions will be a *cost* of access regulation not a benefit. It also serves to reinforce the notion that competition is a means to an end (or ends), not an end in itself. While promoting competition will usually enhance living standards, it will not always do so.

4.4 Incentives for strategic behaviour

Access regulation may create incentives for socially inefficient 'strategic' behaviour by both access providers and seekers. Examples of such incentives for access providers have already been noted:

- Where the underlying access pricing rules are cost-based, providers will have an incentive to pad their reported costs and to shift costs on to services subject to the access regime.
- Given that mandated access is normally subject to capacity being available, there may be an incentive for service providers to build smaller than optimal facilities.

Energex (sub. 14) and the Australian Gas Association (sub. 29), amongst others, also commented on the perverse incentives that can accompany periodic access price 'resets'. In relation to the Gas Code, the Association observed:

> … in the period immediately leading up to a review of an Access Arrangement, a Service Provider has a perverse (in terms of efficiency outcomes) incentive to delay the introduction of an efficiency until the beginning of the next period of the Access Arrangement. This is because the delay would allow the Service Provider to retain at least part of the efficiency gain through increased profits over the next period of the Access Arrangement. (sub. 29, p. 18)

For their part, access seekers can use the threat of involving the regulator as a bargaining chip when negotiating with the service provider. For example, Specialised Container Transport indicated that it had sought declaration of the Kalgoorlie to Perth railway line to encourage the Western Australian Government to negotiate 'fairly' (transcript, p. 353). While such negotiation may often lead to efficient outcomes, on occasion there may be incentives for the service provider to agree to 'inefficient' terms and conditions of access so as to avoid the costs of regulatory intervention. In a similar vein, the ACCC said that under the access regime for telecommunications:

> Where the access seeker has limited access to information from the service provider the access seeker may seek arbitration in an attempt to identify the parameters likely to be used by the regulator. (sub. 25, p. 75)

It went on to note that this has been a factor contributing to reliance on arbitrated outcomes rather than ‘meaningful’ negotiations under the regime.

Further, upstream or downstream firms might seek to use access regulation to help preserve market power that they enjoy. One example relates to the previously noted issue of investment in inter-connectors to link individual transmission networks to the national electricity market. Such interconnections can greatly reduce the market power enjoyed by regional generators. According to TransGrid, attempts to facilitate such investment have been hindered by:

> The ability of upstream and downstream market participants to influence the investment and pricing arrangements under the [National Electricity Code] with the objective of minimising competition in their markets. It was not surprising to find owners of generation facilities in Victoria and South Australia using the National Electricity Market Code change process to reduce the scope for regulated investment in [cross-border] transmission infrastructure. (sub. 17, p. 2)

In a similar vein, APIA (transcript, p. 173) implied that low tariffs which discourage investment in new gas transmission facilities might be in the interests of some incumbent gas producers.

Some have also argued that access regulation can encourage facility owners and access seekers to collude to preserve monopoly rents. However, in the Commission’s view, this is a consideration in judging the effectiveness of access regulation relative to other instruments available to address access problems (see chapter 5), rather than a cost of access regulation as such. That is, collusion involves the preservation of monopoly outcomes arising in the unregulated market, rather than the introduction of a new cost.

4.5 Regulatory failure

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. The scope for such failure was a theme running through a number of submissions. Synthesising these views, Energex stated:

> Typical behaviours identified by the Regulated Business Forum include inconsistency, subjective judgements, cherry picking methodologies, use of false benchmarks and

asymmetrical approaches that cannot be consistently maintained into the future … All such behaviours raise regulatory risk. (sub. 14, pp. 34-5)

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. As examples earlier in the chapter illustrate, such failure may be manifest in a variety of ways, including insufficient incentives for new investment or reduced incentives for cost-efficient service provision.

A number of participants emphasised that the information required for effective intervention can be particularly daunting if access prices are based on the 'efficient' cost of supply. The NECG commented that:

> … it is highly unlikely that regulators will have access to sufficient sources of information to be able to accurately determine the social costs associated with the supply of the facility at issue. Cost estimation is a formidable problem for regulators, even when the actual costs of the regulated firm are the focus. It is significantly more difficult to accurately estimate the capital costs of a hypothetical, efficiently configured, asset. In either case, crucial cost determinants include the amount of economic depreciation to be allowed and the weighted average cost of capital, neither of which can be reliably estimated without reference to demand for the regulated firm's services. (sub. 39, p. 17)

The problems of dealing with hypothetical situations are even more pronounced in relation to assessments of the likely effects of particular access determinations on future investment decisions.

The difficulties confronting regulators are further magnified by the rapid technological change occurring in some infrastructure sectors. In telecommunications, for example, the emergence of new delivery platforms, each able to provide a range of services, is blurring past distinctions between markets. Such 'convergence' makes it more difficult to apply regulation at the individual market or service level.

Some participants also pointed to problems that can arise from the difficulty of determining what is genuinely a 'bottleneck' facility (see box 3.2). They argued that inappropriate extension of access regulation to non-bottleneck facilities can have irreversible and costly impacts. For instance, the Institute of Public Affairs (sub. 18, p. 3) commented that, in these circumstances, constraints on prices and/or returns will make it more difficult for potential rivals to enter the market. It went on to say that as a result, regulators' decisions 'tend to prevent competition, the very process they were created to enhance.'

Finally, there is a risk that regulators may be subject to capture in ways inimical to the public interest. A number of submissions pointed to the problem of political interference in access and other regulation impinging on the price of infrastructure services. This was a particular theme in a submission from the NECG. It argued that political reactions will often compound the costs associated with regulatory inefficiencies:

> Both in Australia and the UK, a marked tendency has developed for governments to respond to the service inadequacies that price distortions create not by dealing with those distortions directly but rather by seeking to compel investment and service performance. This adds to the direct economic costs of distorted prices … Moreover, it is plainly only a short-term 'fix' as the failure to address the underlying issues means that the core problems have not been resolved. (sub. 39, p. 20)

The NECG also noted that, in a political context, price reductions are always attractive and apparently consistent with the public interest, and can thereby give legitimacy to regulatory processes and institutions.

Some submissions alluded to problems of 'capture' by access regulators. In broad terms, such capture could take a number of forms. For example, regulators may be reluctant to admit errors in previous decisions (capture by precedent). Also, particularly if significant administrative discretion is involved in the application of a regulation, there may be a tendency for regulators to bring their own values and predilections to the decision making process. As noted previously, a number of participants considered that access regulators in Australia have focussed too heavily on the short-term interests of consumers. In relation to the Gas Code, the Australian Pipeline Industry Association commented:

> Given that Part IIIA does not currently have specifically outlined objectives regulators have considerable scope to exercise discretion under regulatory regimes based on Part IIIA. Understandably, given the primary role of regulators as 'consumer advocates' they have applied this discretion with the primary objective of ensuring lower reference tariff prices for consumers, with little — if any — regard to the implications of their actions on the long term development needs for energy infrastructure such as gas transmission pipelines. (sub. 32 p. 2)

Of course, the exercise of such discretion can equally work in the opposite direction — a point noted by a number of user interests. BHP Billiton, for example, raised concerns about IPART's 'flexible' definitions of cross subsidies when setting gas tariffs. It said that this flexibility had led to a $400 million transfer from gas consumers in New South Wales to AGLGN, and went on to ask:

> Are independent State Regulators protecting State interests? Is this consistent with a national competition framework? (sub. 48, p. 72)

4.6 Setting the costs against the benefits

The preceding discussion highlights the many uncertainties that surround access regulation:

- While potential problems arising from monopoly power in the delivery of essential infrastructure services are easy to identify, their actual extent and significance are less clear. This is particularly the case given the range of other reforms to the infrastructure sectors that have increased the competitive pressures on service providers.
- Similarly, while the potential costs of access regulation have been extensively canvassed, evidence of significant costs that can be unequivocally attributed to that regulation is quite limited.
- The benefit-cost trade-off will depend crucially on the purview of an access regime and its detailed requirements. It will also depend on the competence and behaviour of the regulators as well as the parties to access disputes.

Given such uncertainty, the option of no access regulation cannot be dismissed completely. At the very least, as the Hilmer Committee emphasised, there is a need for policy makers to tread very carefully in this area.

That said, the Commission considers that some critics of access regulation have tended to overstate its potential costs relative to the costs that could arise in an unregulated environment. Some of the critics' proffered solutions to shortcomings in current access regimes could be equally difficult to implement and just as problematic in their impact. Also, the perception conveyed in some submissions that access regulators are naive entities with no conception of market realities is itself unrealistic. As the submissions from the key regulators show, they are well aware of the problems in the provisions they are charged with administering.

Further, Australia's experience with access regulation is still limited, and has occurred at a time of considerable change to the nature of service delivery in many of the infrastructure sectors. As the Australian Chamber of Commerce and Industry commented:

> The fact that the National Access Regime remains in its infancy makes it more difficult to assess its effectiveness to date. Furthermore, in addition to its limited history a number of the regime's key concepts have yet to be fully exercised and many of Australia's infrastructure industries are still undergoing significant structural change. (sub. DR67, p. 11)

At this juncture, it is difficult to judge the precise extent to which these structural changes, once fully operational, will reduce the need for access regulation.

FINDING 4.1

Given the in principle case for some curbs on the exercise of monopoly power in the provision of essential infrastructure services, the limited experience in Australia with access regimes, and ongoing structural change in a number of infrastructure sectors, abandoning access regulation at this stage would be inappropriate.

This is *not,* however, an endorsement of the status quo:

- It leaves open the question of what emphasis should be placed on access regulation relative to other relevant policy instruments.
- It also begs the questions of whether access regulation should be generic or industry-specific, and how such regulation should be configured to maximise the net benefit to the community.

In the latter context, the discussion in this chapter points to two factors that are likely to contribute to efficient regulatory outcomes.

First, given the potentially large costs of inappropriate or poorly-applied intervention to facilitate access, the use of access regulation should be confined to situations where *significant* monopoly power is likely to be present. If regulation is applied in more ‘marginal’ cases, there is a high probability that the costs of intervention will outweigh the benefits.

Second, when intervention occurs, it is important that regulators are not overly ambitious in their attempts to remove monopoly rent. Contrary to the suggestions of some participants, this does not mean endorsement for unfettered monopoly behaviour by service providers. Rather, it means that access regulation must recognise the potential costs of a ‘surgical’ approach to rent removal and encourage regulators to focus on the more modest objective of reducing demonstrably large rents resulting from inefficient pricing or denial of access.

These two considerations underpin a number of the Commission’s key proposals for change to the national access regime in subsequent chapters of the report.

5 Access regulation in the broader policy context

Access regimes are only one of several instruments for addressing monopoly power in the delivery of essential infrastructure services. As the Bunbury Port Authority observed:

> … while access is a possibility, it is by no means the sole method of increasing competition and economic efficiency. (sub. 4, p. 1)

Others possible instruments include:

- franchising service provision;
- competitive selling of facility capacity through an auction;
- structural separation of vertically integrated (public) providers;
- general laws against anti-competitive conduct; and
- ‘conventional’ prices control or prices oversight.

The availability of these other instruments could have an important bearing on the scope and nature of access regulation. Accordingly, the first part of this chapter examines their potential contribution to achieving effective access outcomes, and their strengths and weaknesses relative to formal access regulation. Such an assessment is in keeping with the requirement in the terms of reference for the Commission to consider alternative ways of addressing the objectives of access regulation.

Ideally, such an assessment would also consider modifications to these alternative instruments that might allow them to better address access issues. As the submission from the Institute of Public Affairs, on behalf of United Energy, Citipower and TXU Networks, responding to the Commission’s Position Paper emphasised:

> The adoption of a [status quo] 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. (sub. DR61, p. 36)

However, a thorough exploration of this sort would go well beyond the purview of this inquiry. For example, any examination of possible modifications to the general laws against anti-competitive conduct to better address access problems, would need to have regard to the ramifications for a whole range of other economic transactions. Hence, the Commission has focussed its attention on whether the broad thrust of these alternative instruments makes them suitable for addressing access to essential infrastructure.

In ‘optimising’ the policy package for dealing with access issues, there is also the issue of what broad form access regulation should take. Such regulation could be limited to a single generic regime applicable to any infrastructure service meeting the relevant criteria. Alternatively, it could involve reliance solely on industry regimes, each tailored to the circumstances of particular sectors. In between, there is the current approach that provides for both generic regulation and industry regimes. The last part of this chapter addresses the merits of these different approaches.

5.1 Comparing policy instruments

A number of the instruments for addressing access issues can be complementary. For example:

- industry access regimes for a number of infrastructure services mesh with price controls in retail markets;
- general laws against anti-competitive conduct in the Trade Practices Act still apply to access arrangements, notwithstanding the existence of Part IIIA and the various industry access regimes; and
- structural separation of integrated service providers may make the job of access regulators easier (see below).

However, for ease of exposition, it is useful to look at the various instruments on a stand-alone basis.

Further, the discussion that follows focuses on a sub-set of the possible alternatives to access regulation listed above, namely: structural separation; general laws against anti-competitive conduct; and ‘conventional’ price controls. This narrower focus reflects the Commission’s judgement that franchising of service provision and the auctioning of capacity in essential facilities are not generally applicable mechanisms for curbing any monopoly power attaching to such facilities (see box 5.1 and chapter 11).

Box 5.1 **Franchising service delivery and auctioning of access capacity**

Franchising service delivery and the competitive selling of capacity in essential infrastructure facilities through an auction process are types of competitive tender. The former involves a tender for the right to deliver an essential infrastructure service, while the latter is a tender for the right to use the services of an essential facility. Both rely on competition between potential bidders to promote efficient outcomes.

These instruments may be useful in helping to promote cost-efficient delivery of essential infrastructure services or efficient use of those services:

- Franchising has been used in Australia and overseas to reduce system operation and management costs in the provision of urban water and sewerage services.
- Auctioning might be a useful device for allocating access to a facility — either existing or prospective — to those users who value it most highly, without any need for regulatory involvement in price setting.

The Australian Competition and Consumer Commission (ACCC) highlighted a particular role for capacity auctioning in relation to prospective facilities where demand is uncertain, noting in this context that provision for tendering is made in the National Gas Code. It said that:

> This aspect of the Code is well suited to new greenfields projects where demand and returns are uncertain and difficult to assess in the standard framework applied to established pipelines. In such circumstances the returns available to the developer are determined by the tender process and are not subject to regulatory review except as provided for within the known terms of the tender. (sub. 25, p. 65)

Indeed, the Office of the Regulator-General, Victoria (sub. DR112, p. 8) noted that these provisions were employed for the PNG gas pipeline and Victorian country town gas distribution. The National Competition Council (NCC, sub. 43, pp. 120-1) and Professor King (sub. 1, p. 30) also saw a useful role for auctioning in these sorts of circumstances. For its part, the Commission observes that tenders for prospective facilities might deliver similar outcomes to the 'foundation contract' approach (see chapter 4) which is widely used in the gas industry to underpin new pipeline investments.

However, as vehicles for tackling monopoly power attaching to essential facilities, both instruments have significant limitations.

Auctioning is only likely to reduce access prices if it forces an access provider to make available any spare capacity in a facility. (That is, it is the scope for the provider to restrict supply which drives up access prices and gives rise to the possibility of above normal profits.) But in these circumstances, the requirement to make available the extra capacity, rather than auctioning per se, would be driving this outcome.

(continued next page)

Box 5.1 **continued**

Similarly, if a franchise contract provided only for the operation of a facility, the facility owner could still have scope to charge a monopoly price for its use. As the NCC observed, in these circumstances:

> The contracting arrangements might simply transfer the rent-seeking opportunities derivable from the market power to the person conducting the auction. (transcript, p. 491)

In contrast, as noted by Dwyer and Lim (sub. 53), the Energy Users Association of Australia (sub. DR94) and the Network Economics Consulting Group (NECG, sub. DR113) among others, if a contract were to make provision for the construction of an essential facility as well as its operation, it could well be effective in eliminating any monopoly profits attaching to the facility. In effect, such contracts would be a form of the Build-Own-Operate-(Transfer) approach that is being used increasingly to provide new road and social infrastructure such as hospitals.

However, most of the infrastructure so far delivered in this fashion has not been commercially viable and would not therefore have been provided without public involvement and support. As discussed in chapter 11, the benefits of extending this sort of approach to commercially viable projects would be far more problematic. In particular, a bidding process sponsored and controlled by government could have significant implications for the project proponent's intellectual property rights. Accordingly, as a number of participants noted, widespread application of such an approach could harm incentives for innovation. In this regard, Epic Energy remarked:

> If you relied on competitive tendering, the germ of the idea that came out of Epic, and then by working with Phillips, which led to the Timor Sea project, would never have happened. (transcript, p. 442)

That said, as discussed in chapter 11, in some limited circumstances, franchise contracts may be the instrument of choice in promoting efficient access provision and pricing.

The Commission also notes that its sub-set of alternatives to access regulation does not include an approach akin to a resources rent tax, whereby a 'regulatory levy' would apply to any above normal profits earned by a service provider once a project had repaid its cost of capital (as agreed in advance between the provider and the regulator). A number of participants advocated such an approach as part of an access holiday arrangement (see chapter 11).

5.2 Structural separation

Structural separation to address the essential services 'problem' was strongly advocated by the Hilmer Committee:

> … the preferred response to the concern is usually to ensure that natural monopoly elements are fully separated from potentially competitive elements through appropriate structural reforms. (1993, p. 241)

Underlying the Committee's approach was the presumption that a non-integrated provider will have no incentive to deny access to firms operating in downstream (or upstream) markets. Accordingly, the Committee saw structural separation as the key to preventing market foreclosure.

However, as discussed in section 3.2, providers that have been structurally separated can still have incentives to restrict access to their services. Such incentives will exist when, among other things, integrated provision:

- allows for more efficient capture of any monopoly profits from users of the final service;
- reduces the overall cost of service provision; or
- gives greater scope to implement efficient pricing structures (see box 5.2).

In any event, as the Hilmer Committee acknowledged, a non-integrated provider may still have scope to exercise market power when setting terms and conditions for access — even if access is offered to all those seeking it. In these cases, the outcomes for users of the final service may be no less detrimental than those ensuing from the denial of access by an integrated provider (see box 3.3). While the Hilmer Committee argued that monopoly pricing by a non-integrated provider could be addressed through prices oversight or control, the use of different instruments to tackle the same problem would create a number of problems (see chapter 6).

The limitations of structural separation as a means of curbing monopoly power, in many respects, reflect the fact that the approach targets what Tirole (1988, p. 181) has called a by-product of that power:

> … vertical integration or vertical restraints need not be detrimental to welfare even where they are meant to increase monopoly profit. In such circumstances, the issue is the existence of monopoly power per se, not its by-products (vertical integration or vertical restraints).

That said, structural separation may often be a useful adjunct to access regulation. While there may be incentives for some separated providers to reintegrate through explicit or implicit contracts, maintaining such arrangements is likely to be difficult. Such contracts might also breach more general anti-competitive conduct rules. If the costs of pursuing collusive arrangements exceed the benefits, the separated provider will have an incentive to offer open access. In these circumstances, access regulation can focus primarily on addressing any monopoly pricing, rather than having to concern itself with outright denial of access.

Box 5.2 Possible advantages of integrated provision of essential services

Compared with vertically separate provision, integration into related markets may offer a number of advantages to the provider of an essential service. Where legislated structural separation has occurred, these advantages may provide an incentive for contractual re-integration.

Integrated provision and denial of access may give the provider greater scope to capture monopoly profits from users of the final service. King (sub. 1, pp. 3-4) outlines a range of factors that could reduce the provider's profits if it attempted to exercise market power simply by increasing the price of the essential input to downstream (and upstream) firms.

For a number of reasons, integrated provision may be more efficient:

- Fixed administrative and marketing costs can be spread across wholesale and retail outputs.
- Wasteful duplication of effort can be reduced.
- The risks for investors associated with ownership of a single set of assets in a production chain — a form of 'network risk' — are removed.
- There may be cost savings from overcoming information imbalances that can make contracting and contract enforcement difficult under separated provision.

In its submission for Freight Australia, the Law and Economics Consulting Group discussed these potential cost savings in greater detail (sub. 19, pp. 16-7).

Integrated provision may also lead to more efficient pricing of the final service. In particular, it may eliminate the so-called 'double marginalisation' problem that can arise when a non-integrated provider supplies services for use in a downstream market which is also less than fully competitive. The Law and Economics Consulting Group explained the phenomenon as follows:

> Double marginalisation occurs when the upstream monopolist makes a profit by charging a price above marginal cost. Since the downstream firm does not take into account the profits made by the upstream firm in its consumption decision, its perceived marginal input cost is the price charged by the upstream firm, which is higher than the 'true' marginal cost of the input. At the perceived higher marginal cost, the downstream firm tends to consume too little of the input, and as a result, the aggregate profit for the two firms is lower than for a vertically integrated activity. (sub. 19, p. 17)

Eliminating double marginalisation will therefore increase output of the final service as well as monopoly profit — an unambiguous welfare gain.

Indeed, this notion was reflected in specific regulatory proposals put forward by some participants. For example:

- The Australian Rail Track Corporation (sub. DR64, pp. 4-5) and the New South Wales Government (sub. DR109, p. 10) suggested that different access arrangements should apply to integrated and non-integrated entities.
- Similarly, the Australian Pipeline Industry Association (APIA) proposed that:

  … the nature of [an access regime's] declaration and coverage tests should give explicit recognition to the degree of structural separation as a factor in determining whether declaration or coverage is necessary. (sub. DR70, p. 13)

Moreover, structural separation ostensibly removes the capacity for 'strategic' cost shifting between the input and final markets and may thereby further reduce the complexity of the task facing regulators. Commenting on the difficulties of applying access regulation to integrated entities, the Australian Rail Track Corporation said:

> It is extremely difficult for a regulator to monitor and/or appropriately remedy the more inconspicuous behaviours which could occur, and for which the owner has a commercial incentive to carry out. Such behaviours may include the use of creative accounting techniques to disguise cross subsidisation of activities, information 'leaks', day-to-day resolution of operational conflicts and strategic investment (or lack thereof) in contestable parts of the network. Such behaviours are difficult to detect, and only surface via a market outcome after the commercial damage, which can be significant, has been done. (sub. 28, p. 4)

For these sorts of reasons, in a paper prepared for BHP Billiton, National Economic Research Associates (NERA, 2000a) argued that structural reforms to Australian Gas Light Gas Networks (AGLGN) — or rigorous accounting separation (see below) — are necessary for more efficient provision of gas services in New South Wales.

The structural separation (and privatisation) of many public infrastructure providers over the last decade or so may also have been important in creating an environment in which access regulation can operate meaningfully. That is, given the previously entrenched market positions of the integrated public providers, it is debatable whether access regulation alone would have encouraged significant interest in entry into contestable market segments. As Professor Parry (2000) has observed:

> Access is critical to the emergence of competition in the 'de-monopolised' utilities, but the emergence of competitors and competition at the wholesale (commodity) and retail (supply) level is essential. As long as there are clear and enforceable third-party access rights, the precise nature of the access arrangements is arguably far less important than the nature of the structural changes underpinning competition. (p. 138)

Accounting separation

A related policy approach is accounting separation of the wholesale (facility owning) and retail arms of the integrated entity, though the entity remains intact. Accounting separation is usually accompanied by a requirement that the entity's wholesale arm deal with its retail arm and other competitors on a non-discriminatory basis as far as access is concerned.

Accounting separation has some potential advantages. For example, it may help to preserve some of the efficiencies attaching to integration, while still increasing the incentives for the wholesale arm to provide open access. Indeed, Energex saw it as little different from full structural separation:

> It is our view that ring-fencing arrangements today are so effective that they are equivalent to full separation, and any claims to the contrary should be scrutinised very carefully. (sub. 14, p. 26)

As a hybrid measure, however, accounting separation will not completely remove the scope for the entity to use access as a means to disadvantage rivals in the downstream market. Thus, in relation to the current ring-fencing of Western Power's transmission and distribution operations, the Chamber of Commerce and Industry Western Australia (CCIWA) commented:

> Many businesses are sceptical about whether ring-fencing can ever be truly effective, an important consideration when Western Power needs not only to deal fairly with potential competitors in fact, but also needs to be seen to be doing so. (sub. 12, p. 7)

(At the public hearings, CCIWA (transcript, p. 412) noted that the incoming Western Australian Government has signalled its intention to separate structurally Western Power's generation and transmission businesses.)

More specifically, even with accounting separation, it may be hard for the regulator to determine whether the quality of service provided to rivals in the downstream market is as good as that available to the entity's retail arm. Incentives may also be created for shifting costs from the entity's retail arm to its wholesale arm.

In essence, there remains an underlying tension between the pro-competitive objective of accounting separation and the responsibility for managers of the still integrated business to maximise returns to shareholders. Hence, Tap Oil argued that it is 'naive to think that if you transfer an asset out of one entity into another with the same owners that you're going to have any different investment decisions, any different strategies.' (transcript, p. 447)

Nonetheless, accounting separation might possibly lead to more transparent access terms and conditions. In turn, this might help to facilitate the negotiation process, as well as making the job of the access regulator somewhat easier. Clearly, effective scrutiny of ring fencing arrangements will be crucial in this regard. As NERA (2000a, p. 14) commented in relation to AGLGN's operations in the New South Wales gas industry:

> Effective ring fencing cannot be enforced without meticulous accounting and reporting requirements and vigorous, active scrutiny of affiliated transactions and the use of common staff and facilities. There is no short cut.

5.3 Price control

The emphasis on structural separation in the Hilmer Committee report appears to reflect a desire to avoid, wherever possible, 'conventional' price controls. Reflecting a widely held view, the Committee saw explicit setting of access prices by a regulator as being intrusive and 'heavy handed':

> Regulated solutions can never be as dynamic as market competition, and poorly designed or overly intrusive approaches can reduce incentives for investment and efforts to improve productivity. There are costs involved in administering and complying with pricing policies. Finally, from a government's perspective, resort to price control might be seen as an easy and popular way of dealing with what is in reality a more fundamental problem of lack of competition in the area. Since price control never solves the underlying problem it should be seen as a 'last resort'. (1993, p. 271)

Conceptually, however, there are significant overlaps between access regimes and conventional price controls. While access regimes focus in the first instance on the denial of access, as discussed in chapter 3, the concern is often with access prices (and conditions) that unjustifiably make it uneconomic for the access seeker to operate in a related market. Thus, as noted, in some cases, denial of access and monopoly pricing of access can have virtually identical effects on the price and output of the final service.

Moreover, the 'bite' in most access regulation comes from the power of a regulator to determine prices and conditions if the service provider and access seeker are unable to agree to terms. As the NCC commented in its submission:

> … it is questionable whether any purpose would be served by an access regime that simply defined an obligation to supply, without also providing a means for determining the terms and conditions of that supply. Any such regime would simply invite evasion, as the obligation could be undermined through the setting of terms that made access unprofitable or ineffectual. (sub. 43, p. 21).

Not surprisingly, therefore, the access arrangements that ensued from the Hilmer Committee's report have involved a considerable element of price regulation:

- Some of the industry regimes operating under the Part IIIA umbrella provide for the regulated setting of prices for the essential input and/or the final services concerned. Also, price oversight applies to a range of services provided at major airports.
- Other industry regimes condition the negotiate-arbitrate process through reference tariff arrangements.

It is also important to recognise that, over (a possibly long period of) time, the practical differences between access regimes based on a negotiate-arbitrate approach and conventional price controls are likely to diminish. That is, as the stance of the arbitrator on appropriate access prices and conditions becomes evident, it should increasingly influence private negotiations between access providers and seekers. Similarly, under an approach which relied on general competitive conduct rules to combat the denial or monopoly pricing of access, determinations made by the courts could also have a conditioning effect on the negotiation process.

The Commission notes that a number of participants questioned the strength of this conditioning effect — citing confidentiality of arbitrated outcomes, the difficulty of extrapolating particular determinations to other areas and uncertainty associated with changes in regulatory personnel as constraints on convergence in outcomes under the different instruments (see box 5.3).

Box 5.3 **Constraints on convergence between access regulation and conventional price controls**

At the roundtables, a number of participants suggested that several factors will limit convergence between negotiate-arbitrate access regulation and conventional price controls:

Confidentiality. The details of access determinations under industry regimes have usually been kept confidential. One participant at the Sydney roundtable commented, for example, that information emerging about even the basis for ACCC determinations under the telecommunications access regime has been limited.

Difficulty of extrapolating decisions to other areas: Several participants argued that, as each access determination is different, it is difficult to judge what a decision for one service or access dispute might mean for another service or dispute.

Regulatory personalities: There were also suggestions that regulated outcomes cannot be divorced from the regulatory personalities involved. One roundtable participant said that the extent to which a regulator is bound by previous decisions is not great and, when there is a change in personnel, uncertainty increases and the precedential value of earlier decisions declines. Another participant commented that, notwithstanding the existence of 'rules', predicting regulators' behaviour is fraught with risk.

Equally, however, the view among many of those same participants that Australian access regulators have often been overly generous to access seekers (see chapter 4) is itself an example of 'regulatory conditioning'. Significantly, the Law Council was in little doubt about the strength of the conditioning effect, stating that:

> … the analysis of the normal negotiations of pre-trial settlements also applies to settlements that are negotiated under Part IIIA. That is, once clear rules are established by the ultimate arbitrator, the parties will always settle on outcomes that are reasonably close to the rules of the arbitrator. (sub. 37, p. 20)

Of course, comparisons between instruments must also have regard to non-price factors. Notably, an 'obligation to supply' under a mandated access arrangement or a court order providing for access distinguishes these two instruments from conventional price controls (see below).

Nonetheless, the preceding observations indicate that there will be significant commonalities in negotiate-arbitrate access regulation, conventional price controls and oversight arrangements, and court-based approaches. Thus, in discussing the relative merits of price monitoring regimes and access regulation, the Institute of Public Affairs observed that while the latter may be intrinsically more intrusive:

> The end product may be that they're both pretty much the same, and that occurs with a lot of regulation. (transcript, p. 56)

More generally, the discussion suggests that the key policy choice is not one of price control versus other less intrusive forms of regulation. Rather, it is in many — though not all — respects one of determining the best instrument for *regulating* access prices and conditions in any particular circumstance. In this vein, BHP Billiton argued that:

> … the debate should move on from 'heavy handed' versus 'light handed. It should focus on 'Effective Regulations'. … Emotive labelling of regulation is adding no substance to the debate of whether regulation is delivering the desired policy outcomes. (sub. 48, p. 67)

The framework for analysis outlined above is also useful in 'netting out' factors and outcomes that are likely to be broadly common across the various regulatory instruments. For example, the complex task of setting prices for infrastructure services is often cited as an argument against price control. However, from the preceding discussion it is clear that such difficulties are unlikely to be avoided by relying on negotiate-arbitrate regimes or court-based solutions. As Forsyth (2001, p. 9) argued in his submission to the Commission's inquiry into Price Regulation of Airport Services:

> The real difficulty is … that all of the problems which are encountered with regulation of the final price are also encountered with access regulation.

Similarly, to the extent that each of these instruments lowers the returns that facility owners can expect to earn, all will affect incentives to invest in essential infrastructure.

Negotiate-arbitrate regimes versus conventional price controls

'Conventional' price controls can take various forms, including 'CPI minus X' price or revenue caps applying to baskets of items, or controls on the price of individual services. They can apply either at the intermediate or the final service level. And they can be related directly to production costs or, alternatively, linked to some sort of productivity benchmark.

In an access context, one difference between conventional price controls and negotiate-arbitrate regimes is that price controls provide less scope for service providers and access seekers to negotiate a price for access. Indeed, where the price of an individual essential service is regulated, all scope for negotiation on price (as distinct from conditions) is removed.

More importantly, conventional price controls place no onus on the service provider to deal with an access seeker. This is obviously crucial where denial of access, as distinct from monopoly pricing of access, is the issue. That is, in the absence of some sort of obligation to supply, the service provider could simply refuse to deal with some or all access seekers at the regulated price, and thereby effectively circumvent the price control.

It is important to recognise that access regulation is not totally immune from these sorts of problems — service providers may still have capacity to frustrate access through technical barriers and the like (see box 5.4).

But such capacity is likely to be markedly less than under a conventional price control. Accordingly, some sort of access rule or obligation to supply will almost always be required to complement a conventional price control.

In theory, the use of dual instruments might offer the prospect of more efficient outcomes in certain circumstances. For example, the opportunity to employ global price or revenue caps in final markets, as distinct from simply controlling the price of the essential input, could give more 'degrees of pricing freedom' to an integrated service provider.

Box 5.4 **Non-price barriers to access provision**

A number of participants commented on the scope for service providers to use non-price barriers to frustrate the intent of access regulation. For example, BHP Billiton referred to a number of these barriers that it has encountered in seeking to negotiate access to gas pipelines, including:

- priority of transportation for existing contracts; and
- 'unduly restrictive' gas specification.

It went on to argue that:

> … while access regulation is focussed on the price of access, it is essential that other terms of access are also considered. It is necessary for the regulator to have sufficient expertise in the gas industry to differentiate between genuine technical issues, and technical issues that are being used as a disguise for barriers to access. (sub. 48, p. 79)

The arrangements for allocating capacity in an essential facility might also be used to frustrate access. Capacity allocation issues appear to be particularly relevant in the rail sector. In this regard, the New South Wales Minerals Council stated:

> In rail, difficulties can arise where a customer has a right to access under an access regime or agreement, but access to a particular timetabled trainpath may not be available. … In the Hunter Valley, in practice coal traffic has the lowest priority of all traffic, even on lines where it pays all fixed costs and non-coal traffic pays only variable costs. (sub. 22, p. 6).

As discussed in chapter 4, limitation of the size of new gas pipelines to preclude the possibility of access has also been mooted.

That said, such problems are likely to be less significant than those that might arise were essential service providers simply subject to price controls with no requirement for them to deal with each access seeker. As the Board of Airline Representatives of Australia argued in the context of airports:

> Price regulation does not deliver access. For example, if an airport does not wish to address congestion issues (and prefers a 'quiet life'), or alternatively is denying access to obtain a collateral benefit, price regulation will not further encourage or require the airport to provide access.
>
> Secondly, price regulation does not often address the non-price terms and conditions on which access is provided. Price regulation cannot impose contractual non-price terms and conditions between the airport and users of airport services. This is an inherent weakness in price regulation. (sub. 49, p. 5)

The Commission's views on the impacts and limitations of price controls in an airports setting are set out in the draft report for its inquiry into Price Regulation of Airport Services (PC 2001a).

However, previous experience with retail price controls suggests that, in practice, the likelihood of such gains is questionable. In this regard, the NCC argued:

> The Australian experience with price control … [highlights that] the control of utility prices to final consumers is inherently a highly politicised process, which is rarely likely to lead to outcomes consistent with efficiency principles.
>
> Additionally, the approach seems to seriously under-estimate the difficulties inherent in going from a given final price, even if efficiently set, to the determination of appropriate charges for the supply of the intermediate inputs (such as access). (sub. 43, p. 26)

More generally, there are likely to be advantages in using one rather than two legislative instruments. As the NCC stated:

> … it seems desirable to bring together, within a single legislative framework, the determination of the obligation to supply and of the terms and conditions of that obligation. This ensures that the obligation has some substance; and by defining the broad parameters of the manner in which terms and conditions will be set, the framework also makes it possible to assess the impact that imposing the obligation will have on competition and on efficiency more generally. (sub. 43, p. 27)

The NECG (sub. 54, p. 10) similarly noted that, from an institutional efficiency perspective, the use of dual instruments 'is a questionable use of resources'.

Also, a negotiate-arbitrate approach is driven by complaints, meaning that its focus is on specific problem areas. In contrast, conventional price controls applying to a basket of services may extend beyond areas where market power is a problem.

However, relative to conventional price controls, the negotiate-arbitrate approach also has disadvantages. For instance, it may provide greater opportunities for collusion between the access provider and seeker to share monopoly rents — although the scope to sustain such collusive arrangements is questionable, especially if the service provider has to deal with multiple access seekers. As the NCC commented:

> The claim that negotiations in the context of declaration or the availability of declaration will serve as the fig-leaf for widespread rent-sharing seem … to abstract from the regulatory context in which the relevant negotiations sit.
>
> The essence of that context is that any access seeker can trigger the arbitral process, once the facility at issue has been bought within the scope of the regime. … Under most conditions, there is simply no deal that — given the availability to all comers of the regulated price — will allow durable rent-splitting to occur. (sub. 43, p. 31)

Agreements to share monopoly rents could also be in breach of Part IV of the Trade Practices Act.

More significantly, a negotiate-arbitrate regime is likely to have higher transactions costs than conventional price controls (see box 5.5). That said, once regulatory pricing precedents are established under a negotiate-arbitrate regime, the regime will, to some degree, become self-policing. In these circumstances, some of the transactions costs of conventional price controls might be avoided.

Box 5.5 **Some transactions costs considerations**

Negotiate-arbitrate access regimes are likely to be more time consuming than conventional price controls. This will especially be the case if an access regime makes a distinction between the provision of access and the price and conditions of that access, and involves further negotiation between the parties after a general right of access has been created. As noted, the limited experience with Part IIIA indicates that achieving access outcomes may take a number of years.

Some participants also pointed to the high transactions costs inherent in the Part IIIA approach of determining the terms and conditions of access to a particular service on a user-by-user basis. In this regard, Australian Pacific Airports Corporation commented:

> Part IIIA by its design deals with the situation where a specific access seeker is in dispute with an access provider … Whilst declaration makes arbitration available to all users the only remedies available are one-on-one arbitration between the access provider and each user. … In those situations where there are multiple users of facilities … and where there is no apparent reason for access to be denied by the access provider, it is by no means clear that declaration under Part IIIA is the best or most appropriate regulatory response. (sub. 10, p. 3)

In even stronger terms, Qantas' submission to the Commission's companion inquiry into the Prices Surveillance Act stated:

> … if Part IIIA were the only regulatory instrument controlling prices for airport services, each airport user would need to negotiate directly with airports and, in the event of disputes, notify the disputes to the ACCC. The ACCC would then be required to arbitrate each individual dispute. Not only would such an approach be costly, time consuming and inefficient, it would be extraordinarily complex and prone to error. (Qantas 2001, p. 8)

Similarly, in commenting on the application to have Western Power's south west interconnector system declared under Part IIIA (see chapter 2), the CCIWA said it hoped that if the application is successful:

> … there is some easier way of arriving at some new set of access conditions, rather than individual access seekers having to go through a separate negotiation process. (transcript, p. 416)

However, to the extent that negotiations within a negotiate-arbitrate access regime are conditioned by previous arbitrations, the transactions costs are likely to diminish over time. Further, the Sydney Airports Corporation (sub. DR114, p. 48) suggested that the prospect of 'rigorous' ACCC arbitrations will encourage negotiated outcomes in all but the most intractable of situations. As discussed in the text, provision for access undertakings can also help to address some of the inflexibilities of a pure negotiate-arbitrate approach.

The upshot of the preceding discussion is that negotiate-arbitrate regimes will often have advantages over conventional price controls augmented with some sort of obligation to supply.

However, as the airports example in box 5.5 illustrates, this will not always be so. Moreover, where a negotiate-arbitrate framework is used, the appropriate degree of reliance on negotiation will depend on the particular circumstances. Hence, the NCC remarked that the negotiate-arbitrate approach should be seen as a flexible instrument, rather than as 'one size fits all' (sub. 43, p. 34). Consistent with this view, many participants saw an important role for undertakings within the Part IIIA regime, after as well as before declaration (see chapter 10).

Such flexibility and regulatory tailoring could be construed as inconsistent with the primacy that the national access framework gives to commercial negotiation. In reality, however, the issue is one of degree. Thus, the introduction to the Gas Code specifies that one of the Code's objectives is:

> … to provide sufficient prescription so as to reduce substantially the number of likely arbitrations, while at the same time incorporating enough flexibility for the parties to negotiate contracts within an appropriate framework.

Another important implication of the preceding discussion is that the efficiency of outcomes is likely to depend more on the pricing principles underpinning the arbitration or regulated price setting process than on the degree of prior commercial negotiation involved.

5.4 Reliance on general competitive conduct rules

It would be possible to engage in a similar comparison of negotiate-arbitrate access regulation (or conventional price controls) and a court-based approach to access relying on general competitive conduct rules.

Again, this would reveal some differences, such as the likely higher transactions costs of the court-based approach. It would also raise questions about the capacity of the courts to address issues related to the detailed terms and conditions of access. A common observation is that courts around the world have been reluctant to address such matters — at least without the benefit of specialist input.

However, such comparison would also reveal similarities and overlaps between court-based and regulated solutions. As Yarrow (2000, pp. 2-3) observes in the context of industry-specific regulation, the boundaries between approaches are blurred:

> Competition law generally relies on an *ex post* approach in providing detail and precision to general 'standards' of conduct, whereas sector-specific policies tend to be characterised by a more prescriptive approach, wherein detail and precision are determined *ex ante*. Again, however, there is no bright-line boundary between the two, but rather a spectrum of different mixes: conduct remedies determined under competition law can become *ex ante* constraints for later periods (see the proposed remedies in the Microsoft case), and case law precedents can also sometimes come close to establishing precise rules (eg. cost-based tests for predatory pricing). Similarly, whilst the imposition of price controls for access to certain network facilities is clearly a form of *ex ante* regulation, other rules governing access (eg. non-discrimination requirements) might equally well be established … via application of general competition law ...

Beyond these general considerations, there is the more specific issue of whether Australia's current competitive conduct rules would provide an effective *stand-alone* mechanism for delivering access to essential infrastructure services. As noted in chapter 2, the provisions most relevant to access are contained in Section 46 of the Trade Practices Act.

The debate about the effectiveness of Section 46 in an access context dates back to the Queensland Wire case of the late 1980s. Queensland Wire litigated against BHP on the grounds that BHP had used its market power for a proscribed purpose by refusing to sell Queensland Wire Y-bar used in the manufacture of fence posts. BHP supplied Y-bar to its wholly owned subsidiary, Australian Wire Industries. After a series of court cases, Queensland Wire's application was upheld in the High Court. However, in its judgement, the High Court made no reference to an essential facilities doctrine of the sort applying in the USA and Europe (see appendix D).

The Hilmer Committee raised significant concerns about the applicability of Section 46 to infrastructure access issues. These related mainly to the perceived difficulty for an access seeker to satisfy the courts that denial of access has been predicated on a proscribed anti-competitive purpose, as opposed to simply establishing that access prices and conditions depart from competitive market norms:

> There have been suggestions that the US essential facilities doctrine … could be imported into Australia through judicial interpretation of s.46. However, the High Court has not embraced such a doctrine and the Federal Court has specifically rejected it. In these circumstances, unless s.46 were amended in some way, access would only be available where a firm was able to prove it had been denied access, or access on reasonable terms, because of a proscribed purpose. (p. 243)

The Committee observed that there could also be difficulties for the courts in determining terms and conditions — particularly the price of access — and went on to conclude that:

> Although the courts have been prepared to grant injunctions requiring one firm to deal with another on the basis of previously agreed prices, they may decline to order supply because of the difficulties in calculating a reasonable price. (p. 244)

Some commentators have argued that the Hilmer Committee misunderstood the Queensland Wire Case and that Section 46 could reasonably be used to address access to essential infrastructure services. Others have agreed with the Committee that the section would not be an effective remedy in this area. Such divergences in view were also apparent amongst participants in this inquiry (see box 5.6).

Suffice it to say that, as a stand-alone mechanism for providing efficient access to essential infrastructure services, there remain considerable doubts about the efficacy of Section 46 specifically and Part IV more generally. This is particularly the case as Australian trade practices law does not normally provide remedies against firms which are able to earn monopoly rents. Notably, in the Full Federal Court decision in *ASX Operations Pty Ltd v Pont Data Australia Pty Ltd*, the court said:

> The Appellants emphasised, in our view correctly, that Section 46 does not strike at 'monopolists' or those in a 'monopolistic position'. Nor does it look to the attainment of a commercially 'reasonable' result. It asks whether a corporation has a substantial degree of market power in a market and then proscribes the taking advantage of that power for certain purposes. (1991, ATPR 41-109 at 52 666)

Further, it is significant that no major developed country relies solely on general competitive conduct rules in this area (see appendix C). Even New Zealand — which comes closest to this approach — has buttressed its general competitive conduct rules with other measures. For example, information disclosure requirements apply to some essential service providers. Moreover, according to a recent NERA report (2000b), the New Zealand Government is moving to re-regulate the electricity industry.

The Commission also observes that some of the mooted modifications to the Part IV provisions to increase their effectiveness in an access context would make them less distinguishable from access regimes and price controls. The suggestion to contract out access price setting to an expert body is a case in point.

Moreover, as noted at the outset of this chapter, an examination of possible modifications to Part IV to address access issues more effectively would need to have regard to the ramifications for a whole range of other economic transactions. Indeed, in the Commission's view, the merits of pursuing changes to this general statute to address a specific problem are questionable. As the Board of Airline Representatives argued:

Box 5.6 **Views on the efficacy of Section 46 as an alternative to access regulation**

There is general acceptance that Section 46 of the Trade Practices Act could be used to address access issues that arise in relation to essential infrastructure services. However, views on its likely efficacy for this purpose vary.

In a compendium marking the twenty fifth anniversary of the Trade Practices Act, Warren Pengilley, a Professor of Commercial Law, argues that the courts would have no difficulties in applying Section 46 if access had already been granted. He says that they would simply order access on a non-discriminatory basis to a second or subsequent access seeker. Pengilley acknowledges that a difficulty would arise if there had been no prior dealings, and therefore no defined access price. However, he suggests that, as in the USA, delegation of responsibility for determining prices to specialist agencies would address this problem. (Pengilley 2001)

In the same volume, John Kench, a senior legal practitioner, concurs that Section 46 could reasonably address access issues and that a specialist 'essential facilities' doctrine is not required. He contends that the courts are perfectly capable of working out terms and conditions on presentation of submissions and expert argument, and supervising orders. He goes on to suggest that the most challenging issues raised under Section 46 would be the legitimacy of reasons for refusing access. (Kench 2001)

Some inquiry participants supported these propositions. For example, the Bunbury Port Authority stated that:

> … an access regime is in our view unnecessary. The existing requirements of the Trade Practices Act (excluding Part 3A) are sufficient to ensure that access to necessary infrastructure complies with legislation. (sub. 4, p. 2)

Similarly, Energex commented that with Section 46 and ring-fencing of integrated providers in place, there is no significant need for an access regime. It noted, however, that changes could be made to improve the coverage and effectiveness of Section 46 — for example, giving the ACCC power to issue 'cease and desist orders' to strengthen the speed and power of enforcement (sub. 14, pp. 26-7). The submission from the Institute of Public Affairs on behalf of Citipower, United Energy and TXU Networks (sub. DR61, p. 36) also advocated consideration of changes to Section 46 that would enable it to function as an alternative instrument to Part IIIA — although it did not suggest what those changes might be.

In contrast, most other participants who addressed this issue argued strongly that Section 46 would *not* be an effective remedy for the access problem.

Typifying these views, at the Sydney roundtable, Henry Ergas contended that court-based decisions are difficult to generalise and that courts are reluctant to view issues prospectively, focussing instead on remedying past harm. He also noted that:

- Section 46 establishes an intent hurdle — the essence is not what was done, but why; and

(continued next page)

Box 5.6 **continued**

- reliance on the section would thrust the courts into an ongoing regulatory and monitoring role for essential services — a task to which they are not well suited.

The Queensland Mining Council focussed on problems created by the need to establish intent under Section 46:

> Misuse of market power is currently difficult to prove under the TPA because of the need to provide evidence of an essentially subjective purpose ie. to damage a competitor, prevent entry to the market or prevent competitive conduct.
>
> Other TPA provisions, such as those against exclusive dealing, are easier to use because they rely on observable facts and likely effects of anti-competitive conduct, irrespective of the purpose behind the conduct. However these provisions are complementary to statutory access rights rather than alternatives to access. (sub. 27, p. 4)

The ACCC similarly emphasised the difficulty of establishing intent in the absence of a 'smoking gun'. It argued that particular difficulties can arise when a firm's conduct substantially lessens competition, but the firm has not engaged in a positive act to 'injure' its competitors:

> The text book example is of a public enterprise that does not have a profit-maximising motive and consequently prices below costs with the unintended effect of destroying or deterring new entrants.

The ACCC went on to suggest that, in the context of access to essential infrastructure, intent to harm competition is not the appropriate focus for intervention. It argued that the emphasis should instead be on establishing an environment that promotes economically efficient and competitive markets. The ACCC also noted other critiques of a Section 46 approach, including:

- the lack of significant case law in regard to access issues;
- doubts about the capacity of the courts to make trade-offs between competition and efficiency in cases where restrictions on competition may be efficiency-enhancing;
- the difficulty of establishing generally applicable access prices from penalties, injunctions and court orders granted in relation to a specific access dispute; and
- the difficulty for poorly-resourced new entrants of operating through the court system. (sub. 25, pp. 19-22)

The Law Council noted that many of the cases brought under Section 46 have been 'access' cases, and that the section is available as a fall-back mechanism to deal with access issues not covered by a regulated access regime. However, it went on to suggest that '… the courts are not ideal bodies for establishing and monitoring pricing or access regimes.' (sub. 37, p. 9).

AAPT Limited (sub. 42), the Board of Airline Representatives of Australia (sub. 49) and the Electricity Markets Research Institute (sub. DR75) were among other participants who questioned the capacity of the anti-competitive conduct provisions in the Trade Practices Act to address access issues adequately.

> … section 46 applies to a broad range of firms that have 'substantial market power'. In general, significant access issues only arise in a much smaller range of firms — those that exhibit natural monopoly and bottleneck characteristics. Accordingly, it would be undesirable to amend a competition provision that has generalised application in order to deal with a problem that exists in only a narrower category of firms. (sub. 49, p. 4)

5.5 Is there any need for a change in the policy balance?

Negotiate-arbitrate access regimes, conventional price controls and general competitive conduct provisions can all intrude significantly on property rights. They are also all complex and resource-intensive instruments with the potential for significant unwanted side effects. Moreover, the differences between them — particularly negotiate-arbitrate regimes and conventional price controls with an associated 'obligation to supply' — are less significant than they might first appear. Indeed, the detailed pricing approaches underpinning policies to facilitate access are likely to be as, or more, important for outcomes than the nature of the broad instruments used to give effect to those policies.

In the previous chapter, the Commission concluded that it would be inappropriate to abandon access regulation at this stage. It argued that a preferable strategy would be to monitor the effects of the national access regime (modified to reflect the proposals in this report) and to review it again once a richer case history is available.

Similarly, the Commission can see no compelling reason for a *significant* change in the balance between the use of access regulation and other policy instruments available for promoting efficient access to essential infrastructure. Such a change would increase uncertainty for market participants without any guarantee of improved outcomes. Again, a policy of monitoring and review seems a more appropriate course of action. As Yarrow (2000) observes:

> Since the mappings between market processes and outcomes are highly uncertain, considerable stress should be placed on the notion of *discovery*. Given the uncertainties, it is simply not possible to deduce the most appropriate rules from (a) the end objectives and (b) economic analysis of relevant markets. At its best, such analysis can help develop hypotheses about the likely consequences of particular rules but, ultimately, frameworks of market governance will need to be subject to the test of experience. (p. 10)

It follows that the short-term policy focus for access regulation should be on how to improve its effectiveness and limit its costs. Such an approach does not, however, rule out some minor re-balancing in the use of the different policy instruments.

Hence, in later chapters, the Commission has canvassed a possible role for price monitoring as an alternative to coverage under access regimes.

FINDING 5.1

There is no reason for a significant change in the balance between the use of access regulation and other policy instruments available for promoting efficient access to essential infrastructure. Any such change would increase uncertainty for market participants without any guarantee of improved outcomes. However, the balance should be reviewed periodically in the light of emerging evidence of the effectiveness of particular instruments.

5.6 Generic or industry-specific access regulation?

Improving the effectiveness of access regimes and limiting their costs will involve, for the most part, changes to detailed regulatory requirements.

However, at a broader level, there is the issue of the appropriate emphasis in Australia's access 'package' between the generic national access regime and industry-specific regimes. This emphasis has obvious implications for the role and scope of the Part IIIA regime under review in this inquiry.

Australia's dual legislative approach embodies many of the strengths of generic regulation, while still providing the flexibility to cater for industry-specific circumstances impinging on access arrangements. Although the approach does not appear to be emulated elsewhere, it was widely supported by participants. Typifying these views, the New South Wales Government argued:

> The current system, which involves a generic national regime alongside a network of national and state based industry-specific regimes, provides a good balance between regulatory flexibility and national consistency. NSW is of the view that there is no case for making any significant changes to the current system. (sub. 44, p. 2)

This view in turn implies that the key policy issue is how best to ensure an appropriate relationship and balance between the generic and industry-specific components of the access package, rather than deciding between two discrete approaches.

The advantages of a generic approach

In common with other areas of regulation, a generic approach to access regulation has a number of advantages. Among other things, it can:

- *facilitate a consistent approach across infrastructure sectors*: In this regard, the NCC argued:

  [A generic] approach … makes for consistency as between industries and as between jurisdictions, enhancing predicability and reducing the risk that resource allocation will be distorted by the differing treatment of like cases. (sub. 43, p. 35)

  And, in pointing to the advantages of a generic approach, the New South Wales Minerals Council spoke about the inconsistencies that have resulted from the use of several State regimes as well as Part IIIA to regulate rail access:

  … it would be desirable for a single type of access regime to apply to all networks to ease border problems between networks. There would be benefits in simplicity, consistency and efficiency in operation, pricing and regulation. … In general, the same principles for access and pricing should be equally applicable to all monopoly infrastructure networks. (sub. 22, p. 9)

- *readily accommodate changes in 'surprise' candidates for access regulation*: The ACCC commented that a generic regime 'may provide a better mechanism for responding to [new access] issues as they arise.' (sub. 25, p. 9)
- *facilitate the dissemination of regulatory lessons across sectors without dispersing limited regulatory expertise*: In this regard, the NCC noted that 'a proliferation of different approaches prevents the achievement of economies of scale and scope in the design and implementation of regulatory options.' (sub. 43, p. 19)
- *reduce the prospect of some forms of 'regulatory capture'*: The ACCC commented:

  A single economy wide regulator may be less prone to 'regulatory capture' than sector-specific regulators. The broader responsibility of an economy-wide regulator helps to reduce the risk that a regulatory regime will either be captured politically or by an industry or become entangled in an antagonistic relationship with industry chiefs. (sub. 25, p. 99)

The advantages of an industry-specific approach

An industry-specific approach provides scope for explicit recognition of differences between infrastructure sectors in access arrangements. If differences impinging on access matters are substantial, then tailored regimes are likely to provide greater certainty to access providers and seekers than a generic regime which relies more on interpretation in any particular circumstance. As the Law Council remarked:

> … Part IIIA has been augmented to a large extent by industry-specific regimes such as those developed for telecommunications, gas and electricity. Industry-specific regimes address industry-specific issues more comprehensively than a generic access regime could ever do. (sub. 37, p. 2)

Similarly, in supporting the continued use of industry regimes to complement Part IIIA, Professor Brunt commented that:

> Each of these industries has its own technical features requiring specialised expertise and technically expressed rules. Further, the industry-specific regimes exist! (sub. 21, p. 5)

In a telecommunications context, PowerTel contended:

> … although Part IIIA is designed to facilitate access on commercial terms to essential infrastructure, it is not appropriate to telecommunications networks which have very different physical characteristics and historical origins than other network based facilities such as those used in transport and energy.
>
> … the specific and prescriptive elements of Part XIC provide numerous advantages over the more general regime provided for in Part IIIA. (sub. 8, pp. 3-4)

These sentiments were endorsed by AAPT Limited (sub. 42).

And, in an airports context, Avis (sub. 40, p. 17) contended that the Part IIIA criteria do not take account of the unique monopoly position held by airport operators.

More generally, a number of participants referred to the potentially high transactions costs of the Part IIIA declaration-arbitration process were it to apply in sectors such as airports and telecommunications where there are likely to be multiple access seekers (see box 5.5). Australian Pacific Airports Corporation concluded that:

> If access is the issue and a large number of applications is to be expected then an industry specific arrangement may be appropriate. Such an arrangement should deliver more predictable outcomes for both access seekers and providers but at the same time it should deliver outcomes which are consistent with a more generic structure. (sub. 10, p. 3)

Reliance solely, or largely, on a generic national regime would also raise significant Commonwealth-State issues (see below).

Is there a case for changing the current approach?

In its Position Paper, the Commission noted its general preference for generic approaches, but recognised that industry-specific arrangements are:

- an important part of the current landscape; and
- likely, in a variety of circumstances, to deliver more efficient outcomes than case-by-case declaration under Part IIIA.

Accordingly, the Commission found that there was no reason to move away from the current dual approach, arguing that it draws on the strengths of both the generic and industry-specific approaches, while avoiding some of the pitfalls of a one-dimensional solution.

However, in response to widespread concerns about inappropriate divergences in the requirements of individual industry regimes, the Commission went on to argue that there would be value in strengthening the framework role of Part IIIA. Consistent with the views of a number of participants (see box 5.7), it said that a stronger role for Part IIIA in guiding and disciplining industry regimes would help to minimise unwarranted variations in those regimes. The Commission also commented that:

- for such convergence to occur, there must be general acceptance that Part IIIA and industry regimes diverge only where specific circumstances make this absolutely necessary;
- Part IIIA should contain clear objectives and pricing principles to guide access decisions;
- as far as possible, common principles and criteria should apply across the various Part IIIA access routes; and
- the Part IIIA framework should apply to all industry-specific arrangements.

Responses to the Position Paper findings

Some of the responses to the Position Paper strongly endorsed the Commission's preliminary findings on these matters (see box 5.7). Indeed, APIA (sub. DR70, p. 2) went further, arguing for a 'timely realignment of industry specific regimes to the Part IIIA principles through a process operating in parallel with development of a revised Part IIIA'. Similarly, Duke Energy International, while questioning whether industry regimes like the Gas Code are required given the existence of Part IIIA, went on to say that:

> … in order to capture the benefits of the Commission's review, it is essential that where industry specific regimes continue to exist, they are revised to fully reflect any changes to Part IIIA. (sub. DR95, p. 4)

Likewise, the New South Wales Government (sub. DR109, p. 7) contended that the key elements of the Part IIIA regime 'should be part of all industry specific regimes'.

Box 5.7 **The framework role of Part IIIA**

Various participants argued that Part IIIA should play an important role in providing a framework for, and discipline on, industry-specific access arrangements. For example, in submissions received prior to the release of the Position Paper:

The Law Council recommended that:

> …a modified Part IIIA be retained as a template for future access regimes that are industry-based; industry-specific regimes must comply with Part IIIA's policy blueprint before being adopted. Part IIIA will serve as a kind of 'bill of rights' for future access regimes, and as a 'fall-back' regime only for industries where no specific regime is in place. (sub. 37, p. 3)

It also said that it agreed:

> … with the proposition discussed at the Melbourne and Sydney round tables that as far as possible the principles which are generic to all industries should be addressed in Part IIIA, with industry specific issues being addressed in separate regimes. Where the generic 'tree' branches out into specific 'twigs' will be a matter of degree for each industry. (p. 9)

The Queensland Mining Council argued:

> It is essential that the national access regime remain in place as the default regime, to encourage state governments to develop their own effective arrangements. … Further, it is important that the National Competition Council continue to be able to exercise reasonable discretion in evaluating the state-based regimes against the principles of effectiveness contained in clause 6(4) of the Competition Principles Agreement. … Our council believes this has influenced in a positive way the development in Queensland of what coal and minerals rail users expect will be a comprehensive and rigorous rail access regime. (sub. 27, p. 5).

The ACCC observed:

> Part IIIA and the Competition Principles Agreement offer consistent criteria against which the standard and quality of the access regime must be measured. This helps to ensure the integrity of the access provisions. (ACCC, sub. 25, p. 9)

Similarly, in their responses to the Commission's findings in the Position Paper:

The Australian Council for Infrastructure Development argued:

> Whilst there are some issues which need to be addressed in an industry specific context, AusCID is strongly committed to an overarching framework such as that provided by Part IIIA … to operate as a model for the convergence of the existing regulatory schemes. (sub. DR80, p. 1)

In supporting the Commission's position, the Australian Rail Track Corporation said:

> Industry codes are developed by incumbent participants, and can result in a regime that is designed to preserve the current industry structure and competitive positioning. Principles included in Part IIIA should seek to prevent this from occurring. (sub. DR64, p. 6)

And, Australia Pacific Airports Corporation said that while there is often merit in an industry-specific approach to deal with the 'peculiarities' of particular sectors, differences in approach should be limited to operational issues and not extend to broader coverage matters. (transcript, p. 109)

However, other participants disputed the contention that strengthening the framework role of Part IIIA is necessary to promote greater consistency across individual access regimes. For instance, at the public hearings, CCIWA reiterated comments made in its initial submission (sub. 12, p. 10) that single State-based regulators with responsibility for a suite of industry regimes can facilitate consistency under an industry-specific approach. It went on to argue that, relative to reliance on an over-arching national regime, this approach might facilitate desirable regulatory competition between jurisdictions and that:

> … it is appropriate that regulatory regimes, by and large, are determined in the context of the populations who are affected by those regulations. (transcript, p. 413)

In a similar vein, the Victorian Department of Infrastructure said:

> It is … preferable that where State Governments have primary responsibility for rail asset management, they retain the ability to regulate the asset, including access arrangements. … Typically this has been achieved through State based regimes provided that they are consistent with the Competition Principles Agreement in order to promote the development of a nationally competitive rail freight market. (sub. DR97, p. 2)

The Western Australian Government observed that there are numerous avenues available to achieve an appropriate degree of consistency in access regulation. It went on to express a strong preference for relying on changes to Clause 6 of the Competition Principles Agreement (CPA) to achieve this goal:

> To make Part IIIA a model for all access would be insensitive to States' and Territories' legitimate interests in regulation and has the potential to introduce unwelcome uncertainty as to the status of existing industry-specific regimes.
>
> Rather, Western Australia would see any 'framework' changes that affect industry-specific regimes (as opposed to the administrative processes pertaining to the Part IIIA backup for access) to be matters for further negotiation between jurisdictions under a revised Competition Principles Agreement. Western Australia would remain open to considering and negotiating any changes that the Productivity Commission recommends to Clause 6 as the cornerstone of the national access regime. (sub. DR69, p. 3)

The Queensland Treasury (sub. DR105, p. 6) similarly saw Clause 6 of the CPA as being at the top of the access hierarchy 'because it recognises the possibility of developing access regimes other than the Part IIIA default regime'. Nonetheless, it supported the Commission's proposals to strengthen Part IIIA's framework role through the inclusion of an objects clause and pricing principles (see chapter 6).

The Commission's assessment

The Commission's primary concern in formulating its preliminary finding in the Position Paper was to reduce the scope for unwarranted divergences across individual access regimes. Clearly, there are several ways of pursuing this objective. Indeed, a commitment by all Australian Governments to the objective is arguably more important than the instrument ultimately used to achieve it.

In the Commission's view, there will be some situations when relying on a national regime to encourage greater consistency in approach could have advantages. This is especially likely to be the case for infrastructure services, such as interstate rail, which transcend jurisdictional boundaries. Moreover, the 'default' declaration route in Part IIIA will continue to be an influence on the requirements of industry regimes, irrespective of Part IIIA's position in the access hierarchy. The application by Freight Australia to have its own services declared in response to perceived inadequacies in Victoria's rail access regime — see chapter 2 — is a current example.

That said, the Commission accepts that there would equally be advantages in relying on Clause 6 in conjunction with Part IIIA to discourage unwarranted divergences in the requirements of individual access regimes. As the representations from the Western Australian and Queensland Governments illustrate, Clause 6 is an important part of the access 'compact' between the Commonwealth and the States and Territories. Pursuing greater consistency through 'matching' modifications to both Clause 6 and Part IIIA is therefore likely to facilitate shared ownership of the issues and remedies involved. Reflecting this change of emphasis, the Commission has modified a number of the preliminary proposals in the Position Paper relating to certification matters (see chapter 9).

FINDING 5.2

The current approach of a national access regime operating in tandem with industry-specific regimes has significant advantages. In effect, it draws on the strengths of both the generic and specific approaches, while avoiding some of the pitfalls of a one-dimensional solution.

Some changes to both Part IIIA and Clause 6 of the Competition Principles Agreement are nonetheless required to strengthen the access framework and to discourage unwarranted divergence across industry-specific regimes.

6 Objectives and coverage of Part IIIA

In the previous chapter, the Commission found no compelling case for departing from the current arrangements whereby the national access regime complements industry-specific regimes. On the contrary, it found that this dual approach offers many advantages.

Nonetheless, as participants have indicated, there is scope to improve the operation of Part IIIA. At the broad level, many echoed the views of the Office of the Regulator-General, Victoria (ORG, sub. DR112) which saw a need to clarify the regime's objectives. Others pointed to the need for greater guidance on likely pricing outcomes under the regime. This chapter canvasses ways to address these concerns through amendments to the Part IIIA architecture.

In looking at the efficacy of the overall regime, the chapter also addresses whether Part IIIA should:

- be confined to vertically integrated bottleneck facilities or continue to cover non-integrated facilities;
- address sources of market power other than natural monopoly;
- rely solely on criteria-based testing or also specify exemptions from the regime; and
- be denominated in terms of facilities, or services provided by facilities.

The structure of the chapter is consistent with the proposals for incremental changes to Part IIIA sought by most participants. A few submissions proposed more far-reaching reforms. For example, Professor Maureen Brunt (sub. 21) recommended a 'drastic simplification' of Part IIIA by replacing Divisions I and II with market conduct provisions for nationally significant corporations possessing substantial market power, regardless of their association with the supply of infrastructure. Professor Brunt considered that such a regime would better complement section 46 and Part VII of the Trade Practices Act (TPA).

However, as discussed at length in the context of the declaration criteria in the next chapter, the Commission has reservations about broadening the coverage of Part IIIA beyond the services provided by infrastructure facilities.

6.1 Specifying the objectives of access

Clear specification of objectives is fundamental to all regulation. It is particularly important where there is scope for divergence between the intent of regulation and the interpretation of its operational criteria. More specifically, for access regimes to function efficiently, clear objectives are needed to promote:

- decisions that are well targeted to the identified problem and which minimise unintended side effects;
- greater certainty for current and prospective facility owners, access seekers and other interested parties;
- consistency among policymakers, the judiciary and those responsible for implementation and enforcement; and
- regulatory accountability.

Having specified clear objectives, the operational criteria of the access regime — for instance, tests for coverage, thresholds and materiality — must relate directly to those objectives. These 'rules of the game' and associated decision making criteria need to be internally consistent, transparent and readily understood, in order to minimise the potential for inconsistent interpretations and outcomes.

Objectives can be set only after the problem requiring a remedy is understood. Chapter 3 identified that access problems stem from the potential for owners of essential infrastructure facilities (bottlenecks) to exercise market power. A key concern relates to the possibility of outright denial of access — the most extreme manifestation of the exercise of market power — but monopoly pricing of access can have similarly deleterious effects. Thus, access legislation is intended to curb the monopoly power of providers of essential infrastructure services by facilitating access to such services on reasonable terms and conditions.

The need for an objects clause

Section 2 of the TPA contains a general high level objects clause which identifies the object of the Act as being to 'enhance the welfare of Australians through the promotion of competition and fair trading and provision for consumer welfare'. The Australian Competition and Consumer Commission (ACCC) noted that Section 2 was amended in 1995 when Part IIIA was inserted into the TPA — the implication being that Section 2 was seen as providing sufficient guidance at that time (sub. DR93, p. 4).

However, this view was not shared by the National Competition Council (NCC) which considered that Section 2 is:

> … somewhat ambiguous in the role and priority to be accorded to the various concepts identified and there is no explicit indication as to how the section is to be taken into account in interpreting specific provisions. … the specific context of Part IIIA would benefit from a more explicit objects clause. (sub. DR99, p. 8)

Indeed, the desire to provide a more explicit indication of how specific provisions should be interpreted is exemplified by section 152AB of Part XIC of the TPA — which gives effect to the telecommunications access regime. Section 152AB specifies that the object of that access regime is 'to promote the long-term interests of end-users of carriage services'. The appropriateness of that particular clause is discussed by the Commission in its report on telecommunications competition regulation (PC 2001c). Nevertheless, its embodiment in the legislation exemplifies a useful general principle.

In contrast, because Part IIIA of the TPA does not embody an objects clause, its objectives must be imputed from requirements in the regulations, ancillary material and the legislature's discussion preceding its implementation. Moreover, judicial decisions have meant that the interpretation of some criteria has been 'evolutionary'. The Law Council of Australia was particularly critical of the lack of clarity in the current framework:

> Part IIIA seems to have been inserted into the TPA with little thought about how its objects and terminology interface with the rest of the statute. This leads to confusion about its purpose, operation and scope … (sub. 37, p. 27)

A consistent theme expressed by many participants was the need for a clear statement of objectives in Part IIIA. For example:

> The access provisions are … written in cumbersome and uncertain language, in a structural design of Byzantine complexity. Much could be achieved by the Commission if it were to pursue a clear agreement on objectives … (Brunt, sub. 21, p. 1)

> … Part IIIA should contain a specific objects clause. The inclusion of such a specific clause would assist interpretation of the legislation, and support both the implementation and administration of the legislation. (TransGrid, sub. 17, p. 4)

The importance of having explicit objectives in Part IIIA is further underlined by its role in influencing the architecture of industry-specific access regimes via the shield that 'effective' regimes provide against declaration (see chapter 2). This also was emphasised by some participants. For example:

> Part IIIA does not currently have specifically outlined objectives, yet it has formed the basis of access regulatory systems and pricing regulatory systems … (Australian Pipeline Industry Association [APIA], sub. 32, p. 2)

> In order to assist with the facilitation of a more consistent approach by regulators to regulation of access to rail and other infrastructure, ARTC would support a statement of the objectives of the national access regime. Such objectives would clarify the definitions and criteria associated with the various paths to gaining access and provide greater certainty to access providers and seekers. (Australian Rail Track Corporation [ARTC], sub. 28, p. 7)

The Commission agrees with these views and considers that insertion of an objects clause into Part IIIA would provide guidance which has been lacking for this relatively new area of economic regulation. This lack of guidance has been exacerbated by the paucity of decisions establishing precedents for the relative weighting that a regulator might attach to a particular criterion in the legislation (such as those relating to arbitrations).

Indeed, the ACCC — the only participant to question the need for an objects clause specific to Part IIIA — acknowledged that 'objects clauses can be useful in the interpretation of legislation and in informing the exercise of legislative discretion' (sub. DR93, p. 1).

In sum, the Commission considers that an objects clause would reduce uncertainty by assisting all parties — regulators, the judiciary, access seekers, facility owners and potential infrastructure investors — to interpret the intent of various criteria.

6.2 The objectives of Part IIIA

An objects clause must capture the intent of often complex legislation in relatively few words — otherwise, misconstrued purposes and/or over-emphasis on particular matters could still lead to unintended outcomes.

A number of participants foresaw problems in achieving a clear specification of objectives. Concerns were variously expressed about perceived tensions between:

- the different interests of users and facility owners;
- efficient use of infrastructure and efficient investment; and
- short-term versus long-term efficiency considerations.

For example, the New South Wales Minerals Council stated that 'the assessment of 'long-term' benefits will be a subjective one, and many will be unhappy with short-term benefits being in favour of long-term benefits' (sub. 22, p. 10).

In essence, all of the above concerns are manifestations of views about the extent to which access pricing should strike at the monopoly profits or rent which can attach to essential facilities. Often this is articulated as a desire not to allow facility owners free rein to extract large rents, but also not to reduce facility owners' profits to such an extent as to deter investment in such facilities.

Not surprisingly, user groups and infrastructure owners displayed quite different perspectives on how the national access regime should trade off reductions in access prices against the need to provide sufficient returns to facility owners to ensure ongoing investment in, and maintenance of, essential services.

Typifying the general stance of user interests, the National Farmers' Federation argued that access prices which do not provide for efficient use of existing facilities will damage the competitiveness of downstream industries. It said that:

> The whole object of economic regulation under Part IIIA of the Trade Practices Act is to avoid abuse of monopoly power by ensuring that natural monopolies do not charge users more than would be charged in a hypothetical competitive market. (sub. 26, p. 8)

Similarly, BHP Billiton stated that:

> … it may be seen as an unpalatable choice to be told that infrastructure investment will only be forthcoming on the basis that users agree to a form of economic coercion — the sort of monopoly pricing which regulation is imagined to prevent. It is not established that there is an inherent conflict between static and dynamic efficiency or that monopoly pricing is necessary to induce investment in infrastructure. (sub. 48, p. 59)

AAPT Limited (sub. 42, p. 4) sought to focus Part IIIA specifically on 'the promotion of welfare or interests of those persons who consume the service, or services'.

However, others considered it crucial that an objects clause recognise explicitly longer term investment and efficiency issues. For instance, Energex, which proposed a number of objectives, including controlling the abuse of monopoly power, nonetheless favoured as the *highest* priority objective:

> To promote long term economic efficiency, including dynamic efficiency, taking into account the desirability of fostering investment, innovation and productivity improvement … (sub. 14, p. 18)

This objective draws on elements of the approach taken by the Hilmer Committee (1993, p. 279) which sought to balance short and long term objectives. It considered that an appropriate principle for national competition policy might be:

> The promotion of long term economic efficiency, taking into account the desirability of fostering investment, innovation and productivity improvement, and the desirability of discouraging a person who has a substantial degree of power in a market from using that power to set prices above efficient levels.

That said, the Hilmer Committee (1993, p. 253) acknowledged that striking the appropriate balance is not easy, as in this often quoted passage:

> Neither the application of economic theory nor general notions of fairness provide a clear answer as to the appropriate access fee in all circumstances. Policy judgements are involved as to where to strike the balance between the owner's interest in receiving a high price, including monopoly rents that might otherwise be obtainable, and the user's interest in paying a low price …

The Commission considers that Part IIIA must seek to promote efficient use of essential infrastructure in a way that does not discourage efficient investment. Therefore, in terms of what the Hilmer Committee called policy judgements, the Commission considers it appropriate to give particular weight to ensuring that investment in essential facilities is not jeopardised. While it is unarguable that access can promote investment in markets using the services of essential facilities, such investment is contingent on preserving incentives to build or expand those facilities in the first place.

Efficiency and the promotion of competition

The ultimate objective of access legislation is to enhance community welfare. In an operational sense, however, this is difficult to convey in a meaningful way. To this end, the objective of Part IIIA has been couched in terms of promoting competition in the delivery of infrastructure services. This is reflected in the reasoning of the Australian Competition Tribunal, which has argued:

> The purpose of an access declaration is to unlock a bottleneck so that competition can be promoted in a market other than the market for the service. The emphasis is on 'access', which leads us to the view that s 44H(4)(a) is concerned with the fostering of competition; that is to say it is concerned with the removal of barriers to entry which inhibit the opportunity for competition in the relevant downstream market. (cited in Brunt, sub. 21, pp. 2-3)

In other words, consistent with the broad thrust of national competition policy, greater competition is employed as a proxy for improving community welfare. As experience in a wide range of circumstances has shown, the promotion of competition is usually compatible with improved community welfare.

Competition policy initiatives, in the main, aim to improve efficiency by removing institutional barriers and/or impediments which artificially distort or mask price signals (for example, production quotas and mandated cross-subsidies). In the case of access regulation, however, the presumption is that unregulated markets will not promote efficiency — thus, regulatory intervention to induce competition is required to promote efficient outcomes. By definition, this requires judgements (and the scope for error) about what might constitute the appropriate degree of competition. Put simply, competition is a means to an end, rather than an end in itself.

Viewed in this light, it is possible to have *too many* competitors as a result of providing access on terms and conditions which are too favourable to third parties. This can promote wasteful activity in downstream markets and deny the community the benefits of dynamic efficiency gains — for example, by deterring investment in new essential infrastructure. These concerns are discussed at length in chapter 4.

Hence, the objectives of Part IIIA need to recognise that the promotion of competition is desirable from a community perspective only when such competition is *efficient*. As the NCC noted:

> … the overall objective of micro-economic reform is to promote efficiency, and through it the competitiveness and long term growth prospects of the Australian economy; the objectives of access regulation should mirror, and contribute to, that wider goal. Moreover, no other set of considerations can provide outcomes that, from the point of view of the community as a whole, are superior to those that will be obtained through application of an efficiency criterion. (sub. 43, p. 27)

The New South Wales Government also stressed the importance of efficiency. It contended that 'promotion of competition' fails to capture important dynamic aspects of efficiency:

> … Part IIIA should have a statement of objectives. The promotion of competition in another market as a *de facto* objective is not a sufficiently rigorous motivation for a national access regime. The key objective of Part IIIA should be to promote long run economic efficiency. … In addition, the promotion of 'efficient facility use' and 'efficient investment' could be inserted as subsidiary objectives. This set of objectives recognises the interests of policy makers in 'promoting competition' and the interests of facility owners in 'ensuring a reasonable return on their assets that facilitates appropriate levels of maintenance and investment'. (sub. 44, p. 3)

Given the emphasis on competition in the TPA, and the now substantial body of legal precedent revolving around competition as a proxy for efficiency, the task at hand is to marry competition more explicitly to efficiency. In the Commission's view, such unification is best pursued at the regime's operational level, notably within the declaration criteria (see chapter 7). This leaves scope to focus the objectives for the regime on improving efficiency — the fundamental reason for intervention in this area.

6.3 An objects clause for Part IIIA

For the reasons outlined above, the Commission considers that an objects clause in Part IIIA should:

- incorporate an explicit efficiency objective reflecting both short term and long term considerations — in particular, recognising legitimate user/consumer interests and long term investment dimensions; and
- recognise the role that Part IIIA plays in providing a framework for industry-specific regimes.

On this basis, in the Position Paper, the Commission proposed the following objects clause:

> The objective of this Part is to:
>
> (a) enhance overall economic efficiency by promoting efficient use of, and investment in, essential infrastructure services; and
>
> (b) provide a framework and guiding principles for industry-specific access regimes.

Participants' views and the Commission's assessment

Sub-clause (a) of the proposed objects clause was supported by the overwhelming majority of participants, including a regulator — the ORG — which stated that:

> … there are currently no objectives set out in Part IIIA. As a result, regulators are required to infer the objectives that are implicit by reference to the declaration criteria … the Office supports the Commission's recommendation that an objects clause be inserted in to Part IIIA which provides that the primary objective of the national access regime provisions be *to enhance overall economic efficiency*. (sub. DR112, p. 4)

That said, some participants offered more qualified support. For example, the Chamber of Minerals and Energy of Western Australia (sub. DR66), the Australian Chamber of Commerce and Industry (sub. DR67) and the Energy Users Association of Australia (EUAA, sub. DR94) considered it worth stating explicitly that enhancing efficiency be achieved through the promotion of competition.

The ACCC went further and questioned what is meant by 'economic efficiency' and whether the term was an improvement on 'promotion of competition':

> … it is difficult to say that by changing the emphasis from 'the promotion of competition' to 'the efficient use, of, and investment in, infrastructure' there will be a significant change in incentives such that new infrastructure facilities will only be constructed where it is economically efficient, from the social perspective, to do so. (sub. DR93, p. 5)

However, the Commission does not see a need for amendments to the Position Paper proposal to address either of these concerns. As noted above, the means — such as promoting competition — are best addressed through the Part IIIA operational criteria.

More importantly, the Commission considers that the absence of a specific objects clause in Part IIIA means that the way and extent to which efficiency is reflected in decisions depends on how access regulation is interpreted by the regulator. It is therefore of the view that the proposed objects clause, by drawing attention to efficient use and efficient investment, should help to redress the potential for interpretations which discourage efficient investment in essential infrastructure. As the Australian Council for Infrastructure Development (AusCID, sub. DR117, p. 3) submitted 'there is nowhere else in the Trade Practices Act where efficiency is given an explicit role'.

Indeed, this explicit emphasis on efficient investment in essential infrastructure facilities in sub-clause (a) was particularly well received by participants. Even so, during the public hearings, the Commission explored with many participants the question of whether sub-clause (a) might have overly elevated investment matters — by giving efficient use and investment 'equal billing'. Arguably, Part IIIA is foremost an instrument for promoting efficient *use* of existing essential infrastructure, but in a manner that does not jeopardise incentives to invest in new infrastructure.

However, participants generally supported the construction of sub-clause (a) *because* it signals that efficient use and efficient investment are equally important. For instance, the Network Economic Consulting Group (NECG) noted that:

> … one of the main consequences of regulatory arrangements may be to distort investment and so it's important that, in designing those regulatory arrangements, proper attention be paid to the fact that in attempting to cure what may be the weakness of the entirely unregulated arrangements, you don't create significant difficulties with respect to what might be the strength of those less regulated arrangements: namely, the fact that they will not undermine or distort the incentives to invest (transcript, p. 210)
>
> … one of the great strengths of the [Position Paper] proposal was that it said '… there's a real issue here with ensuring the longer term benefits to consumers, not just the shorter term benefits' … (transcript, p. 210)

The Queensland Treasury submitted that, when Part IIIA was implemented, it had been intended that it would have due regard 'to ensure appropriate investment incentives are maintained'. It went on to argue that:

> After five years of operation there is significant debate as to whether third party access regulatory outcomes have reflected, or supported, this original objective. … There would be much to gain from an explicit legislative statement of the objectives of third party access, with specific reference to the objective of encouraging investment … the [Position] Paper's proposal for the insertion in Part IIIA of an objects clause which makes explicit this objective is supported. (sub. DR105, pp. 6-7)

Adopting a similar position, the South Australian Government (sub. DR121, p. 4) supported the objects clause, but suggested that 'the need to promote efficient long term investment in essential infrastructure services should be emphasised more strongly'.

On the basis of submissions and input at the public hearings on the Position Paper, the Commission therefore considers that the balance between efficient use and investment incentives in the proposed objects clause is appropriate.

Sub-clause (b) of the draft objects clause was also supported by the majority of participants who commented on it. For example, APIA said that it:

> …welcomes the proposal to link the Part IIIA objects clause with industry specific regimes. This could best be done by incorporating the Part IIIA objects clause into those regimes. (sub. DR70, p. 13)

Expressing a similar view, AusCID said:

> Efficiency objectives are important not only in the declaration process but also in … the certification process for an access regime and the acceptance of any industry code. The objects clause should guide each step. (sub. DR80, pp. 6-7)

Taking an even stronger position on the framework role for Part IIIA, Energex proposed new objects clauses directed more at the wider remit of regulation per se than a regime for essential facilities. It considered that:

> Part of our understanding is that once the Productivity Commission comes out with its final report, that a lot of the argument and principles in this inquiry will be basically transferred to State jurisdictions, so we have that sort of long term view in trying to get matters fixed now so that when perhaps further reviews take place at a jurisdiction level, that those same principles will flow through. (transcript, p. 371)

The NCC supported sub-clause (b) in principle, but saw it more as a description of Part IIIA (and better placed in a second reading speech) than as an objective:

> One of the functions of Part IIIA is … to provide a framework and guiding principles for industry specific regimes through the certification and undertaking process. The most effective way of ensuring that all industry specific regimes are disciplined by Part IIIA is to bring them within the jurisdiction of Part IIIA (sub. DR99, p. 10)

The thrust of sub-clause (b) was not, however, unanimously supported. The Western Australian Government raised concerns that the Position Paper contained proposals which taken together, 'would result in a considerable shift in powers from the States and Territories to the Commonwealth in respect of access regulation (sub. DR69, p. 1). It questioned whether Part IIIA should provide 'a binding framework for industry-specific access regimes' (sub. DR69, p. 2, transcript, pp. 454-60). In this light, it had some concerns about the intent of sub-clause (b).

As discussed in chapter 5, the Commission recognises that the national access regime is the product of a cooperative approach entered into by all governments and reflected in the Part IIIA-Clause 6 arrangements. In putting forward sub-clause (b), the Commission never envisaged that the Part IIIA framework role would be *binding*. Rather, its intention was that Part IIIA should provide the framework to guide, rather than prescribe, the requirements of State and Territory industry regimes. In many respects, the Commission's intention was encapsulated by the ARTC which said that Part IIIA should provide a framework for access regimes:

> … by creating pressure to eliminate unwarranted differences in individual access arrangements and by encouraging regimes to replicate desirable features of the national regime… (sub. DR64, p. 7)

The key mechanism for achieving this is the threat of declaration. To avoid the possibility of services provided within a particular jurisdiction being declared under Part IIIA, States and Territories generally seek to ensure that such services are covered by their own industry access regimes and that these regimes are (or could) be certified — that is, found to be effective. However, other than the conditioning effect manifested through the threat of declaration, the design and operation of State and Territory access regimes is a matter for the relevant jurisdiction.

Significantly, there was consensus that unwarranted divergence in the form and operation of access regimes must be avoided. For example, the Queensland Treasury, which like the Western Australian Government emphasised the importance of Clause 6 of the Competition Principles Agreement (CPA) in the access hierarchy, nonetheless supported a framework role for Part IIIA. It considered that the objects clause for Part IIIA should be inserted into the Clause 6 certification criteria to ensure that all access regimes operate with the same objectives (sub. DR105, pp. 4-7).

Against this backdrop, the Commission remains of the view that Part IIIA, as the default access regime and the inducement for certification of State and Territory access regimes, should continue to have a framework role. In particular, along with Clause 6, it should be a vehicle for constraining unwarranted divergence across individual access regimes. The degree to which this can be achieved and how quickly are matters for further deliberation — for example, unnecessary divergence can be deterred through demonstration effects and regulatory benchmarking, or it could be promoted more actively through agreed amendments to the criteria for certification set down in clause 6 of the CPA. (In this regard, chapter 9 contains proposals for the Commonwealth and the States and Territories to progress jointly some of the Commission's recommendations relating to the Clause 6 principles.)

That said, the Commission has changed the wording of its draft sub-clause (b) to make it clear that the role of Part IIIA is to act as a discipline on, rather to prescribe the composition of, industry-specific regimes.

RECOMMENDATION 6.1

The following objects clause should be incorporated in Part IIIA of the Trade Practices Act 1974:

'The object of this Part is to:

(a) promote economically efficient use of, and investment in, essential infrastructure services; and

(b) provide a framework and guiding principles to discourage unwarranted divergence in industry-specific access regimes.'

What about distribution?

The ACCC questioned the focus of the objects clause because it considered that the concept of 'economic efficiency' does not have regard to distributional issues:

> While the concept of 'economic efficiency' entails a measure of social desirability, it focuses on the productive, allocative and dynamic dimensions of a market, without regard to any distributional issues. (sub. DR93, p. 5)

While this is true, in general, curbing monopoly power for efficiency reasons will reduce transfers from final users of infrastructure services to facility owners. Thus, there will often be a congruence between the pursuit of efficiency and distributional outcomes that many would regard as desirable.

Nonetheless, because consumers of infrastructure services are a diverse group covering a wide range of income levels this may not always be so. This illustrates the problems of trying to target distribution through such regulation. As the NECG noted, distributional objectives are more appropriately addressed using instruments which can be better targeted to achieve the desired outcomes:

> Commonly, monopoly pricing is attacked because it involves a transfer of wealth from consumers to the monopoly producer. However, the most serious problem caused by monopoly pricing is the loss of social welfare, which results from the monopolist's profit maximising restriction of output …
>
> This is not to suggest that distributional issues are unimportant — they are important, and need to be addressed. However, concerns about income distribution are best dealt with through explicit distributional policies that rely on the instruments available through the tax and welfare systems. (sub. 39, p. 20)

Other participants concurred that the national access regime is not appropriate for addressing distributional concerns. The Queensland Mining Council submitted that:

> We do not believe it would be appropriate to include distributional issues in [Part IIIA] … in our view that is a matter for governments to determine outside the operation of access regimes. (sub. 27, p. 6)

In a similar vein, the NCC stated that:

> The national framework for competition policy ought not to be concerned with the distribution of income – distributional goals are best pursued by other, more direct, means. (sub. 43, p. 28)

And, responding to the Position Paper, EnergyAustralia (sub. DR106) expressed the same view.

Indeed, explicit pursuit of broader distributional goals through an access regime could be inconsistent with the efficiency objective of Part IIIA. For instance, if a regulator attempted on distributional grounds to set low access prices to assist particular groups of consumers, it could have adverse (short and long term) effects on efficiency. Yet, by using a more targeted instrument, such as budget-funded community service obligations, selected groups of consumers could be assisted without those deleterious impacts.

At a recent conference on Regulation and Investment (convened by the ACCC), it was noted that overseas experience had also shown the drawbacks of pursuing distributional goals through access (and related) regulation. For example, the former Chief Economist of OFTEL (the telecommunications regulator in the United Kingdom) noted that well-meaning regulation designed to accelerate artificially the spread of new services more broadly than otherwise would occur — for example, to ‘thin’ regional markets — could actually deter or delay investment in such services.

For all of these reasons, the Commission considers that it is not appropriate to provide the regulator with the discretion to use Part IIIA to pursue distributional outcomes.

FINDING 6.1

The national access regime is not an appropriate vehicle for pursuing distributional outcomes.

Elaboration of the objects clause

An objects clause is a first stage espousal of the purpose of legislation. As a general statement of principle, an objects clause, of itself, does not provide regulators with all of the guidance necessary to ascertain the balance between the interests of current and prospective infrastructure providers, access seekers, end users and, more broadly, on how best to improve efficiency of resource use.

Therefore, it might be useful to elaborate on the intent of the objects clause in any Explanatory Memorandum that accompanied a Bill to implement changes to Part IIIA. More generally, in drafting any consequent changes to the legislation, consideration could be given to using notes and examples within the legislation to guide the intent of constituent Divisions.

That said, the Commission agrees with the note of caution expressed by the NECG on this matter:

> In view of the potential scope for error in undertaking the task of drafting the Explanatory Memorandum, we consider that the Commission should focus on the approach of tightening the provisions of Part IIIA itself to overcome the need to rely solely upon an objects clause. (sub. DR76, p. 17)

In a similar vein, the ACCC commented that:

> … an objects clause is no substitute for clearly expressed legislative provisions. For instance, to ensure certainty of the provisions the most important requirement in relation to Part IIIA is clearly defined declaration criterion, and a well-defined and understood list of matters that must be considered in the context of certification, arbitration and assessment of undertakings. (sub. DR93, p. 4)

Perhaps also reflecting this view, AusCID saw the need for reference to the objects clause in a number of Part IIIA provisions. It said:

> … even greater utility would be derived if the objects clause were not simply an underlying statement of policy intent *to which resort could be had in cases of ambiguity*, but also something to which the relevant decision maker, the [National Competition] Council, the designated Minister, or the ACCC in its arbitration role, must have regard in applying the criteria (sub. DR80, p. 6, emphasis added).

The Commission agrees with the views of the ACCC and sees merit in AusCID's proposal on this issue. It considers that the objects clause should not simply be viewed as extrinsic material to be referred to only when the meaning of a constituent provision of Part IIIA is unclear. Rather, it should condition the interpretation of relevant provisions of Part IIIA — particularly, where the ACCC is required to arbitrate disputes and assess proposed undertakings based on a list of unweighted decision criteria.

Moreover, while the declaration criteria are somewhat different — as all of the criteria must be met — there remains a case for the objects clause at least to be considered in the context of the 'public interest' criterion (see chapter 7).

For these reasons, the Commission is of the view that the objects clause should be taken into consideration in all Part IIIA determinations, including coverage recommendations by the NCC and subsequent decisions by the relevant Minister.

(The Commission is also proposing in chapter 9 that it be a requirement that an industry access regime contain an objects clause in order for it to be certified as ‘effective’.)

RECOMMENDATION 6.2

For all coverage decisions and determinations under Part IIIA, the relevant decision maker should be required to have regard to the objects clause.

The Commission considers that whether this recommendation is best implemented by restating clause (a) of the objects clause in all of the relevant sections of Part IIIA, or by making this aim explicit in the objects clause section itself, is a matter for those drafting the requisite legislative amendments to Part IIIA. (AusCID (sub. DR117, p. 2) provided examples from a variety of Acts to illustrate how an objects clause could be made more directive rather than ‘used simply when an ambiguity arises in the interpretation of particular issues’.)

6.4 The need for pricing principles in Part IIIA

If an objects clause is to have more than symbolic value, it is important to ensure that, in an operational sense, the objectives are pursued. In the first instance, this depends on the criteria which govern the various access routes — declaration-arbitration, certification and undertakings. Impinging on all of these routes is the matter of access pricing — a point noted by APIA which contended that:

> In setting Part IIIA objectives it should be recognised that currently Part IIIA is largely an ‘access only’ regulatory system, yet third party access to natural monopoly infrastructure creates the need for pricing principles. (sub. 32, p. 2)

The ACCC (2001b, p. 4) recently noted that efficiency of service use and efficient investment — the key elements of the Commission’s recommended objects clause (above) — are determined to a large degree by the terms and conditions of access:

> The [ACCC] believes that access pricing proposals should be designed to:
>
> - prevent monopoly rent-taking by facility owners; and
> - provide efficient market signals for the use of existing facilities and for future investment.

Thus, to meet its objectives and perform its framework function adequately, Part IIIA must address pricing concerns. While Part IIIA currently contains some broad criteria to guide regulators when conducting arbitrations for declared services, assessing undertakings and certifying access regimes as effective, these are so general as to be of limited value. More specifically, in an operational sense, the criteria do little to signal what constitute 'efficient access prices'. For example, when arbitrating an access dispute for a declared service, the ACCC must take a range of matters in to account, all of which could have an impact on the prices set. These criteria are:

(a) the legitimate business interests of the provider, and the provider's investment in the facility;

(b) the public interest, including the public interest of having competition in markets (whether or not in Australia);

(c) the interests of all persons who have rights to use the service;

(d) the direct costs of providing access to the service;

(e) the value to the provider of extension whose cost is borne by someone else;

(f) the operational and technical requirements necessary for the safe and reliable operation of the facility; and

(g) the economically efficient operation of the facility (s. 44X).

Clearly, the ACCC must exercise significant judgement in interpreting what each matter means for pricing. As the Law Council observed:

> … the meaning of some of the terms used in the arbitration criteria … are unclear. It is also uncertain whether all criteria must equally be satisfied, or whether some may be traded off against others. (sub. 37, p. 21)

In turn, potential access seekers and service providers effectively receive little guidance on how the ACCC might act in a particular situation — other than by reference to precedents which have yet to be set. The NCC argued that:

> … the pricing principles that are currently applied in the context of arbitrations for declared services are too vague to provide guidance to the parties involved in access issues. S.44X(1) merely sets out a range of factors, some difficult to interpret (for example, the direct costs factor), without any indication of the weight to be put on each factor or of the basis on which they are to be combined.
>
> This has far-reaching effects:
>
> - it makes it difficult, in the context of declaration decisions, to determine the consequences of declaration, as so much latitude exists as to the terms and conditions of access;
> - it likely reduces the willingness of the parties to achieve commercial settlement, as they have little basis for determining the likely outcomes of arbitration; and

- it hinders the task of arbitrators and encourages appeals from arbitral decisions. (sub. 43, p. 48)

Many first round submissions agreed with the NCC's view that greater guidance on pricing principles would provide some much needed certainty to both service providers and access seekers, in turn improving the operation of the negotiation-arbitration framework which is central to most access regimes (see also chapter 8). As Freight Australia, which is both an access seeker and a provider, commented:

> In a negotiate and arbitrate access regime, it is important that all relevant parties — including the regulator — have a clear understanding of the 'market rules' for determining commercial terms and conditions. In this regard, there is guidance value in having a clear set of robust pricing principles. (sub. 19, p. 3)

Similarly, the Law Council saw the inclusion of pricing principles as particularly important in conditioning negotiations:

> A very real problem with a two-stage process is that if an access provider is concerned with the price that the ACCC might eventually set, it will strenuously fight declaration because if the access seeker gains declaration, that will greatly weaken the ability of the access provider to bargain over price. The Law Council recognises that while it is not possible to provide detailed pricing guidelines which will be applicable in all situations, the problem identified can be partially addressed by providing some very broad guiding principles. These fundamental principles should go some way to allaying the fears of access providers about inappropriate pricing if they are subject to arbitration. (sub. 37, p. 21)

Some participants also considered that the inclusion of pricing principles in Part IIIA could help to promote greater consistency in the pricing approaches adopted in industry regimes.

As well as assisting regulators, inclusion of transparent pricing principles housed within access legislation would help to ensure that their decisions were consistent with the intent of the legislation. Where a regulator is required to interpret vague and conflicting pricing criteria, it is open to accusations that its own views will affect pricing outcomes. For instance, the Institute of Public Affairs (IPA, sub. 18) suggested that the ACCC's approach focuses too heavily on short term considerations. On the other hand, the Energy Markets Reform Forum (sub. 7) suggested that the pricing approaches adopted by some regulators have allowed facility owners to retain monopoly rents. Pricing guidelines could help to address such concerns.

Participants’ responses to the Position Paper

In its Position Paper, the Commission agreed with the views of participants that greater pricing guidance in Part IIIA would provide benefits. Accordingly, it proposed that pricing principles should be included in Part IIIA with application to arbitrations for declared services, assessments of undertakings and evaluations of whether existing access regimes are effective.

As discussed in chapter 12, there was much commentary on the specifics of the Commission’s proposed pricing principles. However, the concept of having principles within Part IIIA was widely endorsed. For example:

> … we welcome the proposal made in the Commission’s Position Paper that pricing principles should be inserted into Part IIIA. (IPA for United Energy, Citipower and TXU Networks, sub. DR61, p. 30)

> … we support the Commission’s proposals to … incorporate a set of pricing principles in Part IIIA to make access determinations more ‘predictable’ (Freight Australia, sub. DR62, pp. 1-2)

> AusCID sees the introduction of appropriate pricing principles within the TPA as a critical issue arising out of the Commission’s Position Paper … it is the terms and conditions on which access is granted that have the key impact on incentives for investment. (AusCID, sub. DR80, p. 38)

Among other participants supporting the inclusion of pricing principles in Part IIIA were the ARTC (sub. DR64), the Australian Petroleum Production and Exploration Association (APPEA, sub. DR65), APIA (sub. DR70), the Australian Gas Association (AGA, sub. DR84), the EUAA (sub. DR94) and EnergyAustralia (sub. DR106).

However, the ACCC, as the body responsible for assessing undertakings and conducting arbitrations, saw no need for pricing principles within Part IIIA. It said:

> The ACCC does not concede that it is necessary to include additional guidance in Part IIIA relating specifically to access pricing. Rather, access is about a large range of issues, only one of which is the price of access. … The ACCC believes that Part IIIA’s existing declaration criteria are sufficiently broad to deal with [the] whole range of access issues. The ACCC believes that introducing pricing specific principles would tend to over emphasise pricing issues at the expense of other, equally important, terms and conditions of access. (sub. DR93, pp. 26-7)

The ACCC also noted that industry specific codes, such as electricity and gas, already include pricing principles. It further considered that the meaning of the proposed principles would be ‘indiscernible’ unless read in conjunction with the Position Paper, which a court would not have the freedom to rely upon.

Concerns that generic pricing principles will necessarily be so broad as to limit their effectiveness were shared by some other participants. For example, Duke Energy International considered that:

> … in order to be acceptable and applicable in all circumstances, these principles will need to be pitched at a high level and as such, are unlikely to significantly constrain regulatory discretion and therefore will not provide adequate certainty to service providers. (sub. DR95, p. 3)

Similarly the NECG, while supporting the inclusion of pricing principles in Part IIIA, commented that:

> … these proposals will not, by themselves, provide the environment in which investors can do their part to achieve the objectives of Part IIIA. (sub. DR76, p. 32)

And, while suggesting that legislated pricing parameters 'can assist in ensuring consistency of terms and conditions across access regimes and regulators', the Queensland Treasury (sub. DR105, p. 5) acknowledged that there are limitations as to their effectiveness in achieving this objective.

The ORG (sub. DR 112), which supported 'the objective of providing greater clarity' for pricing of infrastructure services, raised concerns about the relationship between generic pricing principles in Part IIIA and the principles applying under industry regimes. It alluded to a tension between pricing principles that are so general as to be meaningless and prescriptive principles which would constrain regulatory approaches under industry access regimes. Accordingly, it questioned the efficacy of developing pricing principles for Part IIIA without recourse to the requirements of specific regimes. It suggested that:

> … there is a need to review other regulatory instruments such as the National Electricity Code and the National Gas Code at the same time as defining the set of high level principles that could potentially be embodied in Part IIIA. This would ensure that there was greater consistency between the overarching framework and the regulatory instruments lying underneath, as well as improve the efficiency and effectiveness of the detailed approaches taken to pricing in specific industries. (sub. DR112, p. 12)

The Commission's assessment

The Commission does not agree with the view put by the ACCC that the breadth of the declaration criteria mean that further guidance on pricing is unnecessary. The declaration criteria provide no guidance for any party seeking to expedite negotiation on the terms and conditions of access, either before or after declaration. This was stressed by many participants, including the NCC, which reiterated its view from the first round of submissions that pricing principles would provide much needed guidance in arbitrations.

The Commission also has difficulty accepting the ACCC's proposition that providing guidance on such a critical matter as pricing should be avoided because this might be seen to devalue the importance of non-price terms and conditions. Moreover, the fact that some industry regimes already have pricing guidelines does little to weaken the case for comparable provisions in Part IIIA — if pricing guidelines are appropriate for other access regimes, they would have merit for a regime such as Part IIIA where precedents are so lacking.

That said, the Commission acknowledges that general pricing principles cannot and should not be expected to remove all of the uncertainty surrounding the terms and conditions of access. This stems from the balancing involved in devising principles at a high enough level to cater to a diverse range of circumstances. In this respect, the Commission agrees with the NCC's view that 'while keeping the principles general and high level inevitably reduces the level of guidance provided … it would not be appropriate to prescribe particular methodologies' (sub. DR99, p. 10).

Thus, a key role of pricing principles is not so much to prescribe what should happen in a particular situation, but to rule out approaches and methodologies which would be inappropriate. More generally, even pricing principles which signal that a particular outcome could fall within a wide band provide, at least tacitly, some discipline on regulators to justify the outcome of a particular determination. For example, transparent pricing principles might allay concerns that a regulator will simply bring its own values to bear when setting the terms and conditions of access. Indeed, the Sydney Airports Corporation did not support the Hilmer Committee's proposal for case-specific pricing principles to be issued at the time of declaration because of the pricing discretion exercised by the ACCC. It said:

> … the ACCC exercises immense discretion under Part IIIA and related regimes and … none of these provide definite guidance to the ACCC on how it is to balance what are often diametrically opposed public interest considerations. It would be … only too easy for the ACCC to take individual decisions … unduly focused on price reduction at the expense of investment promotion. (sub. DR114, p. 71)

Similarly, in a joint submission, AusCID, APIA, AGA and the Electricity Supply Association of Australia expressed strong reservations about the ACCC's claims that the current arrangements provide sufficient flexibility to determine appropriate pricing structures. The parties noted that they 'have found it impossible to predict with any degree of certainty … how access will be regulated' (sub. DR119, p. 3).

A generic model for pricing principles could also have desirable demonstration properties. On this matter, the Western Australian Government (sub. DR69, p. 5) had 'no particular concerns with proposed pricing principles' but considered that the application of the principles to the assessment of the effectiveness of industry regimes should be achieved through renegotiation of Clause 6 of the CPA.

The Commission agrees that the inclusion of pricing principles in Part IIIA for evaluating the effectiveness of State and Territory access regimes is infeasible without changing the current Clause 6 arrangements. It has recommended accordingly in chapter 9. Suffice to note at this stage, that the Commission considers that there is a role for the jurisdictions to renegotiate elements of the certification criteria, including the incorporation of pricing principles.

As regards the ORG's suggestion that Part IIIA pricing principles should be developed in conjunction with those embodied in existing access regimes, the Commission considers that its recommended principles are of a sufficiently high order to not conflict generally with industry-specific approaches. Indeed, if particular industry regimes included approaches to pricing which were in direct conflict with the specific pricing principles (set out in chapter 12), this would, prima facie, suggest poor regulatory practice that should be remedied.

In sum, the Commission considers that introducing pricing principles into Part IIIA would have a number of benefits, including:

- providing better guidance on how the broad objectives of access regimes should be applied in setting more detailed terms and conditions;
- providing a measure of certainty to regulated firms and access seekers, in turn improving the operation of the negotiation-arbitration framework;
- providing some guidance for the pricing principles and/or approaches employed in industry regimes; and
- helping to address concerns that a regulator's own values will unduly influence decisions relating to the terms and conditions of access.

RECOMMENDATION 6.3

Pricing principles should be included in Part IIIA with specific application to arbitrations for declared services, assessments of undertakings and evaluations of whether existing access regimes are effective (see recommendation 9.2).

Whether the Commission's proposed pricing principles would have a *direct* bearing on certification depends on the acceptance of recommendation 9.2 and, in particular, a requirement that for a regime to be found effective, it include appropriate pricing principles. But even if this latter element of recommendation 6.3 was not accepted, the Commission considers that the pricing principles would still have desirable demonstration properties by providing a model which could be adopted and/or modified to suit the particular circumstances of industry regimes.

6.5 Integrated and non-integrated bottleneck facilities

There are two broad schools of thought on what sort of essential facilities access regulation should cover:

- It should target only vertically integrated facilities, with 'residual' monopoly power issues addressed through other forms of prices oversight — essentially the model proposed by the Hilmer Committee (1993); or
- It should be based on an infrastructure facility's bottleneck position in the market, rather than whether or not it is integrated into adjacent markets — essentially the current approach under the Part IIIA regime.

In the case of a vertically integrated facility, access regulation, as well as providing a means for access, *must* address the terms and conditions of access. Otherwise, the facility owner could offer an access price which effectively denied access to the service. This is the undisputed 'base case' for coverage of an access regime.

Among participants who thought that access regulation in general and Part IIIA in particular should be limited to this base case, a major consideration was that it will often be in the interests of a non-integrated provider to encourage access to its services (box 6.1). These participants were therefore of the view that the issue for non-integrated facilities is primarily one of monopoly pricing which can be addressed adequately via a price oversight mechanism.

Box 6.1 **Some views on the coverage of non-integrated facilities**

- Infrastructure owners which control a single asset with no vertical integration either upstream or downstream have no incentive to use market power (if it exists at all) to reduce the level of service offered. … It is therefore incongruous that the National Access Regime applies in these situations. … uncompetitive behaviour … should be dealt with under the … the Trade Practices Act … (AusCID, sub. 11, p. 11)
- 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 extract further monopoly rents. The problem of access regulation in this situation … is strictly a problem of pure monopoly pricing. As such, prices monitoring or surveillance would be sufficient to remedy the problem. (Freight Australia, sub. 19, p. 6)
- By its very nature, the non-vertically integrated firm does not provide services to its competitors … However, it is possible to conceive of circumstances where access may be denied leading to anti-competitive outcomes. … in these instances, there are remedies available in Part IV of the TP Act … (Australian Pacific Airports Corporation, sub. 10, p.2).

However, as discussed in chapter 3, many other participants questioned the appropriateness of such an approach. Typifying these views, the NCC stated that:

> … the exclusion from the scope of the regime of entities that are not vertically integrated would have two effects.
>
> To begin with, it would induce socially costly avoidance and evasion. Avoidance would occur as entities restructured merely so as to avoid coverage. This would result in once-off costs; additionally, the loss of economies of scope, and the possibility that the vertical separation would result in double marginalisation, mean that continuing social costs would be incurred. At the same time, the difficulties inherent in defining what is meant by 'vertical integration' would incite evasion, as entities structured their affairs so as to 'walk the line'. The very great difficulties that have been faced, in the context of s.45A(2) of the TPA, in giving meaning to the concept of a 'joint venture' highlight the extent of the problems that are likely to arise.
>
> Secondly, such a restriction would allow behaviour that is socially costly to escape from the main remedy available in the Australian competition policy regime. As no benefits to the community can be identified from this outcome, the rationale for making coverage dependent on the presence of vertical integration is extremely weak. (sub. 43, p. 24)

Position Paper proposal

In the Position Paper, the Commission concurred with those participants who argued that limiting the application of Part IIIA to integrated entities would raise the sort of problems noted by the NCC (and discussed in chapter 3). The Commission also argued that:

- the efficacy of Part IV in addressing third party access issues — in particular, monopoly pricing — would be questionable (see also chapter 5). In this regard, it pointed to widely expressed doubts about the scope to establish the intent behind the use of monopoly power, which is necessary to secure action under Section 46 of the TPA;
- addressing monopoly pricing of access by non-integrated service providers through a price monitoring mechanism rather than Part IIIA would see different instruments used to address monopoly pricing by essential facilities — an access regime for integrated facilities and prices oversight for non-integrated facilities; and
- a regime which was confined to vertically integrated facilities would have less capacity to accommodate 'transitional' situations. In particular, it would rule out subjecting public sector facilities, which have been separated, to closer scrutiny to ensure that such separation was not undermined by contractual reintegration through exclusive dealing with favoured suppliers in the downstream market (see also chapter 3).

On the basis of these considerations, the Commission considered that the status quo, in which all essential infrastructure facilities that meet the relevant materiality criteria are covered by the national access regime, had a number of important advantages. It therefore proposed that there be explicit recognition in Part IIIA that the regime covers eligible services provided by both vertically integrated and non-integrated facilities.

Response to the Position Paper

Few participants commented on this aspect of the Position Paper. Specialised Container Transport (sub. DR85), the EUAA (sub. DR94) and the Queensland Treasury (sub. DR105) endorsed the Commission's proposal and the majority of participants who had previously argued for Part IIIA to apply only to vertically integrated facilities also appeared to accept it. That is, they did not re-iterate their previous position.

However, the ARTC continued to mount a case for different regulatory treatment based on the degree of vertical integration. It proposed a prescriptive *third party* access regime 'in circumstances where the access provider is related to entities with upstream or downstream market significance (vertically integrated)' and an *open* access regime 'in circumstances where the access provider has no upstream or downstream interests' (sub. DR64, pp. 4-5). Elaborating on its position at the public hearings, the Corporation said it was not proposing two discrete regimes within Part IIIA, but that the degree of control over prices and conditions *within industry regimes* should take account of firm structure (transcript, pp. 159-60).

Further, in a submission on behalf of United Energy, Citipower and TXU Networks, the IPA questioned the Commission's rationales for retaining coverage of non-integrated facilities within Part IIIA. It argued that:

- any inconsistency of treatment from not covering non-integrated facilities would be minor and could be addressed through changes to regulatory structures;
- structural separation to avoid Part IIIA would be unlikely, given the one-off costs;
- the problems identified with transitional situations essentially reflect the entrenched culture of State owned monopolies which could be addressed through other means (such as the exclusive dealing provisions of Section 47 of the TPA);
- evasion by 'walking the line' could be taken into account by a regulator in determining whether a facility was truly non-integrated. Over time, a body of precedent on approaches to determining what structures were deemed to constitute integration would evolve (see also discussion below); and

- socially costly behaviour could be adequately addressed by Part IV of the TPA and a revamped Prices Surveillance Act with stronger price control powers.

With these matters in mind, the IPA said that greater attention should be given to:

- creating a 'sub-part' of the PSA that was specific to downstream industries and consistent with the principles of Part IIIA; and
- considering whether amendments to s46 of the TPA would enable it to function as an alternative instrument for facilities that would otherwise be likely to be subject to Part IIIA (sub. DR61, pp. 35-6).

A number of participants also raised concerns with the Commission's proposal to make the status quo with respect to coverage explicit within Part IIIA. For example, the Law Council cautioned that:

> … there is a doubt when you read the legislation perhaps — particularly having regard to the fact that the Hilmer report and I think the Competition Principles Agreement was really only talking about vertically integrated facilities — that the legislation appears to apply to both. But it's been made clear that is the interpretation that has been adopted by the Tribunal. Now, unless one wants to alter that, again why the need to change the language? … I can also see the difficulty in trying to define what is vertically integrated and what isn't.
>
> … if you're going to spell it out, then you're going to have to say what you mean by vertically integrated and not vertically integrated and there is a problem (transcript, pp. 268-9).

The NCC also noted that any statement in the Part IIIA legislation specifying coverage in terms of vertically integrated or non-integrated facilities would, in a statutory sense, have to address a range of definitional issues:

> You've got concepts of holding companies, companies that are legally separate but have common ownership, you have got concepts of vertical integration through contractual arrangements, and it would just seem that getting into having to increase the complexity and the technical definition section of the act is just a question of what would be achieved by that when in fact its silence at the moment seems to be doing exactly what it is that the Commission seemed to be supporting. (transcript, p. 487)

The Commission's assessment

The Commission does not resile from its view that it is appropriate to have one consistent framework for all essential bottleneck facilities — whether integrated or not. Indeed, the fact that the IPA acknowledged the need for significant changes to the PSA in order to fulfil the role currently catered for by Part IIIA is a recognition of the potential problems that could arise in removing non-integrated facilities from the coverage of Part IIIA. Moreover, as noted in chapter 5, the Commission sees considerable problems in seeking to modify generally applicable statutes in order to cater to the particular circumstances of third party access.

In any case, changing the nature of the coverage of Part IIIA based on characteristics such as vertical integration could create considerable problems for legal interpretation — possibly further increasing incentives to alter firm structures to avoid coverage. While it has been contended that such problems could be overcome through precedents, in the Commission's view, to the extent that sufficient precedent could ever be established in a regime where declarations are so uncommon, this could take many years.

At the same time, given the concerns about the legal interpretation of changes to give legislative expression to the status quo, the Commission no longer sees value in jeopardising the current interpretation that Part IIIA applies to both integrated and non-integrated essential services. It has, therefore opted to let current practice stand.

FINDING 6.2

Part IIIA should continue to cover eligible services provided by both vertically integrated and non-integrated facilities.

6.6 Natural monopolies or market power?

The majority of participants, considered that Part IIIA should apply only to natural monopolies. For example, the Law Council, in adopting a 'harm-minimisation' approach, stated that:

> Given the impact on the incentive to innovate and invest and the potential for new entry against non-monopolies, there is no reason for Part IIIA to apply to facilities other than natural monopolies. (sub. 37, p. 5)

The NCC (sub. 43) noted that it expected that Part IIIA would be 'limited to facilities with natural monopoly characteristics'. On the other hand, the ACCC (sub. DR93) argued that Part IIIA should also serve to constrain duopoly behaviour and even what it referred to as 'natural oligopolies'. (This is discussed further below in the context of telecommunications.) Some other participants also considered that the national access regime should take into account alternative sources of market power. For example, Professor Brunt (sub. 21) suggested that Part IIIA should apply to all significant corporations possessing substantial market power.

Whether an access regime should address market power in general or be based on a key source of market power — such as a natural monopoly technology — is an important issue which bears directly on the nature of the declaration criteria. Clearly, market power can arise from other sources such as:

- unfair trading practices — for example, the formation of cartels;
- legislated monopolies — where legislated restrictions on competition create a monopoly even though the market could efficiently sustain more providers; and
- network externalities — a phenomenon which can arise from complementarity between network elements, or between elements of different networks. Allied to this may be the advantages of 'first mover' incumbency.

In the Commission's view, the first two categories should fall outside the purview of access regulation. Monopoly behaviour which arises from the abuse of market power (such as exclusive dealing and predatory pricing) is typically and appropriately dealt with under Part IV of the TPA. Part IV presumably also serves to deter such practices.

Similarly, monopolies which owe their market power to legislative restrictions on competition generally should be addressed by reform of that legislation. The use of an access regime would, by and large, be an inappropriate policy response. As the New South Wales Government noted:

> … rather than imposing more regulations to achieve competitive outcomes, the legislation should be reviewed to remove competitive restrictions. The imposition of more regulations has the potential to create new restrictions … (sub. 44, p. 4)

As an aside, legislated monopolies are in a similar class to non-commercial conduct by a public enterprise. In this latter regard, the ACCC (sub. 25, p. 20) cited the example of a public enterprise which does not have a profit maximising motive and consequently prices below costs with the *unintended* effect of 'destroying or deterring new entrants'. Clearly, an access regime could be used in such instances, but other more direct remedies such as commercialisation, privatisation or the introduction of competitive neutrality requirements would be preferable.

Of course, it is possible to envisage situations where policy makers might determine that a legislated barrier to entry should be retained, thereby maintaining a monopoly bottleneck in a market. An example might be an environmental land use restriction which meant that it was not feasible to develop a second facility. In such circumstances, exposure to access regulation may be desirable to counteract the resulting market power for the service provider. There may also be exceptional cases where, in the absence of any other remedy, an access regime could be used as a second best solution to address the effects of 'bad' policy.

The case of network externalities (see chapter 3) is more complex. For example, a particular service which may be potentially competitive could be bundled with, or tied to, a network, thereby placing the incumbent facility owner in a position to exploit monopoly power in providing the service.

The ACCC considered that a failure to address the market power associated with network externalities can have significant implications, such as inflated prices leading to allocative inefficiency. It contended that the national access regime provides a means of addressing these inefficiencies.

AAPT Limited also considered that Part IIIA should account for network effects:

> … there can be situations in which firms which are not monopolists but still hold market power are able to exercise that power to the detriment of access seekers and consumers. For example, the telecommunications industry is one in which ‘network effects’ can unfairly advantage a dominant network … (sub. 42, pp. 4-5)

As indicated by AAPT, the presence of network effects is a major issue for telecommunications competition regulation.

In the Commission’s view, the network externalities issue lends some support to the notion that Part IIIA should test for market power with the *source* of that market power being of secondary importance.

However, a potentially significant problem with such a market power based approach is that market power exercised by firms which do not employ natural monopoly technologies will often be unsustainable. And, where market power is only transitory, an access regime can mute the very pricing signals which attract increased competition.

At any particular point in time, it may be very difficult for a regulator, let alone a court, to distinguish between transitory and sustainable market power. Hence, loosening the Part IIIA tests to provide for the possibility of application to situations where market power arises for reasons other than natural monopoly could have unforseen consequences. That is, the looser the coverage criteria, the greater the prospects that a highly intrusive form of regulation could be extended to some infrastructure facilities which did not warrant it.

These observations do not necessarily rule out explicit provision for network externalities. However, infrastructure sectors characterised by network externalities — in particular, airports and fixed networks in telecommunications — will often also employ natural monopoly technologies. Hence, tests focussed on natural monopoly characteristics are, in practice, likely to address most situations where the primary source of market power is network externalities.

For these in-principle and practical reasons, the Commission considers that Part IIIA should, in terms of its declaration criteria, continue to focus on natural monopoly technologies. However, as noted in chapter 3, defining a natural monopoly technology is a difficult exercise, particularly when that definition must form the basis for legislation. Accordingly, there may be limits on the degree of legislative precision that can be accommodated by workable declaration criteria. This issue is discussed further in chapter 7.

In advocating that Part IIIA should focus on situations where market power arises from a natural monopoly technology, the Commission is not suggesting that this would preclude a broader market power test in particular industry access regimes. For example, there may be specific industries, such as telecommunications, where strong barriers to entry mean that, even with more than one service provider, the supply of an essential service carries with it substantial market power. Thus the Commission's report on Telecommunications Competition Regulation (2001c) has proposed that the access regime for that sector — where there is more than one provider of some essential inputs — should have declaration criteria that take into account other sources of market power.

Moreover, a focus on natural monopolies still leaves open the question of the definition of the market. As discussed in chapter 3, there are circumstances in which a service provider employing a natural monopoly technology may have little market power. Equally, an access problem can be 'defined away' if a broad enough market definition is adopted. However, in the Commission's view, these are issues that are most appropriately addressed via the declaration criteria, where the concept of the market will be an important consideration in the materiality of a declaration application (see chapter 7).

FINDING 6.3

Part IIIA should continue to focus on addressing market power arising from natural monopoly that leads to the denial or monopoly pricing of access to essential infrastructure services. In sectors such as telecommunications, however, it may be appropriate for industry regimes to address additional sources of market power impinging on the provision of access to the essential services concerned.

6.7 Other coverage matters

Exclusions from Part IIIA

As Part IIIA is aimed at the services provided by essential infrastructure facilities, its coverage provisions generally exempt the supply of goods. This is in keeping with access regimes around the world and also the views of the Hilmer Committee.

However, where goods are an integral but subsidiary part of a service, the exclusion may not apply.

Apart from goods, other exclusions from Part IIIA include the use of intellectual property and the use of a production process — again, unless they are an integral but subsidiary part of the service.

The rationales for these exclusions are to ensure that manufacturing plants are not caught up in the Part IIIA regime, that access to intellectual property is already covered by dedicated licensing arrangements and that access does not artificially and inefficiently break up an integrated production chain.

At first glance, these exclusions appear reasonable. However, the NCC considered that it is timely to re-appraise them:

> With five years experience in the operation and interpretation of the declaration criteria, there is a question about whether these restrictions were needed and whether they serve any purpose. (sub. 43, p. 52)

Indeed, it could be argued that, if the coverage of Part IIIA is confined to the *services* of natural monopolies, manufacturing plants involved in the supply of goods should be excluded automatically. The retention of a 'national significance' test in the declaration criteria provides a further safeguard against application to manufacturing plants (see chapter 7).

A number of participants raised particular concerns about the 'production process' exclusion, citing the recent Federal Court case relating to Hamersley Iron (see appendix D). For example, the Western Australian Government submitted that:

> The Hamersley case also raised, without adequately resolving, the question of the scope of the 'production process' exemption from the definition of 'service'. …
>
> The incorporation of a production process within a broader service potentially subject to declaration may in fact be a defining feature of vertical integration. The Federal Court's broad reading of the production process exclusion may reduce the likelihood of declaration where there is vertical integration, a result at odds with Hilmer's suggestion that the focus of the Commonwealth's access regime would be on vertically integrated monopolies. (sub. 38, pp. 12-3)

Similarly, the ARTC said of the Hamersley case that:

> This legal interpretation seems to encourage vertical integration and other business structures designed to avoid declaration. If exclusion of production processes from Part IIIA is desirable, then the definition needs to be more specific. (sub. 28, p. 9)

In contrast, the New South Wales Government (sub. 44, p. 4) contended that it was too early to tell whether the Hamersley decision might encourage firms to integrate vertically to avoid declaration. More generally, it noted that to date, ‘no problems have been identified with the exclusions from Part IIIA’.

However, in its response to the Position Paper, the NCC said that the Hamersley case is having wider implications:

> The issue of the proper interpretation of ‘production process’ has been raised again in the context of an application by companies in the Normandy group for declaration of services provided by the electricity transmission and distribution networks owned and operated by Western Power. Western Power is seeking a determination from the Federal Court that the service that is the subject of the application is not a service under Part IIIA on grounds which include that it is an integral part of Western Power’s production process. The outcome of these proceedings may also have an impact on the National Electricity Code, as the industry code undertakings rely on the definition of service under Part IIIA. (sub. DR99, pp. 14-5)

The NCC argued that removal of the current exclusions would allow consideration of whether a service should be declared to be determined in the context of the declaration criteria.

While the Commission has some sympathy with this view, it is not convinced that removing the production process exclusion would offer a significant prospect of achieving better outcomes. In the particular instance of Hamersley’s operations, the Federal Court’s finding that the rail operations were more than a mere conveyance system and were integrated into Hamersley’s production processes might not have been unreasonable (see appendix D). That is, it may have been inefficient to declare Hamersley’s rail operations.

More generally, under declaration criteria which focus on promoting competition, removing the production facility exclusion would place much greater emphasis on the public interest test criterion to rule out declaration where the inefficient break-up of a production process might arise. The Commission is not confident that the public interest test could be used in such a way.

However, should the outcome of the Western Power case have the potential to rule out declaration where it would be efficient, or otherwise have negative ramifications for Part IIIA, including the potential to undermine the National Electricity Code, this issue would need to be revisited. Depending on the timing and outcome of that case, the forthcoming review of energy markets could provide an opportunity to address this issue further.

The production facility issue aside, there was no evidence presented of problems arising from the other exemptions from Part IIIA.

RECOMMENDATION 6.4

While the current exclusions from the coverage of Part IIIA should be retained, developments in relation to the 'production facility' exemption should be monitored by the National Competition Council. Should judicial interpretation of that exemption lead to outcomes that detract from efficiency, it may be necessary to remove the provision or clarify its intent.

If there are to be exemptions from Part IIIA, the issue arises as to whether other activities should be excluded. In this context, Dr Barry Aldrich suggested widening the exclusions as a means to narrow the scope of Part IIIA:

> Exclusions and other statements should be listed that will serve to clarify and substantially narrow the range of facilities for which defined use might be declared. Such a list will incidentally serve to illustrate the intended scope of Part IIIA (sub. 31, p. 5)

More specifically, the IPA on behalf of United Energy, Citipower and TXU Networks argued for a tightening of the definition of a 'bottleneck' such that Part IIIA would only apply to facilities which provide a service *to* a market and not facilities that serve a *supply* source. It argued 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. (sub. DR61, p. 13)

While having some sympathy with the IPA's argument, the Commission considers that there might be problems in defining bottlenecks in this fashion. In particular, what constitutes an 'upstream facility', rather than a transmission network serving an upstream market, could sometimes be a source of dispute. Notably, in the case of gas gathering lines (an example cited in the joint submission), participants in the gas sector expressed a range of views on whether Part IIIA coverage should apply (see box 6.2). Hence, in the Commission's view, the current approach of testing services against generally applicable criteria is preferable to attempting to draw the sort of limits around the regime suggested by the IPA.

Box 6.2 **Access to gas processing plants**

APIA considered that:

> Some might argue that natural gas production is a ‘production process’ for the purpose of Part IIIA and thus cannot be covered by access. If so, this indicates a fault in the structure of the access model, which looks only at ‘bottlenecks’ in the middle of the supply chain and not the market as a whole. (sub. 32, p. 9)

It added that while an Upstream Issues Working Group (under COAG) had found no need to mandate an access regime, it had found a strong case for developing a set of ‘best practice principles’ for access. APIA went on to recommend that:

> Access to certain upstream facilities – notably gas processing plants – could encourage greater competition in these non-competitive upstream markets. To this end Part IIIA should be amended to make it clear that gas production activities can fall within the framework of access to essential facilities. (sub. 32, p.10)

In contrast, APPEA considered that:

> Access regimes are not necessary for production or processing facilities where those facilities are available on a competitive basis. … production or processing facilities are reproducible in larger or smaller versions and do not exhibit natural monopoly characteristics. This is demonstrated by the economic duplication that occurs in the upstream facilities. For example, there are nine gas processing plants in WA and five pipelines to shore, but there is only one Dampier to Bunbury pipeline.
>
> APPEA member companies … are accustomed to negotiating commercial cooperation and have successfully concluded numerous third party access arrangements …
>
> There have also been no interventions in jurisdictions which have power to mandate access to upstream facilities, which indicates that normal, commercially negotiated arrangements are working satisfactorily. (sub. 35, pp. 4-6)

Occupying the middle ground, the AGA (sub. 29) considered that, to ensure that the benefits of competition reform accrue to the end-users of gas, no part of the supply chain should be quarantined from competitive pressures, including upstream gas facilities. That said, it considered that the most effective way of promoting basin-on-basin competition would be to create the market and regulatory preconditions for long term investment in interstate pipelines to link various basins around Australia.

As regards the specifics of gas production facilities, the Commission considers that access issues and the findings of the COAG Upstream Issues Working Group should be addressed in the forthcoming review of energy markets and/or the Gas Code.

Finally, as noted in chapter 4, because access regimes can have a ‘chilling’ effect on investment, there is a strong in-principle case for excluding those investments which are expected to provide only normal returns. However, for the reasons set out in chapter 11, the Commission considers that specific mechanisms operating within Part IIIA would be preferable to a blanket exemption for ‘marginal’ projects.

Facilities or services?

Under Part IIIA, it is the service, not the facility, which can be declared. The emphasis on services provided by a facility is premised on the observation that some of the services provided by a bottleneck facility may be contestable. Therefore, declaration of entire facilities could result in an unnecessary infringement of property rights.

The Commission received a range of views on whether the current focus is appropriate. The ACCC noted that several issues relating to the definition of a service have been considered judicially, but that on the whole:

> … the various decisions relating to declaration have not given rise to significant problems … it is too early to be suggesting changes to the definition of service. (sub. 25, p. 73)

The Western Australian Government also considered the current distinction between services and facilities to be appropriate:

> Granting access to the facility, rather than to services, could allow access seekers to demand, for example, that their employees actually control the facility for the time that their product uses it. Apparently, when the third party access policy was first released, a number of facility owners and prospective access seekers believed that this was what the policy meant. Access to the facility, rather than to the services of the facility, may raise issues of third party liability, insurance and safety. It would also increase the likelihood of the regulator being required to intervene in commercial and risk management matters relating to physical control of the facility. (sub. 38, p. 14)

Santos Limited raised concerns about an increase in regulatory risk, were this aspect of the current arrangements to be changed:

> Any relaxation of the service definition is likely to impinge on a wide range of activities and facilities operating in the production and processing sections. Particularly it is likely to affect: oil refining, mineral processing, chemical processing and may extend to all production processes including manufacturing plants. It is not an argument to say that significance is a test which would provide protection. State regimes and regulators seriously diminish the meaning that significance may have in a national context. Further, the stated intention of some states to use access for 'state development' rather than 'competition' reasons will also influence this outcome. (sub. 34, p. 5).

The Law Council of Australia expressed reservations about technical legal arguments which arose in the Sydney Airports case about what constituted a facility. In that case, the Tribunal saw it necessary to address whether the relevant facility was the concrete hard stands, or the passenger and freight aprons adjacent to the international terminal, or some combination of hard stands, aprons and the international terminal, or indeed, the entire airport. The Law Council considered that the legislation should be amended and that the declaration criteria should refer only to a ‘service’ (sub. 37, p. 11).

The Motor Trades Association of Australia (MTAA) questioned the appropriateness of the distinction between services and facilities from the perspective of its desire to see the introduction of an access regime for petroleum terminals. It argued that ‘distribution networks of terminals cannot be easily duplicated’, adding that:

> The Government has said that it has advice that Part IIIA is not applicable to terminals that have distribution facilities as Part IIIA applies to services and that terminals with distribution facilities are not services. (sub. 9, p. 2)

In a follow-up submission, the MTAA argued that:

> Access continues to be generally denied to resellers. Because of that and the nature of supply contracts and franchise arrangements in the oil industry, the oil majors have an increasing level of influence over both the wholesale and retail sectors of the petroleum industry. (sub. DR115, p. 3)

However, this inquiry into the operation of Part IIIA is not the appropriate forum to determine whether particular facilities such as petroleum terminals should be covered. The Commission notes that a fuel taxation inquiry, due to report to the Government in March 2002, among other matters, is examining ‘the interplay between fuel taxation and related issues such as petroleum pricing, cost structure and marketing arrangements with particular attention to the effects of competition (in particular access to supply)’ (Treasurer and Minister for Industry, Science and Resources, 2001). The specific concerns raised by the MTAA would seemingly be encompassed by this inquiry.

More broadly, there do not appear to be significant problems arising from the current emphasis on services in Part IIIA. That said, while shifting the emphasis to facilities could create a range of problems — such as coverage of non-essential services provided by essential facilities — the Commission considers that there is some attraction in shifting the balance of Part IIIA even further towards services. (Indeed, if the regime were being introduced today, there would a case for delineating it solely in terms of services.) However, the legislative changes required to focus Part IIIA solely on services could create considerable uncertainty about how regulators and the judiciary would interpret the change of emphasis. As discussed further in the context of the declaration criteria in the next chapter, such action does not appear to be warranted.

FINDING 6.4

The current emphasis of Part IIIA on the services provided by essential infrastructure facilities is broadly appropriate.

7 Declaration

Part IIIA provides a two stage process for access to essential infrastructure services through declaration of a service, and subsequent negotiation and (if necessary) arbitration of terms and conditions of access to that service. This chapter discusses the declaration process, which is designed to deal with access to services provided by infrastructure already in place (as distinct from prospective investment in essential facilities). The negotiation-arbitration phase is discussed in the next chapter.

From one perspective, declaration is a little used residual route for access. To date there have been only two successful declarations (one of which was an interim measure). And, while the National Competition Council (NCC) has recommended that a few other services should have been declared, most of the main candidates — electricity, gas, rail, airports and telecommunications — are already covered by industry-specific regimes.

Nevertheless, it is equally important to recognise that:

- the threat of declaration plays a pivotal role in shaping State and Territory industry access regimes; and
- even though declaration confers an obligation only to negotiate, with ensuing arbitration criteria defining (or conditioning) the terms of access for declared services, it is still a significant intrusion on the property rights of service providers which weakens their bargaining position relative to that of access seekers.

It is therefore not surprising that there was much comment from participants on the Part IIIA declaration criteria.

7.1 The Commission’s approach

In its Position Paper, the Commission provided two tiers of proposals for reform of the declaration criteria. Tier 1 involved some wording changes to key existing criteria, whereas tier 2 provided a new package of declaration criteria. It considered that the tier 1 proposals would improve the *likelihood* that the services of essential facilities would be declared only where this would improve efficiency. The tier 2 package sought to give more prominence to the regime's efficiency objectives to ensure that the provision of access would be confined to bottleneck facilities and *would* significantly improve efficiency. However, as these proposals involved substantial changes to the current arrangements, the prospect of a net gain was considered to be less certain.

After the release of the Position Paper, three developments had a significant bearing on the Commission's thinking and approach:

- a change in emphasis by legal practitioners — from initially proposing substantive amendments to the declaration criteria, to subsequently raising concerns about how any changes might be interpreted by regulators and the judiciary;
- the decision by Australian Competition Tribunal (the Tribunal) on coverage of the Eastern Gas Pipeline (EGP) under the Gas Code; and
- participants' reaction to, and the Commission's further development of, proposals to minimise the adverse impacts of Part IIIA on new investment in essential facilities.

Judicial interpretation of changes to the declaration criteria: In the first round of submissions, many participants proposed extensive changes to the declaration criteria. For example, the Law Council of Australia recommended replacing all of the existing criteria with a new declaration package focussed explicitly on natural monopoly services.

However, in their responses to the Position Paper, the legal fraternity adopted a much more conservative and cautious stance. Some contended that making even minor amendments to the declaration criterion to reflect more accurately a particular interpretation would be fraught with risk. They suggested that the courts would be likely to interpret such amendments from the standpoint that a change in policy 'direction' must have been intended.

Mr Ian Tonking, appearing for the Law Council, said:

> … it's a peculiar characteristic of lawyers I suppose, who are fixated on language, to assume that any change must be made for a purpose and if particular language has been interpreted in a particular way and it's then changed, then those changing it must intend that it means something different from what it's been interpreted to mean, even if what it was interpreted to mean wasn't apparent on the face of the language before… That sort of catch up change, in other words, will be interpreted not just as a catch up but as trying to make some change in some other direction. (transcript, pp. 265-6)

Similarly, Ms Linda Evans (Clayton Utz) for the Australian Council for Infrastructure Development (AusCID), noted:

> … from the lawyers' perspective any changes which are made will assume to achieve a different purpose from that which currently exists. So it's difficult to effect a sort of tidying up or increased clarity because that will be assumed to mean a change from what is now set down … (transcript, p. 260)

The message in such advice is that there is need for considerable caution when proposing modifications to legislated criteria.

The Eastern Gas Pipeline decision: After the release of the Position Paper, the Tribunal handed down a decision on an appeal against the decision to cover the EGP under the Gas Code. The decision involved the interpretation of the coverage criteria for the Code which essentially mirror the Part IIIA declaration criteria.

Several participants referred to the outcome of the EGP decision when responding to the Commission's proposals for changes to the declaration criteria. Indeed, the decision led some to retreat from their initial positions given their perceptions that the meaning and interpretation of the declaration criteria has been settled satisfactorily. A few, however, argued that the decision has still not fully clarified matters and indeed had caused new difficulties.

Minimising the adverse impacts of Part IIIA on new investment: In the Position Paper, the Commission floated the possibility of introducing some sort of 'access holiday' as a means of addressing the negative impact that access regulation can have on incentives to invest in essential facilities. In response, participants proposed a range of specific mechanisms to provide better investment incentives — including binding rulings on whether a proposed new investment is likely to meet coverage criteria; placing new infrastructure outside the purview of Part IIIA until initial costs have been recouped; and regulatory compacts involving higher regulated rates of return for risky new investments (see chapter 11).

Most of these proposed arrangements are designed to operate in place of the standard Part IIIA arrangements. Therefore, if they were adopted, the reach of the declaration criteria could be narrowed substantially to cater for a residual group of infrastructure and to define the benchmark for any binding ruling arrangement. (Changes to the declaration criteria could also have implications for the coverage criteria in the Gas Code.)

Addressing the recent developments

The above developments led the Commission to modify the approach adopted in the Position Paper. As many participants drew on the recent Tribunal decision to respond to the Paper, this chapter has adopted the following 'chronological' structure:

- the initial views of participants on the current declaration criteria prior to the Position Paper (and hence before the EGP decision) are discussed in section 7.2;
- the Commission's initial assessment of the declaration criteria leading to its proposals for change in the Position Paper are discussed in section 7.3;
- participants' responses to the Position Paper proposals, including the implications of the EGP decision, are discussed in section 7.4; and
- the Commission's final assessment and recommendations are provided in section 7.5.

Also discussed in this chapter (section 7.6) is the merit or otherwise of allowing the NCC to recommend price monitoring as an alternative to declaration.

7.2 Participants' initial views on the declaration criteria

The current formulation of the declaration criteria are presented in box 7.1. Participants' comments on the criteria centred on the tests for promotion of competition, (natural) monopolies, national significance and the public interest. There was little comment on the tests relating to health and safety and whether a service is already covered by an effective access regime.

Box 7.1 **Declaration criteria**

Section 44(G)(2) of the TPA states that:

> The Council cannot recommend that a service be declared unless it is satisfied of all of the following matters:
>
> (a) 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;
>
> (b) that it would be uneconomical for anyone to develop another facility to provide the service;
>
> (c) 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;
>
> (d) access to the service can be provided without undue risk to human health or safety;
>
> (e) access to the service is not already the subject of an effective access regime;
>
> (f) access (or increased access) to the service would not be contrary to the public interest.

The promotion of competition test

(a) 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

This criterion requires the NCC to assess whether the relevant upstream or downstream market is different from the market for the service and whether competition would be promoted in that other market.

The genesis of the criterion can be traced to the Hilmer Committee which considered that a right to access should be created only where ‘access to the facility in question [was] *essential to permit effective competition* in a downstream or upstream activity’ (Hilmer 1993, p. 266, emphasis added). Subsequently, Clause 6(1) of the Competition Principles Agreement (CPA) specified that the Commonwealth would put forward legislation to establish a regime in which ‘access to the service is *necessary* in order to permit *effective* competition in a downstream or upstream market’ (emphasis added). Clearly, criterion (a), which refers only to promoting competition, sets a lower standard than envisaged initially for declaration.

In the first round of submissions, several participants expressed concerns about the application of criterion (a) by the Tribunal in its deliberations on the review of the of declaration of freight handling services at Sydney International Airport (the Sydney Airport case). For example, Mr Tonking argued that criterion (a) was too easily satisfied:

> … the Tribunal was constrained by the words of the statutory criterion — would competition be promoted by access, not was access essential to effective competition. If access is equated to the removal of an entry barrier, as it is likely to be in virtually every case, it is difficult to envisage how the conclusion could ever be other than that competition (that is, in the Tribunal’s terms, more competitors) would be promoted by declaring a facility open for access. In other words the wording of the test predetermines the outcome, all other things (such as the national significance of the facility) being equal. (sub. 5, p. 6)

Rio Tinto Limited (sub. 15, p. 17) also considered that ‘concerns about the widening of coverage have been given added weight by a recent [Sydney Airport] … Tribunal decision’. Similarly, Freight Australia (sub. 19, p. 8) noted that ‘an imprecise interpretation of that phrase [would promote competition] can arbitrarily raise or lower the hurdle for meeting the test of an essential service’.

In contrast, the Australian Competition and Consumer Commission (ACCC, sub. 25, p. 72) considered that ‘it is too early to argue that the declaration criteria should be amended to overcome perceived shortcomings’. In part, the ACCC’s view was shaped by a report by National Economic Research Associates (NERA) —

included within the ACCC submission — which found that ‘to date there have been no applications of Part IIIA that have been inconsistent with the application of access regimes internationally as a result of the declaration criteria’. Yet, in relation to the Sydney Airport case, NERA (2000, p. 46) commented that:

> The ACT [Australian Competition Tribunal] stated that the removal of barriers to entry to competing firms was sufficient to meet the requirement that declaration would promote competition.
>
> … this interpretation could potentially lead to more extensive application of access regimes than in other countries, where the requirement tends to be more tightly defined along the lines of competition not being possible without access to the essential facility.

The Law Council also raised concerns that criterion (a), as interpreted by the Tribunal in the Sydney Airport case, means that a ‘trivial’ increase in competition might justify access. It went on to argue that the criterion should be modified to include reference to a substantial increase in competition:

> Access is permitted where it would merely promote some competition, however trivial or insignificant, in another market, rather than it being essential to permit **effective** competition in an **upstream** or **downstream market.** … The Law Council suggests that the criteria be amended to include a reference to the promotion of a substantial increase in competition. (sub 37, p. 12)

Participants at the roundtable discussions similarly advocated that criterion (a) be modified to reflect the promotion of *effective* or *substantial* competition. However, the NCC argued that incorporating ‘substantial’ into criterion (a) would materially alter the balance of Part IIIA:

> … the test in Part IIIA requires that declaration will promote competition — it is not a test of likelihood but rather one that requires a degree of certainty … to require both the effect to be certain and that it be substantial could materially alter the balance of Part IIIA. (sub. 43, p. 37)

The Network Economics Consulting Group (NECG, sub. 54, p. 17) initially endorsed the NCC’s view. Prior to the EGP decision (see below), it said that attempts to amend the criterion to reflect a substantial promotion of competition would ‘raise the threshold to an inappropriately high level, leading to under-inclusive application of Part IIIA’.

Some participants also expressed doubts about the value of the ‘whether or not in Australia’ rider. Indeed, Rio Tinto saw its potential impacts as perverse:

> … while it is a reasonable presumption that an increase in competition in global markets would bring global benefits, it will not necessarily ‘enhance national living standards and opportunities’… Indeed, under certain conditions, the Australian community may actually suffer detriment from increased competition in a global market in which it trades. (sub. 15, p. 18)

Conversely, the Queensland Mining Council argued that the clause ‘is an important clarification that recognises the benefits from greater Australian penetration of overseas export markets’ (sub. 27, p. 9).

The monopoly test

(b) that it would be uneconomical for anyone to develop another facility to provide the service

Criterion (b) is generally considered to test for the existence of natural monopoly. The NCC submitted:

> The notion underlying the national regime is that access to facilities with natural monopoly characteristics is needed to encourage competition in related markets. The Council therefore expects that the application of the national regime will be limited to facilities with natural monopoly characteristics. (sub. 43, p. 80)

The ACCC contended that, notwithstanding the emphasis placed on natural monopoly facilities in the Hilmer Committee report, relevant CoAG communiques and the Second Reading Speech, this criterion:

> Extends beyond the natural monopoly case to natural duopolies or oligopolies, that is, where there are already two (or more) facilities but it would be uneconomic to develop another one. (sub. 25, p. 71, footnote 87)

However, the potential for a wider interpretation of criterion (b) was of concern to many participants. For example, Freight Australia submitted that:

> The issue of concern to Freight Australia — and probably other infrastructure owners or operators — is whether [some recent] declaration decisions reflect a departure from the access principles in Clause 6 of the Competition Principles Agreement and/or a shift in the NCC’s approach to applying access regulation as a means of dealing with simple (as opposed to natural) monopoly pricing problems. (sub. 19, p. 10)

Some participants proposed new criteria to confine declaration more stringently to natural monopoly situations (see box 7.2). Professor King’s proposed declaration criteria included a test for natural monopoly *technologies*. The NECG considered that defining a natural monopoly technology was unhelpful because ‘competitive conditions must be assessed relative to market’:

> … all economists know that the test of whether supply is sub-additive must be carried out with a definition of the supply and demand curves (that is, the market) in mind … The distinction between a natural monopoly technology and a natural monopoly seems like a somewhat overblown way of making this very simple point. (sub. 54, p. 14)

However, a feature of the tests suggested by King and Freight Australia is that they also introduce criteria to test explicitly for market power. Thus, to some extent, their approaches deal with the concerns raised by NECG that natural monopoly must be addressed in the context of a market. Moreover, the proposals would also help to meet the concern expressed by the Western Australian Government about the lack of an explicit test for market power in the current criterion (b):

> There is a question whether the 'uneconomical to duplicate' criterion adequately rules out declarations in cases where real substitutes exist, for example where intermodal competition precludes a natural monopoly existing, suggesting that regulation is not needed. In such a case, regulation of one industry and not the other could be potentially deleterious to longer term, more robust competition where the other industry is highly concentrated. The Inquiry could consider whether the criterion appropriately reflects the significance of substitutability and the extent of competition in substitute markets. (sub. 38, p. 3)

Box 7.2 **Testing for natural monopoly**

Professor King's proposed tests aim to capture the elements of natural monopoly in non-technical terms. King proposed that a service not be declared unless:

> (a) access (or increased access) to the service will substantially increase competition in the market for a final good or service;
>
> (b) the service is an input into further production and there is no alternative service or production process available to the access seeker that reasonably can be used for the production of the relevant final good or service; and
>
> (c) efficient production of the service necessarily involves an infrastructure facility with high fixed costs and relatively low operating costs so that it is likely that the development of another such infrastructure facility by any person will raise the total cost of supplying the market for the relevant final good or service. (sub. 1, p. 10)

King's criterion (b) tests for substitute services to determine the existence of market power, and criterion (c) tests for a natural monopoly technology.

Freight Australia's proposal included a discrete 'essentiality' test (as a first step) to eliminate cases that are not relevant for access regimes:

> For a facility to be identified as essential, the services of a natural monopoly must be necessary for the development of effective competition in a related market. This will — in turn — depend on the degree of substitution at two levels:
>
> (i) if there are alternative (that is, substitutable) inputs or processes available to downstream competitors which enables the production of an equivalent final good or service at a competitive price, then the essentiality test is *not* met; **and**
>
> (ii) if there are other final products available that are in competition with that of the firms requiring access to the facility in question but which do not use the input produced by the monopolist, then the essentiality test is *not* satisfied (sub. 19, p. 13).

This proposal presumes that a natural monopoly is self-defining. The essentiality criteria test for market power based on the presence of substitute services and the extent of competition in final markets.

The Law Council also expressed concern that criterion (b) could see access regulation extended too widely. However, rather than proposing an amendment to criterion (b), it proposed (in its initial submission) that all of the declaration criteria be recast in terms of 'natural monopoly services' (see box 7.3).

Box 7.3 **The Law Council's proposed declaration criteria**

In its initial submission, the Law Council proposed new declaration criteria, applying solely to natural monopoly services. Its full set of declaration criteria were:

> A service should only be declared if:
>
> (a) the service is a natural monopoly ('natural monopoly service'); and
>
> (b) the natural monopoly service is of significance to the national economy of Australia, taking into account:
>
> (i) the importance of the natural monopoly service to constitutional trade and commerce;
>
> (ii) the importance of the natural monopoly service to the national economy; and
>
> (c) the natural monopoly service is supplied by an entity that is also supplying goods and services upstream and downstream of the natural monopoly service; and
>
> (d) access to all or part of the natural monopoly service is necessary to promote a substantial increase in competition in a market (excluding competition in relation to the re-supply of the natural monopoly service); and
>
> (e) access is likely to result in a net public benefit, taking into account, among other things:
>
> (i) economic efficiencies;
>
> (ii) whether access can be provided at an economically feasible cost; and
>
> (iii) where there is a safety requirement, that appropriate regulatory arrangements exist or can be implemented. (sub. 37, pp. 16-7)

Against all of these arguments for change, the NCC contended that:

> The current test is a superior approach to any explicit test of natural monopoly. Testing for whether a facility is or is not a natural monopoly in a technical sense is a complex and controversial process, which generally involves the estimation of econometric cost functions. … twenty years of intense debate among leading econometricians about whether local telecommunications networks are genuinely natural monopolies did not yield any firm conclusions. Explicitly rephrasing the criterion in terms of natural monopoly would simply invite the presentation of ever more complex and costly economic evidence … (sub. 43, p. 39)

The NCC's reservations about seeking to construct an explicit natural monopoly test were influenced by its view that the meaning of the test has been clarified by the Tribunal's decision in respect of the Sydney Airport case. Its said that in the decision, the Tribunal had interpreted criterion (b) in terms of the costs and benefits of development of another facility for society as a whole 'as opposed to the narrow accounting view of uneconomic or simply issues of profitability'. King (sub. 1) noted that, in this context, ‘uneconomic’ would involve an explicit natural monopoly test if it were taken to mean that it would be socially undesirable to develop another facility.

Taking a somewhat different tack in supporting the current criterion (b), the NECG (sub. 54, p. 15) argued that the criterion tests whether a facility is a bottleneck, rather than whether it is technically a natural monopoly. It added that the criterion can exclude facilities which are natural monopolies but not bottlenecks, ‘while providing a policy response to situations in which a facility is a bottleneck even though it cannot be shown to satisfy the rather strict tests that must be used to identify natural monopoly’. The NECG concluded that ‘the test as it currently stands is therefore likely to be a better guide to the economically efficient conditions for regulation than a natural monopoly test’. (The NECG subsequently raised concerns about how this test had been interpreted by the Tribunal in the recent EGP decision — see below.)

The national significance test

(c) that the facility is of national significance, having regard to:

(i) the size of the facility;

(ii) the importance of the facility to constitutional trade and commerce; or

(iii) the importance of the facility to the national economy.

The purpose of this criterion is to ensure that only facilities with a significant role in the economy fall within the scope of Part IIIA. Some participants suggested that the criterion was included to guard against perverse outcomes which have arisen under the essential facilities doctrine in the United States — for example, providing for access to ski fields and football stadiums (see appendix C).

On that basis, some felt that this criterion should be retained and even strengthened. For instance, the Institute of Public Affairs (sub. 18, p. 3) stated that the coverage of Part IIIA should be restricted more narrowly and confined to facilities of ‘major national significance’.

Conversely, AAPT Limited expressed concern that ‘the emphasis on “national significance” could result in facilities or services which are still important but on a regional, rather than national, level being ignored’ (sub. 42, p. 8).

Some participants also commented on the way the test is constructed. For instance, the Law Council (sub. 37, p. 14) noted that ‘[t]he national significance criterion is linked to the facility rather than the effect on competition or the service that is being declared’. By way of illustration of the problems this could raise, it argued that while Sydney International Airport is a significant facility, the declared cargo handling services were not significant.

The 'public interest' test

(f) that access (or increased access) to the service would not be contrary to the public interest

Matters which could be considered under the public interest test are varied. For example, the non-exhaustive list of 'public interest' considerations listed in Clause 1(3) of the CPA includes: ecologically sustainable development; social welfare and equity; occupational health and safety, industrial relations and access and equity; economic and regional development; the interests of consumers; the competitiveness of Australian businesses; and the efficient allocation of resources. Hole et al. (1998) found that a number of these matters had arisen in early declaration applications (see box 7.4).

Box 7.4 **Interpretation of the 'public interest' test**

In an evaluation of the use of the public interest test in access cases, Hole et al. (1998) noted that, in the limited number of cases available for consideration, the NCC's approach had been firstly to examine criteria (a) to (e). Where these criteria had been met, the presumption was that access would be in the public interest. Thus, in applying criterion (f), the NCC then considered arguments about whether granting access would be contrary to the public interest.

Hole et al. further noted that, in applying criterion (f), the NCC had considered a range of such arguments raised in consultations, including:

- the environmental effects of access (such as environmental benefits arising from the replacement of some road freight services by rail transport);
- the potential for granting access to impede State government reform programs (for rail); and
- the adverse effects of access on the ability of the NSW Government to raise coal royalties through its coal-carrying rail service (p. xii).

Hole et al. noted, however, that 'none of the issues raised by participants has apparently had a deciding influence in terms of their effect on access decisions'.

Source: Hole et al., (1998).

The NCC (sub. 43, p. 79) submitted that a key public interest consideration is the impact that declaration would have on economic efficiency, including 'incentives for innovation and investment (dynamic efficiency)'. Indeed, it suggested that the public interest test provides the primary vehicle within the declaration criteria for assessing the net impacts on efficiency (see box 7.5).

Box 7.5 **The NCC's approach to interpreting efficiency in the public interest test**

> *A key public interest consideration* is the effects of declaration on economic efficiency. Economic efficiency entails production of a service at least cost (technical efficiency); ensuring that services are provided to those who value the services most highly (allocative efficiency); and preserving the incentives for innovation and investment (dynamic efficiency).
>
> … Potential costs of declaration include administrative and compliance costs for businesses. They also include the costs of 'regulatory failure' caused by the interference in property rights. If applied inappropriately, Part IIIA could undermine price signals, innovative activity or the incentives for investment.
>
> It is important to avoid applying Part IIIA in ways which may yield short-term static gains in technical and allocative efficiency but which constrain the realisation of longer-term dynamic efficiency gains. (sub. 43, pp. 84-5)

However, a number of participants drew attention to problems of handling efficiency in this 'residual' fashion. For example, the Law Council observed:

> The NCC states that it will avoid applying the access regime in ways which may yield short-term 'static' gains in technical and allocative efficiency but which constrain the realisation of longer-term 'dynamic' efficiency gains. The problem is that this decision is not open to the NCC, because once declared, pricing is subject to negotiation by the parties and, if they fail to agree, is determined by the ACCC. (sub. 37. p. 15)

The Australian Rail Track Corporation (ARTC) raised concerns about the public interest test being expressed in the negative. It considered that this did not provide a sufficient constraint on the continued cross-subsidisation of certain services.

> Cross-subsidisation should be exposed and un-commercial activities, if cessation is considered to be to the detriment of the public interest, should be funded separately and outside the competitive framework. Relief from the competitive framework under the negative public interest test merely enables the service provider to continue to mask cross-subsidisation. (sub. 28, p. 10)

7.3 The Position Paper proposals

Based on its assessment of the evidence and the views of participants, the Commission considered that there were deficiencies in the Part IIIA declaration criteria that could lead to inappropriate declaration of services. Accordingly, it proposed some modifications to help ensure that coverage of the regime would be more tightly confined to natural monopolies and that declaration would result in a marked increase in competition (tier 1). It also proposed a more extensive overhaul of the declaration criteria to focus directly on the objective of enhancing efficiency (tier 2). The rationales for these proposals (and the proposals themselves) are outlined below.

The tier 1 proposal

The Commission considered that ‘promotion of competition’ (criterion (a)) can be seen as a proxy, backed by a body of legal precedent, for the achievement of efficient outcomes (see chapter 6). However, to be an effective proxy, the competition to be promoted needs to be ‘effective’ or ‘substantial’. If as a result of mandated access there were only a minor improvement in competition, declaration would be of little practical benefit and, given the potential costs of intervention, could be damaging for the economy.

It might seem unlikely that the regulator or the courts would regard a marginal increase in competition as sufficient for declaration. Yet the Sydney Airport case indicated that criterion (a) could be interpreted in this way. The Commission therefore felt that shifting the balance to require a material effect would be desirable. It considered that this could be achieved by inserting the word ‘substantial’ in criterion (a).

The Commission acknowledged the reservations raised by the NCC that criterion (a) is not a test of likelihood but a test that declaration *would* promote promotion. On that basis, the NCC questioned whether one could ever be certain that declaration would promote a substantial increase in competition.

However, the Commission noted that ‘substantial’ is not a new term for the purposes of trade practices law. It is used and interpreted extensively in Part IV of the TPA where Sections 45, 47 and 50 require the interpretation of ‘substantially lessening competition’. Similarly, Section 46 is couched in terms of a ‘substantial degree of power in a market’ and ‘substantially damaging a competitor’.

On the matter of criterion (b), the Commission considered that declaration should, as far as practicable, be confined to that class of infrastructure where the negative effects from the misuse of market power are likely to be greatest — natural monopolies — but acknowledged that conveying the defining characteristics of natural monopoly in words that are both legislatively and judicially meaningful is difficult. Nevertheless, it considered that a re-specification of the criterion in terms that it would be uneconomic to develop ‘a second facility’ would confine the scope of Part IIIA more tightly to monopoly service provision. It felt that such a change would rule out application of Part IIIA to duopolies and oligopolies which the Commission considered should not fall within the purview of the generic regime.

In terms of criterion (c), the Commission was of the view that, given the costs of the inappropriate application of access regulation, Part IIIA should cover only those infrastructure facilities which are of significance for the Australian economy. It recognised that this might rule out a facility which was significant in terms of a State's economy but not of 'national significance', but noted that it was difficult to gauge how much of a problem this posed in practice — perusal of NCC declaration decisions indicates that it has gone to some effort to point to the links between intra-state facilities and the national economy.

The Commission endorsed the approach adopted by the NCC in assessing economic efficiency (among other matters) under criterion (f), but considered that having to do so under this residual criterion is necessary only because of the absence of *explicit* materiality tests in the declaration criteria.

Regarding the current onus of proof in the public interest test, the Commission noted that access regimes and competition policy in general are based on a presumption in favour of competitive markets. Given this, it found it reasonable that the public interest test should provide scope for rebuttal of this premise.

In sum, apart from the problem of having efficiency matters considered as a residual in the public interest, the areas of concern identified by the Commission were:

- the scope for declaration to proceed where the effect on competition could be trivial; and
- weaknesses in the natural monopoly criteria which could allow coverage of services without substantial and sustainable market power.

Under an approach which sought to confine changes to areas where the benefits were relatively certain and which could be implemented without large costs, the Commission considered that these problems could be addressed through changes to the wording of the first two criteria. Accordingly, it proposed that:

- criterion (a) be amended to: 'that access (or increased access) to the service would lead to a substantial increase in competition in at least one market, other than the market for the service.'
- criterion (b) be amended to: 'that it would be uneconomic for anyone to develop a second facility to provide the service.'

The tier 2 proposal

While the Commission considered that the tier 1 proposals would reduce the scope for inappropriate declarations, it noted that some important deficiencies would remain.

- The criteria would continue to rely on promotion of competition as the proxy for improved efficiency.
- Any explicit assessment of economic efficiency considerations where a divergence with promotion of competition might occur would rely on the NCC's interpretation of the public interest test (see box 7.5) — and only in the sense that efficiency outcomes would not be contrary to the public interest. Thus, a substantial increase in competition that yielded only a negligible improvement in efficiency could still be sufficient to secure declaration.
- The criteria would still lack effective tests to assess *explicitly* whether the provider subject to declaration faces competition from substitute services and exercises substantial market power, and whether access would significantly improve efficiency having regard to the interests of users and of future investment in essential infrastructure services.
- The terminology in the declaration criteria would continue to include references to both facilities and services — which has been the source of some confusion (see chapter 6).

These deficiencies led the Commission to question whether fine-tuning the criteria would be sufficient. Accordingly, it developed an alternative set of declaration criteria — focussed solely on services — to reflect more closely the underlying efficiency objectives of Part IIIA. It proposed that, for a service to be declared under Part IIIA, it should meet all of the following criteria:

> (a) the service is of significance to the national economy and the entry of a second provider of the service would not be economically feasible;
>
> (b) no substitute service is available under reasonable conditions that could be used by an access seeker;
>
> (c) competition in downstream markets is insufficient to prevent the provider of the service from exercising substantial market power;
>
> (d) addressing the denial of access, or the terms and conditions of access, to the service concerned is likely to improve economic efficiency significantly;
>
> (e) access to the service is not already the subject of an effective access regime; and
>
> (f) access (or increased access) to the service would not be contrary to the public interest.

7.4 Participants' views on the Position Paper proposals

As noted in the introduction, the recent Tribunal decision on the EGP has been a significant development in the interpretation of the declaration criteria. The impact of the EGP decision is demonstrated by the fact that:

- The NCC, which had its declaration decision set aside by the Tribunal, nevertheless argued that the meaning of the declaration criteria had now been settled by the EGP and Sydney Airport decisions and that further change was not warranted (sub. DR99).
- AusCID's initial submission had been critical of the declaration criteria, whereas its submission on the Position Paper no longer saw a need for the more significant changes to the criteria suggested by the Commission. AusCID noted that its current position had been reached:

  > … largely as a result of the eastern gas pipeline decision which came after the Commission's Position Paper, and if [the submission] were being written before the eastern gas pipeline decision then the outcome may be slightly different. I think if you were starting with a blank sheet of paper you would probably write the declaration criteria quite differently. … [But] we have now had a couple of decisions which indicate that we're not getting bad outcomes and not a bad approach to the thresholds that should be applied in determining whether or not particular services fall within the criteria. (transcript, p. 260)
- Conversely, the NECG (also representing many service providers), which in its initial submission saw no need to amend the existing declaration criteria, subsequently supported the 'broad thrust of the Commission's tier 1 and tier 2 proposals for reform of the declaration criteria' (sub. DR76, p. 22).

The salient features of the EGP case are outlined in box 7.6 and considered in more detail in appendix D.

Implications of the EGP decision

In commenting on the EGP decision at the public hearings, Henry Ergas from the NECG (who had provided expert evidence to the Tribunal on behalf of Duke Energy International which owns the pipeline) said that, relative to the Sydney Airport decision:

> … the outcome is to alter the balance within the provisions of the Act by putting less weight on the 'uneconomic to develop' test — making it do in a sense less work, and imposing more weight on the 'promotion of competition' test which, in the Tribunal's decision, is the one that does virtually all of the work. (transcript, p. 213)

During this discussion, the Commission asked the NECG if the Tribunal's reasoning in the EGP case might be analogous to the Commission's tier 2 proposal — that is, a natural monopoly technology criterion operating as a screening device, with subsequent tests for market power determining the materiality of the declaration application. The Chairman of the Commission put to Mr Ergas:

> You could imagine … situations, for example, a rail infrastructure which … under the narrow definition was a natural monopoly technology but wouldn't be declared because

of, say, strong intermodal competition. That might be analogous to what happened in the Duke situation. (transcript, p. 213)

Box 7.6 The Eastern Gas Pipeline decision — the 'Duke' decision

In its decision to recommend that the EGP should be covered under the provisions of the New South Wales and Victorian Gas pipelines access regimes, the NCC (2000c, p. 15) stated that it was 'firmly of the view … that there is a real danger or likelihood of parallel pricing behaviour between the Eastern Gas Pipeline and Moomba to Sydney Pipelines'.

The Minister for Industry, Science and Resources (2000) in declaring the facility said:

> I concur with the NCC's examination of other existing pipelines and agree that other existing pipelines, such as the Moomba to Sydney Pipeline and the Interconnect, are not effective substitutes for the services provided by the Eastern Gas Pipeline, and that it would be uneconomic to develop them to provide the services of the Eastern Gas Pipeline. (p. 4)

Many participants were very critical of this coverage (declaration) decision. For example, the Institute of Public Affairs stated that:

> The NCC argued that they should regulate both pipelines since they did not traverse parallel routes and that, even if they did, regulation would still be necessary to prevent collusion! It is clear such analytical reasoning … gives regulatory agencies the opportunity to control virtually every economic activity in the country. (sub. 18, p. 8)

Duke Eastern Gas Pipeline Pty Ltd appealed the coverage decision to the Tribunal, which handed down its decision on 4 May 2001. The Tribunal found that coverage of the EGP would not promote competition in upstream or downstream markets over the existing voluntary open access offered by Duke. It considered that, owing to competition from other pipelines, EGP does not have market power. The Tribunal therefore ruled that the EGP is not covered.

One interpretation of the EGP case is that criteria (a) and (b) could *together* be regarded as elements of a natural monopoly test — in effect, a natural monopoly characteristics or technology test for the service narrowly defined (the uneconomic to develop test in criterion (b)) and a market power test (the promote competition test in criterion (a)). In its decision, the Tribunal stated:

> Every haulage service will of necessity be from one point to another. That is the commercial service actually provided by the pipeline operator to its customers. That service may be of different use to the producers in the origin market or to the customers in the destination market, but it is the same service. No market analysis is necessary or appropriate in the description of the services provided by the pipeline. However, questions of market definition and market power do arise in the context of criterion (a). (ACT, 2001, paragraph 69)

Whatever the intrinsic merits of the Tribunal's approach, the relative ease with which a gas pipeline could meet criterion (b) indicates that criterion (a) needs to do a lot of work — at least in that sector.

In response Mr Ergas said:

> That is absolutely right; that what the … EGP decision would say is the railroad going from point A to point B would meet the criterion of being ‘uneconomic to develop’ … At the same time if you had intermodal competition it would be the case that the competition test would not be met. I have reluctance to accept the concept of a natural monopoly technology because I believe that a natural monopoly is a form of monopoly so that to be a natural monopoly you have to be a monopolist to begin with. (transcript, pp. 213-4)

The NECG therefore considered that, while the outcome of the EGP case was appropriate, the Tribunal’s ‘point-to-point’ interpretation of the service supplied by the EGP (see box 7.6) revealed a weakness with criterion (b):

> The Tribunal’s decision is very heavily focused on … the term ‘service’, the issue being uneconomic to develop another pipeline or facility to provide the service. It interprets the term ‘service’ as being not a question of economics but rather, as it puts it, as a question of fact. (transcript, p. 213)

In a later submission, the NECG (sub. DR116) elaborated its view about the consequences of the Tribunal’s approach to defining the service in this way:

> The Tribunal [characterised] the EGP’s services for the purposes of interpreting the ‘uneconomic to develop’ criterion as the physical transport of gas between Longford and Sydney. The Tribunal took the view that this service was so defined irrespective of the substitution possibilities that might exist at either end of the pipeline. (p. 37)
>
> One important implication of this approach to the definition of the relevant service is that it is consequently carried over into how the ‘uneconomic to duplicate’ test in criterion (b) should be applied. For example, once the service provided by the EGP had been defined by the Tribunal, any pipeline providing a differently defined service was automatically ruled out of contention as an effective competitor irrespective of whatever evidence could have been provided with respect to the substitutability of the services provided by that pipeline with the services provided by the EGP. (p. 40)

On the other hand, the NCC, which also referred to the EGP decision in addressing the Commission’s Position Paper proposals, supported the Tribunal’s approach to defining the service:

> … a gas consumer in Sydney does have the practical ability to deal with gas producers in the Cooper Basin or in the Bass Strait. While gas molecules and delivered gas may be homogeneous, the different available gas transportation services to a particular consumer are not. A consumer may care a great deal about a particular gas transportation service if that consumer wants to contract with a particular gas producer.
>
> The fact that gas transportation services are not homogeneous is made apparent if the correct point-to-point approach to the delineation of these services is adopted. Thus it is obvious that a gas transportation service from Moomba to Sydney [the MSP] is quite distinct from a gas transportation service from Longford to Sydney [the EGP]. This is not to say that these services cannot be substitutes for each other, but it is quite wrong

> to simply assume they are the same service and that consumers are indifferent as between them. (sub, DR125, pp. 9-10)

The NCC also contended that such a point-to-point definition of a service reflects the nature of gas pipelines and has limited applicability to other essential facilities:

> To the extent that there are difficulties associated with that origin-destination market analysis of gas pipelines, those problems are confined to the analysis of gas pipelines and are not readily transferable to other infrastructure services. (transcript, p. 496)

It said, for example, that in defining airport services, it would be inappropriate to use a point-to-point definition of services such as flights originating in Melbourne or terminating in Sydney. More generally, it further submitted that:

> … the argument that the natural monopoly characteristics of all transport infrastructure should be assessed using origin/destination market analysis, without regard to the relative utility of … alternate infrastructure services, is untenable. (sub. DR125, p. 16)

The Commission notes that the point-to-point delineation of a service may not be unreasonable for the purposes of determining 'whether it be would be uneconomical to develop another facility to provide the service'. Indeed, the fact that the two pipelines serving the Sydney market also serve other locations is a relevant consideration — for example, laterals from the MSP service centres such as Canberra, Orange, Bathurst and Wagga Wagga.

However, in a market context, identical products sourced from varying locations or suppliers, even if they involve dissimilar price or service arrangements, would not normally be regarded as different in an economic sense. Thus, a point-to-point delineation of a service as adopted by the Tribunal in the EGP case appears to be essentially a test of natural monopoly technology or characteristics, independent of market considerations.

The NECG considered that this has widespread deleterious implications:

> … in rejecting the market-definition based approach to testing for natural monopoly, the *Duke* decision signifies assent to the 'production technology' test for natural monopoly proposed by the NCC. …
>
> However, … there are serious problems with the NCC's 'production technology' approach and ultimately, it is neither viable nor efficient.
>
> … the NCC's interpretation of the natural monopoly concept prevents criterion (b) (the 'uneconomic to develop' criterion) from fulfilling its filtering or gatekeeper role for intervention under the Gas Code or Part IIIA because the regulatory hurdles implicit in the 'production technology' approach to identification of natural monopoly can easily be satisfied by any locationally-specific facilities that have their output defined sufficiently narrowly.

> … the effective weakening of criterion (b) under the definition of natural monopoly endorsed in *Duke* means that a much larger part of the weight of the decision as to whether or not to cover (or declare) a facility must be placed on other criteria – in particular, criterion (a) (the 'promotion of competition' in another market criterion). … (sub. DR116, pp. 40-1)

The Commission agrees with the NECG that the concern underlying the application of access regulation ultimately relates to a market condition — that is, the provider of the service is likely to have significant and ongoing power in an appropriately defined market. On that basis, criterion (b) could be amended along the lines that *it would be uneconomic for anyone to develop another facility to provide the service in that market*. This is essentially the NECG's argument — to consider natural monopoly in a market context, rather than an investigation of whether or not a particular facility is characterised by a natural monopoly technology.

However, in assessing whether or not a service provider has a natural monopoly in a market, the Commission does not see an *in principle* problem in adopting a two stage procedure involving:

- a screening device to test for the existence of a natural monopoly technology (or natural monopoly characteristics); and
- an evaluation of the availability of substitutes (and any other relevant factors) to assess whether the service provider has substantial and enduring market power.

Indeed, in an administrative sense, such a two part assessment of natural monopoly proper may well be more workable than attempting to grapple with an assessment of the nature of the technology simultaneously with broader issues of market power, such as substitution possibilities and the like. That said, in terms of the practical application of a two stage process, the key would be to ensure that the assessment of market power was sufficiently robust to quarantine declaration only to those bottleneck facilities with substantial and enduring market power.

The two stage approach was implicitly endorsed by the NCC in its defence of leaving market analysis outside the assessment of the 'monopoly' status of the facility service:

> In analysing this issue in the context of the Gas Code, the question about service identification is: what is the pipeline owner selling and a gas trader or gas user purchasing from that pipeline owner (or what service *could* be bought and sold)? That defines the relevant service. Such an approach is consistent both with the correct statutory interpretation and with economic analysis.
>
> In other words, the correct approach is to define the product that is sold (that is, the service) and *then* test for substitutes for that product to define market boundaries for that service.

> … introducing market analysis into the very *delineation* of a service risks choosing the wrong market as a starting point. This may involve an inappropriate assumption about relevant substitutes and/or confuse the distinction between the market in which the service is provided and the relevant downstream market. (sub. DR99, pp. 12-3)

As noted above, a two stage approach underscores the importance of setting a suitably high hurdle for criterion (a). In this context, the NCC used the EGP decision to address the Commission's concern in the Position Paper that the current construction of criterion (a) does not adequately eliminate the prospect of 'trivial' declarations for which the costs could outweigh the benefits. The NCC submitted:

> The [Commission's] proposal reflects a concern that the current criterion (a) sets too low a hurdle, based on an interpretation of the implications of the *Sydney Airports* decision.
>
> This concern needs to be revisited in the light of the Tribunal's decision in the *Duke* matter. This decision applied the same test of 'promote competition' as in the *Sydney Airports* matter. The Tribunal in the Duke case said:
>
>> The meaning of this term was discussed by the Tribunal in Sydney International Airport. The Tribunal said (at 40,775) that the notion of 'promoting' competition':
>>
>>> "involves the idea of creating the conditions or environment for improving competition from what it would be otherwise. That is to say, *the opportunities and environment for competition given declaration, will be better than they would without declaration*"
>>
>> The Tribunal concluded that the TPA analogue of criterion (a) is concerned with the removal of barriers to entry which inhibit the opportunity for competition in the relevant downstream market. It is in this sense that *the notion of promotion of competition involves a consideration that if the conditions or environment for improving competition are enhanced, then there is a likelihood of increased competition that is not trivial*. We agree. (Duke decision, paragraph 75, cited in sub. DR99, pp. 24-5, emphasis added)

However, in the Commission's view, this quote from the Tribunal reinforces the case for bolstering criterion (a) with a requirement for a substantial increase in competition. The two italicised statements are not equivalent. The first, from the Sydney Airport judgement that '*the opportunities and environment for competition given declaration, will be better than they would without declaration*' would hardly ever not be met — as Mr Tonking (sub. 5) made clear. The second, draws on the Sydney Airport decision but focuses on the substantiality of the effect by emphasising the '*likelihood of increased competition that is not trivial.*'

While the Commission considers the latter interpretation to be more appropriate, 'non-triviality' still potentially sets too low a hurdle — given the need to focus on natural monopoly bottlenecks. More importantly, because the EGP decision places so much emphasis on criterion (a) to establish the materiality of a declaration application, the case for strengthening that criterion has increased since the release of the Position Paper.

Would a strengthened criterion (a), in conjunction with criterion (b), be sufficient?

It is apparent from the EGP decision that the existence of close substitutes for a service provided by an essential facility — at least for gas pipelines — is not necessarily sufficient to rule out declaration *in terms of criterion (b).* Thus, a key question is whether the availability of close substitutes will always be a determinative factor in assessing criterion (a).

On this matter, the NECG (sub. DR116, p. 41) submitted that 'criterion (a) is wholly inadequate to the task of being a robust filter to inappropriate regulatory intervention'. Underlying this proposition is a concern that, if the availability of substitute services is not a factor in the consideration of criterion (b), it could be omitted entirely, leaving criterion (a) as an inadequate defence against inappropriate declaration.

However, the EGP decision demonstrates that the Tribunal initially addressed the question of the availability of substitute services in its deliberations on criterion (b), before concluding that this matter was a material factor in deciding whether access (coverage) would promote competition in another market — that is, in criterion (a).

Thus, in relation to criterion (b), the Tribunal stated that:

> A literal construction of criterion (b) might require the decision-maker, in the application of the criterion, to ignore the existence of pipelines which have already been developed. ...
>
> There is no logic in excluding the existing pipelines from consideration in the determination of whether criterion (b) is satisfied. The policy underlying the Code would not be advanced if the Tribunal were to proceed in that blinkered way. We therefore think it appropriate to enquire whether the MSP or the Interconnect provide or could be developed to provide the services provided by means of the EGP. The proper characterisation of those services is itself an issue of construction which is addressed later. (ACT 2001, paras. 55-7)

And, when discussing market power in the context of criterion (a), the Tribunal concluded that:

> … EGP will not have sufficient market power to hinder competition based on the commercial imperatives it faces, the countervailing power of other market participants, the existence of spare pipeline capacity and the competition it faces from the MSP and the Interconnect. As EGP does not have market power, the Tribunal cannot be satisfied

> that coverage would promote competition in either the upstream or downstream markets. (ACT 2001, para. 124)

Hence, the Tribunal's decision demonstrates that criterion (a) was applied to determine whether the facility providing the service occupied a bottleneck position in a market and that it had market power.

Indeed, the NECG acknowledged that:

> … the Tribunal accepted that the EGP did not have sufficient market power in the South East Australian gas market to hinder competition in another market. Thus the Tribunal concluded that it was not convinced that coverage would promote competition in either upstream or downstream markets and, accordingly that criterion (a) was not satisfied. (sub. DR116, p. 39)
>
> ... the Tribunal makes it clear that it cannot simply be assumed that access or increased access will promote competition: rather, it must be demonstrated that the provider of the service at issue has the ability and incentive to distort competition in the dependent markets. (sub. DR116, p. 9)

Moreover, as to whether the EGP decision has diminished the usefulness of criterion (b), it is instructive to note the Tribunal's views on this matter:

> …Natural monopolies often require big upfront investments in infrastructure, but their operating costs are relatively small, and vary little as more of the infrastructure's capacity is brought on line.
>
> …Thus we accept that if a single pipeline can meet market demand at less cost (after taking into account productive allocative and dynamic effects) than two or more pipelines, it would be 'uneconomic', in terms of criterion (b), to develop another pipeline to provide the same services. (ACT 2001, paras. 60-4)

This indicates that, regardless of whether or not the point-to-point definition of the service constrained the manner in which the Tribunal could address questions of market power, it clearly understood the concept of natural monopoly.

For its part, the NCC, in responding to the concerns raised by the NECG, concluded that:

> Even if there were some merit in the NECG arguments about flaws in the Tribunal's application of a natural monopoly test, this would hardly amount to cause for amendment of the legislation. Criterion (b) would retain its test of natural monopoly. The proposition that the Tribunal's decision robs the 'uneconomic to develop' test of any practical bite, or that the test will be met wherever a facility has excess capacity, is without foundation. (sub. DR125, p. 18)

In a late submission, the NECG re-iterated its views and strongly rejected the 'NCC's contentions' outlined above (sub. DR126, p. 7).

As there have been no further Tribunal decisions since the EGP, it is relevant to note the NCC's most recent 'post-EGP' interpretation of the declaration criteria. In an Issues Paper on the application for partial revocation of coverage under the Gas Code for the MSP, the NCC stated that:

> Following [the Sydney Airport and EGP] decisions it is possible to describe the current state of Australian law as determining that coverage (or declaration) is available only:
>
> - in relation to the services of natural monopoly infrastructure (or infrastructure with natural monopoly characteristics); and
> - where that infrastructure exerts market power in another (upstream or downstream) market so that access regulation will demonstrably promote competition. (NCC 2001b, p. 24)

In sum, the Commission considers that having criterion (b) operate as a screening device for natural monopoly technologies (at least for point-to-point transmission services like gas pipelines) is not necessarily inappropriate, provided that criterion (a) is strengthened.

As the Explanatory Memorandum which accompanied the introduction of Part IIIA indicates, 'the notion underlying the regime is that access to certain facilities with *natural monopoly characteristics*, such as electricity grids or gas pipelines, is needed to encourage competition in related markets, such as electricity generation or gas production' (emphasis added). Similarly, the Hilmer Committee (1993, p. 240), in noting that natural monopoly is difficult to define, couched the essential facilities problem in terms of 'economic activities [that] exhibit natural monopoly characteristics'. It need not be an onerous task, involving extensive market analysis, simply to determine whether a service passes a natural monopoly technology screen, so long as substitution possibilities are considered elsewhere.

In the Commission's view, the Tribunal's decision on the EGP does not suggest that a two stage process of assessing natural monopoly characteristics (or technology) and market power involves a significant risk that the scope for close substitutes to limit market power will somehow 'fall between the cracks'. That said, the fact that case law in this area is still being developed means that it would be unwise to be complacent — there is always a possibility that future Tribunal decisions might see some of the concerns raised by the NECG realised (see further discussion below).

Finally, the Commission considers that it is essential that criterion (a) only be met where the facility in question can exercise *substantial and enduring market power*. It is therefore of the view that criterion (a) must be strengthened (see below).

Additional views on the tier 1 proposals

Consistent with the concerns expressed about major changes to the declaration criteria and the measure of 'comfort' provided by the EGP decision, many infrastructure owners supported the sorts of changes incorporated in the Commission's tier 1 proposal.

For example, the Australian Pipeline Industry Association (APIA) said it 'wholeheartedly endorses the concept of strengthening the declaration criteria based on the guiding principle that there must be clear evidence of market failure before any affirmative decision on declaration is made' (sub. DR70, p. 14).

Similarly, AusCID said it was 'supportive of amendments which ensure that inappropriate declaration does not occur and is therefore supportive of the Commission's recommendation [on criterion (a)]' (sub. DR80, p. 30). The Australian Gas Association supported the tier 1 changes 'to ensure that declaration of infrastructure assets only occurs where it would lead to a *substantial* increase in competition and that it would be uneconomic for anyone to provide a second facility' (sub. DR84, p. 5).

Others to express support for the thrust of the tier 1 proposals included the Queensland Treasury (sub. DR105), EnergyAustralia (DR106) and the Northern Territory Government (sub. DR111). There was, however, little in the way of comment on the proposals from user groups.

Both the NCC and ACCC considered that a case for any change to the current criteria had not been adequately established. Reflecting the concerns noted earlier about possible unintended consequences of changing the wording of the declaration criteria, the ACCC argued that:

> … courts would strive to give meaning to the new criteria so as to differentiate those criteria from the existing provisions, which the [Productivity] Commission considers have operated appropriately. This may … lead to greater uncertainty. (sub. DR93, p. 6)

Specific comments on criterion (a) — the competition test

While many of the issues about the 'height' of the hurdle that criterion (a) should provide are discussed in the context of the EGP case (above), participants raised a number of other matters germane to this issue.

The Northern Territory Government contended that the Commission's proposal would address a perceived anomaly within the Part IIIA framework:

> It appears anomalous that the competition test applied in considering an application for declaration (ie that access would <u>promote</u> competition in at least one market other than

the market for the service) is a lower threshold than would be applied in consideration of an undertaking or State/Territory regime (ie that access is necessary to permit effective competition in at least one market). (sub. DR111, pp. 2-3)

It went on to conclude that the Commission's tier 1 proposals:

> … would increase the likelihood that services would only be subject to declaration when a significant increase in competition would result. This would avoid the costs inherent in providing access in cases where only a limited increase in competition (and, by implication, only limited benefits) would result. (p. 12)

Some other participants were supportive of the intent behind the proposal but unsure about the appropriateness of the word 'substantial'. For example, the Australian Chamber of Commerce and Industry (sub. DR67, p. 17) accepted the need to strengthen criterion (a) but was uncertain whether the meaning of the word was clearly understood.

Other participants such as the Chamber of Mines and Energy of Western Australia (sub. DR66, p. 3) were not convinced that criterion (a) needed to be modified. And, in keeping with their belief that the current criteria as a whole are appropriate, the NCC and the ACCC considered that a requirement in criterion (a) for 'a substantial increase in competition' would be too high a hurdle. The ACCC contended that:

> … it is difficult to know how a decision maker could be satisfied that access (or increased access) would lead to an increase in competition that was real, or of substance. The test requires determination with certainty; there is no scope to assess the likelihood or probability of an increase in competition. … in the case of markets for essential services that display monopoly characteristics, the ACCC does not consider it would be appropriate that such a measure of materiality, particularly associated with the degree of certainty envisaged, is appropriate. (sub. DR93, pp. 7-8)

And, the NCC said:

> A requirement that access would 'lead to a substantial increase in competition' seems to require an actual demonstration that increased competition would, in fact, occur rather than a focus on creating the conditions for increased competition … Any introduction of a 'substantial increase in competition' requirement should be accompanied by the notion of the *likelihood* of such an increase. (sub. DR99, p. 25)

The Western Australian Government raised similar concerns — specifically, about the words that access would *lead to* a substantial increase in competition. It stated:

> If adopted, it may be necessary to introduce the notion of likelihood to this criterion, otherwise there may be scope for a service provider to seek revocation on the basis that new entry has not **in fact** occurred within a reasonable time. Such a revocation would be an unfortunate outcome since the potential gains from increased contestability (ie. the threat of new entry) would be lost. For this reason, Western Australia is not attracted to the proposal as currently worded. (sub. DR69, p. 4)

Finally, the Queensland Mining Council supported the retention in criterion (a) of the clause 'whether or not in Australia' — which the Commission's tier 1 proposal had omitted. It considered that the clause provides:

> … an avenue for exporters to argue the case for a declaration where the competition that would be enhanced refers to their ability to enter new overseas markets. … if that clause was taken out, I'm not sure what it would imply. (transcript, p. 405)

Specific comments on criterion (b) — the 'monopoly' test

There was much less comment from participants about the proposed change to criterion (b). Those participants who focussed on this particular criterion were generally not in favour of the proposed wording, though some saw merit in the intent to confine declaration more tightly to cases of natural monopoly.

Consistent with its views that market analysis should be undertaken as part of the assessment against criterion (b) (see discussion above), the NECG contended that the criterion should be modified to refer explicitly to the existence of alternatives in the market for the services in question. It proposed the following modification.

> (b) that it would be uneconomical for anyone to develop another facility to provide the service or a substitute for the service in the same market as that in which the service is provided. (sub. DR116, p. 52; sub. DR126, p. 8)

The ACCC (sub. DR93) maintained its position that, while it is clear that the declaration criteria will apply most often to facilities with natural monopoly characteristics, there may be circumstances in which regulation of duopolistic or oligopolistic services is warranted. Similarly, EnergyAustralia did not accept the notion underlying the proposed criterion (b) — that the existence of two facilities providing the same service ensures adequate competition (sub. DR106, p. 1).

The NCC considered that the reference to a 'second facility' in the proposed test:

- might skew interpretation away from the current technology neutral approach toward a view that the 'second facility' should duplicate the first;
- may overturn existing authority that the criterion should take account of existing infrastructure (potentially) providing an effective substitute service; and
- introduces a private meaning of 'uneconomic' that runs counter to the Tribunal's endorsement of a social cost/benefit approach that equates with the identification of natural monopolies.

It also considered that the current wording of criterion (b), as interpreted by itself and the Tribunal, achieves the outcome desired by the Commission (sub. DR99, pp. 24-9).

While acknowledging that the Commission had emphasised that it was important that 'a second facility' not be interpreted narrowly to mean a second facility based on the same technology — rather than any second facility which could provide an equivalent service — some other participants concurred with the NCC that the former interpretation might be adopted in legal proceedings. AusCID noted:

> The notion of second facility … seemed to have a much greater notion of identicality with the first facility than the notion of another facility, and … it harks back to … the lawyers' approach which says, 'If this is a change it must be for a reason. Therefore perhaps the reason means it … is a technology specific issue.' (transcript, p. 261)

Similarly, Mr Tonking (in a private submission) said that the Tribunal had already reached the view that 'notwithstanding the use of the word "develop", account should be taken of existing facilities'. He cautioned that 'any change will likely lead to an inquiry as to what was intended and this may introduce new uncertainties' (sub. DR58, pp. 1-2). This view was also put by the Law Council (sub. DR108).

Participants' views on the tier 2 proposal

The response to the Commission's tier 2 proposal to overhaul the declaration criteria was limited. Of those few who chose to comment on the proposal, most were supportive. For example:

> We support the Commission's proposals to: … amend and focus the declaration criteria in Part IIIA on the objective of promoting overall economic efficiency (tier 2). (Freight Australia, sub. DR62, p. 2)

> ARTC considers that merely patching the current wording may result in greater inconsistency. ARTC agrees that much greater benefit to the process could be derived from a re-structuring of the criteria. (sub. DR64, p. 9)

> APIA supports the proposal for further declaration criteria and recommends that it be viewed as a Tier 1, and not Tier 2 as outlined in the Position Paper (sub. DR70, p. 14)

And, the NECG (sub. DR116, p. 52) considered that the tier 2 criteria would reintroduce a concept of substitutability 'into the "bottleneck" filter … that has been nullified by the *Duke* decision'.

EnergyAustralia (sub. DR106, p. 2), on the other hand, contended that while there was a need to overhaul the current criteria, the tier 2 criteria 'are somewhat vague and open to different interpretations'.

AusCID similarly supported the intent of the tier 2 proposal, but had reservations about its implementation. It said that it:

> … agrees with the Commission that the regulatory regime should:

- have explicit criteria which clearly express the purpose to which each is directed. This will have the effect of limiting the discretion vested in decision makers;
- target natural monopoly infrastructure where the control of that natural monopoly infrastructure enables the owner/operator to exercise a substantial degree of market power in a dependent market; and
- ensure that access is only granted where to do so would significantly improve efficiency.

> What is more difficult to assess is whether the amendments which have been proposed will bring about the result desired by the Commission. What has been proposed involves quite a different approach both in terms of the economic framework used and also in terms of how the criteria would operate in practice. AusCID, while supportive of the intent, is concerned that the proposals may have the effect of increasing uncertainty with no assurance that the outcome of the application of the criteria will provide at least as high a threshold as currently applies. (sub. DR80, pp. 33-4)

In a similar vein, Mr Tonking, representing the Law Council, cautioned that:

> … there are about twice or three times as many words there as there are in the present set of criteria and that lends about two or three times as many opportunities for lawyers to take different views as to what those words mean …
>
> … if you introduce additional refinements or gradations of meaning to criteria then obviously people will again say, ‘Well, that must be there for a purpose. How does it apply to me? What arguments can I advance?’ So the issues perhaps become more complex or more attenuated. … It doesn’t necessarily mean that there shouldn’t be an attempt to rework the language at some stage but I think it is something that would need to be exposed for quite some time for debate … (transcript, p. 269)

The Queensland Treasury (sub. DR105, p. 21), which supported the tier 1 proposal, also considered the tier 2 changes would be ‘too disruptive’. The South Australian Government acknowledged that there was a case for raising the hurdle for a service to be declared to a ‘significantly higher’ level than under the current regime. However, it considered that the proposed tier 2 criteria:

> … as worded, and taken together, could be so narrow that almost nothing could be declared. This might be even narrower than intended (sub. DR121, p. 4)

Finally, and consistent with their views on the tier 1 proposal, both the NCC and the ACCC opposed the tier 2 proposal.

> The Council is concerned that the proposed new declaration criteria are, in part, a response to perceived issues that are, in fact, illusory. In addition, some of the proposed criteria would create tensions with legal interpretation, and may, in some instances, bring perverse results (NCC, sub. DR99, p. 5)
>
> … whatever the merits of the approach proposed by the Productivity Commission, mere amendment of the criterion will lead to greater uncertainty … it is only recently

> that authoritative interpretations of the existing criteria have been available to assist all parties. In the absence of any clearly demonstrated shortcomings in the existing criteria, the costs related to amending the criteria may in fact outweigh the advantages at this stage. (ACCC, sub. DR93, p. 10)

Some more specific comments on the tier 2 proposal are contained in box 7.7.

Box 7.7 Some comments on the tier 2 criteria

(a) the service is of significance to the national economy and the entry of a second provider of the service would not be economically feasible.

The NCC felt that the word 'entry' created a risk that the test would exclude consideration of existing alternative service providers. It also said that the effect of changing the emphasis from 'facility' to 'provider' would be unclear. Both the NCC and AusCID said that 'economically feasible' had no basis in law (although the term is drawn from Clause 6 of the CPA). AusCID also contended that the proposed test lacked guidance on the interpretation of 'national significance'.

The ACCC was concerned that the test was too restrictive and could rule out declarations that might otherwise be appropriate. It also considered that, while the 'significance' threshold was worthwhile, such 'materiality' matters appeared to be repeated in criterion (d). It suggested that two materiality tests would be wasteful.

(b) no substitute service is available under reasonable conditions that could be used by an access seeker; and (c) competition in downstream markets is insufficient to prevent the provider of the service from exercising substantial market power

On these twin criteria, the NCC considered that it already is well established in Australian law that market analyses need to consider both supply and demand side substitution possibilities. The ACCC had a similar view, noting that if production and consumption substitutes prevent a service provider from exercising market power, it is unlikely that the first criterion would be satisfied. The NCC also had concerns about the emphasis of the test on downstream, rather than all dependent, markets.

AusCID questioned how the 'reasonable conditions' proposition could be tested. It asked, for example, whether an access seeker would need to demonstrate ex ante that the offered conditions were unreasonable. The ACCC said that assessing reasonableness could be extremely time consuming and resource intensive.

EnergyAustralia considered that competition in downstream markets is only relevant where there is a realistic threat of changing suppliers.

(d) addressing the denial of access, or the terms and conditions of access, to the service concerned is likely to improve economic efficiency significantly.

The NCC contended that this test might preclude declaration where small or negligible increases in efficiency would result.

(continued next page)

Box 7.7 **continued**

(The Commission accepts that all net increases in efficiency are worth 'taking' if possible. However, given imperfect information and the costs of inappropriate declaration, the hurdle needs to be sufficiently high to ensure that there is a very strong presumption that declaration would achieve such gains).

The ACCC considered that, in practice, this criterion would require the regulator to conduct a pricing study at the time of declaration, whereas the current approach separates declaration from the determination of access prices. It said this would mean a higher degree of intervention as the regulator would need to give a view on terms and conditions at the time of declaration — potentially undermining the post-declaration negotiation process. It further argued that, at least under the current arrangements, the test would require both the NCC and the ACCC to form views on terms and conditions which would be wasteful and could cause uncertainty if the two bodies had divergent views.

Notably, there was little in the way of concern about employing the term 'efficiency'. Indeed, Tonking (for the Law Council) considered it would not be problematic:

> … on my limited reading of the economic literature in this area that tends to be advanced by lawyers and by economists arguing in this area, the sort of improvements in competition based on economic efficiency tend to go hand in hand. In other words, it's not competition for competition's sake but it's competition with an efficiency objective. … I don't think it would be likely to be interpreted to make a major change to the thrust of the legislation as it is at the moment. (transcript, p. 270)

In a subsequent submission, the Law Council said that efficiency considerations should be dealt with explicitly in the declaration criteria. It noted, however, that:

> The measurement of efficiency enhancements is likely to be a more complex task than the assessment of a promotion of competition. … It would no doubt take into account dynamic, productive and allocative efficiency and presumably those would need to be assessed from a societal point of view … (sub. DR108, p. 4)

The Law Council went on to suggest that an alternative approach might be to amend the current public interest criterion along the lines that: access would not be contrary to the public interest having regard to the impact of the denial of access, or the terms and conditions of access, on economic efficiency. It considered that:

> Adopting an approach which does not require affirmative proof of economic efficiency but rather requires it to be clear that declaration would not adversely impact efficiency would seem to ameliorate the evidentiary difficulties which may be encountered in proving an enhancement in economic efficiency. (sub. DR108, p. 4)

One participant, EnergyAustralia, commented on criterion (f) — the public interest test. It noted that, as the criteria would become focussed solely on non-efficiency considerations, greater guidance was needed on its interpretation in order to reduce uncertainty and regulatory risk.

Source: ACCC (sub. DR93, pp. 9-13), NCC (sub. DR99, pp. 29-36), EnergyAustralia (sub. 106, p. 2), Law Council of Australia (Mr Tonking, transcript, p. 271 and sub. DR108, pp. 3-4))

7.5 Assessment and recommendations

Based on responses to the Position Paper, the implications flowing from the Tribunal's decision on the EGP (in conjunction with the Sydney Airport case), the input from members of the legal profession and its further assessment of the issues raised, the Commission considers that pursuit of its tier 2 proposal would not be appropriate at this stage.

While the Commission sees an in principle case for focussing more explicitly on monopoly power and efficiency issues, it has doubts whether, at this juncture, the benefits of introducing new and untested declaration criteria would be large enough to exceed the accompanying implementation and adjustment costs. Indeed, settling the interpretation of a completely new declaration package could take several years. Moreover, if specific arrangements to limit the application of Part IIIA to a narrower range of investments were introduced (see chapter 11), the potential field of candidates for declaration would be reduced. This would further weaken the case for a substantial overhaul of the criteria.

In the Commission's view, the priority at this stage is to reinforce criterion (a) to ensure that it provides a sufficient hurdle against inappropriate declaration. As noted, it considers that the outcome of the EGP case and the Tribunal's reasoning indicate that the case for strengthening criterion (a) has increased since the release of the Position Paper. While the EGP decision has highlighted the need to have a robust criterion (a), the Sydney Airport case and aspects of the EGP decision itself suggest that the current criterion (a) cannot be relied on to provide a bulwark against inappropriate declarations. Thus, the Commission remains of the view that criterion (a) should be strengthened by a requirement that declaration promote a *substantial* increase in competition.

Concerns have been expressed by some participants that 'substantiality' needs to be couched explicitly in terms of the likelihood rather than certainty of such an effect. Indeed, on this matter, the Commission does see some merit in the Western Australian Government's view that the clause 'would *lead to* a substantial increase in competition' could connote a higher hurdle than a formulation of 'would *promote* a substantial increase in competition'. Given the cautions from some lawyers, there is a case for limiting changes to those that are absolutely necessary to achieve the desired outcome.

However, the Commission is not convinced by arguments from the NCC and the ACCC that there would be a problem with the clause 'would promote a substantial increase in competition'. These participants argued that adding one word — substantial — would fundamentally alter the criterion to such an extent that the test would require a demonstration that increased competition *would* occur, rather than simply establishing that declaration would create the conditions for increased competition.

Yet it is clear from existing declarations and Tribunal decisions that the regulators and the courts are capable of determining that, even where patterns of competition are yet to emerge, declaration would promote competition. Equally then, it should be possible to make an assessment about the likely magnitude of such effects on competition.

In the light of general concerns about how legislative changes might be interpreted, the Commission is now of the view that the rider in criterion (a) — 'whether or not in Australia' — should be retained. Under section 4E of the TPA, for the purposes of the Act, the word 'market' means a market in Australia unless some other intention is specified. On that basis, the absence of 'whether or not in Australia' could be interpreted as an attempt to convey that the promotion of competition in export markets is irrelevant in the consideration of a declaration application. This could rule out declaration where the access seeker was an exporter even where it would improve efficiency.

As regards criterion (b), the Commission acknowledges that its Position Paper proposal could again create interpretation problems. In particular, reference to a 'second facility' could (wrongly) be interpreted as referring to a service based on the same technology. It therefore is not pursuing that proposal further.

As regards the NECG's proposed amendment to the wording of criterion (b), the likelihood that such a change would reduce the prospect of inappropriate declarations must be set against the costs (and interpretation risks) of introducing a new and untested criterion to essentially force decision makers and the judiciary to test for 'classical' natural monopoly only in that criterion.

In the Commission's view, the current state of case law has not established that there is a significant risk that facility services with natural monopoly characteristics but little market power, on account of the existence of substitute services, will be declared. Hence, at this stage of the development of Part IIIA, it does not consider that the uncertainty that introducing a significantly modified criterion could engender is warranted. (That said, the Commission reiterates its caution that it would be unwise to be complacent about the possibility of inappropriate declarations — see below.)

For the reasons outlined above, the Commission considers that provided that criterion (a) is strengthened, criterion (b) can operate as part of a two step test for determining whether a facility providing a service based on a natural monopoly technology is in a position to exercise substantial and enduring market power.

RECOMMENDATION 7.1

Clause 44G(2)(a) of the Trade Practices Act should be amended such that access (or increased access) to the service would promote a <u>substantial</u> increase in competition in at least one market (whether or not in Australia), other than the market for the service.

If it is considered that the inclusion of the word 'substantial' carries a concomitant requirement for greater certainty of the outcome, an explicit concept of likelihood may need to be embodied in the revised criterion.

A cautionary postscript

Although the Commission has opted not to pursue further its formal tier 2 proposal, it is not as sanguine as some participants that judicial interpretation of the declaration criteria is fully settled. For example, the owners of the Moomba to Sydney pipeline, which was deemed to be in competition with the EGP, have submitted an application to the NCC for revocation of coverage of their pipeline from the Gas Code. This case has yet to run its course.

The Commission reiterates that, to the extent that the existence of substitute services is not dealt with under criterion (b), it is imperative that it is assessed effectively under criterion (a). If this were not the case, the key question of the market power related to natural monopoly would not be properly addressed. Given that case law in this area is still in the developmental phase, the Commission considers that it would be prudent to monitor developments regarding declaration/coverage/revocation activities. Should judicial interpretation in the future indicate that even the strengthened declaration criteria were not delivering appropriate outcomes, there may be a need for more significant changes to the criteria. In that event, the Commission remains of the view that the broad thrust of its tier 2 approach in the Position Paper would provide the basis for a more robust set of criteria.

As in the Position Paper, and drawing on the comments from participants in box 7.7, the Commission considers that any revamped declaration package should embody:

- *A screening test:* to ensure that the service (rather than the facility) is of significance to the national economy and that it stems from a natural monopoly technology. Recognising that identification of natural monopoly is a difficult task, it would be sensible to err on the side of definitional simplicity — that is, a simple natural monopoly technology test, supported by further criteria to test for materiality.

- *A market power test:* to assess whether the service provider is in a position to exercise market power. The test should provide for the identification of the scope for any substitution in production or consumption.
- *A 'materiality' test:* allied closely to the objectives of the national access regime. It should ascertain whether the provision of access would improve economic efficiency significantly. Such a test should have regard to the impact of providing access on users of the service and (in the absence of specific measures to cater for new projects) on investors in essential infrastructure facilities.
- *A public interest test:* to assess whether there are non-efficiency considerations that should have a bearing on the declaration decision. Matters considered under the current 'health and safety' criterion could be incorporated in this test.

Of course, even if the Commission's preceding recommendation to require that declaration promote a substantial increase in competition were implemented quickly, it could still take a number of years for its impact to become fully apparent. Thus, review of the efficacy of the criteria, modified in accordance with recommendation 7.1, could reasonably occur as part of the proposed next review of Part IIIA (see recommendation 16.2).

RECOMMENDATION 7.2

The next scheduled review of Part IIIA (see recommendation 16.2) should examine the interpretation of the declaration (coverage) criteria, modified in accordance with recommendation 7.1, to assess whether further strengthening of particular criteria or recasting of the criteria to focus explicitly on market power and efficiency considerations is required.

7.6 Price monitoring as an alternative to declaration

Given the relatively intrusive nature of declaration, a question arises as to whether there might sometimes be instances where price monitoring could have a role to play as an alternative to more formal price control.

More specifically, in the Part IIIA context, price monitoring potentially could be used:

- *As an alternative to declaration*: In assessing an application for declaration, there could be instances where the NCC/Minister regulator was unsure whether the scope for, or likelihood of, the exercise of monopoly power was sufficient to warrant declaration. Faced with only two choices — to declare or not to declare — a cautious decision maker might adopt the former course. (This is also relevant for 'coverage' under the gas code — see box 7.6.)

- *As an 'exit strategy' for revocations*: For instance, where the market power of a declared facility had been eroded over time, or a new competing service established, revocation of the declaration could be contingent on a subsequent period of price monitoring to provide assurance to the community that any residual market power would not be exploited.

Importantly, price monitoring has little applicability in a Part IIIA context as an instrument to 'regulate' the terms and conditions of access. This is because, after declaration, the next stage — negotiation and arbitration — must be capable of delivering timely access on reasonable terms and conditions. Clearly, price monitoring would not guarantee that the obligation to negotiate arising from declaration would result in access on reasonable terms and conditions.

Position Paper

In the Position Paper, the Commission noted that provision for price monitoring as an alternative to declaration might reduce the potential for inappropriate 'marginal' declarations. In essence, price monitoring could be used to collect information on prices and costs to allow the significance of any market power to be established. Also, where the provider was in a position to exercise market power, price monitoring could effectively place the facility owner 'on notice' and create pressure for it to constrain its prices. In contrast, where the provider of the essential service was not in a position to exercise market power, monitoring would have no effect on market outcomes.

However, the Commission noted that such an approach would not be without some risk. In particular, the NCC might use the provisions to refer matters for monitoring in cases where it would otherwise have made a recommendation not to declare. Such a referral would have no resource cost for the NCC, as price monitoring would be the responsibility of the ACCC.

The Commission concluded that the use of price monitoring as an alternative to declaration, or as an 'exit strategy' (see above) could usefully be explored further. It therefore sought further input from participants on these matters.

Views of participants

Many participants (mainly service providers) advocated price monitoring as an *alternative to more explicit price (and related) regulation* under various industry-specific access regimes and codes — for example, Australia Pacific Airports

Corporation (sub. DR60) with respect to airports and Energex Limited (sub. DR81) with respect to electricity regulation.

The role for price monitoring as an *alternative to declaration* within Part IIIA elicited only limited interest from participants. This is probably not surprising given the residual nature of Part IIIA declarations. That said, the NCC was attracted to the idea:

> The Council supports the proposal to provide for prices monitoring as an alternative to declaration. Market power problems associated with natural monopoly can vary by degree. The availability of prices monitoring as an alternative to declaration would mean that declaration would not be imposed in some marginal cases where the criteria for declaration are met but where competition may emerge in a dependent market despite the market power of a natural monopoly service provider. Prices monitoring of the service provider would facilitate this oversight.
>
> … Thus, in response to a declaration application under Part IIIA, a recommendation could be made, as appropriate according to the respective criteria, to:
>
> - declare the infrastructure service for a period of time;
> - declare the infrastructure service for prices monitoring for a period of time; or
> - not declare the infrastructure service. (sub. DR99, pp. 38-9).

The NCC further considered that a decision to *impose* price monitoring should be separate from the *conduct* of price monitoring.

However, the ACCC (sub. DR93, p. 13) submitted that, while price monitoring 'may be a useful additional tool', it is not a substitute for access. It contended that:

- if the declaration criteria are designed to identify services to which a facility owner may have an incentive to deny access, any service satisfying the declaration criteria must be subject to the access regime;
- even if the cause of inefficiency is the extraction of monopoly rent rather than denial of access, the use of price monitoring rather than the current rights for access at reasonable conditions 'would inappropriately "water down" the benefits that an access regime can offer to upstream and downstream competition and efficiency'; and (relatedly)
- that price monitoring is not a significant deterrent to a facility owner extracting excessive rents — 'this is particularly true where price monitoring is undertaken over a number of years and there is no clear and significant consequence for charging excessive prices' (sub. DR93, pp. 13-4).

Perhaps alluding to the NCC's decision to declare the EGP for coverage (see box 7.6), the ACCC said that:

> One possible instance where price monitoring may be appropriate is where the only reason the regulator is satisfied that the service meets the declaration criteria is its concern about the likelihood of parallel pricing behaviour or collusion. (sub. DR93, p. 14)

Adopting a similar view, the South Australian Government (sub. DR121, p. 6) considered that price monitoring, as a complement to declaration, could be used to determine whether collusion was occurring 'particularly in circumstances where there are only two or three providers of a service'.

Some other participants also suggested that price monitoring would only be applicable in limited circumstances. The Western Australian Government contended that:

> Price monitoring could be a relatively un-intrusive form of regulation that creates incentives for providers of 'at risk' services to price transparently. However, it should not extend to services for which reference tariffs are approved by Regulators and where independent arbitration mechanisms already exist. In general, it should not extend to regimes that are certified as effective (consistent with the removal of a declaration threat where a certified regime exists).
>
> … A price monitoring declaration could potentially be designed as a 'show cause' notice where the affected party has limited period of time to prove that monitoring is unwarranted or unduly harsh. (sub. DR69, p. 9)

The ARTC (sub. DR64, p. 11) considered that price monitoring as an alternative to declaration might have application for non-integrated access providers whose revenue from providing access was the principal source of income. It argued, however, that any vertically integrated providers should be subject to the full Part IIIA access regime.

The Commission's view

Price monitoring as an alternative to declaration

The Commission considers that the proposal put by the NCC for the use of monitoring in cases where the 'criteria for declaration are met but where competition may emerge in a dependent market despite the market power of a natural monopoly service provider' is not consistent with the declaration-negotiation-arbitration arrangements of Part IIIA. Where the declaration process has been triggered, by definition, someone is seeking access to the facility on reasonable terms and conditions. With the declaration criteria met, it would seem incongruous for that person then to possibly be denied access on reasonable terms and conditions while the declared facility was monitored to ascertain 'whether competition might emerge in a dependent market'. As the ACCC indicated, if the declaration criteria are met, the service should be subject to access regulation. To suggest otherwise would seemingly indicate that the declaration criteria can be met inappropriately. On this matter, the Commission considers that its recommendation to raise the hurdle for criterion (a) should reduce the likelihood of 'marginal' declarations.

The ACCC's view that price monitoring might have a role in Part IIIA where a regulator is unsure about the likelihood of parallel pricing behaviour, is the situation the Commission had in mind when preparing the Position Paper. Indeed, it raised the possibility of monitoring because it had serious reservations about the decision to recommend that the EGP be covered under the Gas Code. While the Commission considered that the implied reason for recommending coverage — the potential for parallel pricing — was difficult to sustain given the existence of what appeared to be a *competing* facility, it nonetheless felt that, in the light of the NCC's inclination to declare such a facility, price monitoring would have provided the option for a less prescriptive response.

However, after the release of the Position Paper, the Tribunal set aside the coverage decision. Thus, the system delivered appropriate closure of the issue, whereas the price monitoring option would have put the owners of the EGP in the position of having to wait until the end of the monitoring period, at which time, presumably, another application for coverage could have been lodged.

Of course, one case does not negate the potential usefulness of price monitoring as an alternative to declaration. Indeed, the Commission has not changed its view that such an option has merit in principle. However, as noted above, the proposed strengthening of the declaration criteria should narrow the scope for 'marginal declarations'.

Moreover, if adopted, proposals to limit the exposure of certain new investments to Part IIIA (see chapter 11) would mean that some potential candidates for price monitoring would be subject to other arrangements, at least for an interim period. Further, a pricing history would be available if and when such services became subject to declaration.

In sum, the Commission considers that there is insufficient evidence of problems arising from marginal declarations to justify additional 'engineering' of Part IIIA at this time. (Such engineering would need to encompass consideration of appeals processes and the checks and balances that might be required should State Ministers be able unilaterally to implement price monitoring for services that had been recommended for declaration by the NCC.)

This is not to deny, however, that such an option could have a role in industry specific regimes if there were evidence of more significant problems arising from marginal declarations such that the benefits of a price monitoring option would outweigh the likely implementation costs.

An exit strategy for revocations

There was little comment from participants on the role of price monitoring as part of an exit strategy leading to revocation of Part IIIA declarations. This is not surprising given that only one service — cargo handling facilities at Sydney Airport — is currently declared.

While the Commission considers that an 'exit strategy' option has some attraction in principle, given that Part IIIA is essentially a residual route for achieving access, there does not seem to be a strong case to make provision for problems which may never arise. Again, however, the exit strategy option may be useful for some industry-specific regimes.

Concluding comments

As noted, the Commission is proposing that Part IIIA should be subject to a further review (see recommendation 16.2). If, at the time of this review, it was determined that there was evidence of inappropriate marginal declarations or difficulties with revocations, there may be a case to revisit the price monitoring issue.

In its recent report on the Prices Surveillance Act (PC 2001b), the Commission has proposed that provision be made for the NCC to recommend prices monitoring in cases where it has decided not to recommend declaration of a facility and as an 'exit strategy' for revocations. Such provisions in a revamped prices monitoring arrangement could be activated by relevant future amendments to the Part IIIA legislation — pending resolution of the implementation issues outlined above (for example, whether an appeals mechanism would be required). The Commission reiterates, however, that it does not see this option as being warranted at this stage of the development of Part IIIA.

8 Negotiation and arbitration

Declaration of a service under Part IIIA establishes a right for access seekers to negotiate terms and conditions of access. If negotiation is unsuccessful, Part IIIA provides an enforceable right to dispute resolution through arbitration by either a private arbitrator or the Australian Competition and Consumer Commission (ACCC). However, the arbitration provisions are yet to be tested.

This chapter canvasses a range of matters relating to the post-declaration phase of Part IIIA including:

- measures to encourage negotiated outcomes and, where appropriate, faster progression to arbitration (section 8.1);
- the scope to improve the arbitration criteria and to align the arbitration provisions better with the objectives of Part IIIA (section 8.2); and
- the merits of amending Part IIIA to permit multilateral arbitrations (section 8.3).

8.1 Encouraging negotiated outcomes

Part IIIA does not preclude private negotiation between an access seeker and a facility owner independently of the national regime. Thus, if a service has been declared, this typically means that negotiations have been unsuccessful.

Declaration shifts the negotiating balance. The fact that negotiations for declared services are underpinned by the threat of arbitration will inevitably condition those negotiations. For example, if it is perceived that the ACCC would seek to remove the service provider's monopoly rent, this would provide an incentive for access seekers to eschew negotiation and move quickly to arbitration and for service providers to delay such a move. It might also see an access provider agree to terms and conditions prior to declaration to avoid the possibility of 'harsher' arbitrated outcomes. Such strategic considerations are considered further in box 8.1, bearing in mind there are yet to be any arbitrated outcomes under Part IIIA.

Box 8.1 **Strategic behaviour under the negotiate-arbitrate model**

In access negotiations, the access seeker is seeking a 'low' access price (that is, terms and conditions) and the service provider is seeking a 'high' access price. The negotiation process is an exploratory procedure which aims to determine whether there is an intersection of the 'offer' and 'acceptance' positions. The prospect of an arbitrated outcome conditions these negotiations.

Depending on the experience with a particular regime, it is almost inevitable that arbitrated terms and conditions will be less favourable to a service provider than its lowest offer price. This strengthens the negotiating power of the access seeker — the threat of arbitration can be used as a bargaining tactic.

However, the access seeker is confronted with the reality that the negotiate-arbitrate process can be time consuming. Indeed, for a 'first mover' that instigates declaration, a decision may be several years away. (For example, at the extreme, it could involve initial negotiation; application for declaration; a Federal Court case on matters of law; declaration; appeal to the Tribunal; negotiation; arbitration; and appeal to the Tribunal.) This strengthens the negotiating power of the service provider.

The longer parties have had to observe the behaviour of the regulator — particularly, its attitude to the price of access — or the greater the clarity provided by any pricing guidelines in the access regime, the greater will be the certainty about the outcomes of an access dispute. A higher degree of certainty, by reducing the 'room to manoeuvre', will generally strengthen the bargaining position of one of the parties.

Other relevant factors include the ability of parties to bear the costs of such protracted processes, and information asymmetries causing imbalances in negotiating power.

Given that the arbitration process is not without costs and is likely to lead to further delays in gaining access, there would appear to be benefits in encouraging negotiated outcomes. Against this backdrop, this section discusses some approaches for encouraging negotiated outcomes, including:

- mandatory information disclosure requirements;
- interim determinations with backdating provisions; and
- final offer arbitration.

In this context also, the pricing principles recommended by the Commission in chapter 12 would assist in conditioning and expediting the negotiation process (see box 8.2).

However, as a prelude to discussing these options to encourage negotiation, this section considers the value of requiring parties which have already been through unsuccessful commercial negotiations to negotiate again following declaration. This raises the issue of whether arbitration, rather than further negotiation, should follow the declaration of a service and whether there should be structural changes to limit or remove the post-declaration negotiation phase.

Box 8.2 **Pricing principles and negotiation**

Without pricing principles, negotiation can be somewhat unguided — at least until such time as arbitrated precedents are established. This could take a long time. From this perspective, pricing principles would be a particularly important adjunct to speedy negotiation during the early stages of an access regime.

This point was made by a number of participants. For example, the Network Economics Consulting Group said:

> Given the critical importance of decisions such as the type of access pricing methodology to be utilised and the relative importance to be given to monopoly rent control versus ensuring investment incentives, it is a matter of some concern that Part IIIA provides almost no practical guidance on these issues. It is important to note that any additional clarity that can be brought to the current pricing principles will also likely improve the prospects for successful dispute resolution between access seekers and access providers. If the principles were clearer, parties to disputes or potential disputes would have a clearer understanding of the likely arbitrated outcome and hence would more readily agree on a commercial settlement. (sub. 39, p. 25)

Similarly, the Queensland Mining Council said:

> Greater certainty and a reduction in the incidence of disputes, appeals and arbitrations would be achieved by incorporating guiding principles relating to key characteristics of access regimes, such as pricing, transparency, ringfencing (in the case of vertically integrated entities), efficiency and incentive regulation. (sub. 27, p. 6)

And Freight Australia said:

> In the case of a negotiate-arbitrate access regime, a common set of pricing principles could narrow the differences in parties' expectations about possible pricing outcomes. This would save some transaction costs incurred by the parties in trying to guess each other's bargaining positions, thereby facilitating private negotiations. (sub. DR62, p. 7)

The Law Council of Australia, drawing on its understanding of the '90 per cent of litigation settled prior to trial', stated that once clear rules are established by the arbitrator, the parties will always settle on outcomes that are reasonably close to those rules. It went on to point out that:

> Efficient results (whether from negotiation or from arbitration) rely on the arbitrator's developing rules and practices that promote efficiency. If that occurs, negotiation will be fine. (sub. 37, p. 20)

Changes to the negotiate-arbitrate model

As noted, an application for declaration indicates that initial private negotiations have failed, which in turn raises the question about the efficacy of requiring further negotiations. In addition, a number of participants argued that under the current negotiate-arbitrate model, declaration without terms and conditions is not particularly useful. For example, the Law Council noted:

> One of the issues which arises because of the two stage process is that some issues which may ultimately prevent access being granted may not be dealt with in the declaration stage, Stage 1, and so the parties may have to undertake both Stage 1 and the negotiate/arbitrate stage (Stage 2) before access is finally denied. For example, in the *Sydney International Airport* decision [Sydney Airports Corporation Limited] argued that the Tribunal should consider issues to do with the viability of the access seekers. The Tribunal refused, saying that this was an issue that could be dealt with in Stage 2. The protected contractual rights issue raised in the *Hamersley Iron* case is another example of this (sub. 37, pp. 20-1).

As a means of expediting outcomes, there are a number of possible changes that could be made to the negotiate-arbitrate model. These include:

- dispensing with post-declaration negotiation and moving directly to arbitration;
- a provision for the regulator to move more quickly to arbitration following the declaration of service. (In the Position Paper, the Commission proposed that Part IIIA be amended to provide for arbitration to commence 30 days after declaration, unless both parties notified the ACCC that a settlement was likely); and
- a proposal by Sydney Airports Corporation Limited (SACL) to enable the regulator to issue enforceable directions to parties to facilitate negotiations.

A declaration-arbitration model

Moving immediately to arbitration following the declaration of a service could reduce the time taken to achieve a final outcome and address the problem identified by the Law Council — namely, that declaration without reference to terms and conditions is ‘unguided’.

However, there was opposition from participants to the idea of dispensing entirely with negotiation following declaration. Professor Brunt commented on the practical problems which arise from having declaration separate from arbitration, but still considered that separation was warranted on grounds of due process:

> At first blush, the separation of declaration from the specification of terms and conditions appears nonsensical: How can declaration be determined to be, broadly, in the public interest, if the terms and conditions are unknown? Yet I have come to believe that separation can and should be justified on grounds of adjudicatory and regulatory process … a determination on declaration is quasi-judicial (adjudicatory) with the outcome essentially a positive or negative order (akin to an injunction). (sub. 21, p. 4)

For somewhat different reasons, SACL opposed any merging of the declaration and negotiate-arbitrate phases of Part IIIA. It considered that this:

> … would be inappropriate because terms and condition, should so far as possible, be negotiated commercially by [the] access seeker and access provider. For the regulator to intervene ahead of those negotiations is unnecessary and would promote continued regulation when the aim should be to promote commercial settlement. (sub. DR114, p. 70)

For its part, the Commission notes that dispensing with post-declaration negotiation would be a less radical departure from the current arrangements than might first appear. For the most part, the change of arrangements would only relate to the *first* access seeker. That is, the declaration would remain generic so that any *subsequent* access seeker could enter into commercial negotiation with the service provider. Failure to achieve agreement would result in a further arbitration, as would occur under the current arrangements.

Nonetheless, like participants, the Commission has reservations about dispensing with post-declaration negotiations for the initial access seeker. Just as it is inappropriate to try automatically to solve every dispute via negotiation, so would it be inappropriate to remove all possibility of negotiation after declaration. As noted by the National Competition Council (NCC) and others, declaration does change the negotiation dynamic. Hence, there can be circumstances where declaration may facilitate a negotiated settlement without the need for further regulatory involvement. The Commission further notes that the residual nature of the Part IIIA declaration route implies that a relatively high proportion of cases may involve only one access seeker. From this perspective, dispensing with provision for post-declaration negotiations would be a significant change.

Regulator to initiate arbitration

There was little response from participants to the Position Paper proposal that the provisions of Part IIIA should provide for arbitration to commence 30 days after the declaration of a service unless both parties to the dispute notified the ACCC that a settlement was likely. Those who did respond contended that such a provision would be unnecessary. For example, the ACCC, as the body that would be responsible for overseeing the proposed provision, argued that Part IIIA already provides a low threshold for either party to notify a dispute:

> The threshold for notification of a dispute is … extremely low and it is open to either party, in particular the access seeker, to notify a dispute. (sub. DR93, p. 16)

A similar view was put by the Chamber of Minerals and Energy of Western Australia:

> Currently, the impact of declaration is to provide an enforceable right to negotiate access. If this fails, the seeker can then seek arbitration and presumably would do so. The Chamber is not convinced there is any requirement for an automatic initiation of arbitration. (sub. DR66, p. 3)

The Queensland Treasury (sub. DR105) also did not support the proposal, on the ground that it would provide too little opportunity for negotiation.

The South Australian Government commented that it may be impractical to impose such a time frame on negotiation:

> There may be many reasons why a negotiated result may not be practical in such a time frame, for example, the need to clarify the nature of required access, consult affected parties, or discuss infrastructure enhancements. (sub. DR121, p. 4)

The Commission accepts that, as either party, and in particular the access seeker, can seek arbitration at any point during negotiations, a provision for arbitration to commence automatically after a certain time is not required. Furthermore, the Commission's recommendation (see below) for the access provider to make relevant information available to the access seeker within 28 days places a de facto time limit on negotiation and acts as a trigger for arbitration.

Regulatory mediation in negotiations

To exert greater discipline on the post-declaration negotiation process, SACL suggested that the ACCC — as in the telecommunications regime — should be empowered to issue enforceable directions to the parties to facilitate the conduct of negotiations. In effect, the ACCC would assume a mediation role:

> Part IIIA should include a provision along the lines of sections 152BBA, 152BBB and 152BBC of the telecommunications access regime ... Those provisions give the Commission a power to issue enforceable directions to the parties to a dispute to facilitate the conduct of negotiations between them, and allow the ACCC to assume a mediation role in such negotiations at the request of the parties.
>
> … provisions of such a nature should be included in Part IIIA, and drafted in terms which encourage and reinforce their use by the ACCC to require the parties to negotiate their issues in dispute between them to the point where the only outstanding issues really are matters of intractable dispute. (sub. DR114, p. 73)

However, in a Part IIIA context, the Commission considers that enabling the ACCC to issue enforceable directions and assume a mediation role in the (pre-arbitration) negotiations would involve inserting a layer of regulatory involvement in the negotiation process. Given the general presumption that negotiated terms and conditions will usually be preferable to those outcomes directed or imposed by a (less than fully informed) regulator, it considers that there should be no regulatory involvement in the negotiation process unless an access dispute has been formally triggered.

In sum, the Commission considers that changes to the current negotiate-arbitrate approach of Part IIIA are not warranted. Given this, a number of options to streamline the negotiation phase are discussed below.

Mandatory information disclosure requirements

Negotiation between access seekers and providers can be affected by imbalances in information available to the parties. In particular, the service provider will have a greater appreciation of the cost and price structures of the services in question, their technical operation, the degree of spare capacity and the scope for capacity augmentation. Such information imbalance weakens the bargaining position of the access seeker.

Moreover, the service provider may be in a strong position to withhold or 'eke out' relevant information. In such cases, the access seeker is likely to regard even relevant information with suspicion, because it is not in a position to test its veracity. Many participants commented on this problem (see box 8.3).

However, it is important to note imbalances in information are not all in the one direction. As discussed further below, the service provider may also face difficulties in responding to an ill-defined request for access.

To assist access seekers and promote efficient negotiation, some industry specific regimes and the generic access regime used in Queensland incorporate mandatory information disclosure rules. These rules are discussed briefly in box 8.4. As indicated there, various concerns have been raised in relation to some of these requirements — most notably those in the Gas Code. Nonetheless, the examples outlined in box 8.4 illustrate the range of requirements that can be used to further negotiations between the parties.

Box 8.3 **Negotiation under conditions of asymmetric information**

Those involved in the administration of Part IIIA — the NCC and the ACCC — noted that asymmetric information is a problem for access regulation. The NCC referred to:

> … cynicism on the part of the access seeker about the reliability of the information provided to it by the infrastructure owner, given what is often a limited ability to test the reliability of that information. (sub. 43, p. 44)

The ACCC (sub. 25, p. 27) noted that its experience with the telecommunications regime indicates limited incentives for vertically integrated access providers and access seekers to conclude effective agreements on terms and conditions where there is a market power imbalance and where information asymmetries arise.

AAPT Limited, describing its experiences under the telecommunications regime, said:

> An access provider will often take steps to delay the granting of access. … One of the major problems confronting an access seeker is 'information asymmetry'. The access provider will always have a significant advantage in negotiation and arbitrations by virtue of the fact that it understands the technical operation and the costing structure of the service far better than an access seeker ever could. (sub. 42, p. 9)

BHP Billiton, referring to the gas and electricity codes, submitted that:

> Asset owners have resisted providing the regulator and users with the information they need to properly assess the asset owners' proposal. Months have been wasted while the regulator pursues additional information from the asset owner.
>
> Asset owners should be obliged to maintain regulatory accounts that are available to the regulator and users. These accounts should be standardised, audited and consistent. This is essential to address the information asymmetry that exists with regulated businesses. (sub. 48, p. 3)

Stanwell Corporation Limited said:

> [Distribution Network Service Providers] generally … seek to entrench the problem of information asymmetry in their favour — DNSPs do not offer additional relevant information … (sub. 3, p. 10)

Indeed, in its Position Paper, the Commission considered that mandatory disclosure rules for Part IIIA would be a reasonable means to help address information asymmetries and expedite access negotiations for declared services. To this end, it proposed that Part IIIA should require the provider of a declared service to give sufficient information to enable the access seeker to engage in effective negotiation. In addition, the Commission sought participants' views on the nature and extent of information that would be needed to meet the 'sufficiency' requirement.

Box 8.4 **Information disclosure requirements in industry-specific regimes**

The Gas Code

Under the Gas Code, service providers are required to provide an access seeker with a range of information on capital costs, operations and maintenance costs, overheads and marketing costs, systems capacity volume assumptions and information on key industry performance indicators. However, the regulator may allow some of the information to be aggregated or not disclosed if it considers that disclosure would harm the legitimate business interests of the service provider or prospective users of the service.

The code requires the service provider to establish and maintain an 'Information Package' for each pipeline covered by the code. As well as providing the information required under the disclosure requirements, the package must also detail the service provider's procedures relating to access. The service provider is required to provide a copy of the package within 14 days of a prospective access seeker requesting a copy and paying any applicable fee.

A number of concerns were raised about these requirements. In a paper prepared for BHP Billiton, National Economic Research Associates (2000a, p.12) considered that there were problems with the quality and quantity of information provided to users, excessive claims of confidentiality and slow responses by regulators. It said:

> As a result of these problems, stakeholders are frustrated because of their inability to secure vital information on the source of their charges. … Without the ability to examine these issues transparently, stake holders are unable to determine, regardless of the resources they devote to the process whether or not they are being charged with legitimate costs.

BHP Billiton cited the example of the South Australian Independent Pricing and Access Regulator's comments that Envestra had failed to supply adequate information to users and regulators and, in particular, that the allocation of costs betweens users was not specifically addressed. It commented that:

> Unfortunately some service providers appear to believe that the provision of adequate information to enable users to understand the derivation of the elements of the Access Arrangement is optional. (sub. 48, p. 70)

Telecommunications

The Telecommunications Act 1997 provides for the mandatory disclosure of information relating to the service provider's network.

(continued next page)

Box 8.4 **continued**

This network information which must be provided on request from an access seeker includes:

- information on operations support and traffic flow and on the treatment of particular calls (such as toll-free calls); and
- network planning information such as the characteristics of traffic being offered by the provider so as to allow the access seeker to plan its own network; and
- quality of service information (eg conditions affecting the quality of service).

The service provider and the access seeker are required to agree to confidentiality procedures (or failing agreement, procedures determined by the ACCC) before the information is provided. The information must be provided as soon as practicable following the request. The network information is not restricted to services declared under Part XIC of the Trade Practices Act (PC 2001c).

Rail

The Victorian rail regime provides that the operator of declared rail transport services must make a formal proposal of terms and conditions of access within 14 days of receiving an access application from an access seeker and provide 'information of a kind and in the form specified by the [Office of the Regulator-General]'.

The New South Wales rail access regime specifies that the Rail Access Corporation must provide the access seeker, within 28 days of a request, information on the regime, registered agreements and a description of its procedures and pricing policies. However, the Corporation must not divulge information which could harm any access seeker.

The South Australian rail access regime specifies that an operator must provide an access seeker with information relating to: use of the infrastructure; the extent it would be necessary and technically and economically feasible to extend the infrastructure to meet the access seeker's requirements; and the terms and conditions on which the operator would be prepared to provide a particular service.

Queensland's generic access regime

Under Queensland's generic access regime (see chapter 2), the access provider is required to provide information on:

- how the price for supplying the service is determined;
- service-related operating, capital and maintenance costs;
- the service-related value of its assets and the method of valuation;
- estimates of the spare capacity available; and
- the operations of the facility.

The Queensland Competition Authority, as the regulator, may allow some information to be aggregated or not disclosed if it considers disclosure is likely to damage the commercial activities of the access provider, access seeker or user of the service.

Participants' comments on 'sufficient' information

There was widespread support for mandatory information disclosure for declared services. While some participants proposed quite detailed information requirements, most considered that the information should be of a general nature to reflect the generic nature of the Part IIIA regime itself.

The NCC commented that the mandatory provision of information to access seekers would greatly improve the negotiate-arbitrate provisions of Part IIIA:

> The Council considers that amending Part IIIA to require service providers to supply information to prospective access seekers would greatly improve the efficacy of the negotiate/arbitrate mechanism. In dealing with State and Territory access regimes, the Council's experience is that information asymmetry between providers and access seekers is a major issue of concern to stakeholders. (sub. DR99, p. 41)

Similarly, the Queensland Treasury (sub. DR105) supported the mandatory disclosure of information and pointed to the disclosure provisions in the *Queensland Competition Authority Act 1997* (see box 8.4).

As to whether any information requirements should be of a general, rather than a prescriptive nature, the NCC said:

> While the Gas Code offers guidance on the type of information that should be made available to access seekers, the Council recognises that the Gas Code is relatively prescriptive in nature. It would be appropriate, within a general regime such as Part IIIA, to limit information requirements to broad categories. (sub. DR99, p. 42)

Expressing a similar view, EnergyAustralia said:

> EnergyAustralia believes that there should not be a set of prescribed information disclosure requirements embodied in Part IIIA. (sub. DR106, p. 3)

Indeed, some participants focussed on principles rather than specific detail. Freight Australia contended that mandatory information disclosure would be better based on a set of design principles, which would see disclosure:

- limited to information that the regulator can determine is possessed by the access provider;
- confined to information that would be generated and kept by an access provider in the course of its business; and
- based on mutual obligation — that is, the access seeker should also provide adequate information to the service provider.

Elaborating on the last point, Freight Australia submitted that:

> Just as access seekers are frustrated by an access provider who withholds relevant information, an access provider may and can be equally frustrated by access seekers with ambiguous or ill-specified access requests. An access provider is not likely to be able to offer credible terms and conditions without knowing the commerciality or technical feasibility of the access request. (sub. DR62, p. 5)

The South Australian Government also advocated the ‘mutual obligation’ approach to information provision:

> … there does not appear to be any obligation on the access seeker to provide good quality information about the service that is sought. (sub. DR121, p. 4)

In a similar view, the NCC considered that while some information — for example, the process through which the service provider would negotiate access — should be made available for services upon declaration, other information should be provided to an access seeker only after it had submitted a request for access. Notably, it said that this request for access should contain sufficient information from the access seeker to enable the access provider to continue negotiations. On receiving the request for access, the service provider would then provide information on:

- the availability of the relevant service; and
- … the terms and conditions of access being offered by the service provider and the basis for those terms and conditions. (sub. DR99, p. 41)

The Australian Gas Association (AGA) focussed its comments on the need to limit disclosure to relevant matters and not to require disclosure of commercially sensitive information. It said:

> … information collection should be confined to matters relevant to the purpose for which the information is required. Information requirements should not be open-ended, and information should only be used for the purpose for which it was collected. The second principle is that maintenance of the confidentiality of information provided by commercial entities is the key to a process of information provision operating effectively. (sub. DR84, p. 6)

Conversely, the New South Wales Minerals Council argued that the cost and price information of a monopolist should be not be considered commercially sensitive as, by definition, it faced no competition. In a rail context, it also expressed concern that out of date and inaccurate information supplied by providers did not allow rail users to determine whether their access charge was appropriate. Consequently, it considered that:

> … information provided to access seekers should be audited by an independent regulator to ensure it is accurate and relevant, particularly in cases where there is no regulator. (sub. DR63, p. 7)

The issue of regulatory intervention in relation to information provision was also raised by other participants. One approach put forward by BHP Billiton to overcome problems with the consistency and quality of information, was that infrastructure owners should be required to maintain regulatory accounts that would be available to regulators and users. As noted in box 8.3, it proposed that 'accounts should be standardised, audited and consistent' (sub. 48, p. 3).

Similarly, Freight Australia (sub. DR62) considered that all information should be able to be verified by the regulator while the NCC (sub. DR99) saw some role for the ACCC in vetting information. Importantly, however, the NCC acknowledged that including a sanction for not meeting the information requirements would be superfluous due to the ability of the access seeker to notify a dispute and trigger the arbitration process of its own accord. It said:

> The arbitration provisions could be automatically triggered if there is a failure to provide the information. This may not, however, be necessary, as such a failure would enable the access seeker to notify a dispute in any case. (sub. DR99, p. 41)

The Commission's view

Given the widespread support for some form of mandatory information disclosure provisions in Part IIIA, the key issue is not whether such provisions should be introduced, but rather what they should entail. The Commission concurs with the view that, given the generic nature of Part IIIA, it is appropriate to express such information requirements in broad terms. It considers that detailed information requirements, such as specific pre-determined information packages, are more suited to industry-specific regimes. Consequently, as with the proposed pricing principles (see chapter 12), information disclosure requirements should be at a sufficiently high level as to be applicable to the diverse set of circumstances likely to be dealt with by the Part IIIA regime.

In particular, the Commission also sees it as important that such requirements involve a 'two-sided' process which requires access seekers to provide sufficient information about their technical and commercial requirements to enable effective negotiations to commence with access providers. Such disclosure would reduce the scope for service providers to regard requests for access as ill-defined and ambiguous or resource and time-intensive 'fishing expeditions'. At the same time, the processes by which a provider of a declared service will negotiate access to, and the availability of, the service should be made clear to the access seeker.

To enable the access seeker to determine the appropriateness of the terms and conditions offered, the service provider should provide sufficient information to allow the access seeker to make a reasonable assessment of the basis on which those terms and conditions were made. This requires that such information include relevant details about the costs associated with operating the facility and providing the service.

Given the opportunity for the access provider to delay the negotiation of access through delays in the provision of information, the Commission considers that — as in the industry-specific regimes containing provisions for the mandatory disclosure of information — such information should be provided within a specific period. A 28 day limit for the service provider to meet their obligations commencing from the time at which the access seeker submits a properly constituted request outlining its technical and commercial requirements for access to the service, would seemingly be appropriate

Another issue is the degree of regulatory involvement in the information disclosure process. Clearly, negotiation could be facilitated by the imposition of some form of sanction or penalty for failure to meet time frames or information 'sufficiency' requirements. However, as Part IIIA remains a residual access route, the Commission is of the view that regulatory involvement in the vetting of information or in applying sanctions to meet 'sufficiency' or time frame requirements is not required. It considers that there should not be regulatory involvement in the Part IIIA negotiation process unless an access dispute has been triggered.

In any case, as the NCC noted, the access seeker can initiate arbitration, and would most likely do so, if the access provider failed to provide sufficient information. Consequently, the threat of arbitration would provide a discipline for the timely provision of 'sufficient' information and for the access provider to negotiate in good faith.

Furthermore, should commercial negotiations break down, the access seeker could reveal to the regulator during an arbitration the information acquired from the service provider in the course of negotiations. Consequently, any failure on the part of the service provider to comply with the information disclosure requirements would become apparent to the ACCC.

Of course, without regulatory oversight of the information disclosure process, there could be no formal provisions for the ACCC to rule on whether withheld information was legitimately commercially sensitive. However, the Commission considers that introducing such provisions would be akin to early arbitration — and hence, incompatible with an approach which sought to limit regulatory involvement in the negotiation phase. In a Part IIIA context, it seems appropriate to allow a service provider the discretion to work around any commercial sensitivities in providing sufficient information to the access seeker to enable negotiations to continue. Where the withholding of commercially sensitive information resulted in the breakdown of negotiations, the access seeker could trigger an arbitrated outcome.

RECOMMENDATION 8.1

The arbitration provisions of Part IIIA should be amended to provide for 'two-sided' information disclosure requirements involving both the access provider and the access seeker. The access seeker should be required to provide sufficient information, including technical and commercial requirements, to enable the access provider to respond to the request for access. The provider of the declared service should be required to provide sufficient information to an access seeker to facilitate effective negotiation on the terms and conditions of access. This should include:

- ***information on the availability of the service, including any reasons why the service is not available on the conditions sought by the access seeker;***
- ***an offer of the terms and conditions of access to the service; and***
- ***sufficient information (such as the costs of operating the facility and providing the service) to enable the access seeker to make a reasonable judgement of the basis on which the terms and conditions of access were determined.***

This information should be provided within 28 days of the access seeker submitting its request for access to the service provider.

Backdating provisions

Backdating refers to a provision within an access regime for the regulator to specify that the determination will apply from some earlier point in the process — for example, from the time a service was declared or a dispute was notified.

Such provisions can be used as a means to streamline the negotiation phase by increasing the attractiveness to an access provider of a negotiated settlement relative to delaying and seeking an arbitrated outcome. That is, backdating can reduce the incentive for the service provider to delay settlement of the terms and conditions of access and the gains to it from setting a high access price. In turn, this may increase the incentive for it to reach an efficient commercial settlement.

The telecommunications regime allows the ACCC to backdate the provisions of a final determination to the date of commencement of an access dispute. This requires that declaration under the regime provides for a mandatory right of access and that the regulator can make interim and final determinations. The regime further provides for 'compensation' based on the difference between the final determination access price, the prices charged before an interim determination, if relevant, and the price charged after the interim determination.

Further, there are proposals to amend the telecommunications access regime to backdate the provisions of an access determination for a declared service to the date that negotiations commenced between the access provider and access seeker in relation to that service. The objective is to remove the incentive for access seekers to notify disputes to the ACCC at the earliest possible opportunity (Alston 2001).

Unlike the telecommunications regime, declaration under Part IIIA does not automatically provide access: rather, it provides a right to negotiate and for legally binding arbitration if negotiation fails.

In the Position Paper, the Commission commented that, for backdating to be effective, there would have to be a major change to Part IIIA — namely, the introduction of a mandatory access right. (A mandatory right of access in Part IIIA would, as in the telecommunications access regime, ensure a commencement date for access and hence a date from which access could be backdated.) The Commission argued that such an amendment would be inappropriate given the residual nature of the Part IIIA regime and the alternative options to expedite negotiations.

However, in response to the Position Paper, the ACCC contended that Part IIIA would not, in fact, need to be amended to permit backdating. It pointed out that it:

> … does not accept that for backdating provisions to be effective, Part IIIA would require significant amendment. Once declared the ACCC can make an arbitral determination requiring the provision of access [see section 44V(2)]. (sub. DR93, p. 15)

In addition, the ACCC noted that, for backdating to work effectively, it would need only to determine when the access seeker had access to the service. It said:

> The important point if provision allowing for the backdating of arbitrations is to provide an effective incentive to negotiate terms and conditions of access is not whether Part IIIA provides a mandatory right of access, but whether the access seeker has access to the declared service at the time the dispute is notified. (sub. DR. 93, pp. 15-16)

On the other hand, SACL, while supporting the inclusion of backdating provisions in Part IIIA, recognised that without a mandatory right of access to underpin backdating it would only be feasible in some situations:

> The fact that [backdating] provisions do not currently exist in Part IIIA would seem to be based on a presumption that the negotiation of terms and conditions will arise only in circumstances where access has not previously or yet been provided. That of course

> will not always be the case and, in relation to airports specifically will seldom if ever be the case … (sub. DR114, p. 74)

For its part, the Commission acknowledges that a mandatory right of access would not be required to permit backdating if the access seeker had access at the time a dispute was notified. However, the limited experience to date with Part IIIA suggests that a declaration is typically triggered by a party seeking, rather than already having been provided with, access to a particular infrastructure service. As a residual access route, this is likely to be the case in the future as well.

In these circumstances, implementing backdating provisions would be complex. For example, compensation issues become quite complex without a mandatory right of access — where access had occurred any backdated compensation could be based on the extent of over (under) charging for access to that service, but where access had not been provided until after an arbitral decision it would be difficult to calculate compensation.

The Commission does not see a need to make explicit provision for backdating in Part IIIA merely to cover cases in which access had been provided prior to a dispute being notified. At this stage in the evolution of Part IIIA, amending what is largely a residual access route to introduce a mandatory right of access would be a somewhat 'heavy-handed' response.

Final offer arbitration

A further variant to encourage negotiation, by increasing the risks of arbitration, is final offer arbitration (FOA). The NCC considered that a 'radical' alternative for dispute resolution in Part IIIA would be to:

> … introduce a variant on the classic arbitration model and use a final offer arbitration structure to determine the outcome. … As a commercial methodology it has much to commend it. How far it can be utilised in the policy context of access regulation may be more contentious. (sub. 43, pp. 15-16)

The essence of FOA — sometimes called 'baseball arbitration' because of its use in negotiations over remuneration for baseball players — is that each party makes a final offer and the arbitrator picks one. The arbitrator cannot offer an intermediate solution. Early proponents of FOA claimed that it promotes convergence, because if a party submits an ambit claim it places itself at risk that the arbitrator will select the other, more 'reasonable', offer. However, subsequent research has indicated that evidence of convergence under FOA is equivocal.

FOA has been used to a limited extent in an access context overseas. The Canadian rail system provides for an arbitrator to review the final offers of shippers and carriers. A Canadian Review Panel found that between 1988 and 2000, some 22 FOAs had been initiated. It noted that:

> More than half the matters submitted for arbitration have been settled by the parties before the conclusion of the arbitration hearing, suggesting that the availability of FOA is very likely an incentive to reaching a negotiated settlement. (CTARP 2000, p. 21)

However, the Panel found a high level of dissatisfaction with FOA among service providers who considered that:

> … a shipper may negotiate to receive the best combination of service, car supply and rates from the railway, then use FOA to try to move the rate even lower. As a result of their dissatisfaction with FOA, [service providers] recommend it be replaced with a commercial arbitration process. (CTARP 2000, p. 22)

In the Position Paper, the Commission noted that under FOA there would be no guarantee that the ‘winning’ terms and conditions would be consistent with good public policy outcomes. This could have serious efficiency consequences if inappropriate access prices were afforded to a major entrant, particularly where multiple access seekers were likely. Nevertheless, it sought further information from participants on the merits or otherwise of FOA in a Part IIIA context.

Participants responding to this request were also unconvinced as to the merit of FOA in respect of access regimes. The AGA considered that:

> The aim of access regulation should be to have efficient access prices. In contrast, final offer arbitration could lead to inappropriate pricing determinations that affect efficiency over the long term, with significant potential for the distortion of downstream markets. (sub. DR84, p. 18)

In a similar vein, the ACCC noted that, even with pricing principles to guide offers made under FOA, there would be a risk of the regulator selecting the wrong price:

> … even if the pricing principles offered precise guidance, if there was information asymmetry between the parties to the arbitration the risk that divergent offers would be made, and an inefficient price set, would remain high. There would also be a risk, if pricing was divorced from an understanding of the revenue requirements of a business, that the regulator may choose a price with the potential to bankrupt an access provider. (sub. DR93, p. 15)

The New South Wales Minerals Council was also sceptical and said:

> Final offer arbitration might work if it were applied to access pricing alone. If however a dispute were to involve complex technical matters it is unlikely that this type of arbitration would work satisfactorily. (sub. DR63, p. 8)

In the light of these comments and the evidence from Canada that FOA has not been particularly successful in an access context, the Commission is not pursuing this approach. In its view, there are a number of ways to encourage efficient negotiation — for example, through the use of pricing principles and information provision — where negotiation is used to resolve issues in conjunction with conventional arbitration.

8.2 Improving the arbitration provisions

Apart from introducing information disclosure requirements, the Commission considers that there is little need to change the negotiate-arbitrate format in Part IIIA. Given that the arbitration process is yet to be tested, the case for changing the detailed arbitration criteria might also seem limited. However, consistent with its views on the need to better focus Part IIIA on improving efficiency in the use of, and investment in essential infrastructure, the Commission considers that there would be benefits in making some 'pre-emptive' changes to the arbitration criteria.

Division 3, Subdivision C of the Act (arbitration of access disputes) covers a number of areas including determinations (s.44V), restrictions of determinations (s.44W) and matters the regulator must take into account (s.44X).

As set out in chapter 2, there are a range of matters that the regulator must consider under these sections when arbitrating terms and conditions for services declared under Part IIIA. These include: the legitimate business interests of the provider; the public interest; the interests of all users; the costs of providing access; the value to the provider of extensions; operational and technical requirements necessary for safe and reliable operation of the facility; existing contractual obligations for provision of the service to other users; and the user's needs.

Significantly, no guidance is provided on the relative importance of these matters. Hence, it is not clear whether all of the criteria must be (equally) satisfied or whether some can be traded off against others.

In the Commission's view, a key requirement in guiding arbitration is the inclusion of pricing principles into the Part IIIA regime. (The detail of these pricing principles is set out in chapter 12.) To provide this guidance and increase certainty as to likely arbitrated outcomes, these pricing principles should be incorporated in the arbitration criteria.

In addition, a number of other matters likely to improve the arbitration process are discussed below including:

- aligning arbitration with the objectives of Part IIIA;

- the scope of arbitration;
- considerations other than efficiency;
- directions to extend or expand facilities; and
- paying for arbitration.

Aligning arbitration with the objectives of Part IIIA

As outlined in chapter 6, the objective of Part IIIA should be to promote the efficient use of, and investment in, essential infrastructure services.

Indeed, a number of participants called for explicit reference to the proposed objects clause in the arbitration criteria. For example, the Australian Council for Infrastructure Development (AusCID) stressed:

> … as a mechanism to provide clarity in policy intent, an objects clause would be valuable. AusCID believes that even greater utility would be derived if the objects clause were not simply an underlying statement of policy intent to which resort could be had in cases of ambiguity, but also something to which the relevant decision maker, the National Competition Council (“Council”), the designated Minister, or the ACCC in its arbitration role must have regard in applying the criteria. (sub. DR80, p. 6)

The NCC agreed that the objects clause should be taken into account in interpreting and applying the Part IIIA criteria relating to arbitration. It said:

> … that the amendments should require that (at least this part of) the objects clause be taken into account in the interpretation and application of all Part IIIA provisions, including provisions relating to declaration, arbitration, undertakings and effective access regimes. (sub. DR99, p. 9)

The Commission concurs that legislative provision specifying that arbitrations under Part IIIA are to take account of the objects clause would provide guidance to the ACCC in the arbitration process and ensure that the intent of the legislation is well targeted. Accordingly, it has recommended that regard should be had to the objects clause in all Part IIIA determinations (see recommendation 6.2).

Scope of arbitration

Under the current Part IIIA arrangements, where an access dispute is triggered for a declared service and arbitration occurs, the ACCC can consider any matter it determines to be relevant. This can occur even where the parties have resolved most issues and only a few outstanding matters remain.

Re-opening all facets of access negotiations, including those on which the parties have already reached agreement, adds to delay. Indeed, to preserve the incentive for the parties to negotiate in the first instance, it is important that they can do so in the knowledge that agreed matters are unlikely to be re-visited. Moreover, re-opening all matters can place the ACCC in the position of 'micro-managing' commercial arrangements.

It would of course be reasonable for the ACCC to be made fully aware of all agreed matters to ensure that there are no potential breaches of other parts of the TPA. In turn, limiting arbitration to matters in dispute may not be possible where, for example:

- a particular determination would have implications for other matters previously agreed by the parties; and
- the agreed terms and conditions were to be embodied in an application for a *generic* undertaking.

Against this backdrop, the Commission, in the Position Paper, proposed that in arbitrating terms and conditions for declared services, the ACCC should *generally* limit its involvement to matters in dispute between the parties. It further proposed that where matters agreed between the parties were subject to re-assessment by the ACCC, the ACCC should be required to explain its reasons for doing so.

The AGA agreed with the proposal and said:

> Given the objective of an access regime is to promote economic efficiency by replicating efficient market outcomes there is little justification for regulators to intervene in matters not in dispute between parties seeking to negotiate for the provision of access. (sub. DR84, p. 6)

Similarly, the Queensland Treasury (sub. DR105, p. 21) said, '[the] ACCC should not be permitted to reassess matters which have been agreed between parties'.

For its part, the ACCC commented that, in the context of Part XIC arbitrations, while it had generally sought to reduce the number of matters in dispute, it may not always be possible to do so. It said:

> In the experience of the ACCC, the matters in dispute may change over time from the date of notification of the dispute to final determination. Not only will matters in dispute be settled but new issues can be disputed. In these circumstances there would be dangers in limiting the ACCC to only those matters originally in dispute. (sub. DR93, p. 17)

While concurring with the ACCC's assessment that matters in dispute can change over time, the Position Paper proposal did not involve placing agreed matters completely off limits to the ACCC. Rather, the intention was to discourage the unwarranted re-opening of matters that had been previously agreed to by the parties to the dispute. Moreover, the Commission's proposal did not seek to bar the ACCC from arbitrating on any matter; rather, it would simply place an onus on the ACCC to explain its reasons for examining those matters previously agreed between the parties.

The Commission remains of the view that placing such limits on the scope of arbitration would result in a more timely and efficient arbitration process. The related accountability requirement for the ACCC to justify re-opening matters agreed to between the parties is not unreasonable, as it provides an appropriate balance between the provision of flexibility to the ACCC and certainty to the parties in dispute. Such accountability is consistent with the proposed public reporting requirements for the ACCC in respect of accepted undertakings and arbitrated determinations (see chapter 15).

RECOMMENDATION 8.2

The Australian Competition and Consumer Commission, in arbitrating terms and conditions for declared services, should generally limit its involvement to matters in dispute between the parties. Where matters agreed between the parties are subjected to re-assessment, the Commission should be required to explain its reasons for doing so in the post-arbitration report (see recommendation 15.6).

Considerations other than efficiency

Access regimes, in seeking to curb monopoly power attaching to some essential infrastructure facilities, will typically result in lower prices for users of the final services concerned. Hence, the pursuit of efficiency will often result in distributional outcomes, such as the reduction in transfers from consumers to facility owners, likely to be considered by many as beneficial. However, if access regulation is used explicitly to assist particular groups of consumers, efficiency may be compromised without the distributional objectives necessarily being met (see chapter 6).

That said, the Commission recognises that there may be instances where a regulator is required by legislation or a Minister to contravene this principle. Indeed, governments have used particular industry regimes to subsidise certain classes of users, rather than employ alternatives such as budget-funded community service obligations. Such situations might conceivably arise for a declared service under Part IIIA.

Moreover, there may be circumstances where other public interest considerations may be relevant — for example, regional policy might necessitate some departure of terms and conditions from those which would be appropriate based on efficiency considerations alone.

The Commission therefore sees merit in a specific requirement that, in the event that the ACCC introduces considerations other than efficiency into the setting of terms of conditions for declared services under Part IIIA, it be required to make this explicit, and explain its reasons for doing so. As in the case of reassessment of matters not in dispute discussed above, this requirement could be implemented through the proposed public reporting requirements for all Part IIIA determinations (see chapter 15).

RECOMMENDATION 8.3

Where the Australian Competition and Consumer Commission introduces considerations other than efficiency when arbitrating disputes for declared services or assessing proposed undertakings, it should be required to make this explicit and explain its reasons for doing so.

Directions to expand and extend facilities

S. 44V provides for the ACCC to make a determination requiring the provider to extend the facility. However, s.44W stipulates that the ACCC must not make a determination that would require the provider to bear any of the costs of extending the facility or maintaining extensions to the facility.

The NCC said in relation to the Clause 6 principles which parallel s.44V and 44W that:

> In some situations, the needs of an access seeker can only be met by:
>
> - extending the geographical range of a facility; or
> - expanding the capacity of a facility.
>
> These are matters that, in the first instance, should be subject to negotiations between the parties. But clause 6(4)(j) requires that where agreement cannot be reached, the arbitrator must be empowered to require an extension, provided certain conditions are met.
>
> Clause 6(4)(j) elaborates on these conditions, covering:
>
> - technical and economic feasibility, and safety considerations;
> - the owner’s legitimate business interests; and
> - adjustments to access tariffs to reflect the costs and benefits of the extension to the parties.

> The Council considers that geographical extensions should not necessarily be the responsibility of a facility owner. It may be appropriate for a business seeking geographic extensions to undertake the necessary construction work itself and gain access to an existing facility through interconnection. For this to be feasible, an access regime would need to empower the arbitrator to require interconnection, provided the 6(4)(j) conditions are met. This approach was adopted in the National Gas Regime.
>
> While the wording of 6(4)(j) refers only to extensions, a more efficient way to address a capacity issue is sometimes through expansion of capacity. For this reason, it would be appropriate to apply the 6(4)(j) principles to expansions. The National Gas Regime, WA Rail and NT/SA Rail Regimes adopted this framework. (sub. 43, p. 116)

The NCC's discussion is useful as it is possible to draw from it three different forms of extension:

- geographic extension (extending the geographical range of the facility);
- interconnection (the ability of the access seeker, which constructs the extension itself, to connect to an existing facility); and
- capacity expansion (increasing the capacity of the existing facility).

Apart from the NCC, there was very little comment on these matters in the initial submissions.

In the Position Paper, the Commission raised concerns about the power of the ACCC to direct facility owners to extend facilities and argued that directly mandating investment represented an unwarranted intrusion into the commercial dealings of private firms. It concluded that:

- any geographical extensions to a facility should not necessarily be the responsibility of the owner;
- there was merit in empowering the arbitrator to direct the service provider to require interconnection — it proposed that such a provision should be included in Part IIIA; and
- there was no clear case for the ACCC to be able to direct for 'capacity expansion' within the meaning of s.44V and W (the Part IIIA counterparts to Clause 6(4)j).

Participants' responses

The NCC, in seeking to clarify the powers of the ACCC in relation to directing facility expansions and extensions, commented that there was nothing in s.44V to prevent the ACCC from directing an access provider to expand the capacity of a facility. It submitted that the provision gives the ACCC the implicit right to make such a determination. The NCC considered that this would be appropriate on the basis that, if spare and developable capacity were to be treated differently, facility owners would have an incentive to build and design facilities with sub-optimal capacity to circumvent the provision of access. It said:

> There appears to be no policy justification for regulating spare and developable capacity in different ways. If Part IIIA did not apply to developable capacity, infrastructure providers would have strong incentives to design facilities with minimal spare capacity, but maximal opportunities to develop capacity. (sub. DR99, p. 43)

The Queensland Treasury (sub. DR105, p. 21) supported the NCC's view observing that 'the capacity for a regulator to require extensions is critical.'

The ACCC was similarly of the view that section s.44V should enable the regulator to direct an access provider to expand capacity and said:

> If the ACCC does not have the power to require extensions or expansions, a facility owner may have an incentive to maintain inefficient levels of investment. (sub. DR93, p. 18).

In this context, the ACCC cited the example of the Moomba to Adelaide pipeline which is covered under the Gas Code — where it has unequivocal powers to direct a capacity expansion (see box 8.5). Similarly, the South Australian Government (sub. DR121) pointed out that the Gas Code, unlike Part IIIA, makes explicit provision for the regulator to direct capacity expansion.

Box 8.5 Excess demand and capacity expansion on the Moomba to Adelaide pipeline

The Moomba to Adelaide pipeline is fully compressed and demand for the pipeline's services exceeds capacity.

Consequently, the pipeline owner has the potential to make monopoly profits by agreeing to carry gas, outside the queuing policy, where the access seeker is willing to pay prices in excess of the reference tariff established for the pipeline under the provisions of the Gas Code.

The ACCC considered that it would be more efficient to have the existing owner gradually develop a parallel service by looping the existing pipeline, than have a new entrant construct a new facility and duplicate the entire existing pipeline.

Source: (sub. DR93)

The ACCC further noted that where demand for a service exceeded the capacity of the facility, the service provider would have scope to exercise market power. It said that this is a particular concern where:

> … it would, at that time, be inefficient to develop a completely new facility. (sub. DR93, p. 18).

Consequently, it considered that limiting the ability of the regulator to direct a facility owner to expand capacity, ‘has the potential to hand back to facility owners monopoly power in situations where demand approaches or exceeds capacity.’ (sub. DR93, p. 18)

The Commission’s assessment

In assessing the merits of giving the ACCC scope to direct an access provider to extend or expand its facility in the context of a determination under s.44V and s.44W of Part IIIA, the Commission has used the following hierarchy:

- geographic extension;
- interconnection; and
- capacity expansion.

Underlying all of these categories is the s.44W requirement that access seekers should meet the costs of extensions. The Commission presumes that this provision would not generally be interpreted in a manner which could result in a facility owner having to meet the up-front costs of an extension and then recouping the costs through usage charges. Were this to be the case, the facility owner would face the risk of being left to meet the costs of the extension in the event that the access seeker encountered financial difficulties.

In terms of geographic extensions, the Commission considers that the scope for the ACCC to make a determination requiring the extension of facilities (subject to the conditions set out in s.44W) should be retained. It is of the view that, in instances where it is more efficient for the service provider to extend its facility and the access seeker is prepared to pay, the interests of the wider community would be served by such a determination.

Similarly, in regard to interconnection, the Commission considers that the ACCC in a determination should be able to require that a service provider permit interconnection to its facility by an access seeker (at no cost to the facility owner). This should be made explicit in the meaning of extension in s44V.

On the issue of capacity expansion, the status of s.44V is not absolutely clear. The ACCC’s power to direct a facility owner to expand a facility is implicit rather than explicit. As noted, the NCC and the ACCC both saw merit in applying the ‘capacity expansion’ principles in the Western Australian rail access regime and the National Gas Code to determinations made under Part IIIA. For example, the Gas Code makes explicit provision for the arbitrator to require the service provider to expand the capacity of a covered pipeline to meet the requirements of a prospective user.

The rationale for formally extending this provision to Part IIIA to empower the ACCC to require capacity expansions is two-fold:

- some facilities may have been intentionally constructed at a sub-optimal size and/or capacity in order to avoid an access regime; and/or
- demand for the service may have increased, but it still would be uneconomic to build another facility. Hence, without provision for directed expansion, there would be scope for the facility owner to earn monopoly rents (provided that it was permitted to increase prices – see below).

In respect of constructing facilities at sub-optimal size, the Commission considers that, as the Part IIIA declaration and arbitration provisions deal with existing infrastructure, any such 'gaming' on the part of infrastructure owners is more appropriately addressed prior to construction.

In regard to an increase in demand placing pressure on the capacity of existing infrastructure, the issues are even more complex and go to the heart of the nature of the regulation of the facility. A monopoly service provider may well have an incentive to set higher prices for a capacity-constrained facility rather than invest in capacity expansion. This could give rise to monopoly rents — the standard access problem. In this instance, there might be a case for the regulator to mandate capacity expansion.

If, however, the access regime precluded 'congestion pricing' the service provider might respond by expanding the facility, provided that the regime allowed for appropriate pass through of investment costs into prices. In this case, there would be no need for the regulator to direct an expansion of capacity. The Commission notes that Clause 6(4)(j) of the Competition Principles Agreement refers to adjustments of access tariffs to reflect the costs and benefits of 'extensions'.

In other words, the need for provisions covering mandated capacity expansions may depend on the detailed pricing requirements attached to the services in question. Importantly, these questions have never been addressed in a Part IIIA context.

In addition, there are complex issues relating to the treatment of the cost of a capacity expansion. There would be difficulties in having access seekers pay for capacity expansion because, unlike geographical extension, capacity expansion is not necessarily incremental and easily hypothecated to particular users. Capacity expansions can require discrete blocks of investment. As a result, in many circumstances, it may be difficult to attribute the costs to the individual users. The NCC at the public hearing said:

> … it's not quite so easy to determine the cost of expansion and who should pay as it would be for an extension. … Expansion has the ability to benefit a whole range of

> people, not just the person who is part of the arbitration determination at that time … (transcript, p. 502)

In recognition of these difficulties, the Council (sub. DR99) considered that:

> … it would not be appropriate for the restrictions in s.44W that relate to requiring the infrastructure owner to pay for *extensions* to be applied to determinations that relate to *expansions*. The issues surrounding the question of ensuring the infrastructure owner is recompensed for expansions are likely to be more complex that those for *extensions*. These matters are best left to the discretion of the regulator to determine on a case by case basis. (sub. DR99, pp. 43-4)

The NCC has clearly identified the hypothecation problem. For example, even if an infrastructure owner were directed to meet the total costs of a capacity expansion, the difficulties in attributing costs to individual users would remain. This implies a need to consider more vexed issues such as how investment costs can be passed-through to prices, whether all users or only 'late-comers' should pay and the implications for foundation contracts.

These difficulties and complexities may make directed capacity expansions inappropriate in many circumstances. Nonetheless, the Commission recognises that instances could conceivably arise where there would be a case for the relevant regulator to direct a facility owner to expand capacity. In such instances, the Commission considers that providing for such expansions should not leave the service provider at a financial disadvantage. However, while the scope for directed capacity expansion is a feature of some industry-specific regimes, the Commission considers that such a provision is not warranted in Part IIIA given that it is a residual access route.

RECOMMENDATION 8.4

Section 44V of the Trade Practices Act should make explicit that when arbitrating a dispute for a declared service, the Australian Competition and Consumer Commission can require a service provider to permit interconnection to its facility by an access seeker.

Paying for arbitration

S.44ZN permits the ACCC to charge the parties to an arbitration to meet its costs. Furthermore, under s.44Y, the ACCC can terminate an arbitration if it considers that:

- the dispute notification was vexatious;
- the subject matter was trivial, misconceived or lacking in substance; or

- the person notifying the dispute had not engaged in negotiations in good faith.

SACL suggested that if the ACCC terminates an arbitration for any of those reasons it should:

> … charge its costs and apportion all such costs to the party whose dispute notification was vexatious, trivial, misconceived or lacking in substance, or who failed to negotiate in good faith. (sub. DR114, p. 74)

Moreover, SACL considered that there could be occasions where a user of a service would trigger an access dispute to delay the entry of a competitor. Consequently, it suggested that where the ACCC considers that a person who notified a dispute has failed to participate in good faith in the arbitration process, it should be empowered to apply to the Federal Court for a fine to be imposed on the party triggering the dispute or for damages to be awarded to the party harmed by the triggering of the dispute.

The Commission notes that, at present, the ACCC is able to apportion the costs of the arbitration between the parties. While there is currently no *formal* provision for the ACCC to apportion all costs to a party if such a dispute notification was vexatious or trivial, equally it appears that there are no restrictions on the ACCC to apportion costs between the parties as it sees fit.

The more important point is that the arbitration provisions of Part IIIA have not yet been used and there is no evidence that explicit provisions to enable application to the Federal Court for fines and damages are warranted. In the Commission's view, such a provision would entail a further layer of regulation on what is already an overly complex scheme.

8.3 Multilateral access negotiations

Some participants raised concerns about the efficacy of bilateral arbitrations, arguing that it would be more efficient to deal with certain access arrangements on a multilateral basis (see also chapter 5).

In this regard, the ACCC noted that:

> … the negotiate-arbitrate model requires arbitrations to be resolved bilaterally and in private. However, any particular input service is likely to be largely homogeneous and undifferentiated in both cost and quality, so that a similar price should be appropriate for all access seekers except where quantity discounts or other special circumstances exist. Multilateral, public processes would seem likely to provide faster, more effective and more transparent price determinations than the current arrangement. (sub. 25, pp. 75-6).

Similar issues were raised by AAPT Limited which considered, in relation to the telecommunications access regime, that:

> … the inherently private nature of arbitrations reduces the efficiency and effectiveness of the arbitration process generally. Arbitrations are normally conducted on a bilateral basis. This often means that issues of general concern to access seekers (or indeed providers) are considered afresh with every arbitration. This was a particular problem in the various PSTN arbitrations between Telstra and a range of access seekers. There would have been a significantly more efficient and timely arbitral process had the arbitrations been combined and, subject to the parties' consent, made public, at least with respect to issues of principle. The arbitrations would have concluded more quickly and the industry would have gained a useful understanding of the appropriate prices to be used in negotiations for PSTN services. (sub. 42, p. 10)

In contrast, SACL considered that infrastructure owners should not be forced to participate in multilateral arbitrations:

> … property owners should be entitled to have individual access disputes dealt with individually if they so wish, subject to the ACCC's powers to terminate vexatious or trivial arbitrations. It is a fundamental principle, embodied in clause 6 of the Competition Principles Agreement (albeit only in respect of State and Territories specifically) that "access to a service for persons seeking access need not be on exactly the same terms and conditions". (sub. DR114, pp. 71-2)

The NCC, in steering a middle course, considered that the relative efficiency of bilateral and multilateral negotiations depends on the particular characteristics of the services in question. Thus, it noted that, where access involves a small number of parties whose reliance on the process is likely to be infrequent, such as with rail:

> … it is appropriate from an efficiency perspective to rely on broad norms and standards to guide particularised decision-making, rather than seeking to evolve pre-defined rules. (sub. 43, p. 33)

On the other hand, where access involves large numbers of parties and similar issues, such as in the gas and electricity sectors, the NCC submitted that:

> … there are strong arguments for allowing or even mandating the definition of reference terms and conditions for access in the context of (for example) monopoly gas pipelines. (sub. 43, p. 34)

In the Position Paper, the Commission agreed that access via the Part IIIA declaration route is more likely to fall into the NCC's former category. This reflected the fact that those areas where multilateral negotiations are likely to be most advantageous are addressed already by industry regimes.

The Commission went on to comment that, as multilateral access negotiations were unlikely to be particularly relevant for services that might be declared under Part IIIA, its proposal (discussed in chapter 10) to allow undertakings to be lodged before *and after* a service had been declared could be an effective substitute for a multilateral arbitration if the need for such an approach arose.

The ACCC's response to the Position Paper

While the ACCC agreed that it was unlikely that multilateral arbitrations would be used under Part IIIA, it considered that it should have the discretion to operate on a multilateral basis if required. It said:

> … the ACCC considers that allowing the regulator a discretion to conduct multi-lateral arbitrations, after seeking comments from the parties, would be useful. (sub. DR93, p. 17)

Though supporting the Commission's proposal to allow for post-declaration undertakings, the ACCC commented that such voluntary arrangements could not be a substitute for formal multilateral arbitrations. It said:

> While the ACCC supports the proposal to allow undertakings to be lodged after a declaration is made, it does not consider that this proposal is a substitute for multi-lateral arbitrations. While there remains no provision for compulsory undertakings, this proposal relies on the goodwill of the access provider. (sub DR93, p. 17)

Like the ACCC, the Commission remains of the view that the need for multilateral arbitrations is unlikely to arise for those services not already covered by industry-specific regimes. Nonetheless, it may not be sensible to preclude multilateral arbitrations in Part IIIA. In any case, such arbitration would presumably not occur without prior consultation with the parties to enable them to identify any efficiencies from using a multilateral rather than bilateral approach. Were the ACCC to rule against the wishes of parties to the dispute as to whether or not to engage in multilateral arbitrations, it should be required to justify its approach in the post-arbitration report (see chapter 15).

RECOMMENDATION 8.5

The Part IIIA arbitration provisions should be amended to provide the Australian Competition and Consumer Commission with the discretion to conduct multilateral arbitrations following consultation with the parties to the dispute. If the Commission rejects the wishes of the parties as to whether or not to engage in multilateral negotiations, it should explain its reasons for doing so.

9 Certification

Certification is the bridge between Part IIIA and industry-specific regimes. In contrast to the residual role of Part IIIA declarations, industry access regimes are widespread and cover the bulk of Australia’s essential infrastructure services. Where such regimes are certified, exposure of the ‘covered’ essential facilities to a Part IIIA declaration is removed.

Many of the submissions that discussed certification tended to focus on particular features of specific regimes (for example, reference tariffs and regulation of returns). However, for this chapter, the primary emphasis is on the systemic features of certification within a broad Part IIIA setting.

Key issues canvassed in this chapter include:

- the relationship between Part IIIA and Commonwealth, State and Territory industry access regimes;
- the criteria used to judge the effectiveness of access regimes (which are contained in Clause 6 of the Competition Principles Agreement but are drawn on by Part IIIA); and
- the case for allowing for ‘conditional’ certifications.

9.1 Effective regimes

The national access regime includes procedures to ensure that declaration is not extended to areas where effective access arrangements already apply. These procedures aim to avoid regulatory duplication for regimes which meet the Clause 6 criteria for effectiveness.

Assessments of the effectiveness of an access regime can be triggered in the following circumstances:

- *Applications for declaration:* If a (non-certified — see below) access regime is found to cover already the service for which a declaration is sought, the National Competition Council (NCC) must determine whether that regime is effective. If it is deemed to be effective, then declaration is not available.

- *Applications for certification:* Effectiveness can be ‘pre-determined’ for State or Territory access regimes. A jurisdiction can submit its regime to the NCC for testing against the effectiveness criteria. If the Commonwealth Treasurer, after receiving a recommendation from the NCC, certifies the regime as effective, the services in question cannot be declared.

These arrangements act to discourage unwarranted divergences in individual access regimes (see box 9.1).

Box 9.1 **How Part IIIA-Clause 6 operate as a framework for access**

The Clause 6 principles — which are the product of an agreement between the parties to the CPA — are drawn on by Part IIIA and form the basis for determining whether an industry regime is effective. As an effective regime provides a shield against a Part IIIA declaration of the covered services, there are strong incentives for the State and Territories to have their access regimes certified.

This process was illustrated by the Northern Territory Government which, in relation to its access arrangements for its Power and Water Authority (PAWA), outlined the conditioning effect that Part IIIA has on industry regimes:

> The Territory Government chose to apply to the NCC for a recommendation on the effectiveness of its Access Code in order to provide greater certainty for new suppliers and for PAWA. Certification would establish the Access Regime as the sole legal regime for third party access to electricity networks in the Territory. In particular, it would provide immunity against possible recourse to the declaration of the relevant services …
>
> Although declaration would not automatically follow, non-certification would give rise to uncertainty within the Territory’s electricity supply industry in relation to future terms and conditions of access. It is the threat of declaration that creates this uncertainty. (sub. DR111, p. 7)

The Commission supports the continuation of independent reviews of access regimes to determine their effectiveness. It concurs with the view of the Australian Competition and Consumer Commission (ACCC) that:

> Given the potential for conflict of interest between governments in their role as regulator and service provider, the process is necessary to ensure that the objectives of the national access regime are not frustrated. (sub. 25, p. 88)

Given the benefits of certification in reducing unwarranted divergence across access regimes and in minimising the scope for overlaps (see chapters 5 and 6), a key question is whether the certification principles should apply more widely. Currently, the provisions focus only on the access regimes of State or Territory governments — the criteria for judging effectiveness of these regimes are set out in clauses 6(2)-(4) of the CPA (see annex to this chapter).

There are no legislated criteria for assessing the effectiveness of private access regimes. As access regimes need to be legally enforceable (see annex), it is unlikely that most private regimes could be deemed effective. In these instances, to avoid the threat of declaration, private infrastructure owners have the option of submitting an access undertaking

For Commonwealth regimes, the NCC has indicated that should the effectiveness of such regimes emerge as an issue — for example, if a party submitted an application for declaration of a service covered by a Commonwealth regime — it would generally seek to apply the Clause 6 principles. The case for *formally* extending the Clause 6 principles to Commonwealth access regimes is discussed next.

Commonwealth access regimes

The Part XIC telecommunications access regime and the mooted Part XID postal access regime either over-ride Part IIIA or exempt the services concerned from its coverage. In addition, the *Airports Act 1996* fast-tracks declaration of designated airports using weaker criteria than those in Part IIIA.

As these regimes were (or in the case of Post, would be) introduced after the enactment of Part IIIA, the certification of Commonwealth regimes may not have been an issue when the national access regime was introduced. Whether such regimes (and future Commonwealth regimes) should be subject to certification was an issue of some interest to participants.

The NCC considered that it would be desirable for Commonwealth regimes to be subject to review:

> … the community ought to have the opportunity to review these regimes in the light of the principles that the Commonwealth has viewed as required of the access regimes set out by other jurisdictions. … the mere fact of periodic review of these regimes will clarify the scope and possible net benefits of moving to more uniform access arrangements nation-wide. (sub. 43, p. 16)

Some participants pointed to the problems of not providing for the independent review of Commonwealth access regimes. For example, Avis, which conducts operations that are affected by the Airports Act, while supporting a dual approach of an industry-specific regime operating in tandem with Part IIIA, drew attention to some potential anomalies in the airports regime:

> … airport facility users may choose between two mechanisms, namely Part IIIA of the *Trade Practices Act 1974* or s.192 of the *Airports Act 1996*, when seeking to gain access to airport infrastructure. Given that there are different declaration criteria applying under these mechanisms, there has been some confusion and inequities

created amongst access seekers and airport infrastructure providers over their application and consistency. (sub. 40, p. 3)

The anomalies were noted by others involved in aviation, such as the Australia Pacific Airports Corporation (sub. 10). The implication was that, had Commonwealth regimes been subject to certification, such anomalies might have been identified and rectified. As the Network Economics consulting Group (NECG) argued in a more general context:

> Had the Commonwealth been required to submit itself to the scrutiny of the NCC in the introduction of these regimes … it is less likely that they would depart significantly from the principles in Part IIIA. It is even conceivable that they would never have been introduced …
>
> Unless the Commonwealth is able or required to certify its regimes, there is a risk that the growth of disparate industry regimes will continue unabated. This will be detrimental to the industries concerned, and exposes the participants to significantly higher regulatory risks than reasonably necessary. (sub. 39, pp. 12-3).

Position Paper proposals

In the Position Paper, the Commission expressed its view that:

- it would be desirable for all industry-specific access regimes to fall within the effectiveness testing/certification framework;
- while divergence between access regimes to cater to the particular circumstances of different industries is appropriate, the growth of an *independent* group of Commonwealth access regimes should be discouraged; and
- given the broad nature of the Clause 6 principles, the current Commonwealth industry regimes would probably meet the criteria for certification — nevertheless, a requirement to have them tested could help to ensure that the regimes only diverged from Part IIIA where industry-specific circumstances made this necessary.

With these matters in mind, the Commission proposed that the immunity from Part IIIA enjoyed by Commonwealth regimes should be removed so that their effectiveness could be tested in the event that a person sought declaration of a service covered by such a regime. However, it noted that, as access is typically more easily secured under these regimes than under Part IIIA, the prospect of a declaration application (from a user) would be remote. Accordingly, it went on to argue that there was a case for the Commonwealth to be compelled to submit its regimes for certification. While this would be a tougher requirement than that applying to the States and Territories, the Commission contended that it would be reasonable for the Commonwealth to adopt a leadership role on this matter.

Participants' responses to the Position Paper

The responses to the Position Paper were mixed in respect of both of the requirements proposed for the Commonwealth — specifically, that:

- Commonwealth regimes not be exempt from Part IIIA; and
- it be compulsory for the Commonwealth to seek certification of its regimes.

The Chamber of Mines and Energy of Western Australian supported the general extension of certification to Commonwealth regimes (sub. DR66). More definitively, EnergyAustralia endorsed the proposal for the Commonwealth to be *required* to submit its regimes for certification to ensure 'that industry specific regimes are not used as a cover for more heavy-handed regulation' (sub. DR106, pp. 3-4).

The NECG also 'welcomed the Commission's proposal for certification of Commonwealth access regimes', but considered that:

> … even if the recommendation to require certification of Commonwealth regimes is accepted, this may be insufficient to constrain the growth of Commonwealth access arrangements that are inconsistent with the provisions of Part IIIA. We note that the only sanction associated with a failure to achieve certification is the possibility that the services in question can still be declared under Part IIIA. This is an effective deterrent for governments planning to implement regimes that are more light-handed than Part IIIA. However, it is plainly ineffectual as a means of limiting the scope for governments intent on implementing much more heavy-handed regimes … (sub. DR76, p. 19)

Thus, the NECG proposed that measures should be introduced to limit the extent to which *any* government could introduce access regimes that were more onerous than Part IIIA. It suggested two possible mechanisms:

- a show cause provision, whereby governments would be required to provide reasons why an access regime diverged from Part IIIA and when convergence with Part IIIA would be achieved; and
- a provision that allowed access providers to lodge Part IIIA undertakings to protect themselves from Commonwealth, State and Territory regimes.

Adopting a different approach, the NCC supported the Position Paper proposal in principle, but seemed unconvinced about the prospects for removing the immunity from Part IIIA in Commonwealth regimes. On that basis, it favoured an approach with a *lower* degree of compulsion:

> … as the Commonwealth has the power to exempt the services subject to these regimes from Part IIIA, certification is not necessary to protect the services from declaration. Therefore it might be more appropriate to require the Commonwealth to submit their

> regimes to the Council for an assessment of their effectiveness against the clause 6 principles (without that assessment having any formal or legislative requirements). The Council could then publish its assessment. (sub. DR99, p. 47)

The Western Australian Government supported the removal of immunity from Part IIIA for Commonwealth regimes, but did not support a requirement that the Commonwealth be compelled to submit its regimes for certification. It considered that the Commonwealth should, like the States and Territories, have the option of having its regimes certified. It said:

> … the Commonwealth may wish to reconsider its approach in generally precluding by legislation the possibility for declaration under Part IIIA where an industry-specific regime is enacted. Leaving the possibility open would allow users to test an industry-specific regime's effectiveness. (sub. DR69, p. 6).

In part, the Western Australian Government's position appeared to be a manifestation of its views on the appropriate hierarchy of access regimes which, it contended, is such that:

> … the certified industry-specific regimes sit at the top… The basis for our saying that is clause 6(2), which says that [Part IIIA] is not intended to replace the State or Territory regimes. Also, because of the way that the regime is currently designed, whereby certification rules out other paths to access, we see that as fairly … strong evidence of the primacy of industry-specific regimes, whether they be Commonwealth or State regimes, and the need to rule out other paths to access where they have … been legislated by parliaments. (transcript, p. 459)

The Queensland Treasury (sub. DR105) expressed a similar view on the access hierarchy.

The Commission's assessment

Three core issues relating to the relationship between the national access regime and the 'satellite' Commonwealth regimes emerge from submissions. These are:

- an asymmetry in that only the States and Territories have their regimes exposed to a declaration discipline, whereas the Commonwealth can establish access regimes with general immunity from Part IIIA;
- concerns that Commonwealth regimes are more onerous to access providers than Part IIIA; and
- the potential for overlap and/or inconsistencies between the national framework and Commonwealth regimes (for example, Part IIIA and the Airports Act).

Asymmetric treatment

The asymmetric treatment of the access regimes of the Commonwealth and those of the States and Territories would be addressed if Commonwealth regimes did not have *automatic* immunity from Part IIIA. Removal of immunity would, in theory, enable access seekers (or service providers) to submit a declaration application — in turn, creating the impetus for the Commonwealth to have its regimes certified.

However, in practice, the Commission has little doubt that both of the current Commonwealth regimes — covering telecommunications and core leased airports — would meet the certification criteria. Moreover, in the event that the Commonwealth removed the immunity for these regimes, but did not submit them for certification, it is highly unlikely that an access seeker would opt to pursue a declaration claim. While there may be some possibility that a service provider might somehow contrive to seek relief under Part IIIA through self-declaration, in either case, the NCC would probably find the regimes to be effective.

Significantly, both Commonwealth access regimes are also subject to independent public inquiries (see PC 2001a,c). These inquiries are the most effective means to address questions about inconsistencies, overlap and regulatory over-reach within these regimes.

Overall, the Commission sees some value in addressing the asymmetry problem. That is, Commonwealth regimes should be exposed to the threat of declaration to provide parallel treatment with the States and Territories. However, it no longer sees a case for certification to be a mandatory requirement — this would introduce a new asymmetry in treatment.

Commonwealth regimes too onerous

It is apparent that the Clause 6-Part IIIA framework is only able to put a brake on the scope for jurisdictions to introduce relatively ‘light-handed’ regimes. It does not currently provide any checks against a jurisdiction introducing ‘heavy handed’ regimes — nor would it in the future, unless the Commission’s recommended pricing principles were incorporated into the certification criteria (see below).

Nonetheless, the Commission does not endorse the NECG proposals to place ‘show cause’ requirements on all jurisdictions to explain why they have departed from Part IIIA or when convergence with the national regime is expected. It is questionable as to what such a show cause requirement would mean. For example, it is not apparent in what way an ‘onerous’ regime could be said to have departed from Part IIIA, when Part IIIA itself does not limit the extent of regulation attached to an access regime. In this regard, several participants expressed the view that the Gas Code and the National Electricity Code are extremely intrusive and extensive regimes — yet both have the Part IIIA imprimatur. Similarly, for certified State and Territory regimes, a timeline for convergence with Part IIIA would have no meaning — if it has been certified, then it has already converged.

Likewise, the Commission does not see merit in the proposal to undermine Commonwealth, State and Territory access regimes that have been found to be effective, by providing escape routes through Part IIIA undertakings (see chapter 10). If a decision has been made to cover certain activities under an industry regime, then to provide a means for activities to escape that coverage would not be sensible.

Regulatory overlap

Participants expressed concerns about overlap and/or inconsistencies between the national and Commonwealth access regimes. For example, an access seeker that wished to provide a similar service at, say, Melbourne and Sydney airports would be subject to different access arrangements — the Airports Act or Part IIIA in the former instance, and Part IIIA in the latter. The Commission agrees with those participants who contended that such regulatory overlap can foster uncertainty. Exposing Commonwealth regimes to declaration (by removing their immunity) could, in principle, allow the NCC to identify such overlaps (ex post) in the assessment process. Of course, this may not be particularly helpful in addressing problems of inconsistency given that declaration would be unlikely and the regimes are already in place.

However, looking forward — beyond changes emerging from the Commission's inquiries into the telecommunications and airports arrangements — there is a case for any new Commonwealth regimes to be reviewed by the NCC *prior* to enactment. Such a review process, by allowing for the identification of potential problems, would provide the opportunity to rectify these problems before the regime commenced.

RECOMMENDATION 9.1

To discourage unwarranted divergence from the national access framework:

- ***Immunity from Part IIIA afforded to Commonwealth access regimes should be removed and such immunity should not be conferred on new Commonwealth regimes;***
- ***Clause 6 of the Competition Principles Agreement should make provision for the Commonwealth Government to seek certification of its access regimes; and***

- ***prior to enactment, any new Commonwealth access regimes should be submitted to the National Competition Council for comment on their consistency with Part IIIA.***

9.2 Criteria for certification

The status of the Clause 6 principles, which set the broad parameters for effective State and Territory regimes, is formally outlined in s 44DA (in Part IIIA) which reflects amendments made in 1998. It states that the Clause 6 principles have the status of guidelines rather than binding rules. It further specifies that 'an effective access regime may contain additional matters that are not inconsistent with Competition Principles Agreement principles'.

At an operational level, the NCC submitted that:

> While each of the clause 6 principles needs to be reflected in an effective access regime, the Council has avoided a narrow interpretation of the principles. (sub. 43, p. 97)

In a similar vein, the New South Wales Government considered that it was important that the arrangements provide for flexibility:

> The existing system of State/Territory industry specific access regimes provides regulatory flexibility. The system allows for regimes to be tailored to local conditions, whilst simultaneously operating in an overarching national framework, thereby enhancing efficiency and achieving better outcomes. NSW would be concerned with any changes that would diminish this flexibility. (sub. 44, p. 6)

Nevertheless, at the framework level, there are differences between some of the Clause 6 principles and their counterpart criteria in Part IIIA. For example:

- Part IIIA provides a looser declaration criterion (the promotion of competition in another market) than the coverage concept in Clause 6 (access being necessary in order to permit effective competition in a downstream or upstream market) — a point that the Commission has sought to rectify through its recommended amendment to the declaration criteria in chapter 7;
- Clause 6 contains some pricing principles — for example, that the terms and conditions of access to a service need not be exactly the same for all access seekers — that do not have equivalents in Part IIIA;
- Part IIIA includes guidance on when a facility should be considered nationally significant whereas the Clause 6 principles do not;
- Clause 6 includes provisions that determinations should provide guidance on appropriate accounting arrangements, whereas Part IIIA does not; and

- unlike the implicitly broad 'public interest' criterion in the Part IIIA declaration provisions, Clause 6 provides only that dispute resolution take account of 'the benefit to the public from having competitive markets'.

The South Australian Government, which noted some of these differences, considered that 'the inconsistencies between the two provisions should be removed' (sub. 36, p. 10).

The Position Paper proposals

In the Position Paper, the Commission concluded that the flexibility entailed in the NCC's approach and validated by the 1998 amendments was desirable. Given the differences in the particular circumstances of infrastructure industries across Australia, it considered that it would not be sensible to be overly prescriptive. The Commission further noted that:

- flexibility should reflect the need to cater to different circumstances, not simply to accommodate differences between Clause 6 and the Part IIIA criteria;
- the differences may, in part, reflect the fact that Clause 6 predates the national access regime, raising questions about whether there is a case for having (possibly amended) certification principles embodied within Part IIIA; and
- the arrangements are the outcome of a cooperative approach between the Commonwealth and State and Territory governments which could be undermined if the principles were incorporated into Part IIIA.

On balance, the Commission considered that there could well be tangible, rather than just cosmetic, benefits from having the certification criteria embodied within the framework document for the national access regime. It felt that the inclusion of the criteria for all access routes within the one document would increase the standing of Part IIIA as an access framework and foster greater congruence in outcomes under the various access routes. On that basis, it proposed, as part of its tier 2 package of reforms, that the principles used to assess the effectiveness of access regimes should be included in Part IIIA.

Participants' comments and the Commission's assessment

A number of participants supported the notion of Part IIIA being the dominant access framework to drive desired changes to 'subordinate' regimes. For example, the Australian Pipeline Industry Association (APIA, sub. DR70, p. 15), one of the stronger advocates for housing the certification principles within Part IIIA, said that 'it is imperative that a clear path exists to amend all existing regimes in accordance with the revised Part IIIA principles'. To meet these objectives, APIA considered that the Commission's Position Paper proposal should be elevated to 'tier 1 status'.

Others who endorsed the notion of Part IIIA as the lead framework to promote convergence across access regimes — and who also supported the proposal in the Position Paper — were the Australian Petroleum Production and Exploration Association (sub. DR65), the Energy Users Association of Australia (EUAA, sub. DR94), and EnergyAustralia (sub. DR106).

However, there were also significant concerns that such a shift in emphasis would devalue Clause 6 and threaten the cooperative approach between all Australian governments that led to the development of the national access framework. For example, the Western Australian Government stated that:

> Clause 6 is the basis upon which jurisdictions agreed they would enact access regimes for essential facilities. … there are good reasons for affording Clause 6 appropriate status and keeping its content outside of any jurisdiction's legislation. (sub. DR69, p. 2)

It contended that the Position Paper proposal was only one way to promote desirable convergence and that the objective could also be achieved through modifications to Clause 6. Expressing a similar view, the Queensland Treasury (sub. DR105, p. 22) submitted that 'these [certification] principles are set by CoAG and should remain in Clause 6 of the CPA'.

The concern that the current cooperative process could be undermined by inclusion of the certification principles within the Part IIIA legislation was also raised by the NCC:

> … the certification principles are *already* included in Part IIIA by virtue of ss.44M(4) and 44N(2). … The current arrangement is akin to Part IIIA calling up the clause 6 principles as an attached code set by a CoAG intergovernmental agreement (the CPA). As such, the certification principles can only be amended with CoAG approval. … the underpinning co-operative nature of this framework has engendered confidence among States and Territories in the certification process and has contributed to its considerable use (nine regimes covering gas, rail and port services have been certified as effective, with additional activity currently underway in electricity, gas and rail).
>
> If the principles were to be written directly into Part IIIA, the Commonwealth would acquire exclusive control over them and could amend the principles unilaterally. As identified by the Position Paper, this could undermine the co-operative approach taken by governments in developing and implementing Part IIIA. (sub. DR99, p. 48)

The Commission acknowledges that there is more than one way to reduce unwarranted divergence in access regimes. Moreover, it accepts that the general direction of the Position Paper, in having Part IIIA drive reform of the industry access regimes through renewed certifications, underplayed the importance of the cooperative underpinning of Clause 6 to the access ‘compact’ between all Australian governments (see chapter 5).

The Commission therefore considers that efforts to reduce unwarranted divergence across industry regimes would be best achieved through a cooperative approach between the Commonwealth and State and Territory Governments involving modifications to Clause 6, rather than unilateral changes to the certification principles and their incorporation into Commonwealth legislation. In this regard, it notes that the Western Australian Government submitted that it:

> … would remain open to considering and negotiating any changes that the Productivity Commission recommends to Clause 6 as the cornerstone of the national access regime. (sub. DR69, p. 3)

FINDING 9.1

Principles for assessing the effectiveness of industry access regimes should continue to be located within the Competition Principles Agreement.

9.3 Modifications to the Clause 6 principles

Given the 1998 amendments which specify that the Clause 6 principles have only the status of guidelines, it is possible that the current differences between Clause 6 and Part IIIA could continue to be accommodated. However, for the reasons outlined below — including the benefits of preserving the status of Clause 6 as a relevant document in helping to determine the national access framework — some modifications to the principles would be desirable.

On that basis, this section discusses core matters which the Commission considers should be included in the certification criteria. The aim is to streamline, rather than overhaul, the current principles, some of which appear to have been overtaken by regulatory developments in certified regimes.

Objects clause

Specification of objectives is not currently a requirement for certification. For the reasons outlined in chapter 6, it is important that the enabling legislation for all access regimes incorporate a statement of objectives. Ideally, an objects clause should specify that the objective of the access regime is to promote the efficient use of, and investment in, the essential infrastructure facilities concerned.

Certification is analogous to a ‘seal of approval’, but it is at the detailed operational level that agencies such as the Independent Pricing and Regulatory Tribunal of New

South Wales and the Office of the Regulator-General, Victoria are required to regulate infrastructure providers. It is important that those regulators (and the judiciary) are guided by frameworks which specify clearly the overarching objective of regulation in the various infrastructure sectors.

Coverage

The Commission is of the view that declaration under Part IIIA generally should be confined to natural monopolies (chapter 6). However, as noted in chapter 7, declaration criterion (b) — the monopoly test — might potentially allow some essential services that derive their monopoly power from sources other than a natural monopoly technology (for example, network externalities) to be declared.

Not having been required to examine industry-specific regimes in detail, the Commission has not formally assessed the extent to which those regimes address sources of substantial and durable market power arising independently of natural monopoly. It is clear, however, that the Commonwealth telecommunications regime caters to the ‘local loop’ where market power derives from network effects and high sunk costs despite the existence of more than one provider (see chapter 6). Notably, the current criteria in the CPA also potentially allow for the coverage of access regimes to extend beyond natural monopolies. The Commission considers that such a provision is appropriate.

Negotiation and arbitration framework

As currently framed, to be certified as effective, an access regime should encourage an access seeker and provider to settle on terms and conditions of access through commercial negotiation. Where agreement cannot be reached, Clause 6(4)(b) provides that ‘Governments should establish a right for persons to negotiate access to a service provided by means of a facility’. Clause 6(4)(g) provides that ‘Where the owner and a person seeking access cannot agree on terms and conditions for access to the service, they should be required to appoint and fund an independent body to resolve the dispute, if they have not already done so’. Those clauses are based on the traditional negotiate-arbitrate model.

However, it appears that some effective regimes conform, at best, loosely with these principles. For example, some incorporate price controls with limited scope for negotiation and involve a regulator rather than an arbitrator. The Clause 6 principles make no mention of a regulator. As the NCC noted:

> Some access regimes … empower a regulator to determine terms and conditions of access. Where this is the case, the application of clause 6(4)(i) is effectively transferred – at least in part – from the arbitrator to the regulator. In these circumstances, it is

> important that the clause 6(4)(i) [the arbitration] principles are also used to guide regulatory decisions. (sub. 43, p. 115)

In particular, arbitration will often need to be conducted by a regulator, rather than an arbitrator, because the former has a range of enforceable instruments at its disposal (for example, setting reference tariffs). Indeed, this requirement underpins a number of certified regimes. As the NCC indicated:

> Arbitration … has the advantage over more regulated approaches in that it is less intrusive upon property rights and less likely to deter new investment. But it may not always be the most effective way of establishing broad parameters of an access regime … In addition … arbitration is a costly process …
>
> … the most practical way to address regulatory issues is to equip an independent regulator with the necessary discretion and enforcement powers. This has been the approach adopted in most access regimes certified to date. In some cases, jurisdictions have conferred regulatory responsibilities across a number of industries on a generic economic regulator. (sub. 43, p. 105)

The ACCC raised similar issues in the context of the arrangements for gas and electricity:

> The current access regime goes some way to accommodating alternatives to the negotiate-arbitrate model. Both the gas and electricity access arrangements include CPI-X price caps, with starting point prices and the X values on the basis of efficient costs. In both cases the arrangements have been introduced using Part IIIA, using effective regimes in the case of gas, and the access code and undertakings provisions in the case of electricity. (sub. 25, pp. 80-1)

In many respects, whether the terms and conditions of access are conditioned, or determined by, arbitration or more direct regulation should not be of particular consequence for certification. This suggests that the case for mandating *any* particular variant of negotiation as a requirement for certification is not compelling.

However, regardless of the permutation of the negotiation-arbitration-determination model adopted, it is clear that a *regulator* must ultimately have recourse to a price determination mechanism. Without this, there would be no compulsion on a service provider to negotiate seriously and the entire process could be unguided.

Criteria for establishing terms and conditions — pricing guidelines

While regulators/arbitrators should have the scope to determine the terms and conditions where negotiation is unsuccessful or inappropriate, there was considerable disquiet among participants about the sort of price regulation that currently applies under industry access regimes (see chapter 12).

In keeping with its general approach to Part IIIA, the Commission considers that there is a need for pricing principles within an access regime's architecture to underscore all determinations made under that regime. Indeed, pricing guidelines are an important vehicle for giving effect to the objectives of access regulation. The pricing principles developed in chapter 12 are equally relevant to industry-specific regimes. They may, however, require further elaboration to meet the specific requirements of a particular regime.

More specifically, Clause 6 contains one pricing principle which may be at odds with the principles set out in chapter 12. Under Clause 6(4)(i)(ii), the NCC is required to consider 'the costs to the owner of providing access, including any costs of extending the facility but not costs arising from increased competition in upstream or downstream markets'. Couched in this way, there is a danger that it could endorse or promote pricing rules which went beyond removing genuine monopoly rent/excess profits. The Commission considers that its proposed pricing principles are a better way of setting out the relationship between removing monopoly rent and preserving incentives for efficient investment.

Enforcement provisions and appeal rights

Apart from independence and transparency, other important operational aspects of access regimes include the ability to enforce provisions and the scope for appeals.

Enforcement provisions are necessary for an access regime to have any practical impact. These provisions can include enforcement through a regulator, penalties, injunctions to stop legislative breaches and possibly criminal sanctions. Thus, a provision of the nature outlined in Clause 6(4)(c) should be retained. Access regimes also should provide for merit review.

Interstate issues

The relevance of interstate issues for certification arises in respect of clause 6(2) and clause 6(4)(p). The former provides that:

> The regime to be established by Commonwealth legislation is not intended to cover a service provided by means of a facility where the State or Territory Party in whose jurisdiction the facility is situated has in place an access regime which covers the facility and conforms to the principles set out in this clause unless:
>
> (a) the Council determines that the regime is ineffective having regard to the influence of the facility beyond the jurisdictional boundary of the State or Territory; or
>
> (b) substantial difficulties arise from the facility being situated in more than one jurisdiction.

Clause 6(4)(p) specifies that:

> Where more than one State or Territory access regime applies to a service, those regimes should be consistent and, by means of vested jurisdiction or other co-operative legislative scheme, provide for a single process for persons to seek access to the service, a single body to resolve disputes about any aspect of access and a single forum for enforcement of access arrangements.

The NCC indicated that clause 6(4)(p) is also relevant where more than one State access regime applies to a service located within a particular jurisdiction — hence, the Northern Territory and South Australia passed identical legislation to establish the regime for the Tarcoola-Darwin rail link. These criteria reflect a desire to promote consistency where national markets arise.

However, while a degree of consistency has been achieved in sectors such as gas and electricity, in others this has proved far from easy. For example, the ACCC (sub. 25, p. 89) stated that rail was typified by a range of State regimes with different operating systems and conditions of access so that operators seeking to provide services on interstate track have to negotiate with multiple access providers. The Law Council of Australia similarly considered that:

> … the numerous State regimes in national industries such as rail is potentially a far greater problem than the numerous industry-specific regimes. (sub. 37, p. 23)

The Australian Rail Track Corporation (ARTC) was also critical in contending that:

> Clause 6 of the CPA, and possibly parts of Part IIIA, do not provide a clear mechanism by which consistency of access to the national network, where different parts are owned and/or operated by different parties, and are subject to different regimes, can be achieved. As such, access to the interstate network on a consistent basis under a single framework, without a truly national approach to control of the network, will be difficult to achieve in the short term. (sub. 28, p. 17)

However, these problems notwithstanding, the ACCC considered that Clause 6(4)(p) has been instrumental in ensuring greater consistency in rail than might otherwise have been the case. It stated that:

> … the continued operation of clause 6(4)(p) … is necessary to ensuring national consistency of state based access regimes and to promoting the development of interstate markets. [It] supports rigorous application of the clause where proposed effective regimes cover inter-state services. (sub. 25, p. 90)

At a different level, the Western Australian Government had particular concerns that Clause 6(2) effectively provides the NCC with a veto power whenever interstate issues arise (see box 9.2). It submitted that certification of the Western Australian rail regime had been refused on the basis of the NCC's interpretation of Clause 6(2). It proposed that:

- interstate 'difficulties' should only preclude certification when a regime is inconsistent with an existing inter-jurisdictional regime in a manner which causes difficulties for service providers and access seekers; and
- interim certifications should be permitted if it is considered that a regime may be incompatible with a future inter-jurisdictional regime.

Box 9.2 **Rail — the views of the Western Australian Government**

The Western Australian Government noted that when a field of operations is within a State boundary, regulatory regimes can be enacted to meet a range of objectives. However, it noted that:

> Clause 6(2) does not make sufficiently clear what 'difficulties' need to be identified before a state regime is refused certification as an effective regime. The vagueness of the clause gives rise to a risk that it can be used as a veto over certification of an otherwise effective intrastate regime, wherever there is any interstate effect.
>
> Had it been the intention, the CPA could have precluded certification of state regimes applying to facilities with both interstate and intrastate impacts. However, governments did not agree to preclude certification in these circumstances, and in the absence of such a clause, principles of state sovereignty over intrastate matters should be respected. Clause 6(2) is intended to promote consistency in access regimes with an interstate aspect, as opposed to the more exacting task of achieving uniformity. While uniformity is desirable in many sectors, it will generally be achieved by agreement between governments rather than imposition by Commonwealth regulators. (sub. 38, p. 19)

The Commission considers that the underlying objectives of clauses 6(2) and 6(4)(p) are appropriate. Moreover, while there have been problems with certification where interstate issues have arisen, it is not apparent how these clauses could readily be re-configured to achieve better outcomes. Part of the problem appears to lie in the implementation of the principles. The main concerns have centred on regulatory interpretation of the criteria — for example, the meaning of 'substantial difficulties' in Clause 6(2). In this regard, the Commission agrees with the views of some participants that the impending resolution of some interstate issues should not be an impediment to certification. This is addressed in section 9.4 which considers the case for interim and conditional certifications.

Greater consistency in the criteria for establishing terms and conditions of access for regimes covering similar infrastructure services would help to achieve more uniform outcomes. (As noted in appendix B, the basis of the terms and conditions of access under various rail access regimes differs.) Greater consistency of requirements would facilitate the 'meshing' of regimes with interstate dimensions.

Another means of reducing divergence between access regimes for the same infrastructure class may lie in discussion between State regulators — for example, through the Utility Regulators Forum. This Forum, which includes the ACCC, the NCC, State-based general economic regulators and State-based industry specific regulators, was established to promote the exchange of information between regulators and, where appropriate, consistent regulatory approaches. The NCC (sub. 43) considered that further development of joint decision-making arrangements (such as the Energy Committee of the ACCC) could provide another means to engender greater national consistency.

Other matters

Reviews of arrangements: As a matter of good regulatory practice, access regimes should provide for revocation and review requirements for all determinations (see chapter 15). Some participants also expressed concerns about the limited capacity for certifications to be 'rolled over' expeditiously on expiration where there have been no material changes to the regime or in market circumstances. For example, the New South Wales Government noted that its rail access regime was two and a half years in the making but effectively lasted only thirteen months. The Commission is proposing that a formal fast-tracking process be implemented for second round certifications (see recommendation 15.7).

Facility extensions and expansions: The Commission's views on facility expansions and extensions (in respect of the Part IIIA arbitration criteria) were set out in chapter 8. Broadly, the Commission considers that empowering a regulator to require a facility owner to extend its facility geographically or to permit interconnection by access seekers can be appropriate.

New investment: The certified regime covering the prospective Tarcoola-Darwin railway was developed to reduce regulatory risk associated with the threat of declaration under Part IIIA. The certification route was adopted because, in that instance, governments were seeking to provide regulatory certainty before the service provider had been identified. More generally, the Commission considers that there is a strong case for specific measures within access regimes to provide greater certainty for new investments in essential infrastructure facilities and to address the problem of unwarranted regulatory truncation of returns (see chapter 11). Hence, the certification requirements should make provision for such mechanisms in appropriate circumstances.

The Position Paper proposals

In the Position Paper, the Commission proposed, as part of its tier 2 set of proposals, that the certification provisions in Part IIIA should specify that an effective access regime should include:

- an objects clause;
- coverage arrangements that focus mainly on services for which the entry to the market of a second provider is unlikely to be economically feasible;
- dispute resolution arrangements and provisions to establish the terms and conditions of access;
- criteria and pricing principles applying to regulated terms and conditions;
- cost-effective appeal and enforcement provisions;
- revocation and review requirements for all determinations under a regime; and
- where appropriate, provisions to facilitate consistency across multiple State and Territory access regimes applying to a particular service.

In addition, the Commission argued that the degree of reliance on negotiation relative to arbitration and regulation to set terms and conditions of access should not be a part of the effectiveness test.

(In the Position Paper, the Commission did not formally propose that the certification principles should refer to measures to facilitate efficient new investment. Rather, it sought more general comments from participants on how best to proceed in this area.)

Participants’ comments on the Position Paper

Most participants commented on the Position Paper proposal in the broad, rather than on its constituent elements.

The APIA supported the proposal on the grounds that it was important that the certification criteria match Part IIIA:

> … the objects clause for certification of an access regime should be consistent with the objects clause in Part IIIA. Similarly, the coverage criteria for an access regime should be consistent with the declaration criteria. The same approach to consistency should be applied to each of the other criteria proposed. (sub. DR70, p. 15)

The NECG also endorsed the view that core matters should be included in the certification criteria. Moreover, it contended that, particularly in view of any changes recommended for the Part IIIA architecture, the Commission should ‘attempt to reconcile more closely any differences in the certification and declaration criteria’. It highlighted that:

> … the greater economic significance of certified access regimes compared with declared services means that it is far more important to get the certification criteria right … (sub. DR76, pp. 22-3)

The EUAA (sub. DR94) similarly supported the proposed principles, but stressed its desire for ensuring that appeal and enforcement mechanisms are effective, rather than simply ‘cost effective’.

The NCC contended that all of the matters identified in the Commission’s proposal, with the exception of the revamped coverage arrangements (focussing on services for which the entry to the market of a second provider is unlikely to be economically feasible) should be reflected in an effective access regime. It further noted that:

> More or less explicitly, the proposed list reflects the current clause 6 principles and have already been incorporated in all certified State and Territory access regimes. Nonetheless, the clause 6 principles are at times vague and imprecise (for example, in regard to pricing principles) and the Council would welcome a more explicit approach in some areas. (sub. DR99, pp. 48-9)

The NCC also considered that any changes to the criteria would need the approval of CoAG.

The Queensland Treasury (sub. DR105) did not support the reframed principles, arguing that the existing principles, with the inclusion of the Commission’s proposed objects clause, are sufficient. In this regard, it raised particular concerns about the extent to which the certification criteria should dictate the detailed operation of industry regimes. It appeared to be of the view that the Commission had sought to extend the reach of the Clause 6 principles in a way that would condition detailed regulatory practices and arbitral outcomes (see box 9.3).

The Western Australian Government did not respond directly to the Position Paper proposal other than generally indicating that it:

> … would see any ‘framework’ changes that affect industry-specific regimes (as opposed to the administrative processes pertaining to the Part IIIA backup for access) to be matters for further negotiation between jurisdictions under a revised [CPA]. (sub. DR69, p. 3)

Finally, in discussing the effectiveness criteria, some participants referred to the apparent convergence of the undertaking and certification routes. For example, the certified regime covering the Tarcoola-Darwin railway has many attributes of an undertaking. Similarly, the undertaking which forms the basis for the national electricity code resembles a certified regime.

Box 9.3 **Concerns about Clause 6 'over-reach'**

The Queensland Treasury expressed concern that the Commission's proposed principles for assessing the 'effectiveness' of industry regimes might intrude into an assessment of the terms and conditions of access determined by a relevant regulator:

> There is a question … as to whether effectiveness should be conditional upon the terms and conditions of access determined by a regulator, or the regulatory practice adopted by a regulator, in order to satisfy the clause 6 principles. How much of the detail of access terms and regulatory practice should be left to the relevant regulator? … The effectiveness of a regime lies in the way it addresses the first order broad principles set out in clause 6 …
>
> The objective of certification should be to ascertain whether the regime establishes an appropriate broad framework, within which a regulator operates, which places constraints upon the regulator as set out in the principles of clause 6 … Effectiveness should not require an assessment of the terms of access set by the relevant regulator.
>
> … a provision should be included in Part IIIA which specifies the effectiveness of an access regime is not dependent upon the terms and conditions of access established in undertakings and arrangements where this role has been given to a regulator/arbitrator constrained by the principles and factors in clause 6 of the CPA and administrative appeal is available as prescribed in clause 6 (4)(h). (sub. DR105, pp. 8-10)

The ARTC, mindful of the similarities between these two routes of access and responding to the Commission's tier 2 proposal in the Position Paper for a single regulator for all aspects of Part IIIA, proposed that:

> … the certification path to access be made redundant on the basis that the ACCC become the sole adjudicator of access. Effectively, the current process of seeking certification of an access regime via the NCC would be replaced by submitting an undertaking to the ACCC. This would result in greater consistency between regimes across like industry sectors. (sub. DR64, p.11)

(It should be noted that the Commission has opted not to pursue the single regulator proposal — see chapter 14.)

Taking a contrary position, the NCC (sub. DR99) was strongly of the view that certifications and undertakings are quite distinct processes. For example, it noted that whereas a State or Territory has control over the content of a certified regime (subject to Clause 6), it cannot legislate to determine the content of an undertaking. Reflecting on these differences, the NCC went on to address the argument for dispensing with certification:

> … providing for the regulator to accept undertakings in the form of overarching access regimes (rather than focusing on terms and conditions) would raise wider concerns. In particular, it may not be appropriate for the Part IIIA regulator to also have the role of

> assessing whether it or other (usually State or Territory) regulatory bodies are independent, adequately resourced and otherwise able to perform regulatory functions within an appropriate framework of rules.
>
> In addition, as an undertaking is a voluntary process, as distinct from government policy and legislation, it contains no provision for a coverage test. (sub. DR99, p. 46)

The Commission's assessment

It is apparent from the responses to the Position Paper that there was broad support for the proposed certification principles, with only some relatively minor reservations. These were:

- cost-effective appeal processes should not be at the expense of effective appeal processes (EUAA);
- coverage arrangements should not be couched in terms of services for which the entry to the market of a second provider is unlikely to be economically feasible (NCC); and
- assessing the effectiveness of an access regime should not go beyond 'first order' matters for establishing an access regime (Queensland Treasury).

The Commission is in agreement with all of these views. As noted in chapter 14, it considers that expedition of access processes should not be pursued where this might unreasonably limit appeal rights. In addition, it took the view in chapter 7 that the Part IIIA 'monopoly test' declaration criterion should be retained in its current form rather than refer to a 'second facility' as canvassed in the Position Paper. It also agrees (as noted in chapter 6) that, beyond the high level framework matters established under Clause 6, the detailed workings of industry regimes are matters for the relevant jurisdiction. The Commission further concurs with the NCC that the certification and undertaking routes are different and should be retained.

More broadly, the reaction from participants indicates that the nature of the certification principles proposed by the Commission in the Position Paper was generally uncontentious. As the NCC noted, most of the proposals are already embodied in Clause 6.

However, since the release of the Position Paper, a major development of relevance to the proposed certification principles has been further elaboration of proposals relating to new investment measures. As outlined in chapter 11, the Commission considers that Part IIIA should make provision for specific measures to encourage efficient investment in essential infrastructure. It further considers that there is a strong case for amending Clause 6 to allow for parallel provisions to be a feature of industry regimes, where relevant.

With these considerations in mind, the Commission has amended the tier 2 proposal to the following finding, supported by a recommendation on implementation (below).

FINDING 9.2

Ideally, an 'effective' access regime should include the following:

- *an objects clause (specifying that the objective of the regime is to promote the efficient use of, and investment in, the essential infrastructure facilities concerned);*
- *coverage arrangements that focus mainly on services for which it would be uneconomic to develop another facility to provide the service;*
- *clearly specified dispute resolution arrangements and provisions to establish the terms and conditions of access;*
- *clearly specified criteria and pricing principles applying to regulated terms and conditions;*
- *effective appeal and enforcement provisions;*
- *revocation and review requirements for all determinations;*
- *where relevant, provisions to facilitate consistency across multiple State and Territory access regimes applying to a particular service; and*
- *where relevant, provision for measures to facilitate efficient new investment.*

The degree of reliance on negotiation, relative to arbitration and regulation, to set terms and conditions of access should be a matter for individual regimes and not be a part of the effectiveness test.

Some implications

Although most of these matters are already reflected in the Clause 6 principles, the Commission has identified some implementation issues relating to:

- current deficiencies in Clause 6;
- the need for some new provisions; and
- better alignment between Clause 6 and Part IIIA — in particular, some of the Commission's recommendations to change the Part IIIA architecture could exacerbate the current differences with Clause 6.

In terms of current deficiencies, participants identified that the Clause 6 principles make no mention of a regulator. This could be addressed by making it explicit in Clause 6 that the dispute resolution body could be either an independent arbitrator or a regulator — this would have potential implications for Clauses 6(4)(g)-(j), (l) and (o).

Requirements for effective regimes to include an objects clause and to be consistent with the Commission's recommended pricing principles would seem to require new provisions within Clause 6. In particular, inclusion of the Commission's proposed pricing principles into Clause 6 would have ramifications for Clause 6(4)(i)(ii). Indeed, for the reasons set out above, the Commission considers that this Clause should be removed. Also, providing for the sorts of new investment measures described in chapter 11 could have interactions with, and implications for, pricing rules. These may need to be accommodated within any revised Clause 6 principles.

More generally, the Commission agrees with those participants who saw value in aligning the Clause 6 principles more closely with Part IIIA. This would have particular implications for:

- Clause 6(3) — the coverage criteria — which ideally should be aligned with the Part IIIA declaration criteria; and
- Clause 6(4)(j) dealing with facility extensions — the Commission has made recommendations on the similar Part IIIA criteria in chapter 8.

In conclusion, the Commission acknowledges that, left unaddressed, it is possible that Clause 6, in conjunction with Part IIIA, might continue to be workable. As guidelines only, the arrangements provide the NCC with a degree of discretion in its assessments of the effectiveness of industry regimes. However, failure to amend Clause 6 could increasingly see a modified Part IIIA impinging more strongly in shaping the national access framework. For example, modifications to Part IIIA clearly have the potential to change the incentives for States and Territories to have their regimes certified. Thus, alignment of the requirements of Part IIIA and Clause 6 is necessary to ensure that Clause 6 retains its current role in the national access framework — an outcome supported by some State governments.

RECOMMENDATION 9.2

The parties to the Competition Principles Agreement should negotiate changes to Clause 6 with a view to aligning it, as far as practicable, with the modified Part IIIA. In doing so, the parties should have regard to the effectiveness criteria spelt out in finding 9.2.

9.4 Interim and conditional certifications

In the Position Paper, the Commission agreed with participants that the impending resolution of interstate issues should not be an impediment to certification. It saw merit in the Western Australian Government's proposal for interim certifications to be provided in such instances. The Commission went on to note, however, that the capacity for interim certifications appears to exist already — perhaps not in name, but certainly in practice, as shown by the certification of the New South Wales rail regime for 13 months (pending prospective interstate developments).

In its response to the Position Paper, the West Australian Government commented on the Commission's in principle endorsement of interim certifications. It said:

> … though the Productivity Commission appeared to agree … with Western Australia's suggestion that interim certifications be permitted, this does not appear to have been translated into a proposal for reform. (sub. DR69, pp. 7-8)

The Commission sought further clarification on this matter at the public hearings. The Western Australian Government did not elaborate in detail other than to contend that:

> … in essence it boils down to perhaps not basing certification on the concept of time necessarily but on a series of conditions, and so perhaps a better word for that would be conditional certification, so that you can then move towards an interstate model … (transcript, p. 478)

In effect, the Western Australian Government appeared to be arguing for a form of 'conditional' certification pending certain interstate conditions being resolved or incorporated later. This seems to be a different situation than that leading to the 'interim' certification of the New South Wales rail access regime. In that particular instance, the Commission understands that there were no outstanding matters at the time, but rather that there was a prospect of a significant development in the near future.

The Commission is not aware of the detailed reasoning as to why the NCC chose not to recommend an interim/conditional certification for the Western Australian rail access regime. Hence, it is unable to determine whether the outstanding matters revolved around existing or pending interstate issues or more substantive matters. For example, the Western Australian Government hinted at conflicts surrounding the interpretation of the Clause 6 principles — in particular, how the NCC's interpretation impinged on State sovereignty (see box 9.2).

That said, the Commission endorses the principle of providing for interim and conditional certifications where separation of intra- and interstate matters is feasible. Specifically, it considers that, where all the requirements for an intra-state access regime have been met and where this component of an access regime could operate in a self-contained manner, there would merit in granting a conditional certification if the only outstanding matters related to interstate issues. Similarly, it also supports the provision of interim certifications where prospective issues impinging on a regime are expected to loom at some time in the near future.

As noted, there appears to be scope for interim certifications under the current arrangements. However, it is unclear whether provision for conditional certifications would require changes to the Clause 6 principles, as distinct from being a matter on which the NCC could exercise the appropriate discretion.

RECOMMENDATION 9.3

The parties to the Competition Principles Agreement and the National Competition Council should investigate how best to provide for 'interim' and 'conditional' certifications, including whether such provisions would need to be reflected formally in Clause 6 of the Agreement.

Annex Clauses 6(2)-6(4) of the Competition Principles Agreement

6(2)	The regime to be established by Commonwealth legislation is not intended to cover a service provided by means of a facility where the State or Territory Party in whose jurisdiction the facility is situated has in place an access regime which covers the facility and conforms to the principles set out in this clause unless: (a) the Council determines that the regime is ineffective having regard to the influence of the facility beyond the jurisdictional boundary of the State or Territory; or (b) substantial difficulties arise from the facility being situated in more than one jurisdiction.
6(3)	For a State or Territory access regime to conform to the principles set out in this clause, it should: (a) apply to services provided by means of significant infrastructure facilities where: (i) it would not be economically feasible to duplicate the facility; (ii) access to the service is necessary in order to permit effective competition in a downstream or upstream market; and (iii) the safe use of the facility by the person seeking access can be ensured at an economically feasible cost and, if there is a safety requirement, appropriate regulatory arrangements exist. (b) incorporate the principles referred to in sub clause (4).
6(4) (a)-(c)	A State or Territory access regime should incorporate the following principles: (a) Wherever possible third party access to a service provided by means of a facility should be on the basis of terms and conditions agreed between the owner of the facility and the person seeking access. (b) Where such agreement cannot be reached, Governments should establish a right for persons to negotiate access to a service provided by means of a facility. (c) Any right to negotiate access should provide for an enforcement process.
6(4)(d)	Any right to negotiate access should include a date after which the right would lapse unless reviewed and subsequently extended; however, existing contractual rights and obligations should not be automatically revoked.
6(4)(e)	The owner of a facility that is used to provide a service should use all reasonable endeavours to accommodate the requirements of persons seeking access.
6(4)(f)	Access to a service for persons seeking access need not be on exactly the same terms and conditions.
6(4)(g)	Where the owner and a person seeking access cannot agree on terms and conditions for access to the service, they should be required to appoint and fund an independent body to resolve the dispute, if they have not already done so.
6(4)(h)	The decisions of the dispute resolution body should bind the parties; however, rights of appeal under existing legislative provisions should be preserved.
6(4)(i)	In deciding on the terms and conditions for access, the dispute resolution body should take into account: (i) the owner's legitimate business interests and investment in the facility; (ii) the costs to the owner of providing access, including any costs of extending the facility but not costs associated with losses arising from increased competition in upstream or downstream markets; (iii) the economic value to the owner of any additional investment that the person seeking access or the owner has agreed to undertake; (iv) the interests of all persons holding contracts for use of the facility; (v) firm and binding contractual obligations of the owner or other persons (or both) already using the facility; (vi) the operational and technical requirements necessary for the safe and reliable operation of the facility; (continued next page)

	Annex **continued**
	(vii) the economically efficient operation of the facility; and (viii) the benefit to the public from having competitive markets.
6(4)(j)	The owner may be required to extend, or to permit extension of, the facility that is used to provide a service if necessary but this would be subject to: (i) such extension being technically and economically feasible and consistent with the safe and reliable operation of the facility; (ii) the owner's legitimate business interests in the facility being protected; and (iii) the terms of access for the third party taking into account the costs borne by the parties for the extension and the economic benefits to the parties resulting from the extension.
6(4)(k)	If there has been a material change in circumstances, the parties should be able to apply for a revocation or modification of the access arrangement that was made at the conclusion of the dispute resolution process.
6(4)(l)	The dispute resolution body should only impede the existing right of a person to use a facility where the dispute resolution body has considered whether there is a case for compensation of that person and, if appropriate, determined such compensation.
6(4)(m)	The owner or user of a service shall not engage in conduct for the purpose of hindering access to that service by another person.
6(4)(n)	Separate accounting arrangements should be required for the elements of a business which are covered by the access regime.
6(4)(o)	The dispute resolution body, or relevant authority where provided for under specific legislation, should have access to financial statements and other accounting information pertaining to a service.
6(4)(p)	Where more than one State or Territory access regime applies to a service, those regimes should be consistent and, by means of vested jurisdiction or other co-operative legislative scheme, provide for a single process for persons to seek access to the service, a single body to resolve disputes about any aspect of access and a single forum for enforcement of access arrangements.

Source: NCC 2000b.

10 Undertakings

Under Part IIIA, a facility owner can lodge a written undertaking to the Australian Competition and Consumer Commission (ACCC) setting out the terms and conditions on which access to services will be provided (box 10.1). Alternatively, an industry body can submit an access code in the form of an undertaking.

The ACCC is required to conduct public consultations before deciding whether to accept an undertaking. If an undertaking is accepted, the services to which it applies cannot be declared. However, an undertaking cannot be submitted after a service has been declared. (In essence, undertakings are the private sector equivalent of certification.)

In assessing the efficacy of the undertaking arrangements, a number of issues arise. These include:

- whether there should be provision for undertakings to be lodged after an infrastructure service has been declared;
- the criteria for assessing undertakings; and
- problems encountered by those service providers who do not own the relevant facility, in submitting undertakings.

In addition, there is also the issue of whether there should be scope for service providers to lodge Part IIIA undertakings for services potentially subject to certified regimes (see section 10.4).

10.1 Post-declaration undertakings

In contrast to the telecommunications access regime, if a service is declared under Part IIIA, there is no capacity for the facility owner to submit an undertaking as an alternative to arbitration. Yet, for service providers, the incentive to submit an undertaking is likely to be strongest once the threat of declaration has been realised.

The current situation, which does little to promote the use of undertakings, was considered by some participants to be a design flaw in Part IIIA. For example, AAPT Limited, an access seeker/service user (sub. 42, p. 3), considered that 'Part

IIIA should be amended to permit access providers to provide undertakings even when the service is already declared’.

Box 10.1 Part IIIA undertakings

Section 44ZZA of the Trade Practices Act (TPA) provides for a person who is, or expects to be, the provider of a service to give a written undertaking to the ACCC dealing with the provisions of access to the service. The legislation does not outline what should be in an undertaking, apart from a list of examples of matters which might be dealt with — for example, the terms and conditions of access, procedures for determining these conditions and an obligation on the provider not to hinder access and also to provide information to the ACCC or to ‘another person’.

The ACCC (1999) has stated that it must be satisfied, among other matters, that an undertaking is enforceable in the courts. It considers that undertakings should:

- specify the services which are subject to the undertaking;
- specify which terms and conditions are open to negotiation;
- provide a framework for negotiations;
- provide relevant information necessary for meaningful negotiations; and
- include provisions for dispute resolution.

The ACCC also notes that:

> … access pricing arrangements are generally necessary in specifying the terms and conditions. Prices can take the form of specific prices or a range of prices which can be negotiated. They can also be specified as actual prices or as a price formula (p. 28).

Allowing for post-declaration undertakings could provide access seekers with more extensive and timely information than might occur through a protracted negotiate-arbitrate approach. It would also reduce uncertainty for facility owners about the threat of arbitration. In this regard, the Australia Pacific Airports Corporation (sub. 10, p. 4) submitted that it had ‘hoped that access undertakings for airport services would put them beyond the scope of the arbitration provisions of Part IIIA’.

Significantly, provision for post-declaration undertakings was supported by both Part IIIA regulators. The National Competition Council (NCC) stated that:

> Amending Part IIIA to allow for a voluntary undertaking to be accepted for a declared service could improve certainty for both service providers and access seekers, by avoiding the need to determine terms and conditions through arbitration. Further, reducing the reliance on arbitration might increase the efficiency of the regime, particularly if there are likely to be multiple access seekers. (sub. 43, p. 44)

And, in a more general endorsement, the ACCC said:

> There seems to be little reason for the provision of undertakings to be limited as it currently is in Part IIIA. The [ACCC] would support amendments to allow undertakings to be given before or after declaration. (sub. 25, p. 85)

In fact, the ACCC considered that it should be able to *compel* an access provider to submit a post-declaration undertaking, and further that:

> In the event that the access provider failed to comply with a direction to submit such an undertaking, or if the [ACCC] rejected the undertaking submitted, the [ACCC] should have the power, after conducting a public consultation process, to impose an access undertaking on the access provider. …
>
> Such an amendment would not extend the scope for regulation. It would only operate where a service had been declared. In these circumstances the [ACCC] can determine terms and conditions of access through the arbitration of an access dispute. For the [ACCC] to have the power to compel the provision of an access undertaking would merely facilitate the efficient and transparent consideration of issues of general concern to industry. The [ACCC] considers such an approach preferable to conducting a series of bilateral arbitrations. (sub. 25, p. 87)

Presumably this reflects a desire by the ACCC to achieve some economies in arbitration. As noted in chapter 8, undertakings are suited to multilateral access applications whereas negotiation-arbitration is largely a bilateral process.

The Sydney Airports Corporation Limited (SACL, sub. DR114) also considered that service providers should be able to lodge undertakings at any time. However, it opposed any scope for the ACCC to impose undertakings. It contended that 'the intrusion on private property rights that such a regime would entail is simply too great'. Further, in an airport specific context, SACL urged the Commission to:

> … recommend amendments to Part IIIA to oblige the ACCC to accept any undertaking that proposes otherwise reasonable terms and conditions, notwithstanding that it may not apply to all declared services under section 192, and to preclude the ACCC from insisting that services that are not declared be included within an access undertaking as a condition of its approval. (sub. DR114, pp. 72-3)

(On this issue, the Commission's recommendations relating to limitations on the extension of arbitrations to matters not in dispute (recommendation 8.2) and for greater alignment between the criteria for arbitration, undertakings and certification (below) would go a considerable way to meeting SACL's concerns.)

The Position Paper proposal

On the basis of the evidence, the Commission could find no compelling reason for not allowing undertakings to be submitted after a service has been declared. It therefore proposed in the Position Paper, that Part IIIA should be modified to allow an access provider to lodge an undertaking after a service has been declared.

However, it did not support the suggestion that the ACCC be able to compel an access provider to submit an undertaking or to impose an undertaking, arguing that such a change would alter the voluntary nature of undertakings — an imposed undertaking would, in effect, be a determination. The Commission further noted that where an access provider wanted only to operate in a bilateral context, an enforced undertaking would require it to reveal more information to cater to a broader range of circumstances. This could change the dynamics of bargaining, by increasing the incentive for facility owners to negotiate agreements to avoid being compelled to provide information-intensive undertakings. In turn, this could tend to reinforce the use of a bilateral approach.

The Commission acknowledged that allowing (voluntary) post-declaration undertakings might encourage service providers to lodge and then withdraw such undertakings to delay resolution of an access dispute. However, it suggested that, in such circumstances, a post-declaration undertaking could be treated by the regulator as the starting point for arbitration. As the NCC had indicated:

> The general arbitration provisions would remain for declared services not covered by an undertaking. This would ensure that an infrastructure owner develops an undertaking in a timely manner, and does not use the undertaking process to delay arbitration. (sub. 43, pp. 43-4)

Participants' responses and the Commission's assessment

Consistent with the views expressed prior to the Position Paper, there was general endorsement of the Commission's proposal.

From an infrastructure owners perspective, the Australian Rail Track Corporation (ARTC) said that it:

> … agrees that allowing post-declaration undertakings, as an alternative to arbitration would result in economies in regulation and would provide more extensive and timely information for access seekers. (sub. DR64, p. 11)

Similarly, the Australian Gas Association said that:

> … enabling infrastructure service providers with declared assets to lodge access undertakings would represent a positive development in access regulation. Access undertakings under Part IIIA are a far more flexible instrument than once and for all arbitrations made on an ad hoc basis. (sub. DR84, p. 7)

The Queensland Treasury contended that:

> The prohibition on undertakings in relation to declared services has effectively ruled out an important mechanism for creating greater certainty and guidance as to the terms and conditions of access. (sub. DR 105, p. 10)

The Western Australian Government (sub. DR69. p. 8) similarly supported the Commission's proposal. However, consistent with its views about the hierarchy of access regimes, it added that 'undertakings should not be able to be accepted where an industry-specific regime exists and has been certified, or is otherwise found to be effective'. (This issue is discussed in detail in section 10.4.)

The ACCC made additional suggestions on how the process might work, in part to address concerns about the possibility for strategic lodgement and withdrawal of undertakings noted by the Commission in the Position Paper. It submitted that an option would be to allow an undertaking to be lodged and considered at the same time an access dispute was under consideration. While priority would be given to an undertaking, the ACCC could move to impose a determination where the undertaking was rejected (sub. DR93, pp. 19-20).

Given the arguments in favour of post-declaration undertakings, and the widespread support for their introduction, the Commission considers that Part IIIA should be amended accordingly. It also reiterates its view, expressed in the Position Paper, that it would not be appropriate to empower the ACCC to either compel a service provider to submit an undertaking or to impose such an undertaking. Such a provision would mean that the undertaking route would no longer be a voluntary alternative to the negotiate-arbitrate process.

The ACCC's main reason for seeking such powers was its belief that conducting multilateral, rather than bilateral, arbitrations would be more efficient in certain instances. While the Commission does not consider this to be a sufficient justification to change the voluntary nature of undertakings, it is relevant to note that it has recommended that Part IIIA should make provision for multilateral arbitrations for declared services (recommendation 8.5). In addition, although it could be argued that the undertaking route is more transparent than arbitrations — as the ACCC must publish proposed undertakings and invite public submissions on them — the Commission's recommendation that the ACCC provide post-arbitration reports (recommendation 15.6) also would promote transparency.

RECOMMENDATION 10.1

There should be provision in Part IIIA for an access provider to lodge an undertaking after a service has been declared.

10.2 The assessment criteria for undertakings

Many participants saw a need to provide greater guidance on the criteria for assessing undertakings. For example, the NCC observed:

> … s 44ZZA provides only the broadest of guidance to the ACCC, infrastructure owners and access seekers on the things that an access undertaking should contain. The specification of considerations that are less general in nature would improve certainty in undertaking processes and in this component of Part IIIA.
>
> This guidance could draw upon the clause 6 principles, in a general sense, as well as the guidelines developed by the ACCC. The guidance would assist operators in developing acceptable undertakings and assist other interested parties in commenting on proposed undertakings. There would be a greater understanding of appropriate outcomes. (sub 43. pp. 42-3)

AAPT Limited went further in proposing that the ACCC should be required to publicise its assessments of undertakings to guide future use of the provisions:

> The ACCC should, as the designated body that receives undertakings, be required to publish its findings and reasoning. This would provide a useful guide to access seekers on the appropriate price and non-price terms and conditions that they should receive, either during negotiation or during an arbitration, should an access dispute be notified under Part IIIA. (sub. 42, p. 3)

SACL (sub. DR114) similarly argued that Part IIIA should require that the ACCC give reasons for any decision to reject a provision of an access undertaking. (The publication of findings and reasoning relating to access issues is discussed in chapter 15.)

In the Position Paper, the Commission said that there was a compelling case for aligning the criteria for assessing undertakings (s. 44ZZA and s. 44 ZZAA) more closely with those for arbitrations for declared services (s. 44X) and the tests for the effectiveness of terms and conditions provided for in certified regimes (Clause 6). It proposed accordingly.

Participants' responses and the Commission's assessment

There was only limited comment from participants relating to this proposal.

One participant, the Queensland Treasury, did not support alignment of the criteria for undertakings with the certification principles. It considered that 'factors relevant to establishing an access regime (certification) are different to the second tier factors that a regulator must have regard to in determining an undertaking' (sub. DR105, p. 22). In part, its views reflect concerns that aligning the criteria would give the different access routes equal status in the access hierarchy. (As noted above, the Queensland Treasury saw Clause 6 as being at the top of this hierarchy.)

Other participants, however, expressed support for the proposal. The ARTC endorsed the need to provide greater guidance on the criteria for assessing undertakings, adding that 'the incorporation of objectives and pricing principles in Part IIIA will assist in this regard'(sub. DR64, pp. 11-2).

The NCC said that greater alignment of criteria across the various access routes 'would provide greater certainty to service providers on what undertakings might be acceptable'. In addition, it proposed that the criteria could outline that an undertaking should include:

- provisions that accommodate the reasonable needs of access seekers by facilitating access through timely and clear processes;
- provisions to ensure appropriate information disclosure, particularly if the undertaking adopts a negotiate/arbitrate model;
- an appropriate dispute resolution process; and
- an approach to pricing that reflects the efficient use of, and investment in, the infrastructure.

> Including criteria of this nature, coupled with the inclusion of a binding objects clause and pricing principles in Part IIIA, would provide greater certainty to service providers and direction to the regulator in the development and approval of access undertakings. (sub. DR99, p. 50)

And, as noted in chapter 6, the Northern Territory Government pointed to differences between the Part IIIA declaration criteria (access would promote competition) and the undertaking and certification criteria (access necessary to permit effective competition). Referring to the certification of the Tarcoola-Darwin rail access regime, it noted that:

> For a marginal project such as the AustralAsia Railway, the Governments were faced with the anomaly that a third party seeking declaration would face a lower competition test than the Governments or the facility owner would need to demonstrate in order to have the State/Territory access regime or undertaking accepted. This could have led to an unfortunate situation where a service could be declared but could not be subject to an effective State or Territory access regime or an undertaking. Therefore, the Territory welcomes the Commission's proposal to align more closely the criteria applying across the different access routes. (sub. DR111, p. 3)

The Australian Council for infrastructure Development (AusCID) responded to the Position Paper with a range of concerns about the operation of the undertaking process — being especially critical of 'the breadth of discretion which is conferred on the ACCC in its consideration of undertakings'(sub. DR80, p. 22). It argued that:

> … the ACCC, in interpreting the requirements of an undertaking and, in particular, the requirement that an undertaking be *'enforceable'*, has imposed a very high level of prescription on the provider of an undertaking in virtually every aspect of its business. (sub. DR80, p. 20)

It concluded that the 'philosophy which is applied by the ACCC in considering undertakings is one which provides a positive disincentive to their use'.

In line with the direction of the proposal in the Position paper, AusCID sought more explicit criteria for undertakings linked better to the rest of Part IIIA. In particular, it nominated alignment with the proposed Part IIIA objects clause and the pricing principles. Beyond that, AusCID argued that undertakings should establish the framework for negotiation, rather than the detail of an enforceable contract. One of its main concerns was to ensure that undertakings would be appropriately specified to provide a means to facilitate efficient investment (see chapter 11).

Apart from reference in the objects clause and the incorporation of the proposed pricing principles, the Commission does not intend to specify in detail how the criteria for undertakings should be aligned with those for other routes for access. In part, this will depend on proposed negotiations between the Commonwealth, State and Territory Governments on changes to Clause 6 (see recommendation 9.2) — like certification, undertakings can effectively establish the framework for an 'industry access regime'.

That said, the undertaking criteria should be aligned as closely as practicable with the (revised) arbitration criteria, recognising that there will be a need for some systemic differences — for example, the undertaking criteria will need to make reference to whether a service is subject to an existing access regime. The Commission's proposals relating to the arbitration criteria (see chapter 8) for declared services are equally germane for undertakings. The criteria proposed by the NCC, along with the undertaking criteria published by the ACCC (see box 10.1), also contain useful elements.

RECOMMENDATION 10.2

Criteria for assessing proposed undertakings under Part IIIA should be aligned, as closely as practicable, with those applying to arbitrations for declared services and the Clause 6 principles for certification. Specifically, the criteria should incorporate the recommended pricing principles.

(As noted, in chapter 6, the Commission has recommended that the regulator also should have regard to the objects clause for all Part IIIA determinations.)

Another feature of the undertaking route which sets it apart from the other avenues for access is that there is no provision for merit review of an ACCC decision on a proposed undertaking. The Commission sees no case for this lack of appeal rights and is accordingly recommending the introduction of merit review of decisions on undertaking applications (see recommendation 15.1).

10.3 Non-owner undertakings

At a detailed level, the ARTC (sub. 28, p. 11) raised concerns about s. 44ZZA which specifies that an undertaking may be lodged by 'a person who is, or expects to be, the provider of a service'. A provider is defined as 'the entity that is the owner or operator of the facility that is used (or is to be used) to provide the service'.

This has given rise to problems for access to interstate rail track networks. As noted in appendix B, all transport Ministers (except from the Northern Territory) agreed to develop a mechanism for rail operators to gain access to the entire interstate network through the ARTC. An undertaking setting terms and conditions is to be lodged with the ACCC. However, it is not yet possible for the ARTC to submit an undertaking that would cover the entire interstate network, because it is not the service provider in New South Wales, Queensland or parts of Western Australia.

The ARTC explained that:

> … the difficulty arises in that the provider is defined as the owner or operator of the facility that is used to provide the service. In some cases, the party that provides the service (has an agreement for access with the user and is obliged to provide and manage access to the facility for payment) may not be the owner or operator of the facility. (sub. DR64, p. 12)

This issue can also arise for prospective infrastructure projects where the owner and/or operator may not be known — such as occurred with the Tarcoola-Darwin rail line. As the South Australian Government noted:

> A State access regime had to be developed for the planned Tarcoola to Darwin railway because only an infrastructure owner can provide an access undertaking. It would be desirable to have the option of an access undertaking, binding on a future owner, in circumstances where a facility is not yet in place. (sub. 36, p. 9)

In its first round submission, the ARTC similarly requested that the arrangements be modified to allow for non-owner undertakings. In the Position Paper, the Commission requested further information on the merits of such a change. Both the ACCC and the NCC responded with relevant background on the cause of the problem confronting the ARTC (see box 10.2). They then proposed solutions to the

ARTC's concerns which would not involve modifications to the current restrictions on who can lodge an undertaking.

Box 10.2 **Owners and providers**

Section 44ZZA states that: a person who is, or expects to be, *the provider* of a service may give a written undertaking to the Commission in connection with the provision of access to the service. A 'provider' is defined in section 44B to mean ('unless the contrary intention appears'): the entity that is the *owner* or *operator* of the facility that is used (or is to be used) to provide the service (emphasis added).

On this basis, the ACCC considered that:

> 'Owner' refers to the entity in whom the title to, or ownership of, a facility is vested. The term 'operator' is not defined in the Act. It is not a legal concept. The precise scope of this concept is difficult to ascertain with certainty. Nevertheless, the notion of control over the working/functioning of the facility seems to be at the heart of the concept.
>
> This interpretation seems to be consistent with the legislative intention and approach taken to the access issues identified by the Hilmer Committee. An entity that provides services by means of the facility, but does not have control over the asset, does not have the capacity to either obstruct the use of the facility or extract monopoly rents from the exploitation of the facility. Because it is the facility (not the service) that is the natural monopoly, such an entity should not be regulated. To extend the notion of 'provider' beyond those with close control over the underlying facility would radically extend the operation of Part IIIA …
>
> … to be a 'provider' under Part IIIA an entity must be able to (or 'have the legal power or right to') provide the service to which access is sought … (sub. DR93, pp. 19-20).

The NCC expressed a similar view in noting that:

> In terms of the current definition in Part IIIA, the ARTC would not be a service 'provider' for those parts of the interstate network that it does not own or operate (but merely acts as a reseller of access). Consequently, the ARTC cannot submit an undertaking to the ACCC on these resale arrangements. The efficacy of any such undertaking may be in question, since the ARTC can only offer to sell access at prices reflecting the wholesale agreement arrangements plus a margin to cover its own costs. If the wholesale agreements do not accord with good regulatory principles, the agreements may have to be renegotiated for any undertaking to be accepted. (sub. DR99, pp. 50-2)

The ACCC suggested that:

> The simplest method of achieving [a satisfactory] outcome would appear to be to allow a firm that was not 'the provider' of a service to offer an undertaking if it had the consent of the owner of the facility. It would be incumbent on access seekers to satisfy themselves that the level of control exercised by the entity providing the undertaking was sufficient for the purposes of granting access to the facility. (sub. DR93, p. 20)

Taking a slightly different stance, the NCC proposed that:

> An alternative to amending Part IIIA (to allow the ARTC to lodge an undertaking in relation to the resale of track access) is for the relevant track operators to provide an

> undertaking on how access would be provided to the ARTC, or otherwise on how the seamless provision of access to interstate train operators might be achieved. (sub. DR99, p. 52)

Similarly, AusCID, which also opposed changes to allow for non-owners to lodge undertakings, suggested that:

> Specific issues such as those raised by ARTC and the South Australian Government … should not override the more general purpose of undertakings. Those specific issues may well be able to be dealt with through alternate mechanisms if the issue is of significance in a particular situation. For example, in a competitive bid scenario, the bid conditions could provide for the successful bidder to acquire a particular special purpose company which was then to become the service provider. (sub. DR80, p. 20)

Finally, the Department of Transport and Regional Services (sub. 52) referred to the Commonwealth's response to three recent inquiries into the rail sector. In that response, the Government noted that it:

> … is committed to establishing an effective national track access regime and has sought to do so through an IGA [intergovernmental agreement] which established the ARTC. If track access arrangements, as pursued through the ARTC, are not working effectively by mid-2001, the review of the ARTC under the IGA will need to develop a new institutional framework. This may involve a network manager based on Commonwealth legislation, if necessary and practicable.

The Government further commented that:

> … some States have sought to establish wholesale access agreements through which the ARTC acts as the single access provider for interstate operations. The Commonwealth is not convinced that this arrangement will deliver seamless interstate access. (sub. 52, attachment, p. 25)

The Commission accepts that there would be in principle concerns and legal problems in allowing non-owners to lodge undertakings. It may be that the sorts of solutions noted above could address the specific problem faced by the ARTC. Indeed, as suggested by the NCC, the issue might be resolved under the current legislative provisions through cooperative arrangements between the owners of rail infrastructure and the ARTC. However, if this is not possible, the foreshadowed review of the intergovernmental agreement planned for 2002 (see ACCC, sub. 25, p. 52) may need to develop a new institutional framework.

Apart from any rail-specific arrangements relating to the ARTC, the provision for binding rulings could provide another means to address this problem. A binding ruling prior to investment that the declaration criteria are not met (see recommendation 11.2) would almost certainly have addressed the Tarcoola-Darwin railway issue raised by the South Australian Government — it is highly unlikely that the rail line would have met the declaration criteria (given that, due to strong competition from road freight services, it is unlikely to have significant market power). In addition, under the Commission proposals, government-sponsored projects awarded by competitive tender would also be exempt from Part IIIA, thereby obviating any need for an access undertaking (see recommendation 11.2).

However, this leaves a residual sub-set of future government-sponsored projects where there might be a reasonable probability that (ex post) the facility would be declared. Given that the binding ruling avenue would be closed, any attempts by a government to set out, ex ante, the regulatory environment for such a prospective project would need to use the certification avenue (as was the case with the Tarcoola-Darwin railway). However, the Commission would not envisage that many such cases would arise. It therefore, does not consider that there is a sufficient problem to justify changing sections 44ZZA and 44B of the TPA.

FINDING 10.1

The inability of those who do not own infrastructure facilities to submit undertakings is not a sufficiently general problem to warrant changing the current provisions in Part IIIA. The difficulties encountered in relation to the development of an undertaking to cover the entire interstate network should be resolved, preferably through cooperative means, at the State and Territory government level. If this is not possible, the Commonwealth Government should pursue the foreshadowed alternative institutional arrangements for rail.

10.4 Dual coverage and ‘forum shopping’

Under the current arrangements, there is scope for an access provider to submit a Part IIIA undertaking when coverage under an industry-specific regime has not been determined for the infrastructure service concerned, but a regime covering that class of infrastructure service exists. This is particularly germane given the recent application by Duke Energy International to submit a Part IIIA undertaking for its Eastern Gas Pipeline (to the ACCC) which was assessed simultaneously with an application for coverage under the Gas Code (by the NCC).

The ability of an access provider to attain coverage under different instruments raises a number of issues. These include:

- different criteria being used to establish conditions in certified regimes and undertakings, potentially leading to some inconsistency in outcomes;
- the possibility for ‘double regulation’ where an access provider is subject to an undertaking and an industry-specific regime;
- the incentive created for ‘forum shopping’; and

- the scope for duality of access routes to lead to fragmentation of coverage, and potentially frustrate a unified and consistent approach to infrastructure development in a particular sector.

In the first round submissions, these matters were of particular interest to State governments, specifically in relation to the regulation of access to gas pipelines (see box 10.3).

Box 10.3 **Concerns about dual access requirements**

A number of State governments commented on the scope for gas pipeline owners to submit Part IIIA undertakings and therefore potentially operate outside the Gas Code.

The New South Wales Government stated that:

> The existence of dual access routes, particularly those applying to natural gas pipelines, creates market uncertainty and provides opportunity for parties to choose the regulatory regime in which they operate under. From a public policy viewpoint, it is inappropriate to have different regulatory routes to achieve similar goals …
>
> … unless there is a clear public benefit in retaining the dual access routes, consideration should be given to amending Part IIIA so that access is either provided through a certified regime or an undertaking. … NSW has a preference for access to be provided via a certified industry specific regime. (sub. 44, p. 6)

The South Australian Government submitted that:

> The option of the Service provider to file an Access Undertaking under Part IIIA … is most likely to be exercised in the case of new (greenfield) pipelines … There is also, after an Access Undertaking under Part IIIA with respect to a pipeline has been filed, no legal impediment to an application for coverage under the Code. In such a case, if the application were successful, 'double regulation' could apply …
>
> In order to create a single regulatory regime for natural gas pipelines, it will be necessary for the Commonwealth to amend Part IIIA to remove the option of filing an Access Undertaking in the case of gas pipelines. (sub. 36, pp. 5-7)

And the Western Australian Government considered that:

> … overlap occurs where a facility is, or is potentially, subject to coverage by an industry-specific access regime. Given possible difficulties with timing, or the application of such regimes to new projects (before they are built), the owner/operator may seek to have an undertaking accepted in respect of the services provided by the facility so as to invest on a firm basis … consistency in the application of access arrangements within an industry is vital. … (sub. 38, p. 21)
>
> The pipeline industry has made a case that the simultaneous application of Part IIIA and the Code to the same pipeline may expose proponents of 'greenfields' pipeline projects not yet covered but potentially covered under the Code to 'double jeopardy'. That is if such a proponent takes the undertaking route, it may subsequently also be required to submit an access arrangement under the Code … (sub. 38, p. 26)

The Position Paper

In the Position Paper, the Commission acknowledged that one response to the concerns raised by State governments would be to close the avenue for dual coverage. This would involve including a provision within Part IIIA to the effect that undertakings could not be accepted from an access provider (potentially) subject to a certified industry-specific regime.

However, the Commission said that it did not favour such an approach because it considered that, ideally, Part IIIA should provide the lead as a framework for access regimes to:

- create pressures to eliminate unwarranted differences in individual access arrangements; and
- encourage regimes to replicate desirable features of the national regime.

Thus, the Commission found that, to the extent that 'forum shopping' and regulatory 'double jeopardy' are a source of uncertainty, modifying industry regimes to bring them into line with Part IIIA would be a preferable solution to closing off the undertaking option within the generic regime.

Participants' comments on the Position Paper

Reaction to the Commission's position as expressed in the Position Paper was mixed. Consistent with the thrust of earlier submissions (see box 10.3), some State governments reiterated a preference for closing off forum shopping via amendments to Part IIIA, rather than through changes to the Gas Code.

The South Australian Government (sub. DR121, p. 5) said that 'it would be extremely difficult, as is suggested in the Position Paper, to simply align the requirements of the relevant industry regime with those of Part IIIA'.

Reflecting its view about the hierarchy of access regimes, the Western Australian Government contended that:

> Certified industry-specific regimes should be the cornerstone of the national access regime, precluding any other path to access. Underneath each regime a robust framework for determining coverage and revocation is required (as exists in the National Gas Code) … an access undertaking should be an available option only for a (new) inter-state service or services which are not otherwise covered by the regime. A Service Provider should not generally have the choice of submitting an undertaking where a Parliament has passed a regime encompassing its services … (sub. DR69, p. 7)

With this hierarchy in mind, it suggested that:

> … further consideration could be given to Part IIIA removing the option of access undertakings where an industry-specific regime has been certified (and applies or would apply to the service in question) and the question of coverage under that regime has not (yet) been resolved in the negative.
>
> It is not attracted to the option of attempting to amend a certified regime (with more difficult inter-Governmental processes for effecting change) to achieve this. (sub. DR69, p. 7)

A similar view was put by the Queensland Treasury which said that:

> Where industry based or state based regimes are certified as effective regimes, the potential for Part IIIA to apply … should be extinguished. Currently, the declaration route is not available for services the subject of an effective regime. In contrast, the potential still exists for an owner to submit an undertaking under Part IIIA in circumstances where the service provided by the infrastructure is covered by a certified regime. While this avenue exists, the objective of certification is 'undermined'. (sub. DR105, p. 9)

However, in expressing some sympathy with the reasons why facility owners might seek to avoid coverage under the Gas Code, the Northern Territory Government supported the direction of the Position Paper. It submitted that:

> … it is apparent that the Code does not provide the necessary level of regulatory certainty required by investors in new networks … it is uncertain as to whether the ACCC or other regulators could consider a proposed access arrangement on a 'paper' pipeline.
>
> Regulators require the pipeline to be built or the proposal substantially concluded before an application can be seriously considered. … investors need to know the implications of any access arrangement long before settling on a deal.
>
> The alternative is to give an access undertaking for a new pipeline. While this may represent an attractive alternative (and inadvertently defeat the policy intentions of the Code), it still raises the possibility that once the pipeline is built an individual may seek declaration under the Code. This potential scenario opens pipeline proposals to regulatory uncertainty.
>
> There is a need for the Code to be assessed regarding its suitability for handling new investments. Where the above criticisms are substantiated, the Code should be amended to reduce the level of regulatory uncertainty. (sub. DR111, p. 11)

Reflecting an industry perspective, APIA indicated that it already had attempted unsuccessfully to have the Gas Code amended, but in a way which would give primacy to a Part IIIA undertaking. It submitted that:

> In an attempt to remove [regulatory] 'double jeopardy' APIA sought a Code amendment which would mean that if an Access Undertaking under Part IIIA was agreed, it could not be overridden if the pipeline were to become covered under the

> Code. … this rational outcome was not agreed because of the view of [the National Gas Pipelines Advisory Committee] that approval of an undertaking should result in automatic coverage under the Code. (sub. DR70, p. 16)

Conversely, while agreeing that Part IIIA should be the lead framework for access, the Australian Petroleum Production and Exploration Association came to a similar conclusion to the Western Australian Government and the Queensland Treasury on this particular issue. It said:

> An industry specific regime which has been certified as effective … has been found to be consistent with Part IIIA… Recognising this, the Part IIIA process should cause access to those services to be considered via the processes of the industry specific regime… The industry regime is subsidiary to and consistent with the Part IIIA provisions… In the case of gas pipelines, a Part IIIA application regarding access would automatically and quickly find its way into the Code forum, obviating 'forum shopping'. (sub. DR65, p. 1)

The ACCC, responding to the Commission's suggestion that the scope for forum shopping might add pressure to modify industry regimes, said that:

> … in order for the potential for dual coverage to be an incentive for State and Territory access regimes to be aligned with Part IIIA, the undertaking provisions would need to be highly prescriptive. They would need to be so prescriptive that there was only one access model or pricing methodology that would be approved, or accepted, as an undertaking. While Part IIIA allows flexibility in regard to undertakings, it would be impossible for industry-specific access regimes to be designed to avoid the potential for industry participants to game the regulatory framework by offering an undertaking in slightly different terms. (sub. DR93, pp. 22-3)

The ACCC further contended that if Part IIIA is to permit undertakings to be offered by access providers in an industry to which a certified regime applies, it should:

- specifically make provision for this;
- clarify whether there are any limits on the ability of access providers to offer undertakings;
- specify whether an undertaking and the provisions of a certified regime operate concurrently, or whether one mechanism is to be given priority; and
- clarify administrative issues — for example, where there is concurrently an application for coverage of a facility by an access regime and an undertaking has been lodged for assessment, should both processes proceed simultaneously or should one await the outcome of the other?

The Commission's assessment

As noted in earlier chapters, the Commission accepts that it would not be appropriate to use the Part IIIA legislation to force changes to State and Territory access regimes. Nor does it support the use of undertakings purely as mechanisms to escape from, and potentially undermine, industry access regimes (see section 9.1).

It is from this starting position that the following two key issues are addressed. These are the capacity for service providers to submit undertakings:

- for new services which *potentially* could be covered by an industry regime; and
- for services *currently* subject to a certified regime.

In practice, the first issue relates only to the Gas Code. This is because it is the only industry regime which determines coverage via a set of criteria assessed through an NCC inquiry (see box 7.6). In other regimes, the coverage requirements are set in the legislation and there is no provision for an assessing agency (such as the NCC) to undertake coverage assessments. While the first round submissions focussed exclusively on the first issue, responses to the Position Paper ranged more broadly and included views on the latter. These are discussed in turn below.

Gas Code (the Code) coverage issues

In addressing the issue of infrastructure owners potentially subject to the Code submitting 'pre-emptive' Part IIIA undertakings, it should be acknowledged that the motivation for this is the perception that the Code fails to address issues arising in relation to investment in new pipelines adequately — a point noted by the Northern Territory Government, among others.

However, the Commission considers that facilitating new investment should be tackled directly through the sorts of measures canvassed in chapter 11. From the infrastructure owner's perspective, incorporation of these types of direct measures within the Code is likely to be more attractive than avoidance of the Code (regulated by the ACCC except in Western Australia) through a Part IIIA undertaking (again regulated by the ACCC). Operating within the Code would also remove the risk of double regulation.

Of course, the Commission's assessment of measures to facilitate new investment has been undertaken in a Part IIIA context. Nevertheless, it considers that any such measures should also be a feature of industry regimes. Indeed, if such measures were agreed for Part IIIA, there would be almost irresistible pressure to introduce similar arrangements in the Code (and other industry regimes).

More generally, the Commission is of the view that (Part IV issues aside) infrastructure services should not be exposed to the possibility of double regulation. Thus, it considers that a Part IIIA undertaking should not be accepted where coverage under the Code has yet to be resolved.

It would be possible to amend Part IIIA to require that, where a facility owner *potentially* covered by the Code lodged a Part IIIA undertaking for assessment, the ACCC first refer the matter to the NCC to determine whether the service meets the requirements for coverage under the Code.

However, consistent with its views in the Position Paper, the Commission considers that this industry-specific matter would be better addressed by changes to the Gas Code. Indeed, resolution of this issue is not particularly amenable to more general application — as noted above, only the Gas Code incorporates coverage inquiries by the NCC.

RECOMMENDATION 10.3

The Gas Code should be amended to provide that, where a pipeline owner potentially covered by the Code lodges a Part IIIA undertaking, this should trigger an assessment by the National Competition Council to determine whether the pipeline meets the requirements for coverage under the Code. The Australian Competition and Consumer Commission's assessment of the Part IIIA undertaking should be held over pending the outcome of the Council's inquiry.

This recommendation could be considered in the context of any package of recommendations resulting from the forthcoming inquiry into energy markets and/or the Gas Code.

In practice, acting on this recommendation would probably close off the Part IIIA undertaking route for gas pipelines. This is because a pipeline which did not meet the Gas Code coverage criteria would be unlikely to meet the almost identical Part IIIA declaration criteria. Hence, there would be little incentive for the owner to submit a Part IIIA undertaking.

Coverage under certified regimes

Apart from this ex ante coverage issue, there also appears to be a possibility, as noted by the Queensland Treasury and the Western Australian Government, that a provider of an existing infrastructure service covered by a certified industry regime could submit a Part IIIA undertaking.

Section 44ZZB of the TPA specifies that the ACCC cannot accept an undertaking for a service which has been *declared*. However, that section is silent in respect of services covered by a *certified regime*. That said, section 44ZZA provides that the ACCC may accept an undertaking, having regard to a range of matters including 'whether access to the service is already the subject of an access regime'. It may therefore be questionable whether the ACCC would accept an undertaking for service already covered by a certified regime. Nevertheless, the submission from the ACCC clearly countenances this possibility.

The Commission has been unable to ascertain why the section 44ZZB exclusion refers only to declared services. One possibility is that, at the time it was developed, the prospect of facility owners — rather than access seekers — seeking alternative routes of coverage was considered unlikely. (The scope for this to occur has recently been exemplified by the lodging of a declaration application for freight and passenger services provided by the Victorian intrastate rail track network. The application was lodged by the track's lessee, Freight Australia, which is covered by the non-certified Victorian Rail Access Regime.)

If a facility owner subject to a certified industry regime were to have an undertaking accepted by the ACCC, this could raise a range of complex issues. For example, a general principle of statutory interpretation is that, in areas where legislation is in conflict, Commonwealth legislation tends to prevail over State legislation. This might, in turn, create incentives for a facility owner to submit an undertaking designed to engineer conflicts with particular areas of a certified State or Territory regime.

More generally, the Commission reiterates that any potential for double regulation should be avoided. Accordingly, in this particular case, it considers that it would be appropriate to amend Part IIIA to eliminate the scope for facility owners which are subject to certified regimes to lodge undertakings (unless the certified regime itself makes explicit provision for undertakings).

RECOMMENDATION 10.4

Part IIIA should be amended to make it explicit that the Australian Competition and Consumer Commission cannot accept an undertaking if the service concerned is subject to a certified access regime.

This recommendation is couched quite deliberately in terms of *certified*, rather than *effective*, regimes. It is possible that an untested industry access regime could be found to be effective. However, were the ACCC to receive an application for an undertaking by a service provider subject to an untested regime, it would not be able to determine whether or not that regime was effective. Assessment of whether a non-certified regime is effective is the role of Minister drawing on advice from the NCC.

Of course, it would be possible in such instances to make provision for the ACCC to refer the matter to the NCC for an adjudication on whether the applicant was operating under an effective regime. However, in the Commission's view, it would be preferable for jurisdictions to seek certification of their regimes (in advance) to guard against undertakings for covered services, in the same way that certification provides a shield against declaration. This recommendation, if acted on, should increase the incentive for jurisdictions to have their access regimes certified as effective.

11 Facilitating efficient investment

11.1 The need for new measures

As discussed in chapter 4, in the absence of regulation, providers of essential infrastructure services may be able to earn monopoly rents through inefficient pricing or denial of access to those services. If access regulation reduces the scope for such practices, investment in essential infrastructure will potentially be more efficient. As well, investment in markets that use the services of that infrastructure will be facilitated.

However, the information difficulties confronting regulators and the imperfect regulatory instruments available to them mean that, in practice, access regulation may well deter some socially desirable investments in essential infrastructure.

The potential for ‘imperfect’ access regulation to deter investment can be manifest in two main ways.

First, such regulation is likely to increase the general level of risk attaching to investment in essential infrastructure. The inevitable regulatory discretion involved in the implementation of access regulation, constraints on service providers’ capacity to respond to changes in the market environment and perceptions that regulatory decisions will tend to be biased in favour of users, are among the factors that contribute to regulatory risk. While these sorts of risk attach to investment in any regulated activity, the sunk nature of most infrastructure assets and the scale of the investments involved make them a much more significant consideration in the infrastructure area.

Second, and perhaps even more importantly, once an infrastructure facility is operating successfully, it can be very difficult for access regulators to differentiate between genuine monopoly rent and upside (‘blue-sky’) profits accruing to the facility owner. As discussed in chapter 4, the possibility of earning above normal profits if a project proves to be successful will often be factored into an investment decision to balance the possibility of losses in the event that the project fails. Thus, if there is an expectation that access regulators, in seeking to curb monopoly rents, will also remove or reduce upside profits, some new infrastructure investments are likely to be deferred or permanently deterred.

Further, even successful infrastructure projects will not usually generate revenues in their early years sufficient to cover costs. Thus, early losses must be covered by above normal profits in later years as demand for the services concerned increases. But if returns in each year are capped at the risk-adjusted rate of return, the possibility of earning these ‘covering’ higher profits will be removed, again with adverse implications for incentives to invest.

In essence, such truncation problems reflect a regulatory asymmetry — while limiting the upside, access regulation makes no allowance for the downside. The potential for regulatory ‘truncation’ of returns was acknowledged by a wide cross section of participants — including the Australian Competition and Consumer Commission (ACCC), the body responsible for regulating terms and conditions under Part IIIA.

As a number of participants pointed out, various carry-over and averaging provisions can be, and have been, employed to prevent or reduce truncation that could arise were returns for successful projects limited to the regulated rate of return in each and every year. Accordingly, this type of truncation is not pursued further in the chapter (although the Commission emphasises that without a commonsense approach on the part of regulators to measuring returns, it could constitute a significant disincentive to investment).

Conversely, dealing with truncation of returns associated with the possibility of project failure raises more significant problems. The biggest of these stems from the fact that while incumbency in essential infrastructure markets sometimes confers the potential to exercise market power, new investments to provide these services are often contestable at the construction phase. That is, there are no barriers to entry at the construction phase, meaning that the behaviour of the firm that actually builds a facility will be influenced by the threat of competition.

As discussed in chapter 4, contestability has two important implications in an investment context:

- Contestable investments are likely to be undertaken as soon as they are perceived to be profitable (having regard to the risks involved).
- Any expectation that access regulation will truncate returns after the event is likely to deter contestable investment.

While this deterrent effect could, in theory, avoid a possibility of socially premature investment in these circumstances, the more important practical concern is that some worthwhile investments in essential infrastructure will not occur. Hence, there is a strong case for quarantining such investments from exposure to access regulation.

It is also important to recognise that some non-contestable investments undertaken by incumbent service providers may be of a marginal nature. That is, while incumbency may sometimes provide an opportunity to delay re-investment to generate monopoly rents, demand and cost conditions might equally mean that an incumbent will undertake projects that are only expected to return their risk-adjusted cost of capital. Again, such projects are likely to be deterred by the prospect of regulatory truncation of balancing upside returns if a venture in fact proves to be more successful.

However, it can be very difficult to take account of ex ante contestability/marginality in the sort of coverage tests used in Part IIIA and other access regimes. This is because these tests do not seek to determine exposure on the basis of the *expected* profitability of an investment at the time of construction. Rather, they address whether an *incumbent* service provider might have the scope to exercise market power. Investments which were undertaken with the expectation of providing only normal risk-adjusted returns to investors will sometimes meet these criteria.

For these sorts of reasons, support for specific measures to facilitate new investment within access regimes generally, and Part IIIA in particular, has grown during the course of this inquiry. In the Commission's view, the case for such measures is compelling. The focus for policy makers should not be on whether, but how best to address the new investment issue.

Yet as the discussion in the remainder of this chapter illustrates, the search for workable mechanisms that address these investment concerns raises new issues and complexities. A particular problem is that the mechanisms for which the case for implementation is most clear cut would not be widely applicable. Conversely, all of the approaches that could be used in a more general context have potentially significant disadvantages.

In the time available, the Commission has been unable to resolve fully how these disadvantages might be addressed, or what weightings should be attached to some of the competing considerations involved in choosing between possible approaches. The preferred approach is also likely to depend on the circumstances surrounding a particular investment. Accordingly, the focus of this chapter is on identifying what broad measures might have a place on a policy 'menu' to address the problems outlined above.

11.2 The Position Paper approach

Throughout the Position Paper, the Commission emphasised the need for Part IIIA determinations to put more focus on investment issues. Its proposals to incorporate in Part IIIA an objects clause and pricing principles referring specifically to investment, to tighten the regime's declaration criteria and to increase the accountability of Part IIIA decision makers, were all framed with this goal in mind.

At the same time, however, the Commission recognised that such changes would most likely be of limited value in addressing concerns about increased regulatory risk and unwarranted regulatory truncation of returns. Thus, in relation to the role of tighter declaration criteria it commented that:

> … the paucity of declaration decisions to help establish precedents, coupled with investors' generally negative perceptions about regulatory attitudes may mean that tighter declaration criteria would do little to reassure potential investors. (p. 192)

It therefore went on to canvass some specific measures that could be used to exempt from the purview of Part IIIA proposed infrastructure projects that are expected to be only normally/marginally profitable:

- access 'holidays';
- exemption from the regime for 'greenfield' investments (with the option of providing for a claw-back of profits if a project proved to be highly successful); and
- provision for a higher regulated rate of return on risky new investments.

The Commission noted that each of these approaches would have advantages and disadvantages. Nonetheless, it expressed a preference for the access holiday approach, implemented by provision for a null undertaking from the service provider. It suggested that such a regime could have a number of features, including:

- investments covered would be those providing services where none currently exist — that is, greenfield projects;
- the holiday would be for a defined minimum period of 15 or 20 years; and
- it would be granted automatically unless the regulator could demonstrate that it would not be efficient to do so — for example, if there was evidence that the project was *expected* to be highly profitable, or that the standard holiday period was demonstrably too long for the investment in question.

However, the Commission flagged some possible difficulties with this approach:

- definition of a 'new service' and classification of infrastructure according to that definition could be problematic and give rise to gaming; and
- there could be considerable community disquiet if a project granted a holiday subsequently proved to be highly profitable.

The Commission therefore sought further input from participants on the most appropriate way forward.

Refinement of the access holiday proposal

Following the release of the Position Paper, the Commission continued to develop a possible access holiday mechanism. At the public hearings, it sought comment on a more developed proposal based around a time limited exemption for all contestable new investments. For the reasons outlined above, it argued that this class of investments was most likely to be jeopardised by exposure to access regulation.

Specifically, the proposal envisaged that:

- Any proposed investment which qualified as contestable (see below) would be eligible for a fixed term access holiday of, say, 15 to 20 years, unless the regulator could demonstrate that the investment was *likely* to return above normal profits.
- Conversely, non-contestable investments would not be eligible for a holiday unless the project proponent could demonstrate to the regulator that they were likely to be only marginally profitable.
- The concept of contestability would be based on the *potential* for competition, rather than the existence of more than one firm or consortia seeking to undertake a particular project. In effect, the capacity of a project proponent to secure a holiday would depend on whether there were entry barriers that would prevent construction by another entity.
- The concept would be applied in the negative — by identifying those classes of investments where, prima facie, there are likely to be barriers to construction of the infrastructure concerned by another entity.

The Commission went on to suggest that the non-contestable group should be limited to investments by incumbent service providers to refurbish existing infrastructure or to augment a part of a network that was itself subject to an access holiday.

Relative to the proposal outlined in the Position Paper, the effect of this approach would be to expand greatly the range of investments that would qualify for an almost automatic access holiday. That is, while greenfield investments to provide new services would qualify under both, under the developed proposal so too would contestable augmentations to existing networks.

Significantly, the latter would include augmentations undertaken by the incumbent owner of the network, provided that the network was not itself subject to an access holiday and could therefore be covered under the access regime. The rationale for this was that exposure of a network to declaration/coverage under an access regime ostensibly renders an augmentation contestable. Thus, an incumbent which intended to delay augmentation in order to earn monopoly rent could face the risk of an application for coverage of the network, and subsequent construction of the augmentation by another party. (In the case of Part IIIA, this would be facilitated by the interconnection provisions in the arbitration criteria for declared services — see chapter 8.)

Moreover, as noted above, the approach would still allow an incumbent service provider to make a case to the regulator that a proposed 'non-contestable' investment was marginal and deserving of an access holiday.

11.3 Participants' responses

Reflecting the importance of the issue, a significant number of participants commented on the approach canvassed in the Position Paper and the more developed proposal floated at the public hearings.

Not surprisingly, service providers were highly supportive of the view that specific measures are required to quarantine more marginal investments from exposure to access regulation or to otherwise facilitate efficient investment outcomes. Typifying these views, the Network Economics Consulting Group (NECG) commented:

> … we welcome the Commission's recognition that some form of immunity from access regulation is appropriate for certain investments in essential infrastructure … (sub. DR76, p. 26)

The Australian Council for Infrastructure Development (AusCID) argued that:

> … the unique project risk, which investors in natural monopoly infrastructure face, should not be heightened by excessive regulatory intervention to a level which results in sub-optimal levels of investment. (sub. DR80, p. 11)

And, in a gas-specific context, the Australian Gas Association said:

> … most network expansion or new pipeline projects can be argued to be contestable at the construction phase. That is, it will be unlikely that given the competitive process for determining the new service provider, that the prices to end-users will contain any

element of monopoly rent. In these circumstances, it is arguable that a regulated third party access regime on the new infrastructure is inappropriate. (sub. DR84, p. 16)

Significantly, however, there was also in principle support for some form of action from governments, the National Competition Council (NCC) and certain user groups (see box 11.1).

Box 11.1 **Support for measures to facilitate investment**

In addition to service providers, a cross section of other interests expressed support for specific measures to facilitate efficient investment within access regimes generally and Part IIIA in particular.

Users of infrastructure services

It is vital that some mechanism (or mechanisms) be adopted which reflects the different risk associated with different forms of investment; and which permits, when appropriate, *ex post* rates of return which might appear quite high, in recognition of the *ex ante* uncertainty about whether the investment would be profitable at all. (Chamber of Commerce and Industry Western Australia (CCIWA), sub. DR103, p. 3)

… we recognise that an approach to regulating mature networks may not be well suited to Greenfield investments and believe that this matter needs further investigation. (Energy Users Association of Australia, sub. DR94, p. 31)

Governments

While there is a need to ensure competition benefits for end-consumers in the application of third party access principles there is also a need to encourage new investment. It is important regulators signal a willingness to recognise the different risk characteristics inherent in greenfields projects. (Queensland Treasury, sub. DR105, p. 10)

As acknowledged by the Commission, there is a strong case for providing major infrastructure projects, or at the very least certain services provided by major infrastructure projects, that may be only marginally profitable with an “access holiday”. The case is strongest for large scale projects that have a long payback period. Without this additional certainty for investors, the community may be denied the opportunity to benefit from new infrastructure services. (Northern Territory Government, sub. DR111, p. i)

The Tasmanian Government would also support any changes to the National Access Regime that consider the differing commercial incentives that apply between existing infrastructure and greenfield developments. This is an important issue which is particularly relevant to Tasmania in the development of the Natural Gas Project and the ability to provide for future capacity in the development of infrastructure within a commercial private-sector project. (sub. DR118, p. 2)

The NCC

The Council considers it fundamentally important that access regulation not deter or delay efficient investment in infrastructure. The current mechanisms may not be sufficient to provide appropriate certainty for infrastructure investors. (sub. DR99, p. 17)

The Office of the Regulator-General, Victoria (ORG, sub. DR112, p. 6) was more circumspect, questioning whether regulatory truncation is a sufficiently significant problem to justify new measures. The Office contended that current CPI-X pricing arrangements allow facility owners to retain some above normal profits on the provision of access. Nonetheless, it went on to give support for an access holiday arrangement for new investments underwritten by foundation contracts (p. 9).

The major opposition to any move to provide some form of immunity for new investment from the general provisions of Part IIIA came from Dwyer and Lim. Their basic concerns, and the Commission's responses to them, were dealt with in chapter 4. Elaborating on these concerns in the context of access holidays, Dwyer and Lim argued:

> The suggestion that infrastructure investment should be encouraged through access holidays is fundamentally flawed in several respects.
>
> … an access holiday would allow an infrastructure owner free rein to extract monopoly rents through the period of the access holiday and would allow him an agreed real rate of return later on when the infrastructure came under the access regime. This would amount to a form of double dipping. …
>
> … an access holiday necessarily involves … the creation of excess burdens, discouraging investment downstream and upstream as well as in potentially linking infrastructure facilities. (sub. DR100, p. 11)

That said, along with other user groups, Dwyer and Lim expressed some support for the competitive tendering of new infrastructure projects. As discussed in box 5.1 and below, such an approach would, in certain circumstances, be a way of ensuring that any regulatory 'taking' was limited to genuine monopoly rent.

The other significant critic of the view that new approaches or measures are required to facilitate efficient investment within the national access framework was the ACCC. In the context of Part IIIA, it raised particular concerns about access holidays implemented through null undertakings (see below) and went on to argue that investment issues can be adequately accommodated within the current architecture of the regime:

> The ACCC is of the view that a better approach … is, firstly, to ensure that the declaration criteria are sound and, secondly, once a service is declared, to implement appropriate pricing structures and incentive mechanisms in accordance with the risks involved with the facility in question. The ACCC considers this is more desirable than the essentially arbitrary application of exemptions to facilities that are classified as providing "new services" and being "marginally profitable". (sub. DR93, p. 22)

Like Dwyer and Lim, however, the ACCC raised the possibility that another variant of the competitive tendering approach could be used in place of access regulation (see below). It also indicated that its pricing determination for the Central West Gas Pipeline had built in an additional risk premium to reflect the project's greenfield status. As the Commission noted in the Position Paper, in seeking to limit the potential for access regulation to deter socially worthwhile investment, provision for an additional risk premium is an alternative to exemptions.

More generally, the approaches canvassed by these participants confirm that the need to give specific attention to the new investment issue in Part IIIA is not really in dispute. The divergence of views relates to the best way to do so. Accordingly, the remainder of this chapter focuses on the advantages and disadvantages of the various mechanisms that might be employed to avoid compromising efficient investment within an access regime.

11.4 How do the various approaches measure up?

Not surprisingly, developing practical mechanisms that provide for an appropriate balance between the competing considerations that arise in this area is far from easy. On close examination of the various alternatives, there is no unambiguously superior mechanism for dealing with regulatory truncation of balancing upside profits accruing to successful infrastructure projects.

Nonetheless, the assessment of the various approaches that follows helps to narrow and shape the range of responses that could be employed to address the truncation problem. It also suggests that there is a strong case for introducing two supplementary mechanisms to facilitate efficient investment in a limited range of circumstances.

Assessment criteria

In the Commission's view, the following criteria provide a useful check list for assessing the efficacy of the various approaches and mechanisms:

- *the degree to which the truncation problem is addressed*: Self evidently, the less the potential for regulatory truncation of balancing upside returns accruing to successful projects, the smaller will be the deterrent to risky new investments.
- *the degree to which regulatory risk is reduced*: The more certainty that can be provided to investors about the regulatory environment that will apply once a piece of infrastructure is in place, the smaller will be the premium for regulatory risk required by those investors. Again, this is likely to reduce the magnitude of any deterrent effect on investment.
- *community acceptability*: High returns accruing to successful infrastructure projects will inevitably raise concerns about monopoly pricing, even if the possibility of such high returns was necessary to launch the project. This reflects the difficulty of distinguishing between balancing upside profits and genuine

monopoly rent once a facility is in place. In assessing the efficacy of the different approaches, the extent to which community acceptability concerns are addressed will be a relevant consideration.

- *unwanted side effects*: As the Commission acknowledged in the Position Paper, the need to define a sub-group of projects that qualify for different treatment within an access regime might create incentives to modify specific investments simply to fit those qualifying requirements. Similar incentives could also arise in other contexts — for example, if the length of an access holiday was linked to the profitability of a project (see below), creative accounting might be encouraged.

  Further, as discussed in chapter 4, in an unregulated environment, it is possible that competition to capture monopoly profits potentially attaching to an essential infrastructure facility will lead to premature investment. Exemptions from otherwise applicable access regulation could presumably have similar effects. However, as outlined above, the Commission considers that the consequences of not addressing the regulatory truncation and regulatory risk problems are likely to be more serious than any pulling forward of investment. Hence, it would see the potential for premature investment as being a secondary consideration in delineating between any two approaches that provided a comparable response to the more important truncation and regulatory risk issues.

- *administrative efficiency*: The administrative and compliance costs of the various approaches are likely to differ. For instance, a number would require detailed and ongoing information from service providers on a project's revenues and costs and close monitoring by the regulator of that information. There is often likely to be a trade-off between the refinement of incentives to encourage efficient investment and the additional transactions costs involved.

- *minimising regulatory moral hazard*: As a number of participants noted, ex post access determinations by regulators will largely be for 'successful' projects. Hence, continued service provision is unlikely to be threatened by such determinations even if there is significant truncation of returns. Moreover, the likely deterrent effects on future investment of any such truncation will not be manifest for a possibly long time. Together, these factors might lead a regulator to give excessive weight to the interests of users of existing services. In contrast, if the regulator were required to commit to terms and conditions prior to investment, it would be making its decision in the knowledge that an inappropriate determination could result in the project being shelved. Thus, regulatory incentives would align more closely with the longer term interests of both service providers and users and any potential for regulatory 'moral hazard' would be reduced.

All of the mechanisms discussed below would involve ex ante commitments from a regulator. However, most would also require the regulator to make some ex post decisions. The potential for regulatory moral hazard will therefore be a factor in assessing their relative merits.

The implications of the various approaches for service providers' exposure to Part IV of the Trade Practices Act is another relevant consideration. As discussed in chapter 15, while an access arrangement approved under Part IIIA does not quarantine the service provider from Part IV, the NCC questioned whether the potential for regulatory 'double jeopardy' is currently significant. However, the possibility of actions under Part IV might well increase if provisions were introduced to quarantine certain new investments from Part IIIA, or even to sanction prices that delivered high ex post profits for successful projects.

That said, all of the approaches canvassed below could in one way or another give rise to an increased possibility of Part IV actions. Hence, the risk of such actions is unlikely to be a factor in differentiating between individual approaches. Accordingly, the issue is considered in a general context in the final section of the chapter.

The options

Participants' responses to the Position Paper and to the Commission's subsequent access holiday proposal, canvassed a range of approaches for facilitating efficient investment within an access regime. In broad terms, these approaches can be categorised as follows:

- 'binding rulings', given prior to investment, that services provided by a proposed facility would not meet an access regime's coverage/declaration criteria;
- 'framework undertakings' agreed between the service provider and the regulator prior to investment, covering the access terms and conditions to apply to a proposed essential facility. (In effect, these would be a variant of the current undertaking provisions);
- higher regulated rates of return for risky projects;
- access holidays or similar time-based exemptions from coverage under an access regime; and
- profit sharing arrangements.

As the discussion that follows indicates, there are some significant overlaps across the groupings. At least in theory, a number of these broad instruments could be configured so as to have an equivalent impact on a project's expected income stream and thereby on the truncation problem.

Moreover, individual approaches should not be seen as being applicable in every situation. Indeed, to cater for differing circumstances, a number of participants emphasised that a menu of measures is required. For example, the CCIWA said that it does not:

> … support the adoption of a single mechanism as the only means of achieving those objectives. It would prefer that the mechanism be left open to be determined according to the circumstances of the infrastructure and market concerned. (sub. DR103, p. 3)

Similarly, AusCID (sub. DR117, p. 3) argued that 'there should be a range of options open to the investor to gain greater certainty for a new investment'.

Binding rulings

Consideration of the option to allow investors in a proposed infrastructure facility to seek a prior ruling on whether the services provided by that facility would meet the Part IIIA declaration criteria predates this inquiry. For example, the Department of Transport and Regional Services (sub. 52, p. 1) referred to a recommendation from the 1999 Rail Projects Taskforce that:

> Investors should also be able to utilise the National Competition Agreement process to obtain binding rulings on whether a *proposed* investment when completed would constitute 'essential national infrastructure'.

This approach was supported in various guises by many participants. For example, some referred to a need for 'safe harbours' or 'negative declarations' rather than binding rulings as such.

Participants saw provision for binding rulings (or a similar arrangement) as a way of helping to reduce regulatory uncertainty. For example, the NECG argued that:

> We believe that, in addition to reforming the declaration criteria, regulatory risk can be further reduced if procedural reforms are required that will allow a potential investor in infrastructure, prior to the final commitment of funds, to obtain advice from the relevant regulator as to whether or not the infrastructure will likely be subject to a regulated access regime. (sub. DR76, p. 24)

The NECG said that such an approach would also have a positive effect on regulatory behaviour:

> … by more closely aligning decisions on regime coverage with decisions on whether or not to invest (instead of having regulatory decisions made after the funds are committed) safe harbour procedures would act as a significant deterrent to regulatory creep. Regulators' incentives and willingness to unduly extend the scope of regulation

> would be significantly diminished if the costs of that over-extension, in terms of reduced investment, were immediately felt. (p. 25)

Likewise, AusCID referred to provisions in the Gas Code that allow for advance advisory opinions on coverage matters and suggested that a similar mechanism in Part IIIA would be valuable:

> There is considerable merit in advance indications about the prospect of an imposed regulatory outcome. … Advance consideration of [the] issues can be done in a low cost way which has the potential to provide reliable guidance to investors. Such a mechanism could have been used in the Tarcoola to Darwin rail line where, if it were to have been the subject of a declaration application there would have been real doubt if access would promote competition in another market because of the competitive discipline exercised by road transport. (sub. DR80, pp. 15-6)

AusCID went on to flesh out how a binding ruling mechanism might work. Among other things, it suggested that:

- the NCC should be responsible for making a ruling on request from a prospective investor;
- the Council's ruling would generally be binding unless there was a material change in circumstances that justified revocation; and
- while an initial ruling would not be appellable, some form of review mechanism should apply to any revocation of the ruling on the basis of a material change in circumstances.

Significantly, the NCC (sub. DR99, p. 20) also supported provision for a binding ruling mechanism within Part IIIA. It suggested that such rulings would be particularly helpful in reducing regulatory risk for projects such as the Tarcoola to Darwin rail link where it is relatively clear that the declaration criteria would not be met once the facility is in place.

However, the Council emphasised that it is important not to underestimate the information that would be needed to make such rulings. In this regard, it said that more detailed consideration of the issues would be required than under the Gas Code provisions, because advance opinions under the Code are not binding. It therefore suggested that a public inquiry process might be appropriate to facilitate the collection of relevant information.

Like AusCID (and the NECG), the NCC further suggested that there should be provision for an appellable revocation of a binding ruling in the event of a material change in circumstances. Also, at the public hearings, the Council canvassed the possibility of implementing access holidays (see below) through some sort of time-limited binding ruling. (transcript, p. 492)

The Commission's assessment

In the Commission's view, provision for binding rulings would be a useful augmentation to the access armoury. For some proposed projects, the ability to secure a binding ruling that the facility would not be covered by an access regime would remove key risk factors and thereby obviate the need for more costly courses of action to reduce that risk. Indeed, as the NCC noted, even when a binding ruling could not be given, the process might still reduce regulatory uncertainty:

> The fundamental advantage of a binding ruling is that it involves consideration of the relevant issues at the time the investment is made. Even if the Council were unable to reach a firm view on one of the criteria, the process and the views reached in relation to the other criteria may nonetheless provide a much greater degree of certainty to an infrastructure owner than would otherwise be available. (sub. DR99, p. 21)

In illustrating these sorts of benefits, the comments from the Northern Territory Government on the Tarcoola to Darwin rail link are particularly telling. Given the competition in downstream markets from road haulage, the Territory Government recognised that the threat of the railway being declared was small. However, it said that, because of the nature of the investment, this was a risk that could not be left unaddressed:

> … if an application were made, there is a possibility that the NCC may adopt a narrow definition of the market for the service (eg the market for rail freight services) and recommend declaration. This is a risk that financiers are unable to accept without applying a substantial discount to project revenues. (sub. DR111, p. 2)

Had provision for binding rulings been in place within Part IIIA, the need for the Northern Territory and South Australian Governments to explore the possibility of an undertaking and, ultimately to develop a certified regime, would almost certainly not have arisen.

Binding rulings also measure up well against the community acceptability criterion. For the sort of projects that would qualify for a binding ruling that Part IIIA does not apply, high profitability after the event is unlikely to be an issue. That is, such a ruling would only be made where it was clear that the proposed facility did not employ a natural monopoly technology, or that it would face competition from substitute services. Hence it would be highly unlikely to enjoy substantial and enduring market power. Moreover, by reducing regulatory risk, access to a binding ruling might be the determining factor in whether a worthwhile marginal project went ahead. 'Selling' this feature of a binding rulings mechanism is unlikely to be difficult. For the reasons outlined by the NECG, binding rulings would also help to curb any regulatory moral hazard in decision making.

Importantly, however, binding rulings would not constitute a general response to the problem of regulatory truncation of balancing upside returns accruing to successful projects. In effect, they are a means of bringing forward the coverage decision for services provided by infrastructure facilities that are unlikely to have substantial and enduring market power. The risk of truncation of returns if access regulation is inappropriately applied to such projects will still be a concern for investors — as evidenced by the comments from the Northern Territory Government in relation to the Tarcoola to Darwin rail link. However, for the most part, truncation concerns relate to facilities that will potentially have substantial market power once in operation. As such, it is highly unlikely that these facilities would qualify for binding rulings that the coverage criteria were not met.

Further, making provision for binding rulings within access regimes in general, and in Part IIIA in particular, would raise some significant implementation issues.

For example, service providers acknowledged that there would have to be provision for revocation of a binding ruling if circumstances changed materially. Yet providing an exhaustive list in the legislation of what would constitute a 'material' change in circumstances (as distinct from providing guidance on the sort of circumstances that would qualify as material) could be very difficult. The most likely outcome would therefore be that the regulator would be left with scope to exercise discretion on a case-by-case basis. If there was no provision for appeal against a revocation decision, this could expose service providers to some of the regulatory risk and moral hazard that the approach seeks to avoid.

Provision for public inquiries to elicit views on applications for binding rulings — as canvassed by the NCC — would also raise a number of issues. In particular, exposure of a project proponent's intentions to potential competitors could undermine the investment in question. Conversely, a confidential process could limit the opportunity to test the service provider's contentions in relation to the expected profitability of the investment and the degree of competition it would face. The delays and costs associated with a public inquiry process would be another relevant consideration.

Finally, participants envisaged that a decision to grant a binding ruling would not be appellable. Prima facie this does not seem unreasonable. As well as the usual transaction cost considerations, at the time the ruling was sought, the concerns of committed service users would often have been catered for in foundation contract or similar arrangements negotiated with the service provider. And, were there to be provision for appeals after construction, the whole rationale for binding rulings in providing ex ante certainty to investors would be undermined.

However, as Ministers are responsible for coverage decisions under Part IIIA (see chapter 14), a non-appellable binding ruling process could result in a different outcome than an ex post declaration application for the same service. In particular, it would be open to a Minister to grant a non-reviewable binding ruling even if the NCC had recommended that the services concerned would meet the declaration criteria. In contrast, under the declaration provisions, such a decision could be tested through an appeal to the Australian Competition Tribunal (see chapter 15). Addressing the possibility for 'misuse' of binding rulings by implementing an appeals mechanism would add to the complexity of the approach.

Framework undertakings

Submissions from key industry groups argued that provision for ex ante agreements between project proponents and the ACCC on the basis for any future regulated access determinations would be another vehicle for reducing regulatory risk. Such agreements were variously referred to as 'framework undertakings', 'pre-determined regulatory rules' and 'access compacts'. In contrast to binding rulings, the intention is that they would apply to services that would be likely to meet an access regime's coverage criteria. Participants suggested that this sort of approach would be particularly useful in reducing the risk that prices will be set, after an investment is sunk, in a way that truncates returns significantly.

Provision for prospective undertakings already exists in Part IIIA — although none have been agreed. Thus, in many respects, submissions from participants can be viewed as clarifying what such prospective or pre-construction undertakings should involve. Elaborating on the approach, the NECG said that it could take one of two forms:

- a compact between the regulator and the regulated firm on the key regulatory parameters – that is, *ex ante* agreement on the parameters in the regulatory model that are determined by the regulator such as the beta weights to be used when calculating the weighted average cost of capital, whether or not assets will be vulnerable to regulatory stranding (that is, a cost optimisation modelling approach used), and if so the circumstances under which this would occur (i.e. how the optimisation would be implemented), the period between regulatory resets and so forth. The regulator will be bound to agree to parameters that are proposed and that are consistent with the legislative pricing principles, subject to a strict material change in circumstances clause; or
- an undertaking, which would detail the terms and conditions of access for the lifetime of the asset. Again, the regulator will be bound to agree to an undertaking that was consistent with the legislative pricing principles, subject to a strict material change in circumstances clause.

> Were undertakings to be employed, they would need to be administered to reflect the commercial and time sensitivities of investment planning and future access requirements. Undertakings should take the form of streamlined market inquiries rather than the unwieldy processes that, to date, have characterised undertakings under Part IIIA. (sub. DR76, pp. 28-9)

Reflecting a slightly different perspective, AusCID argued that a 'first best' approach would be to reform the current undertaking mechanism to make it clear that undertakings are a framework for access provision and to include specific provision for a dispute resolution mechanism (see chapter 10). In this context, it expressed particular concern about the prescriptive approach taken to date by the ACCC in assessing proposed undertakings.

However, AusCID went on to argue that if improvements to the general undertaking mechanism are not made, then a special type of undertaking should be established to set the parameters for the terms and conditions of access for proposed projects:

> Generally, the process and procedures for these framework undertakings would be the same as those for the current form of undertaking. However, the process is likely to be speedier because the same level of detail would not need to be considered. This process could be conducted in a public context. (sub. DR80, p. 22)

Like the NECG, AusCID also canvassed the possibility of bilateral 'compacts' between the proponent of a proposed infrastructure project and the regulator. Elaborating on how this might work, AusCID said that:

> … there could be provision for a prospective infrastructure owner to provide the regulator (i.e. the ACCC) on a confidential basis, with the factual basis for the investment decision. …
>
> This material, once furnished to the ACCC, would, if any dispute as to access terms and conditions ever arose, be presumptive evidence of all of the factual materials which were provided. The ACCC would be obliged to use this material as the basis for any determination of terms and conditions unless there were a manifest error in any of the material which had been provided. (p. 23)

Similarly, AGL proposed:

> One option for investors who require greater certainty *ex ante* would be a requirement for an explicit regulatory contract between the regulator and the regulated firm. The terms of this contract would be agreed upon prior to the regulated firm making an investment in assets that are likely to be subject to regulated access requirements under Part IIIA. Such *ex ante* agreements will allow the regulated firm to undertake more precise financial modelling with a view to making the final decision on whether or not to proceed with the investment. (sub. DR86, pp. 11-2)

The NCC also saw merit in framework undertakings, but questioned whether amendments to Part IIIA would be necessary to give effect to them:

> … there appears to be sufficient flexibility in the current criteria to allow the ACCC to accept such undertakings. However, a minor amendment with explicit support in the Second Reading Speech may be required to achieve certainty. (sub. DR99, p. 21)

The Commission's assessment

Framework undertakings would have a number of advantages:

- They would help to reduce regulatory risk facing prospective service providers.
- They could provide assurance to the community that market power expected to attach to proposed infrastructure facilities would not be unreasonably exploited.
- Once the up-front transactions costs involved in securing agreement on the conditions of such an undertaking had been incurred, some ongoing costs of this nature could be avoided.

Importantly, however, the extent to which such undertakings would reduce regulatory risk is unclear. In particular, the question arises as to whether it would be possible to legislate for a 'less prescriptive' ex ante undertaking mechanism of the sort advocated by service providers. While the ACCC as the body which would presumably be responsible for assessing framework undertakings did not comment directly on them, its observations in relation to the implementation of access holidays via null undertakings are pertinent:

> It would be very difficult for the ACCC to assess the reasonableness of information provided, including anticipated demand figures. It would also only be possible for the ACCC to accept such an undertaking on the basis that the information provided at the time prior to the project's commencement remained accurate at the time the project came on stream. This raises a number of difficulties. Some projects have such long lead times that the ACCC might be asked to assess the reasonableness of predictions a long time before access to the service becomes an issue. (sub. DR93, p. 21)

This in turn suggests that a 'material change in circumstances' provision — which service providers acknowledged would be required as part of a framework undertaking approach — could be frequently invoked.

Moreover, a framework undertaking would not, of itself, address the regulatory truncation problem. That is, the degree of truncation would depend on the detailed parameters in such an undertaking. For this reason, provision for higher regulated rates of return was an integral part of a number of proposals for framework undertakings or similar instruments.

The regulated rate of return that should be afforded to risky infrastructure investments is, however, a more general issue. Provision for a higher return could also be made ex post — as the ACCC argues it did in its determination for the

Central West Gas Pipeline. The merits of the approach are considered in the next section.

That said, if adjustments to the regulated rate of return were used to deal with the truncation problem, there would be merit in incorporating those adjustments, prior to investment taking place, within a framework undertaking or access compact. Like binding rulings, provision for ex ante adjustments to the rate of return would reduce any moral hazard that might arise when a regulator makes a determination after the event secure in the knowledge that its decision will not threaten the continued availability of the service in question.

Higher regulated prices and rates of return

The scope to address the truncation problem by adjusting the regulated rate of return was a feature of a number of responses from service providers to the Position Paper. Drawing on its recent decision to postpone the reticulation of gas to Barwon Heads after a failure to reach agreement with the ORG on a range of matters, including an appropriate regulated rate of return, TXU Networks commented that:

> The risks associated with reticulation of 'greenfield' projects are simply higher than the risks associated with expanding a gas distribution system that has established markets. TXU contends it should be compensated for this risk of reticulating 'greenfield' projects in the form of a higher cost of capital … (sub. DR89, p. 2)

The approach also received endorsement from access regulators. In suggesting that the approach was preferable to access holidays, the ACCC referred to its use in the Central West Gas Pipeline determination:

> A practical example is the ACCC's decision on the Central West Pipeline in NSW, for which the ACCC approved a post-tax nominal return on equity of 15.4 per cent. For existing pipelines the corresponding returns on equity have been around 12-13 per cent. In the Central West Pipeline decision the ACCC recognised that as a greenfields pipeline it had greater risks than an established pipeline and this higher risk is reflected in the rate of return. (sub. DR93, p. 32)

It also commented that:

> Another feature of the Central West Pipeline decision was an initial regulatory period of ten years, in contrast with the more usual period of five years for established pipelines. Accordingly, in the event that actual volumes exceed forecasts, the service provider will be able to achieve a greater revenue stream than was forecast for an extended period. (p. 34)

The ACCC further observed that use of the Capital Asset Pricing Model (see chapter 13) does not prevent inclusion in the cost base of an allowance for the cost of ‘self insuring’ against specific project risk, or provision for faster depreciation to deal with the risk of regulatory-driven reductions in asset values (‘asset stranding’).

The NCC similarly argued that an adjustment to the cost base or the regulated return on capital is a viable way of dealing with risky new investment. As well as referring to the Central West Pipeline determination, the Council (sub. DR99, p. 19) said that it too had taken ‘account of greenfields issues in its approach to the NT/SA Rail certification’. And, in its submission, the ORG said that:

> … the assumptions adopted in the establishment of the price caps for [risky new investments] deal directly with the project specific uncertainties associated with the future demand and market developments and factors that may impact on costs. In certain circumstances, the Office has made conservative assumptions in favour of the regulated businesses given the uncertainty and imprecise nature of those matters. (sub. DR112, p. 7)

Others to express support for the approach included the Energy Users Association of Australia (sub. DR94, p. 31) and the Queensland Treasury. The latter commented:

> Another alternative would be to allow additional security (eg. longer review periods) and rewards (returns at the mid to higher end of a reasonable range) for socially desirable investments … which exhibit higher risk characteristics. (sub. DR105, p. 12)

However, not all participants saw increases in regulated rates of return as a ready solution to the problems facing investors in risky new infrastructure. For example, AGL implied that the higher rate of return granted in the determination for the Central West Gas Pipeline — to which reference is commonly made in this context — is in many respects superfluous. It stated:

> … in the case of the Central West pipeline, a higher cost of capital was assumed by the ACCC (for price determination) and a longer period between regulatory resets (10 years) was offered. ... However, the reality is that the viability of this project depends on significant regional growth (even if all the existing potential market connected to gas today the project would fail) and the market determines the prices that can be charged. … In other words, there is no need for regulation of this project in the foreseeable future (the market will do that) and the proposed ‘extended’ regulatory period does nothing to reduce risk. (sub. DR86, p. 11)

AGL went on to argue that a profit sharing arrangement (see below) would be a preferable way of addressing the truncation problem and providing greater certainty to investors.

The Commission's assessment

As part of a framework undertaking, ex ante provision for a higher regulated rate of return for a risky new investment could help to reassure potential investors and thereby reduce regulatory risk. However, the effectiveness of the approach in this regard, and in dealing with the truncation of upside returns accruing to successful projects, would depend crucially on the basis for awarding the additional premium for risk.

In essence, to address the truncation problem, the regulated rate of return (or the return provided by a price or revenue cap) would have to *exceed* the ex ante, risk-adjusted, cost of capital for a project. To illustrate this point, consider first what would happen in an unregulated market. There, a risky investment would proceed if the cost of capital was less than the expected weighted average return provided by the range of possible market scenarios. In some cases, risky investments would in practice deliver more than this expected rate of return, in other cases less. Importantly, however, higher expected returns under the more favourable outcomes would be required to balance expected losses under the less favourable ones.

Consider then what happens if the regulated rate of return is capped at the expected risk-adjusted rate of return for the project. This removes the possibility of high returns under more favourable market outcomes and thereby effectively reduces the expected ex ante return for the project. Other things equal, some investments will be deterred. This in turn serves to illustrate that simply reflecting the higher *average* expected risk attaching to new investments in regulated rates of return will not, of itself, address the truncation problem. This is because it does not directly tackle the source of the problem — namely, denial of the opportunity for the service provider to earn above the average expected return.

Thus, to deal with truncation via adjustments to a regulated rate of return, those adjustments would seemingly have to include a premium to compensate for the possibility of project failure. (Alternatively, under a CPI-X price or revenue cap arrangement there would have to be scope for a service provider to earn above its cost of capital under more favourable market outcomes — see below.)

Provision for dedicated 'truncation premiums' within access regulation has been canvassed by some commentators — see, for example, Cooper and Currie (1999). Nonetheless, a number of significant implementation issues would have to be addressed.

To deal with the truncation problem effectively, the premium would have to be large enough for the resulting regulated rate of return to equal or exceed the expected returns to investors under the majority of the upside outcomes factored into the investment calculus for a project. For a proposed project where returns under the various scenarios were expected to vary widely — that is, a relatively risky project — such a truncation premium could be very significant relative to the project's weighted average cost of capital.

Further, to calculate project-specific truncation premiums, the regulator would need to have detailed information on each new investment proposal. As discussed below, some of the access holiday proposals canvassed by participants would also have similar information requirements. Moreover, ex post pricing and rate of return determinations under current arrangements are also very information intensive (see next chapter). Nonetheless, given the degree of judgement involved, calculation of project-specific truncation premiums would inevitably become an additional source of gaming and disputation between investors and regulators. As the NECG commented:

> … the size of the contingency required for any particular project is almost impossible to determine objectively, and would become the subject of extensive debate between the firm and its regulator. (sub. DR113, p. 23)

There is also some possibility that a regulator would seek to claw back part of the truncation premium in negotiations on other aspects of the pricing or rate of return arrangements for a proposed project.

Finally, adding a premium to the regulated rate of return to address truncation could attract the same sort of public criticism as the failure to curb monopoly profits in an unregulated setting.

In responding to the Position Paper, the ORG implied that some of these issues can be, and have been, addressed through the use of CPI-X price or revenue caps:

> … the defining feature of CPI-X regulation is that price controls are set at the commencement of the regulatory period based on assumptions about the revenue requirements for the period of an efficiently operated business (including return of and on invested capital). Those price controls then remain unchanged for the regulatory period irrespective of the actual performance of the business.
>
> This no claw back feature of the regulatory approach provides regulated businesses with the incentive to pursue efficiencies and outperform the assumptions embodied in the price controls, including with respect to the cost of capital. Such efficiencies enable the business to earn and retain returns in excess of the assumed cost of capital within the regulatory period, without the risk that the regulator will subsequently disallow them.
>
> The suggestion that regulators might in fact 'rule out' returns for new investments above the projected cost of capital would only occur under a rate of return approach. (sub. DR112, p. 6)

However, in the Commission's view, reliance on these sort of incentives alone would be an inadequate response to the truncation problem and inferior to some sort of dedicated truncation premium:

- The magnitude of any prospective returns in excess of a project's cost of capital could be extremely difficult to predict at the time of investment.
- To the extent that any excess returns are dependent on service providers achieving greater efficiencies than provided for in the regulated determination, the mitigation of truncation is a residual outcome rather than an explicit goal.
- While the benefits of efficiency improvements can be retained in periods between regulatory resets, they are likely to be at risk of appropriation as part of those resets. Under current practice, most regulated infrastructure will be subject to several resets over its life.

Nonetheless, the observations by the ORG (and comments from some other participants) indicate that provision for explicit truncation premiums — agreed in advance — would, in some senses, be an extension of the direction in which regulators are already moving. The approach might therefore be more acceptable to both government and regulators than an exemption mechanism such as an access holiday.

The Commission further notes that the approach would be applicable where price or revenue caps, rather than direct rate of return regulation, were used to constrain access prices. Under a CPI-X price or revenue cap approach, the truncation premium could enter the equation via a reduction in the X factor. As such, the approach would also be compatible with moves to rely more heavily on productivity-based, rather than cost-based, price and revenue caps (see chapter 12).

Finally, the Commission observes that the disputation likely to be involved in determining investment-specific truncation premiums could be largely avoided by making provision for a standard premium. Indeed, according to Cooper and Currie (1999, p. 31), such an approach is almost inevitable:

> In principle, the correct way to deal with this problem is to adjust the expected cash flows by the impact of the asymmetric clawback provision. In practice it is unlikely to be easy to make the necessary adjustment in this way as it would involve estimating the probabilities of events about which, by their nature, the regulator must be uncertain. In reality, therefore, the adjustment is likely to take place by an *ad hoc* adjustment to the cost of capital that evolves over time with experience.

While such ad hoc adjustment could be viewed as an imprecise response to the truncation problem, 'rules of thumb' would also be required under access holiday arrangements (see below). Suffice to say that provision for a standard truncation premium would clearly be an improvement on the current situation.

Access holidays and other exemption arrangements

In the light of the Commission's in principle support for access holidays in the Position Paper and its subsequent development of how these might operate in a Part IIIA context, there was extensive commentary on exemption arrangements in second round submissions.

A small group of participants raised broad objections to exemptions. Reflecting a user perspective, Dwyer and Lim (sub. DR100) argued that exemptions via access holidays should not be entertained (see section 11.3). Conversely, some service providers suggested that the very concept of an exemption was inappropriate for infrastructure that should not be regulated in the first place. In this regard, Duke Energy International stated:

> With respect to access holidays, DEI does not consider them to be a solution to the regulatory risk associated with new projects unless they are in effect a perpetual null undertaking (that is, for the life of the asset). Anything less than a perpetual holiday will mean that the service provider remains uncovered early in the assets' life while the majority of the project risks are being resolved and will be covered at a time when the project may be achieving its potential. …
>
> As such, DEI considers that the aim of access holidays can best be achieved through a thorough review of the coverage criteria. (sub. DR95, pp. 2-3)

Some other service providers, while supporting the intent of an access holiday arrangement, questioned its usefulness. For example, AusCID said that an access holiday based around the concept of contestability would not apply widely enough:

> AusCID believes that there is great merit in the Commission's proposal on access holidays. However, a limited access holiday system that only affects a small number of projects will not solve the problems faced by investors that the Commission has previously identified. A wider system for determining access is needed, which balances the investor's need to minimise regulatory risk without providing excessive profits. (sub. DR117, p. 6)

Similarly, AGL observed:

> We do not think an access holiday provides the answer for investors concerned about regulatory risk. Any holiday that would remove the risk that the returns for successful projects may be truncated by regulatory intervention would have to occur towards the end of the project, not at the beginning of the project (when returns are below the cost of capital). (sub. DR86, p. 11)

The ACCC (sub. DR93, pp. 20-2) also questioned the efficacy and practicality of access holidays noting, among other things, that:

- there would be difficulties in identifying projects that should qualify for a holiday and determining the conditions that should apply to the holiday;

- given that early in the life of a project the objective of the service provider may be to maximise market growth rather than to monopoly price, fixed period exemptions may not be particularly effective; and
- implementation of holidays through null undertakings — as proposed by the Commission in the Position Paper — would be problematic, given the uncertainty surrounding most projects prior to construction.

However, there was also considerable support for the access holiday approach — although a number of those endorsing it proposed variations to the sort of model put forward by the Commission. Typifying this support, the Australian Gas Association argued:

> Access holidays represent a potentially valuable regulatory tool to address the specific issues facing new infrastructure or infrastructure expansions. The concept of access holidays is one that should be considered as a matter of priority.
>
> Access holidays address two key issues faced by proponents of new infrastructure in regulated environments. The first is that while access regulation effectively caps the profitability of a particular project, access regulation does not mitigate against losses if the project is unsuccessful. … The second issue is the regulatory risk represented by periodic reviews. By offering a measure of protection against regulatory intervention and regulatory resets for a set period that more closely aligns with the actual investment horizon of gas infrastructure assets, access holidays may reduce regulatory uncertainty. (sub. DR84, pp. 19-20)

And, reflecting on its difficulties in securing protection from exposure to Part IIIA for the Tarcoola to Darwin rail link, the Northern Territory Government said:

> The preferable approach would have been to allow an 'access holiday' (ie for the project to fall outside of the risk of declaration) for a period sufficient to satisfy the debt requirements of the project. The risk to efficiency would be minimal and an unambiguous 'access holiday' would provide much greater comfort to financiers. … this is consistent with the practice for major infrastructure projects overseas, such as the channel tunnel, where legislative exemption from prevailing access rules has been granted. (sub. DR111, pp. 3-4)

The key variations proposed by participants to the model floated by the Commission at the public hearings were encapsulated in an extensive commentary on access holiday options from the NECG (sub. DR113). In this submission, the NECG raised a range of possible criticisms of the access holiday approach and the Commission's specific model (see box 11.2). Nonetheless, it argued that access holidays could still be justified in a range of circumstances and that the economic basis for the contestability test in the Commission's model was appropriate:

> Where there is effective competition for the market, owners of new assets are constrained from earning monopoly rents by the threat of earlier entry by a rival firm, even in circumstances where they might otherwise have substantial *ex post* market

power. We therefore believe that the Commission is correct to focus its attention in this area — the type of project that would be covered by an access holiday under these rules would not generally be one that afforded the owner any *a priori* expectation of earning returns in excess of the cost of capital. (p. 12)

Box 11.2 **The NECG view on the efficacy of access holidays**

In its submission dealing specifically with access holidays (sub. DR113), the NECG commented on the model floated by the Commission at the public hearings and on some more general issues relevant to the use of this sort of instrument.

As discussed in the text, the NECG expressed support for the economic arguments underpinning the contestability test in the Commission's model. However, it raised concerns about a number of aspects of the Commission's proposed approach noting, amongst other things, that:

- A fixed-term holiday would commence during a project's loss making period and might have expired by the time 'investment is proved'.
- Conversely, if projects are very successful and provide very high returns to their owners by virtue of the access holiday, users are likely to raise concerns. This in turn might lead to a risk of 'regulatory opportunism'.
- Contestability may be a difficult concept to define in practice, particularly in relation to greenfield projects.
- A fixed-term access holiday does not, of itself, address the problem of 'regulatory taking' after the holiday has expired.

The NECG also raised two more general concerns with exemptions via access holidays. First, it noted the possibility that differentiation between 'old' and 'new' investments could divert resources away from maintenance and renewal of existing infrastructure. Second, it referred to the potential for inefficient pull forward of investment, commenting that in infrastructure markets:

> … *ex ante* competition for the market does not necessarily prevent the exercise of *ex post* market power. In circumstances where investment is contestable, monopoly rents are competed down to normal profits, but in a way that affects the timing of the investment rather than the prices paid by customers. It is therefore correct to point out that there is some danger that awarding access holidays to risky, but marginal, projects would serve to both distort the timing of investment and to increase the prices that customers pay. (p. 18)

However, the NECG emphasised that such concerns do not invalidate the access holiday concept. In particular, in relation to the investment timing issue, it contended that:

> The correct comparison is not with the outcome that would be achieved by an omniscient social planner, but with the current situation in which regulatory risk is deterring new investment. (p. 18)

(continued next page)

Box 11.2 **continued**

It went on to outline some particular circumstances in which (fixed-term) exemptions might be justified, but suggested that:

> … we believe that there are variations to the Commission's proposals that can better incentivise new investment, but also reduce the impact of these distortions and so remove any need to evaluate, say, the 'riskiness' of the project or whether the services provided to customers are genuinely 'new'. (p. 19)

These variations are discussed in the text.

For its part, the Commission acknowledges the validity of a number of the points made by the NECG. For example, it concurs with the view that investment pull-forward matters should be assessed against outcomes under the regulatory alternative, rather than against some sort of theoretical ideal. And, as discussed in the text, there is merit in a number of the NECG's suggested variations to the Commission's access holiday model to address the sort of concerns outlined above. Indeed, the Commission's assessment criteria specifically recognise most of the NECG's concerns.

However, as discussed in the text, the NECG's own proposals are not without problems, illustrating how difficult it can be to intervene effectively in this area.

Source: NECG, sub. DR 113

However, the NECG suggested that variations to, and augmentation of, the Commission's model could enhance incentives for efficient investment and reduce some of the potential draw-backs of a stand alone, fixed-term, holiday approach. Specifically, it canvassed three variations:

- Exemption for projects awarded by competitive tender, implemented by a null undertaking which would specify that no *regulated* access would be provided for the period specified in the tender.
- Exemption until such time as the Net Present Value (NPV) of an investment, discounted using a rate of return agreed on in advance by the project proponent and the regulator, became positive. Thereafter, the project proponent would be allowed to retain a share of the profits — again based on an advance agreement with the regulator.
- Exemption for the lifetime of the asset, with terms and conditions instead established by an undertaking agreed with the regulator prior to investment.

In elaborating on these options, the NECG observed that a key characteristic of the latter two is that they would provide some ex ante certainty about the regulatory environment for the life of a project. It said that a lack of certainty about the regulatory environment after a fixed-term holiday expired was a drawback in the sort of model proposed by the Commission.

The NECG's third variant is identical to the framework undertaking proposal put forward by AusCID and discussed above. Accordingly, it is not considered further here.

The second variant was also canvassed in submissions from individual service providers such as AGL (sub. DR86). Moreover, in criticising the Commission's fixed-term holiday model, Dwyer and Lim commented that:

> Instead of a time-defined access holiday, it would make more sense (in this very sub-optimal scenario) to allow an access holiday only for the period until all capital costs had been recouped with a hurdle rate of return ... (sub. DR100, p. 11)

Dwyer and Lim also lent some support to the resource rent tax approach underpinning the profit sharing that would occur under this variant once a project became NPV positive.

Further, a number of other participants raised the possibility of exempting projects awarded by a competitive tender from exposure to Part IIIA (or other access regimes). For example, the Chamber of Minerals and Energy of Western Australia proposed that:

> … infrastructure proponents [would] participate in a reverse tender of terms and conditions for a standard project, with the lowest bidder able to charge those terms for a specified period. (sub. DR66, p. 5)

The Energy Users Association of Australia and Dwyer and Lim similarly supported such an approach (see also box 5.1). The Association suggested that:

> … consideration be given to the auctioning of monopoly franchises or access to the bidder offering users the lowest prices for a certain service, so that the public or infrastructure users can obtain some benefits from the awarding of monopoly rights. Such franchises would need to be for a specific time after which they would be re-auctioned or open to wider entry. In this way, society is better off: the infrastructure investment is undertaken and society or infrastructure users capture some benefits from the monopoly rents. (sub. DR94, p. 32)

The ACCC (sub. DR93) and the ORG (sub. DR112) also alluded to the role of capacity auctions as an alternative to regulation for setting access prices.

The Commission's assessment

The access holiday/exemption issue is clearly very complex. While all of the access holiday variants (and the truncation premium approach) ultimately operate on a project's net present value, they do so in different ways with different implications for both service providers and users.

These differences in turn bring to the fore the many trade-offs and uncertainties involved in this area. Nonetheless, the input from participants in response to the Position Paper has helped the Commission to refine its thinking on some of the characteristics that any exemption arrangements should have and the situations in which they might apply.

In the Commission's view, permanent exemptions from Part IIIA (or other access regimes) would not be appropriate. This is despite the fact that, for risky marginal projects, a permanent exemption would be required to address the regulatory truncation problem fully. However, permanent exemptions could have unwanted side effects. For example, if they were only available for investments to provide new services, they could encourage excessive maintenance to extend the life of exempt facilities. Also, the possibility of inefficient pull forward of investment may be somewhat greater with permanent exemptions than with conditional or temporary exemptions. Like very high regulated rates of return, perpetual exemptions could also create considerable disquiet among users and the wider community, possibly making them difficult to sustain.

Further, the Commission agrees with participants that where a government allocates the right to build and operate an essential infrastructure facility by competitive tender, that facility should be exempt from (other) access regulation for the period of the tender. Indeed, from a theoretical perspective, such competitive tendering has major attractions in that the role of competition in dissipating any prospective monopoly rents will be manifested through lower prices for access seekers rather than through advancing the timing of investment. In addition, it obviates the need for subsequent regulatory involvement in the establishment of access prices — the source of most of the concerns of both service providers and access seekers. As the NECG noted:

> The essence of this mechanism is that potential owners of infrastructure are requested to define just how much 'blue sky' they require before committing to the investment. From a theoretical perspective, it facilitates the market mechanism focusing on the most contentious issue (ie the area of greatest complexity), being the nature of the risk associated with the project. This is appropriate given a regulator's inherent informational asymmetry and its inability to accurately assess the cost of capital associated with risky investment. (sub. DR113, p. 21)

Competitive tendering is also likely to rate highly against the community acceptability criterion. Not only does it provide some certainty to users about the access prices that will prevail in the future, but it provides assurance that (for the period of the tender) prices will not embody significant monopoly rent.

However, the circumstances in which this sort of approach could be used are limited. This is because it requires government control or sponsorship of a project

— as in the case of the Tarcoola to Darwin rail link. As discussed in box 5.1, extension of a competitive tendering approach to most privately driven projects could lead to major inefficiencies. In effect, it would require government to takeover projects when development applications or project approvals were lodged. Without provision to compensate project proponents for the appropriation of their intellectual property — a very difficult task in its own right — incentives for innovation would inevitably be compromised. The NECG (sub. DR113) and Epic Energy (transcript, p. 442) were among the participants who drew attention to this problem.

Moreover, the use of competitive tendering would not usually remove the need for regulatory oversight of non-price aspects of service provision such as service quality. For some essential services, these aspects are as important as the access price (see chapter 3).

These limitations should not be seen as ruling out the use of the mechanism. Indeed, for a project such as the construction of the second airport in Sydney, it may well be the best way of achieving efficient access provision and pricing. However, like provision for binding rulings, competitive tendering of projects is not a general solution to the investment problem.

The Commission also notes that the ACCC's proposal to give exemptions from Part IIIA to service providers that allocate capacity in their facilities through capacity auctions does not represent a more generalisable permutation of the competitive tendering approach. As discussed in box 5.1, without a requirement to make available spare capacity in a non-congested infrastructure facility, auctioning will do little to curb any market power enjoyed by the service provider.

As regards what might be termed the 'mainstream' access holidays proposals, the Commission observes that a whole range of permutations could be contemplated — some with different features again than those models canvassed above. For instance, in its report on telecommunications competition regulation (PC 2001c), the Commission has discussed an approach based on giving an exemption from price control, but on the condition that access is granted to all users in an open and non-discriminatory fashion (see box 11.3).

In terms of generic characteristics, the Commission sees some advantages in linking an exemption from Part IIIA to a project's net present value:

- This would address concerns that a somewhat arbitrary fixed-term holiday could end while a project was still in the red. (However, in so doing, it would make the hurdle rate of return for a project — itself a contentious and somewhat arbitrary concept — the driver of outcomes.)

Box 11.3 **An access holiday approach for vertically integrated service providers**

Implicit in the access holiday proposals canvassed in the text is that, during the holiday, it would be up to the service provider to determine how best to exercise its market power. Thus, a provider would be free to deny access as well as to charge monopoly prices for it. As discussed in chapter 3, the former is particularly (though not exclusively) relevant to vertically integrated service providers, who may be able to maximise the value of their market power by denying access to potential competitors in downstream markets.

However, in its report on telecommunications competition regulation (PC 2001c), the Commission has canvassed a less 'permissive' variant of the access holiday approach that might be appropriate for investments made by a vertically integrated service provider such as Telstra. The key feature of the approach would be an exemption for Telstra from regulation of access prices on the condition that it provided open and non-discriminatory access to its competitors in downstream markets. That is, the approach would allow monopoly pricing but not denial of access. While the approach canvassed by the Commission envisages that the exemption would apply in perpetuity unless there was evidence that Telstra had attempted to deny access, such an arrangement could equally apply for a pre-determined period, or until such time as a project became NPV positive. The South Australian Government (sub. DR121, p. 9) also suggested such an approach.

The rationale for allowing one form of monopoly behaviour but not the other is that outright denial of access would be more damaging to dynamic efficiency in downstream markets than monopoly pricing. While the Commission does not consider this argument to be relevant or appropriate for most infrastructure sectors (see chapter 3), in the rapidly evolving telecommunications market, there does appear to be a case for such differentiation. In essence, denial of access could stifle the significant and ongoing innovation which has characterised the market in recent years and brought significant benefits to consumers. This argument is developed in detail in the Commission's telecommunications report.

The Commission notes that the 'constrained' access holiday approach has elements in common with the so-called Efficient Component Pricing Rule. This rule sets a price for access based on the cost to the integrated incumbent of providing access, plus the revenue it forgoes in the downstream market by virtue of competition from the access seeker. While the theoretical validity of the rule has been widely debated, its intent is to encourage entry when an access seeker can deliver a downstream service more efficiently than the integrated incumbent. The access holiday variant canvassed in the Commission's telecommunications report would provide similar incentives.

- Relative to a fixed-term holiday, the approach would provide greater certainty about the extent of regulatory truncation. That is, linked to an agreement allowing a facility owner to retain a pre-determined share of the profits if a project becomes NPV positive, the degree of truncation would be known at the time of investment. While a (long) fixed-term holiday might in fact result in a lesser degree of truncation, the precise extent of that truncation could be difficult for investors to assess in advance. (Of course, an ex ante agreement on post-holiday arrangements could also apply to a fixed-term exemption — thereby increasing certainty for investors.)

- It would avoid any potential for regulatory moral hazard that might arise in setting terms and conditions of access for a successful project that had been declared following the expiry of a fixed-term holiday.
- It would reduce the need to define eligibility for the holiday. Indeed, in the limiting case, such an arrangement could apply to any new investment that did not qualify for an exemption from Part IIIA by virtue of more narrowly applicable mechanisms such as binding rulings.
- Unless the profit share retained by the service provider in the event of a positive NPV outcome was very high, the approach would most likely meet the community acceptability criterion. That is, it would be evident to users that they would not be exposed to unfettered monopoly pricing for an extensive period — a perception that might arise if a very successful project had been granted a long fixed-term access holiday.

However, relative to a fixed-term holiday, the NPV approach would also have disadvantages.

For example, as alluded to above, while offering the prospect of greater certainty about the degree of regulatory truncation than a fixed-term holiday, the NPV approach with subsequent profit sharing would not necessarily result in a lesser degree of truncation. Conceivably, a 20 year access holiday might involve a lower *average* level of truncation than an NPV approach with, say, provision for the service provider to retain 20 per cent of the profits if a project was successful. In other words, the relative merits of the two approaches against the regulatory truncation criterion depend crucially on the detailed parameters of each.

Perhaps more importantly, the NPV approach would be much more information intensive, requiring ongoing monitoring of a firm's costs and revenues. Another consequence, acknowledged by the NECG (p. 22), is that the potential for disputation between the service provider and regulator would be high. Apart from the need to agree prior to investment on both the cost of capital for the purposes of assessing when the project became NPV positive and on the profit sharing arrangement to apply thereafter, interpretation of revenue and cost data after a facility was constructed might also be the subject of dispute between the parties. Also, the information disadvantage suffered by the regulator could leave it exposed to gold plating and other ‘gaming’ behaviour by service providers — a potential source of disquiet amongst service users and the wider community.

That said, it is important to recognise that these sorts of problems are also inherent in the current cost-based arrangements for setting access prices after the event (see chapter 12). Indeed, the information required to implement an NPV-based access holiday would be little different from that currently collected by access regulators. And, as noted above, the need for similar information collection and monitoring would also arise under the truncation premium approach. Even the fixed-term access holiday is not totally immune in this regard — declaration of a facility after a holiday had expired would again give rise to the same sort of information and monitoring needs.

The Commission also observes that the NPV approach would require further refinement before it could be implemented. For example, an acceptable definition of ‘profit’ for the purposes of the profit sharing arrangement would have to be agreed (see chapter 12).

In addition, there is the question of how profits not retained by the service provider would be returned to consumers. ‘Consumer dividend’ mechanisms to give effect to these sorts of transfers have been used overseas as part of price cap arrangements (see chapter 12 and sub. DR96). But whatever their feasibility, the need for such transfer measures would raise equity issues. For instance, should users benefit in proportion to their use of the service, or should reductions be linked to willingness to pay? Should the nature of the reductions be left to the discretion of the service provider or should the regulator have some say?

In sum, were an access holiday approach to be adopted, a case could reasonably made for either fixed-term or NPV-based holidays. Again, however, adoption of either approach would constitute an improvement on the current arrangements.

An extension of the profit sharing approach

As noted, the profit sharing component of the NECG’s second access holiday variant has much in common with a resource rent tax. The NECG (sub. DR113) and AGL (sub. DR86), which also advocated a profit sharing approach, explicitly referred to these parallels, with the former observing:

> It is an approach that has been used, with some success, in the petroleum industry. The Petroleum Resource Rent Tax … applies to offshore petroleum exploration and production, but a tax is not imposed until such time as the NPV … of the project, discounted by a factor equal to the relevant cost of capital, is positive. We see no

> reason why a similar approach could not be incorporated into the TPA. (sub. DR113, p. 22)

Dwyer and Lim also saw merit in this general approach:

> … the resource rent tax … approach … seeks to allow investors to recoup investment plus a reasonable rate of return and only appropriates super-normal returns as rent to government. … [It] might be thought of as akin to a system of taxing the profits of a network infrastructure owner and rebating the proceeds to users as a discount on their access charges. (sub. DR100, p. 7)

However, with a sharing of profits if a project is successful, the regulatory truncation problem will not be fully addressed. This is because, *ex ante*, the service provider will only factor into the investment calculus part of the above normal profits potentially accruing to a successful venture.

In contrast, were infrastructure investors to hold a significant number of projects in their portfolio, and if the profit sharing provisions applied to the net return achieved across all of those projects, then the truncation problem would be much better addressed. In effect, investors could balance losses on unsuccessful projects against profits on successful ones, with a 'regulatory levy' applying only if the overall return was positive. In the limiting case, only genuine monopoly rents would be taxed.

But the very high cost of essential infrastructure facilities means that some investment occurs on a stand-alone basis. Moreover, even where an investor has an interest in a number of projects, there is no provision to average returns across them. That is, investments in essential infrastructure are regulated on a project-by-project basis.

Accordingly, the question arises as to whether the outcome of the sort of regulatory averaging process described above could be replicated within a regime which continued to set returns on a project-by-project basis. One possibility would be to allow owners of essential infrastructure covered by an access regime to trade regulatory 'unders' and 'overs'.

In broad terms, such an arrangement might work as follows. Owners of facilities that are unlikely ever to achieve the regulated cost of capital determined ex ante for those facilities, could sell credits — reflecting the difference between actual profits and the higher regulated rates of return — to the owners of successful projects with capacity to earn above regulated returns. These credits would then be used to defray the regulatory levy on those successful projects that would otherwise arise under the applicable profit sharing arrangements. (Where an entity had an interest in a number of infrastructure projects, credits could simply be transferred within that entity rather than sold to another investor.) At least in theory, profit sharing with the regulator (on behalf of users) would again apply only to genuine monopoly rent.

Moreover, investors would presumably take into account the possibility of selling (or transferring) credits if a project proved to be unsuccessful. This would remove or reduce downside risk and, in so doing, address the regulatory asymmetry that underpins the truncation problem.

The Commission has not had the opportunity to test whether this conceptual approach would work in practice. Apart from possibly significant administrative costs, there would be questions about whether markets for credits would be sufficiently deep to produce the outcome hypothesised above. Also, the approach would require close monitoring of transactions by the regulator and might have tax implications.

That said, the essence of the approach is not dissimilar to the trading of pollution credits which is increasingly being used to pursue environmental objectives. Thus, in a situation where further refinement of approaches for facilitating efficient investment within access regimes will inevitably be required, the Commission sees value in such considerations encompassing this extension of the profit sharing approach.

11.5 The way ahead

Notwithstanding the practical difficulties, in the Commission's view, the case for introducing mechanisms to facilitate efficient investment within the national access regime in particular, and access regimes more generally, remains compelling. While the preceding discussion is not definitive on how best to proceed, it does help to delineate a number of features which the policy response should embody.

At the broad level, the Commission considers that the policy response should provide regulators with more than one instrument to facilitate efficient investment. Clearly, differences in the nature of investments within and across infrastructure sectors mean that one size will not fit all. As described below, the Commission sees the need for at least three different generic instruments.

There will also be advantages in employing instruments that apply for the life of a piece of infrastructure, or at least a significant part of it. A legitimate criticism of recent initiatives to increase regulated rates of return for risky new investments is that those higher rates of return are subject to review at a still relatively early stage in the life of the infrastructure concerned. Hence, the degree of certainty provided to investors may not be greatly increased.

As regards specific instruments, the Commission considers that provision for binding rulings and exemptions for new projects awarded through a competitive tender should be introduced to Part IIIA as soon as possible. However, these instruments would only apply in a relatively limited range of circumstances. Thus, an additional instrument (or instruments) is required to facilitate efficient investment in other situations. The nature of this more general mechanism is a matter that will require further detailed analysis and discussion among the principal parties after the completion of this inquiry.

Binding rulings

For a proposed infrastructure facility that is unlikely to enjoy any significant market power, provision to obtain a binding ruling that the Part IIIA declaration criteria are not met could greatly reduce regulatory risk. This would obviate the need to use potentially more costly and time consuming mechanisms, such as certification or pre-construction undertakings, to remove any threat of (inappropriate) declaration under Part IIIA. In turn, the scope to reduce regulatory risk more cost-effectively would lower a project's cost of capital. In some cases, this could be the deciding factor in whether the project proceeded. Moreover, even if no (negative) binding ruling eventuated, the process and the views elicited from the regulator would still help to reduce regulatory risk.

That said, it is important to recognise that binding rulings, prior to investment, that the declaration criteria are not met are unlikely to be all that common. This is because significant market power *is* likely to attach to many essential infrastructure facilities once they are in operation. Consequently, binding rulings cannot be a generally applicable instrument for dealing with concerns about regulatory risk and unwarranted regulatory truncation of balancing upside returns.

As regards administrative arrangements, the Commission would see it as appropriate for Ministers to be responsible for granting binding rulings on advice from the NCC. This would be consistent with the current role for Ministers in deciding on other Part IIIA coverage matters, which the Commission has proposed should continue (see chapter 14).

It also agrees with participants that there should be provision for revocation of a binding ruling by the Minister on advice from the NCC if there is a material change in circumstances. Consistent with the revocation provisions for declaration, such a revocation should be appellable to the Australian Competition Tribunal. Making provision for such appeals would, in turn, reduce the need to define in the legislation what constitutes a 'material change in circumstances'.

However, whether an initial binding ruling should be appellable is a much more complicated issue.

As noted earlier, provision for appeals would increase the time and costs involved in the process. Further, allowing for appeals from access seekers after a facility has been built would undermine the whole basis of the instrument.

On the other hand, consistency with the Commission's proposal to provide for merit review of 'voluntary' undertaking applications (recommendation 15.1) might suggest that service providers should also have a right of appeal against decisions not to grant a binding ruling. Similarly, given that a binding ruling process would merely bring forward the decision on whether a piece of infrastructure should be covered by Part IIIA, there is an argument that there should be comparable appeal rights to those attaching to declaration decisions. Also, without scope for user interests to seek merit review, there is the possibility that the binding ruling process could be used to circumvent legitimate exposure of particular essential infrastructure facilities to the Part IIIA regime.

In sum, the issue of whether appeal rights should attach to decisions on binding rulings is finely balanced. Moreover, the considerations involved received very little attention in submissions, meaning that the Commission did not have the benefit of views from those parties that would be directly affected by provision for appeals or lack thereof. Accordingly, the Commission considers that the question of what appeal rights, if any, should attach to the initial decision on an application for a binding ruling should be resolved as part of the broader process to refine measures to facilitate efficient investment within access regimes (see recommendation 11.3).

RECOMMENDATION 11.1

Part IIIA should make provision for the proponent of a proposed investment in an essential infrastructure facility to seek a binding ruling on whether the services provided by that facility would meet the declaration criteria. Where the Minister, after receiving advice from the National Competition Council, determines that they would not, the services concerned would be exempt from declaration.

A binding ruling should apply in perpetuity, unless revoked by the Minister on advice from the Council on the grounds of a material change in circumstances. Such a revocation should be appellable to the Australian Competition Tribunal.

Projects awarded by competitive tender

The Commission also sees a clear cut case for providing immunity from Part IIIA to essential infrastructure services where both the service provider and the terms and conditions of access are to be determined through a competitive tendering process.

While competitive tendering will generally only be appropriate for government-sponsored projects, its use is likely to see any monopoly rents expected to attach to the facilities concerned dissipated in more favourable terms and conditions for service users, rather than accruing to the provider or resulting in earlier investment. Moreover, specification of the tender aside, the need for regulatory involvement in the establishment of access prices would be avoided.

In the Commission's view, relatively little administrative discretion should be involved in determining whether a tendered project would qualify for immunity from Part IIIA. In essence, the government sponsoring the project would simply have to demonstrate that:

- the licence to construct and operate the facility is to be awarded through a competitive process; and
- favourable terms and conditions of access will be a key consideration in selecting the preferred tenderer.

The Commission therefore considers that such decisions could reasonably be made by the ACCC, rather than by a Minister on advice from the NCC. Moreover, given the limited judgement that should be involved in these determinations, the case for an appeal right would not be strong. There would, however, have to be a provision to revoke the exemption if evidence emerged that the tender had not, in fact, been conducted in accordance with the information initially presented to the ACCC. Like other revocation arrangements in Part IIIA, such a provision should incorporate a right of appeal for the service provider.

RECOMMENDATION 11.2

Where the licence to construct and operate a government sponsored essential infrastructure facility is to be awarded by an appropriately constituted competitive tendering process, there should be provision in Part IIIA to provide the services concerned with immunity from declaration.

Specifically, the Australian Competition and Consumer Commission should be able to issue an immunity for the term of the tender where the government concerned can demonstrate that:

- ***the licence to construct and operate the facility is to be awarded through a competitive process; and***

- ***favourable terms and conditions of access will be a key consideration in selecting the preferred tenderer.***

Provision should also be made to revoke the exemption if it transpires that the conduct of the tender does not conform with the arrangements on which the Commission's decision was based. Such a revocation should be appellable to the Australian Competition Tribunal. The Commission's initial decision should not, however, be appellable.

A generally applicable approach for addressing regulatory risk and the truncation of returns

As regards an instrument to promote efficient investment in facilities that would not qualify for exemptions from Part IIIA under the preceding two mechanisms, the best way ahead is less clear.

All of the instruments that could potentially be used have drawbacks:

- Framework undertakings would not, by themselves, address the truncation problem. That is, some other instrument — for example, provision for a truncation premium in the allowed rate of return — would have to be incorporated within the undertaking.
- While NPV-based access holidays with subsequent profit sharing have a number of intuitive attractions — including avoiding the need to define the period of, or eligibility for, the holiday — they would be information intensive, prone to disputation and open to gaming. In effect, they would suffer from many of the same problems as the current arrangements for regulating access prices once facilities are in place. As discussed in the next chapter, the intrusiveness of these arrangements has been widely criticised by service providers.
- Provision to include a truncation premium in the allowed rate of return would similarly be complex and prone to disputation.
- Conversely, fixed-term access holidays, while avoiding many of these complexities, would be more arbitrary and uncertain in impact. Eligibility criteria would also have to be determined, again giving rise to the possibility of gaming and potentially to some distortions in investment patterns.
- Finally, the feasibility of a 'pure' profit sharing approach, with trading of regulatory 'credits', is far from clear.

That said, it is important not to overstate these difficulties. As noted, most are already part and parcel of current regulatory arrangements. Moreover, the Commission emphasises that the introduction of virtually any form of access holiday or truncation premium arrangement would constitute an improvement on the current situation.

In many respects, the choice of instrument will depend on the priority attached to administrative simplicity and reducing the intrusiveness of access arrangements. In this regard, the Commission continues to see considerable merit in a fixed-term access holiday arrangement. In effect, it would avoid the need for any regulatory involvement in a service provider's affairs for the duration of the holiday.

As suggested in the Position Paper, eligibility for such a holiday could be based on a project's contestability at the construction phase. Interpreted as the absence of barriers to competition at the time of construction, a contestability-based test would see many new infrastructure investments eligible for a holiday. There could also be provision for investors in non-contestable projects to make a case to the regulator for a holiday.

As regards the length of the holiday, it would obviously have to be of sufficient duration to provide scope for investors in a successful project to recoup some balancing upside returns. Given considerable differences between infrastructure sectors in the investment environment, a generally applicable period for the holiday would most likely be too arbitrary. Hence, a possible refinement would be to vary the length of the holiday across sectors to reflect differences in typical pay-back periods for investments. For example, pay-back periods are usually much longer in the energy sectors than in the rapidly evolving telecommunications sector. In some sectors, contract lengths for foundation customers would provide an indication of what the duration of the holiday should be.

However, as discussed earlier, the approach would bring a new set of problems. Apart from eligibility issues, the somewhat arbitrary nature of a fixed-term holiday would most likely be a source of ongoing concern to service providers and users alike. Further, once a fixed-term holiday had expired, access pricing would become subject to the standard Part IIIA arrangements. As noted, these arrangements are no less information intensive and intrusive than NPV-based access holidays or the truncation premium approach.

Of the more 'precise' mechanisms, the Commission sees important advantages in the truncation premium approach. In contrast to an NPV-based access holiday, it could operate within the current Part IIIA framework, rather than requiring the implementation of a new mechanism. As noted, in some respects it would simply be an extension of the direction in which some access regulators already profess to be moving. Thus, it may be more acceptable than a completely new approach.

Further, greater use of productivity-based measures to regulate access prices and revenues (see chapter 12) would seemingly be easier under the truncation premium approach than under an NPV-based access holiday. This is because revenues and costs are key drivers of both the length of an NPV-based holiday and the profit retained by a service provider once a project has returned its cost of capital.

The Commission envisages that the truncation premium approach would be implemented via framework undertakings agreed between the regulator and the service provider prior to an investment occurring. To simplify the negotiation process, and to reduce the possibility of any regulatory 'claw-back' of the premium through reductions in a project's regulated weighted average cost of capital, there would be considerable advantages in setting a standard truncation premium rather than determining it on a project-by-project basis. Again, the standard premium could vary between sectors.

In comparing the truncation premium approach with fixed-term access holidays, the Commission has some leaning towards the former. This is primarily because it could operate within the current Part IIIA architecture. Also, as part of a framework undertaking, it could deliver some certainty about the regulated terms and conditions of access for the life of an asset. In contrast, under a fixed-term access holiday arrangement, the nature of any regulatory involvement in access prices and conditions after the holiday expired would not be known at the time of investment.

However, the Commission is not recommending that either of these approaches be adopted in Part IIIA at this stage. In its view, further analysis is required before any such measures are introduced. It is also desirable that the measures ultimately implemented are tested with interested parties rather than simply being imposed upon them.

Accordingly, the Commission considers that the Commonwealth should take a lead role and, through the Council of Australian Governments, initiate a process directed at refining mechanisms to help ensure that new infrastructure investments are not unreasonably deterred by exposure to access regulation. Given the imperative for such mechanisms, the process should be undertaken with a view to incorporating generally applicable mechanisms within the Part IIIA regime no later than 2003.

As part of this process, consideration should be given to whether such mechanisms, and those proposed in recommendations 11.1 and 11.2, would increase the risk of actions under Section 46 of the Trade Practices Act or Part IV more generally. If there was a prospect that Part IV actions might be used to frustrate the new measures, then the Commission would see a case for explicit provisions in Part IIIA to quarantine *sanctioned* arrangements from exposure to Part IV.

RECOMMENDATION 11.3

The Commonwealth Government should, through the Council of Australian Governments, initiate a process to refine mechanisms (additional to those provided for in recommendations 11.1 and 11.2) to facilitate efficient investment within the Part IIIA regime in particular and access regimes generally. The mechanisms to be considered should include:

- ***fixed-term access holidays available to any proposed investment in essential infrastructure which is determined to be contestable; and***
- ***provision for a 'truncation' premium to be added to the cost of capital that has been agreed between a project proponent and the regulator prior to investment.***

This process should be completed in sufficient time to enable legislative implementation within Part IIIA no later than 2003.

12 Pricing principles for Part IIIA

A range of pricing approaches are used in the various access arrangements operating under the Part IIIA umbrella. For instance:

- Price control under the electricity and gas regimes involves revenue caps for transmission services and price or revenue caps at the distribution stage. The Gas Code combines such caps with reference tariffs. While the National Electricity Code does not require reference tariffs to be published, its principle of non-discriminatory pricing effectively imposes a uniform pricing approach.
- Rail access regimes generally contain the requirement that prices for access are to be between a floor and a ceiling. The floor is set by incremental cost (the direct cost incurred in providing access), while the ceiling is set by stand-alone cost (the cost if the system delivered only the service sought by the access seeker).
- As yet, there have been no arbitrations by the Australian Competition and Consumer Commission (ACCC) for declared services under Part IIIA. However, in arbitrations under the telecommunications access regime, the ACCC has generally adopted the total service long-run incremental cost approach for key bottleneck services — as implemented, a form of average cost — to set access prices.

While there are some similarities in the pricing principles underpinning these arrangements, there are also significant differences (see box 12.1). Some variations in approach are inevitable given differences in the characteristics of each sector. However, many participants expressed concern about unwarranted divergences in the pricing and other requirements of individual regimes (see chapter 5).

As discussed in chapter 6, the Commission considers that introducing pricing principles into Part IIIA would have a number of benefits. In particular, it would provide better guidance and thereby more certainty on how the broad objectives of the regime should be applied. Further, such principles could also condition the pricing approaches adopted in industry-specific regimes, and hence help to address the concerns alluded to above.

This chapter assesses what particular pricing principles would be appropriate for Part IIIA and examines a number of issues that would arise in implementing them.

In this latter context, the Commission notes that while the mechanisms discussed in chapter 11 to facilitate efficient new investment would effectively override the application of the pricing principles in specific instances, such mechanisms are, nevertheless, fully consistent with the intent of the principles set out in this chapter.

Box 12.1 **Pricing principles for access regimes**

The ACCC has established three pricing principles to apply to assessment of Part IIIA undertakings and the pricing of declared services under the telecommunications access regime:

- Pricing should be cost-based;
- Access prices should not be inflated to reduce competition in related markets; and
- Access prices should not discriminate in a way which reduces efficient competition.

Under the National Electricity Code, Schedule 6.7 contains the following principles for network pricing:

- Cost-reflective pricing;
- Non-discriminatory pricing of network services;
- Compatibility with market trading arrangements;
- Network prices for economically efficient investment;
- Network interconnectors managed to reduce the barriers to a national market; and
- Published and transparent network prices.

Under the National Gas Code, Clause 8.1 states that a reference tariff and reference tariff policy should be designed with a view to achieving the following objectives:

- Providing the service provider with the opportunity to earn a stream of revenue that recovers the efficient costs of delivering the reference service over the expected life of the assets used in delivering that service;
- Replicating the outcome of a competitive market;
- Ensuring safe and reliable operation of the pipeline;
- Not distorting investment decisions in pipeline transportation systems or in upstream or downstream industries;
- Efficiency in the level and structure of the reference tariff; and
- Providing an incentive to the service provider to reduce costs and to develop the market for reference and other services.

Source: National Electricity Code, National Gas Code, ACCC 1999.

12.1 What should pricing principles seek to achieve?

The proposed objectives of Part IIIA provide the starting point for developing access pricing principles. Chapter 6 recommended that the objectives of Part IIIA should be to:

(a) promote economically efficient use of, and investment in, essential infrastructure services; and

(b) provide a framework and guiding principles to discourage unwarranted divergence in industry-specific access regimes.

These objectives are directly applicable to access pricing. That is, access prices should promote efficient use of essential infrastructure without detracting from efficient investment.

The Position Paper argued that in order to meet these objectives, it is necessary to set access prices at the right *level* and adopt an appropriate *structure* of prices.

Level of access prices

The benchmark for achieving efficient use of infrastructure is for the price of access to an additional unit of a service to be equal to the cost, or the additional resources used to produce that unit. Prima facie, this implies that prices should be set at the short-run marginal cost (SRMC) of producing the unit. As King says:

> If price were below SRMC there would be excessive demand for the product. If the producer were to meet this demand, then some consumers would purchase the good, despite the marginal cost of production being greater than their personal value. … It is also undesirable to set the price so that a potential purchaser who does value the output at more than the marginal cost of production is dissuaded from buying the product. Such a failure to purchase would lead to a social loss as the cost of providing the product is less than its value to the purchaser and yet the product has not been provided. (sub. 1, p. 17)

But most infrastructure services involve high fixed costs, and often exhibit declining average costs across the relevant range of output. If average costs are declining, marginal cost will be below average cost. Setting a single uniform price at marginal cost would result in the owner facing a revenue shortfall (see box 3.3).

To address this shortfall, Dwyer and Lim (sub. DR100, p. 9) argued that governments should tax any windfall gains in land values arising from infrastructure developments and use these funds to meet the fixed costs of the infrastructure concerned. SRMC pricing would then be possible. Others have argued that full cost recovery is possible under a SRMC pricing approach provided that SRMC incorporates congestion costs once a facility is operating at full capacity.

However, both approaches have major shortcomings (see box 12.2). Indeed, in an inquiry into the water sector, the Industry Commission (IC 1992, p. 62) traced many of the problems in the sector to previous policies of not charging users the full costs of the services they received:

> If people in particular city or region know that a significant part of the costs of their infrastructure will be borne by taxpayers as a whole, they will have an incentive to demand a level of service which exceeds their true willingness to pay. Just as importantly, where governments pick up the bill, water authorities have few incentives to resist unreasonable demands.
>
> … The general consensus among both water agencies and governments is that past government acceptance of cost under-recovery has been the main reason for the plethora of ill judged investments in infrastructure in the Australian water sector.

Box 12.2 **Recovering capital costs under SRMC pricing**

In theory, pricing infrastructure services at short run marginal cost is not inconsistent with recovering capital costs over the longer run.

SRMC will initially be below average cost, and while ever there is excess capacity in the facility, the owner would not receive a return on its investment. However, when the facility reaches capacity, rationing of the service will cause SRMC to rise above average cost. This occurs because SRMC includes opportunity costs. Thus, where there is a capacity constraint, the opportunity cost of providing access to one customer is the value placed on the service by the customer who misses out. When SRMC exceeds average cost, prices will begin to recover capital costs and signal that new investment is required.

Yet such an approach is rarely, if ever, employed for infrastructure pricing. Many infrastructure assets are long-lived and SRMC pricing would mean losses for many years with no certainty of ever covering costs. In addition, such an approach would entail significant spikes in prices as facilities became capacity constrained, followed by sharp drops in prices following investment in new capacity. Paradoxically, such price fluctuations may not send the correct signals to consumers about the efficient use of the service over time.

A separate argument is that it would be efficient to set prices at SRMC and for governments to provide subsidies to infrastructure owners to cover capital and other fixed costs. However, this argument fails to take account of the efficiency costs of raising the taxes to fund subsidies, the incentives for service providers to over-engineer infrastructure if government funded the capital costs, and the difficulty for governments in determining whether there was sufficient demand to justify providing a particular service if users did not actually have to pay for the full cost of that service.

Source: IC 1992

The Position Paper, therefore, endorsed the principle that access prices should generate revenue across a facility's regulated services as a whole that is at least sufficient to meet the efficient long-run costs of providing access to these services, including a return on investment commensurate with the risks involved.

However, for reasons outlined in chapters 4 and 11, prices that generate monopoly rents will generally also be inefficient. As the Network Economic Consulting Group (NECG) commented:

> Ideally access pricing of bottleneck facilities would involve prices low enough to protect access seekers and end customers from the exercise of monopoly power, but also high enough to support the investments needed to deliver the essential service at efficient levels of quality and quantity. (sub. 39, p. 16)

Reflecting a concern to protect users from the exercise of market power, the ACCC's general (though not universally applied) pricing criteria for Part IIIA undertakings and telecommunications access determinations include the principle that 'pricing be based on costs'. However, expressed in this way, the principle raises a number of problems:

- Where price discrimination is employed for efficiency reasons, prices in aggregate (or revenue) may reflect costs, but individual prices cannot be said to reflect costs. Rather, they are based on the demand characteristics of the access seeker or consumer. If each price was required to be based on cost, it could conflict with efficient price discrimination.
- Since the notion of 'cost' has many dimensions — marginal, average, common, stand alone, opportunity — it is not clear what 'cost-based' prices mean. As noted by Freight Australia (sub. 19, p. 16) and Gans 2000, among others, to the extent that cost is interpreted as fully distributed cost — whereby overheads are included in the prices of different products more or less arbitrarily — cost-based prices are unlikely to promote efficiency.
- Most importantly, too great an emphasis by the regulator on strictly aligning revenues with costs may, given the difficulties of accurately estimating an efficient cost-base, actually jeopardise the objective of preserving incentives for efficient investment.

Nevertheless, the Commission argued that a broad principle linking revenues to costs was required to reflect the fact that, with some exceptions, prices that deliver monopoly rents are generally not desirable on efficiency grounds.

Structure of access prices

The Position Paper noted that because marginal costs of (non-congested) infrastructure services are low, an appropriate structure of prices is important to allow infrastructure owners to cover total costs on an ongoing basis with the smallest impact on the use of the services concerned.

Two-part pricing (or more generally multi-part pricing) is one common approach for recovering the total costs of providing infrastructure services. It involves the facility owner charging a fixed amount to entrants for access to the network, plus a use charge based on SRMC or incremental cost. If the fixed charge did not deter potential entrants from joining the network, this approach would allow the facility owner to cover its full costs while avoiding efficiency costs from reduced use of the network.

In theory, two-part pricing can be employed in most situations, although determining the level of the fixed component of the price may not always be straightforward. For example, where there are many access seekers of different sizes — such as in telecommunications — it may be difficult to determine what the lump sum component for each access seeker should be. However, in such cases, this component could be based on how many customers the access seeker has in its final market. That is, the access seeker would pay a fixed charge per *customer*. The use component of the two-part price would then be based on the incremental cost of providing the service.

That said, two-part tariffs do not overcome all efficiency problems. As discussed in chapter 3, lump sum access charges will inevitably deter some customers from using the services. This represents a loss in efficiency, since those users may be willing to pay a price higher than the additional cost of supplying them with the service.

With this in mind, the Position Paper noted that another approach to recovering costs, while minimising reductions in service use, is to charge individual customers different amounts depending on how highly they value the service. This is known as Ramsey pricing or efficient price discrimination. Such price discrimination can be implemented under a single price structure with individual customers paying a different unit charge for the service. Alternatively, it can be implemented as part of a multi-part pricing structure. That is, while all customers would pay the same charge for each unit of the service used, those customers who valued the service highly would pay a relatively high fixed access fee, thereby making a relatively large contribution to common and fixed costs. In contrast, marginal users who valued the service less highly would be charged a low access fee so as not to deter them from taking up the service. This form of price discrimination again allows the facility owner to cover its costs while minimising the losses in efficiency resulting from reduced use of the service.

The Commission went on to note, however, that allowing price discrimination raises the possibility that a facility owner may use price discrimination in anti-competitive ways. Such concerns arise mainly in relation to vertically integrated facilities, where the facility owner might charge less to its own downstream operations than it charged to access seekers for the same type of service. But whatever its particular manifestation, anti-competitive price discrimination is clearly a concern to regulators. Thus, as noted, the ACCC has stated that it considers the prevention of price discrimination when it would reduce efficient competition to be a core pricing principle (see box 12.1).

The Position Paper's suggested pricing principles

The above considerations led the Commission to propose in the Position Paper that access price determinations within Part IIIA should:

- generate revenue across a facility's regulated services as a whole that is at least sufficient to meet the efficient long-run costs of providing access to these services, including a return on investment commensurate with the risks involved;
- not be so far above costs as to detract significantly from efficient use of services and investment in related markets;
- encourage multi-part tariffs and allow price discrimination when it aids efficiency; and
- not allow a vertically integrated access provider to set terms and conditions that discriminate in favour of its downstream operations, unless the cost of providing access to other operators is higher.

While arguing that these principles would have widespread applicability, not only within Part IIIA but also to assist pricing frameworks in industry regimes, the Commission recognised that their application would need to have regard to the access holiday approach mooted in the Paper.

12.2 Responses to the Position Paper's pricing principles

As noted in chapter 6, there was strong support from participants for the inclusion of pricing principles in Part IIIA. Notwithstanding this, there was significant disagreement among participants as to the content of specific principles and there were many suggestions for change. Broad reactions to the principles are summarised below, followed by a discussion of specific suggestions for change.

Infrastructure providers

Infrastructure providers and their representatives generally welcomed the principle that owners should be able to earn a return on their investment commensurate with the risk involved.

That said, the NECG argued that the first principle should be amended to reduce optimisation or regulatory asset stranding (a regulated reduction in asset values). It contended that:

> … the threat of such asset stranding, if it is not properly compensated for, must deter investment and is therefore inconsistent with the proposed objects clause. (sub. DR76, p. 33)

The Australian Council for Infrastructure Development (AusCID) suggested further principles which would have the same effect.

Another general theme from infrastructure providers and their representatives (NECG (sub. DR76), AusCID (sub. DR80) and the Australian Gas Association (sub. DR84)) was that the pricing principles should include the requirement that access arrangements provide strong incentives to infrastructure owners to achieve productivity gains.

Infrastructure users

Some infrastructure users expressed concern that the pricing principles would favour infrastructure providers.

Nevertheless, most users accepted that infrastructure owners should be able to earn a reasonable return on their investment. (In this regard, Dwyer and Lim (sub. DR100, p. 9) reiterated their view that infrastructure prices should be set at marginal cost with government meeting owners' losses through taxes on land.)

However, several user interests raised two specific concerns with the other pricing principles:

- that the principle that 'prices not be so far above costs as to detract significantly from efficient use of services and investment in downstream markets' would not put a sufficient brake on monopoly pricing by infrastructure owners; and

- that while there was a theoretical case for price discrimination, in reality it could involve anti-competitive prices (the Energy Users Association of Australia (sub. DR94, p. 33), the New South Wales Minerals Council (sub. DR63, p. 5), Dwyer and Lim (sub. DR100, p. 10) and BHP Billiton (DR79, p. 10)).

Regulators and governments

The National Competition Council (NCC, sub. DR99 p. 10) considered that the pricing principles needed to be formulated at a sufficiently high level to provide guidance on the appropriate pricing methodologies that should be available to regulators while not prescribing particular methodologies. It considered that the pricing regimes and arrangements already approved under Part IIIA were consistent with the pricing principles in the Position Paper.

On the other hand, the ACCC expressed concerns with the principles:

> If the Productivity Commission maintains its position that it is a problem that Part IIIA does not contain detailed pricing principles, then the ACCC believes that the principles proposed in the Productivity Commission's Position Paper are not the answer. … [and] are unlikely to assist in introducing greater clarity or certainty into the operation of Part IIIA. (sub. DR93, p. 27)

It further noted that it:

> … does not believe that the addition of these principles would greatly alter recent efforts to improve the efficiency of pricing of electricity and gas transmission networks. (sub. DR93, p. 28)

Yet it also expressed the seemingly contrary concern that:

> Including pricing principles in Part IIIA that emphasise efficiency objectives alone would result in an abrupt change in the approach to setting access prices in some instances. (sub. DR93, p. 28)

The New South Wales (sub. DR109), South Australian (sub. DR121) and Western Australian Governments (sub. DR69) and the Queensland Treasury (sub. DR105) broadly supported the substance of the principles presented in the Position Paper. The South Australian Government qualified its support by suggesting that '… pricing principles should explicitly highlight the need for a rate of return that is commensurate with the pricing risks, particularly for new facilities, by making it a separate principle' (sub. DR121, p. 5). And in relation to the principle that price discrimination can aid efficiency, the New South Wales Government considered that this was the case only when monopoly power could not be abused by the infrastructure owner.

The Office of the Regulator-General, Victoria (ORG, sub. DR112) did not raise specific objections to the principles, but questioned the extent to which they would produce greater certainty.

The Commission's assessment of suggested changes

In the light of participants' comments, the Commission considers that while the broad purpose and thrust of the principles in the Position Paper is appropriate, some refinements and additions to their content are necessary.

The level of prices

Two of the proposed principles dealt with the level of access prices — namely, that they should:

- generate revenue across a facility's regulated services as a whole that is at least sufficient to meet the efficient long-run costs of providing access to these services, including a return on investment commensurate with the risks involved; and
- not be so far above costs as to detract significantly from efficient use of services and investment in related markets.

The first principle set a relatively clear floor to revenue allowed within an access regime to facilitate investment in the essential service (without necessarily constraining individual prices). The second principle related revenue to costs, but in a way which provided a degree of 'headroom' for revenue and prices to be above costs provided that this did not significantly impede efficient use of the service.

This latter aspect of the pricing principles drew significant criticism from some participants. BHP Billiton (sub. DR79, p. 10) and Freight Australia (sub. DR62, p. 13) considered that the second principle was too imprecise to provide an effective constraint on prices. Likewise, the ACCC suggested that it was loosely worded and questioned the extent to which the principle could be made operational:

> A concern with the proposed amendment as it stands is how far above costs tariffs should be to encourage new investment and, at the same time, not detract significantly from the efficient use of facilities. (sub. DR93, p. 34)

In one sense, these concerns simply point to the broader difficulties facing regulators in balancing different efficiency considerations. To an extent, these difficulties will remain regardless of how pricing principles are expressed. Nevertheless, the Commission considers that the principles should be worded so as to involve as little uncertainty as possible.

The main and uncontroversial motive for regulating the level of access prices is that, in the absence of regulation, the use of monopoly power held by some infrastructure providers would result in prices that would be inefficiently high. Accordingly, the overarching intent of access pricing is to reduce prices below their unregulated levels and thereby reduce or remove these inefficiencies.

However, in determining how to couch this intent in a way which also gives due consideration to the need to preserve investment incentives, a number of complex issues arise. As discussed in chapters 4 and 11, delineating between genuine monopoly rent and 'upside profits' accruing to a successful project that were factored into the investment analysis (to balance the possibility of losses if the project had proved to be unsuccessful) is very difficult. For this reason, the Commission has proposed that specific measures to facilitate new investment be incorporated in Part IIIA. While the various measures canvassed in chapter 11 would be consistent with the principles proposed in this chapter (and as discussed in box 12.3 would interact with them to some degree), implementing such measures would effectively remove much new infrastructure from the direct application of the pricing principles.

It might be argued that with measures in place to encourage efficient investment, the emphasis in the principles on reducing access prices to encourage efficient use could be strengthened.

However, in the Commission's view, this would be a risky strategy. First, not all new investment would necessarily qualify for such 'special treatment'. For this infrastructure, given the difficulties of measuring costs, attempts to set prices too close to costs would still carry considerable risks for investment. Second, pricing principles will assist regulation of essential infrastructure which is already covered by Part IIIA or industry-specific regimes. If prices were continually aligned with costs, the incentives to make efficiency improvements or to innovate would be weakened. As the NCC commented:

> It needs to be recognised that it is not possible or desirable in all circumstances to completely eliminate excess returns. More specifically, there is a tradeoff between setting prices so as to reflect costs on the one hand, and providing incentives for continued improvements in productivity and efficiency on the other. A pricing regime that sought to force price continually to cost would erode the incentives regulated firms had to drive costs down or in other ways to innovate. (sub. 43, pp. 28-9)

Box 12.3 New investment and the pricing principles

Adopting the sort of mechanisms outlined in chapter 11 to facilitate efficient new investment within the Part IIIA regime would have implications for the role played by the pricing principles. For example:

- Framework undertakings would apply for the life of the project and would set terms and conditions that would supplant the application of the pricing principles (even though, in most cases such terms would be consistent with the principles).
- Similarly, the pricing principles would be supplanted where an access holiday arrangement — either time limited or applying until the project covered its costs — was negotiated.

The pricing principles would become relevant if a facility was declared after a time-limited access holiday had expired. However, their application would need to have regard to the returns earned by the facility over the period of the holiday. Similarly, chapter 11 also canvassed an access holiday arrangement where profit sharing would apply once the net present value of the project had reached zero. In such a situation the project would have achieved, prior to profit sharing, a return on its investment commensurate with the risk. Consistent with the pricing principles, any revenue above reasonable operating and maintenance costs should then be available for profit sharing.

In sum, the pricing principles must necessarily involve a balancing act between addressing monopoly pricing and allowing a degree of flexibility for revenue to be above costs. In pursuing this balance, the Commission considers that the principles should explicitly recognise the role of access regulation in curbing inefficient monopoly rents, but set a clear floor to ensure that incentives to invest are protected. Based on the material presented to the inquiry, the Commission considers that the following pricing principles should guide the ACCC's arbitration for declared services and its assessment of proposed undertakings under Part IIIA .

In seeking to reduce access prices that are inefficiently high, the ACCC must have regard to the following principles:

(a) that the access prices:

(i) be set so as to generate revenue across a facility's regulated services that is at least sufficient to meet the efficient long-run costs of providing access to these services; and

(ii) include a return on investment commensurate with the regulatory and commercial risks involved;

Structure of prices

There were no suggestions to change materially the principle that regulated access pricing should encourage multi-part tariffs, nor the principle that vertically integrated providers should not be able to discriminate in favour of their upstream or downstream operations. However, as noted, user groups were not in favour of the principle allowing for price discrimination when it aided efficiency.

Dwyer and Lim (sub. DR100, p. 10) pointed out that price discrimination may reduce deadweight losses arising from departures from marginal cost pricing, but will not eliminate such losses. A number of other interest groups (the Energy Users Association of Australia (EUAA, sub. DR100), the New South Wales Minerals Council (sub. DR63) Dwyer and Lim (sub. DR100), BHP Billiton (sub. DR79) and the Western Australian Chamber of Commerce and Industry (sub. DR103) acknowledged that, in theory, price discrimination could aid efficiency. However, in practice, they considered that it could lead to anti-competitive, or at least non-transparent, outcomes. For instance, BHP Billiton commented that:

> … a principle that enshrines price discrimination while maybe theoretically acceptable is open to serious abuse by the asset owner and distorts economic decisions in related upstream and downstream markets. (sub. DR79, p. 10)

Similarly, the EUAA considered that price discrimination was a case of :

> … once burnt twice shy…. Whilst we were probably once of a view that there should be a relatively liberal approach applied to things like side constraints on price caps [allowing for price discrimination] we would now take a more cautious view of how those side constraints are applied. (transcript, pp. 84-5)

In support of their concerns, the EUAA and Energy Markets Reform Forum claimed that electricity distributors in Victoria had implemented the recent tariff determination in a manner that resulted in inefficient price discrimination.

The merits of this particular case aside, the Commission acknowledges the broader point that it may not always be easy to distinguish between price discrimination which improves efficiency from that which does not. In this regard, the New South Wales Minerals Council argued that there is a lack of transparency with respect to pricing of rail infrastructure in the State which makes such distinctions more difficult:

> There is a problem proving that efficiency is improved by the discrimination. For example, it has been asserted by the infrastructure owner, but never proved, that the discrimination allowed by and practiced under the NSW Rail Access Regime enhances efficiency. (sub. DR63, p. 4)

The Western Australian Chamber of Commerce and Industry noted that price discrimination could raise fairness as well as efficiency concerns and that, taken to its extreme, it would be widely perceived to be exploitative:

> Ramsey pricing, in particular, can be perceived as exploitative because it requires the people who most want and need a service to be charged the most for it. So a Ramsey pricing telephone company might charge more for calls to emergency services than between households. (sub. DR103, p. 2)

By the same token, price discrimination is often part of arrangements that are seen to promote fairness. For instance, providing pensioners with cheaper travel on public transport outside peak times is a form of price discrimination.

The New South Wales Minerals Council suggested that a key to allowing price discrimination is transparency:

> Before price discrimination is applied, the infrastructure owner should demonstrate to the users affected, and to a regulator if users request it, that the proposed discrimination will improve efficiency. The application of discrimination should be made transparent in any pricing. (sub. DR63, p. 5)

Like the Council, the Commission does not consider that the concerns that price discrimination can raise in particular instances warrant preventing it in all cases. This position is also consistent with the principle enunciated by the ACCC in relation to undertakings that 'access prices should not discriminate in a way that reduces efficient competition'. However, the concerns raised by users reinforce the need for regulators to scrutinise discriminatory pricing arrangements to satisfy themselves that the intent is not to restrict competition.

More broadly, the manner in which this sentiment is best captured in a pricing principle will again be a matter for debate. In the Position Paper, the Commission was concerned to ensure that the pricing principles relating to price discrimination did not lock regulators into endorsing price discrimination in all cases. It considers that, as drafted, they allow the regulator considerable scope to determine whether price discrimination in a particular case would increase efficiency (and explicitly rule it out in one significant case where it would not improve efficiency). Also, the formulation would not rule out requiring that the rationale for, and effect of, discrimination be made clear to the regulator and/or users.

Accordingly, the Commission does not see a need to change the two principles relating to price discrimination put forward in the Position Paper.

Other suggested amendments

There were also suggestions from participants to augment the pricing principles listed in the Position Paper with principles to encourage productivity gains, prevent cross subsidisation, and constrain the extent to which regulators can undertake optimisation of the regulated asset base.

Productivity gains

There was widespread support for the notion that the pricing principles should refer explicitly to the need for incentives for infrastructure providers to make productivity gains. For the reasons outlined in section 12.4 the Commission agrees that a statement of intent is appropriate in high level principles and considers that access prices should:

> *Include incentives to reduce costs or otherwise improve productivity.*

However, as discussed in section 12.4, it is important that this principle not be too prescriptive, because there is still some uncertainty and considerable debate about the appropriate mechanisms to promote productivity gains.

Cross subsidies

The ACCC and the Australian Rail Track Corporation (ARTC) suggested that the principles in the Position Paper would not prevent cross subsidies between services. The ARTC's (sub. DR64, p. 9) concern was that the principles should not allow government imposed Community Service Obligations (CSOs) to be funded through cross subsidies from commercial services. The ACCC was concerned about the potential for cross subsidies between horizontally regulated services or products:

> … one might have expected that if the proposed pricing principles were to disallow cross subsidies between a regulated activity and a vertically related contestable activity, then those same principles would also disallow cross-subsidies between horizontally related regulated services or products. That is, access prices charged at each connection point should be subsidy-free. (sub. DR93, p. 29)

The Commission agrees that subsidy-free prices are a requirement for efficient pricing outcomes. It notes that it is generally accepted that a price is subsidy free if it is equal to, or exceeds, its directly attributable costs of production. Indeed, as described in chapter 2, this test is explicitly embodied in various rail access regimes. Thus, the Commission considers that the following principle should be included to discourage cross subsidies:

> *Revenue from each service should at least cover the directly attributable or incremental costs of providing the service.*

In relation to the ARTC's specific concern, such a principle would oblige governments to fund the difference between the incremental cost of providing CSOs and revenues obtained from the users concerned.

Optimisation and financial capital maintenance

A number of submissions on behalf of infrastructure providers argued that the principles should constrain the extent to which regulators are able to engage in 'optimisation' (which involves the regulator reducing capital values or operating costs to levels that it considers are 'optimal' — see box 12.4).

These suggestions took various forms. AusCID (sub. DR80 p. 39), the Australian Gas Association (sub. DR84. p. 8) and the NECG (sub. DR76) argued that the concept of 'financial capital maintenance' should be included in the pricing principles. Underpinning this proposal was the view that investment will be compromised if investors in regulated assets cannot reasonably expect that funds prudently invested in regulated assets will be recouped. Hence, the NECG recommended that the expression 'efficient long-run costs' in the Commission's pricing principles be replaced with the clause 'costs prudently incurred'. It considered that the former expression could be interpreted as implying that regulators should undertake cost optimisation as a matter of course.

The Commission notes that financial capital maintenance can be interpreted in two broad ways. It can mean either that:

- the risk that regulators will undertake optimisation should, like other risks, be compensated for in the allowed rate of return; or
- that ex post optimisation of asset values should not be undertaken.

The Commission considers that the first interpretation of financial capital maintenance is uncontroversial and is consistent with the clause in the pricing principles that returns to investors should be 'commensurate with the regulatory risk involved'. In particular, as discussed in chapter 13, an access regime which includes provision to optimise asset values ex post, should normally provide an infrastructure owner with a higher regulated rate of return than one which does not.

Box 12.4 **What is optimisation?**

Optimisation is a process within cost-based approaches to setting access prices which requires prices to be based on the most efficient possible capital or operating costs.

Optimisation of operating costs is uncontroversial — consumers should not be expected to pay prices which are based on inefficient operation of infrastructure.

With respect to capital, optimisation can occur at the time an investment is made (ex ante optimisation) or after (ex post). In the case of ex ante optimisation, the regulator certifies that an investment is appropriate or prudent, and can enter the regulatory asset base. The need for such optimisation is also relatively uncontroversial.

Ex post optimisation of asset values can occur at any time after the investment has been made. For instance, if five years after a pipeline-owner makes an investment, a cheaper pipeline technology is developed, the regulator would write down the value of the existing pipeline to reflect the cost of reproducing that service with the new technology.

Ex post optimisation is more controversial. It is justified as emulating the behaviour of competitive markets. However, submissions from service providers argued that the practice increases risks which must ultimately be paid for by consumers. In this context infrastructure markets are different from competitive markets in that they inevitably involve high sunk costs and long lived assets. Indeed, it is these differences which give rise to the case for access regulation in the first place.

Optimisation is often linked to asset valuation methodologies. Ex ante optimisation is consistent with actual cost methods of valuing assets, whereas ex post optimisation is more consistent with replacement cost methods such as Depreciated Optimised Replacement (DORC). Optimisation issues are considered in detail in chapter 13.

However, the principles as formulated in the Position Paper do not preclude optimisation, as would be required under the second interpretation. The Commission agrees that the conceptual basis for optimising asset values is not always clear cut (and that there are practical limitations in the way optimised approaches have been applied in a number of industries — see chapter 13). But in terms of pricing principles for Part IIIA that need to be applicable across a wide range of industries, the Commission does not consider that optimisation should either be mandated or prohibited in all cases. Moreover, it does not consider that the term ‘efficient long-run costs’ obliges regulators to undertake optimisation. If, in a particular case, optimisation would not promote efficiency, then it follows that adopting an approach which does not optimise is consistent with ‘efficient long-run costs’.

Optimisation aside, the NECG considered that ‘efficient long-run costs’ could also be interpreted as requiring regulators to use a cost-based approach to setting access prices. However, the Commission notes that the purpose of this principle is to ensure that access prices provide a sufficient rate of return to a facility owner's investment. Any principle that deals with recovering capital costs — including the principle as amended by the NECG — must necessarily be expressed in a cost-based way. Moreover, as the discussion in the Position Paper indicated, the Commission considers that the principles are intended to provide high level guidance on the pricing conditions which will satisfy the objectives of Part IIIA, rather than specifying the means by which prices should be determined. In particular, they should not be interpreted as specifying that regulators are required to employ cost-based approaches to meet this principle (see further discussion in section 12.4).

In sum, the Commission considers that the pricing principles put forward in the Position Paper do not require amendment to make explicit reference to financial capital maintenance or ex post optimisation issues.

12.3 The Commission's recommended pricing principles

For the reasons set out in chapter 6, the Commission considers there is a role for pricing principles to provide broad guidance for the design of access pricing regimes — often supplemented by more detailed principles in specific cases. Based on the discussion above, the Commission recommends that the following pricing principles be inserted into Part IIIA.

RECOMMENDATION 12.1

The Australian Competition and Consumer Commission, in seeking to reduce access prices that are inefficiently high, must also have regard to the following principles:

- ***(a) that regulated access prices should:***
  - ***(i) be set so as to generate expected revenue across a facility's regulated services that is at least sufficient to meet the efficient long-run costs of providing access to these services;***
  - ***(ii) include a return on investment commensurate with the regulatory and commercial risks involved;***
  - ***(iii) generate revenue from each service that at least covers the directly attributable or incremental costs of providing the service.***
- ***(b) that the access price structures should:***
  - ***(i) allow multi-part pricing and price discrimination when it aids efficiency;***

(ii) ***not allow a vertically integrated access provider to set terms and conditions that discriminate in favour of its downstream operations, except to the extent that the cost of providing access to other operators is higher.***

(c) ***that access pricing regimes should provide incentives to reduce costs or otherwise improve productivity.***

12.4 From principles to practice

As the NCC and ACCC noted, a range of pricing methodologies will comply with these principles and will be suited to different circumstances. That said, implementing efficient pricing within access regimes is far from easy.

Regulators operate under significant constraints. In particular, determining the extent to which costs are 'efficient' for a facility or service is inherently problematic. As noted, one source of difficulty is the level of information available to the regulator. And, as the Independent Pricing and Regulatory Tribunal (IPART, 1999b, p. 3) observes, these problems are compounded by the dynamic nature of the process:

> The competitive process is dynamic and its specific outcomes are unforecastable. No regulator can accurately assess the levels of efficiency or service an industry is capable of over time. Hence, the regulatory framework should aim to create conditions where the industry itself, in response to the incentives it faces, moves towards its continually shifting performance frontier.

Yet as noted, meeting the objectives of efficient use of, and efficient investment in, essential infrastructure implies putting in place access regimes that generate the right *level* of prices as well as the right *structure* of prices. There can be significant efficiency consequences from getting either of these 'wrong'.

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. Moreover, as IPART (1999b, p. 13) pointed out, such attempts have not proven successful in the past:

> The history of intrusive cost-plus regulation is replete with examples of heavily regulated utilities that exhibit low levels of efficiency, poor investment practices and below average service performance. Both theory and experience indicate that repeated frequent confiscation of the benefits of efficiency improvements combined with uncertainty over future regulatory actions will lead to poor performance and welfare loss.

These considerations suggest that regulators should not be too ambitious in their approach, and that governments should not place too great a level of expectations upon them. A sensible goal is to improve significantly on unregulated outcomes, while recognising that precision is not possible.

Ultimately, the approach taken to implementing any pricing principles depends on the instruments available to regulators and the way they can be applied. Because the structure of prices is important, instruments that allow service providers to develop their own price structures are likely to be preferable to those where the regulator is required to impose a structure.

Although the scope to offer such ‘freedom’ will vary from case to case, even where more explicit price control is necessary, those pricing arrangements should still attempt to provide incentives for facility owners to improve efficiency — as reflected in the Commission’s final pricing principle.

In essence, regulators have three instruments to control or influence prices:

- setting access prices for individual services;
- price or revenue caps covering a range of services; and
- price monitoring.

While there is a large literature on the attributes of specific rules for setting access prices for individual services, debate about the appropriate rule in any particular circumstance is not as important as it may first appear. In practice, pricing rules have tended to merge into variations of average cost. To take examples from telecommunications pricing, despite their different titles, rules such as Directly Attributable Incremental Cost or Total Service Long-Run Incremental Cost, as implemented, are all essentially versions of average cost. (Particular attributes of these approaches are considered in some detail in the Commission’s companion report on Telecommunications Competition Regulation (PC 2001c).

More broadly, there are significant overlaps between instruments that are ostensibly quite different. For instance, cost-based price caps and rules tend to have some of the disadvantages of rate of return regulation (see below).

Thus, from a future policy perspective, a more fertile ground for discussion is the scope for price monitoring and incentive regulation — such as non cost-based price caps — to supplant or augment cost-based price setting. This was the theme in a number of submissions to the inquiry, both before and after the release of the Position Paper.

The future role of prices monitoring in the context of Part IIIA was discussed in chapter 6. The following discussion, therefore, focuses on the role and application of so-called ‘incentive regulation’ within access regimes.

Price caps and incentive-based regulation

There are a number of forms of price and revenue caps (box 12.5). In Australia, they are employed in telecommunications, post, gas and electricity transmission and distribution, as well as at major airports.

As the ACCC (2000, p. vii) notes, price and revenue caps can potentially promote efficiency in three ways:

- they can ensure that facilities do not price too far in excess of costs;
- they can provide firms with an incentive to seek cost savings in excess of those needed to fall within the cap; and
- they provide a facility with the freedom to structure its prices so as to recover common costs in the most efficient way.

Indeed, the ACCC considers that they are the instrument of choice for regulating access to vertically separated facilities:

> Incentive regulation in the form of price caps can combine the clarity and certainty advantages of tariff setting and at the same time provide incentives for the service provider to reduce production costs. As such, and given that most of the services regulated by the Commission using Part IIIA are vertically separated, there is a strong case for using price caps in regulating terms and conditions of access (sub. 25, p. 83).

While the incentive provided by price caps to seek cost savings is a strength, like other forms of price control, it also places a requirement on the regulator to monitor service levels, or impose service quality standards. Otherwise, cost savings could be made by cutting service levels, rather than by increasing efficiency. As IPART (1999b, p. 7) stated:

> A measurement methodology and tracking mechanism for the standards of service provided … is a prerequisite for incentive regulation.

The building block approach

Notably, whatever their precise form, price and revenue caps in Australia have been based on a ‘building block’ approach (see box 12.5). Regulators have adopted this approach because it is seen to be objective and transparent, and results in prices which closely track individual facilities’ costs.

Box 12.5 **Price cap terminology**

Global price cap

A form of price control regulation that limits, or ‘caps’, the prices a business can charge. In Australia, price caps are often expressed as the Consumer Price Index less an X factor (CPI-X). Each price is usually weighted by the revenue from that product and the weighted average of prices cannot rise by more than CPI-X. The business is free to change individual prices so long as it remains within the cap.

Revenue cap

Rather than directly limit prices, revenue caps limit in some way the revenue a firm can earn. One common form of revenue cap is a limit on revenue per unit of sales (Laffont and Tirole 2000) — the limit being set in the same way as a price cap (CPI-X) for instance. However, in Australia, and particularly for the gas and electricity industries, absolute revenue caps apply. This means that the business or facility has the freedom to set prices subject to the constraint that it cannot earn more than a specified dollar amount of revenue in any one year. The Maximum Allowable Revenue (MAR) is usually established using the ‘building block’ approach.

Building block approach

The building block approach is a method of establishing the X factor for price caps or the MAR for revenue caps. Using the revenue cap as an example, the capped amount for each year is set by building up the cost-base for the facility from its individual components. The cost-base generally includes: return on capital, depreciation and operating expenses. To obtain these values, the regulator requires information on the asset base of the facility, expected capital expenditure, the weighted average cost of capital for the business and efficient operating and maintenance costs. Since caps are set for future years, forecasts of each of these elements are required as well as forecasts of likely inflation.

The Total Factor Productivity (TFP) model to set X

The TFP model is an alternative way of setting the X factor in price or revenue caps. Under this approach, price setting is decoupled from the costs of the facility. Instead, the X factor is set with reference to the TFP improvements in the industry as a whole, either domestically or internationally. A variant of this approach is setting the X factor using benchmarks of best practice.

Glide paths

Glide paths were referred to in some of the submissions to the inquiry. The concept relates to the transition, or path of prices from one price cap period to the next. A glide path allows a company to retain some of the benefits of its additional efficiency gains over the subsequent regulatory period. This reduces the incentive for providers to defer efficiency enhancements close to the end of a review period and allows for smoother transition to new price levels. (IPART 1999a)

However, a number of participants strongly criticised the building block approach, claiming that it undermines the advantages of price caps. AusCID said that:

> Both the Victorian Regulator General and the ACCC have interpreted 'incentive regulation' of the form 'CPI-X' to mean the so called 'building block approach' which is really thinly disguised cost of service or rate of return regulation. (sub. 11, p. 13)

And KPMG 2000 stated:

> Rather than using it (the building block approach) as one source of information about an outcome they have turned it into **the** outcome. (quoted in Energex sub. 14, p. 7)

The approach is clearly highly information-intensive and intrusive, which participants claimed reduces incentives for good performance. Specifically, it requires the regulator to:

- seek extensive information about a facility's existing and forecast costs, including of any services not regulated (to prevent cost shifting);
- judge whether operating and maintenance costs are based on efficient service delivery; and
- seek information about planned capital expenditure and judge whether that expenditure is justified. This is because capital expenditure will increase the asset base and, therefore, the allowed dollar rate of return.

The need to forecast future costs, and to validate proposed capital expenditure, could lead to the regulator having a significant influence over the running of the business. For example, in relation to the CPI-X regime for major airports, in which the approval of the regulator is required for 'necessary new investment', Australia Pacific Airports Corporation (APAC, 2000, p. 5) claimed:

> The ACCC now scrutinises every investment decision airports make in relation to their aeronautical businesses for which a price increase is sought. This is in an environment where most airports have negative earnings … The ACCC determines what expenditures are to be considered for price increases, whether those expenditures are acceptable and how prices are to be calculated. … This is all to constrain price increases that are smaller than those experienced on a weekly basis in metropolitan petrol markets.

Such outcomes illustrate the tendency for price caps based on the building block approach to suffer from some of the disadvantages of rate of return regulation. Moreover, subsequent efforts of the regulator to address the downsides of rate of return regulation — incentives to 'gold plate' assets and pad costs — could in turn lead to even more intrusive regulation of the sort noted by APAC. In other words, the regulation can feed off itself.

Alternatives to the building block approach

An alternative to the building block approach is to set the X factor with reference to external measures of industry and/or economy-wide productivity. Instead of examining each facility's costs, the prices or revenue of the facility would be allowed to rise by no more than the CPI less the productivity factor. Total Factor Productivity (TFP) for the industry is often the preferred productivity measure. However, X can also be based on measures derived from Data Envelopment Analysis or those obtained through best practice benchmarking.

Under these approaches, if a firm performs better than the 'average' for the industry it retains some or all of the gains, whereas if its costs are higher than average it will be penalised. Thus, they can provide powerful incentives for firms to improve their performance.

While Australian access regimes have relied heavily on building block approaches, productivity-based approaches are well established in other areas of regulation. For instance, they are used as a basis for retail price caps for telecommunications in Australia and overseas. The World Bank (2000, p. 4.1) noted that this form of price cap regulation 'is the most widely accepted form of price regulation in the sector'.

In its final report on price controls for Telstra, the ACCC reviewed the past experience with the company's productivity-based price cap, and recommended that it be continued (ACCC, 2001a). Citipower also cites examples where productivity-based price caps are used to regulate US utilities in a number of sectors (box 12.6). Thus, this approach to setting the X factor cannot be dismissed as conceptually appealing but impractical.

Yet, while productivity-based approaches are clearly feasible, like all forms of price control, they are far from perfect:

- developing robust productivity benchmarks is not costless;
- there will always be scope for dispute as to whether the results of a TFP or benchmarking exercise are applicable in a given situation — for instance, Citipower notes that TFP measures are affected by demand growth which is largely outside the control of utilities; and
- they appear to be less precise than cost-based approaches and, in the short-term, may not align prices as closely with costs. (That said, the apparent precision of building block approaches is often overstated.)

Box 12.6 Examples of productivity-based approaches to price regulation

Citipower provided several examples of productivity-based approaches to price regulation drawing on the experience in North America.

Rail

In 1980 the US Interstate Commerce Commission (ICC) rejected a TFP approach for regulating rail freight prices. Under the initial arrangements it put in place, increases in freight rates were based on the average increase in the rail carriers costs. However, in 1989 after considerable debate, the ICC reversed its position and adopted a TFP approach based on improvements in industry productivity. According to Citipower, the ICC became convinced that workable definitions of TFP could be computed for the rail industry and that the inclusion of a productivity factor was consistent with a fair and reasonable price standard.

Telecommunications

In the Telecommunications sector, price cap regulation was first approved by the Federal Commerce Commission for the interstate services of Local Exchange Carriers in 1991. The need to calibrate the CPI-X formula to the industry unit cost standards is explicitly recognised. For instance, in 1995 the FCC stated that ‘the indexes were adjusted each year in accordance with a formula that accounts for industry wide changes in unit costs’. A similar approach is also employed for telecommunications in Canada.

Earnings share mechanisms (ESMs) were once common in regulating North American telcos, but have become less so since productivity-based measures have been adopted. Citipower suggested that ESMs may, therefore, be a useful bridge or transition from building block to productivity-based approaches.

Energy

Finally, Citipower noted that while productivity-based CPI-X approaches are less common in the North American energy sector, they have been successfully employed to regulate the prices of a number of energy distributors. These include Southern California Edison, Southern California Gas, Boston Gas, San Diego Gas and Electric and the Ontario power distributors in Canada.

Source: sub. DR96

Overseas experience with productivity-based approaches also suggests that they will work best when the initial cost base is in the ‘ball park’. As the Commonwealth Treasury (1999, p. 65) observes:

> The effectiveness of price cap regimes can be undermined if the initial price base significantly diverges from efficient prices. Even after years of operating under a price cap, a firm may still be well below world’s best practice … .

If the initial cost base is too high, and the regulated facility is excessively profitable, the regulator may not be able to withstand community or political pressure to revisit the agreed arrangements. The Institute of Public Affairs (IPA) acknowledged that this is one reason why in the UK:

> … as a regulator Littlechild [an originator of the CPI-X approach] himself found it politically impractical to apply his own theory. (sub. 18, p. 11)

On the other hand, if the initial cost base is too low, the price cap is likely to have a detrimental effect on maintenance of the facility, and may send adverse signals to potential investors in like infrastructure. This suggests that it is not possible, or desirable, to remove cost considerations entirely from setting the X factor. For example, where an industry has undergone fundamental structural change, including a change in ownership, it is understandable that regulators seek the certainty of the building block approach.

In the Position Paper the Commission recognised the complexities of moving to productivity-based approaches and, in particular, the issue of how to establish starting cost-bases. However, it noted that as a result of past building block exercises, cost-bases have already been established for most essential infrastructure services in Australia. Thus, the Commission suggested that there would be significant benefits in taking advantage of this data and relying to a greater extent on productivity-based approaches to capping prices for access to that infrastructure.

The Commission recognised that some regulators are taking steps in this direction, but argued that it would be desirable to have greater regulatory coordination in developing the tools necessary to implement productivity-based price caps. It went on to suggest that regulators should give priority to developing the external productivity benchmarks necessary to implement such approaches, noting that, in evaluating the success of such approaches, the benchmark should not be whether they lead to fully efficient outcomes, but whether they could deliver an acceptable level of improvement on the (likely) unregulated outcome.

The Commission also raised the possibility (as a tier 2 proposal) that consideration be given to making explicit provision for productivity-based approaches for setting price caps in the criteria for certification. Specifically, it suggested that if a ‘building block’ approach has been used to set a price cap, the onus could be placed on the regulator to demonstrate why productivity-based approaches would not be feasible to adjust that cap (at least in periods between cost-based ‘resets’).

Participants’ responses

Infrastructure providers generally endorsed the Position Paper’s support for greater experimentation with ‘external regulation’. As noted, a number of submissions argued that pricing principles should include the requirement that access pricing arrangements should provide incentives to improve productivity. For example, AusCID suggested that:

> Regulators should be required to include strong incentives for producers to achieve productivity improvements. (sub. DR80, p. 39)

Indeed, a number of providers, including the IPA on behalf of Citipower, TXU Networks and United Energy, Energex, and the ARTC considered that the Commission had been too cautious in suggesting there was any continuing need to refer to costs when setting access prices. For example, Energex commented that:

> While the position paper moves away from the dictum that prices must match or track costs, it still requires periodic cost-based resets. This is not necessary under a number of forms of 'true' incentive regulation where the reference point is industry or international benchmarks. (sub. DR81, p. 5)

(One form of incentive regulation proposed by Energex was price service offerings — see box 12.7)

However, other service providers were less dismissive of the role of costs. For example, the NECG, representing 24 infrastructure providers, canvassed various options for incentive-based approaches, some of which retained a cost-based component. Similarly, Citipower (sub. DR 96, p. 18) supported a cost-based approach to initially set prices, although it contended that after the initial assessment:

> Given the potential for ESMs [earnings share mechanisms] and its long history of use in other jurisdictions, Citipower cannot agree that fundamentally "cost based approaches for setting prices will be required at least periodically" (sub. DR73, p. 2).

Not surprisingly, regulators and users were more cautious about the prospects for implementing productivity-based approaches.

The ORG agreed in broad terms that there is a role for productivity-based approaches:

> … the methodology for setting price caps needs to evolve in more efficient directions with experience, and that greater use of industry-wide productivity-based indexes and benchmarks are likely to play an important role in that evolution. (sub. DR112, p. 13)

Box 12.7 **Price service offerings**

Energex referred to the approach United Energy Limited had proposed during the Victorian Electricity Distribution Pricing Review which involved three different price-quality options:

- A base option — which would maintain the existing level of service at the existing price;
- A customer value option — involving an improved service at a higher price, which United claimed customers wanted based on survey results; and
- A customer premium option — involving the best service United could provide but at a higher cost again.

Under each of the scenarios, United would face sanctions for underperformance and rewards for better performance.

The Commission observes that United's approach offers the prospect of linking services more closely with customer needs. It also highlights the one-size-fits-all approach to service quality inherent in most regulatory regimes and the tradeoff that exists at some point between price and quality.

However, the approach was not endorsed by the ORG during the 2001-2005 Electricity Pricing Review. Despite its attractions, reasonable concerns with the approach could include:

- the reliability of customer surveys as proxies for actual willingness to pay for services;
- the possibility that there may have still been significant elements of excess profits in the base case scenario.

That said where such concerns can be overcome — such as through a contractual agreement between the provider and, say, large customers or land developers — it would be desirable if access arrangements had the flexibility to allow for such tailored price-service offerings.

Source: sub. DR81, United Energy 2000.

However, both the ORG and the ACCC considered that the Position Paper had not sufficiently recognised the desirable features of the building block approach, nor some of the practical difficulties in moving to a productivity-based approach. For example, the ORG argued that the building block approach is significantly different from rate of return regulation by virtue of the incentives it can include to improve efficiency. It suggested that such incentives are provided by:

- the commitment not to re-open the price caps for a fixed period; and
- an efficiency carryover amount that rewards a regulated business for previous efficiencies at subsequent reviews.

On the other hand, it argued that productivity-based approaches may not in practice be less information intensive than building block regimes:

> While the building block approach might be regarded by some as being information intensive, it is not evident that a TFP-based approach would be any less information intensive. This proposition should be examined, not simply from the point of view of what information would be required to undertake a TFP study, but also in terms of what exactly would need to be done to fully implement a TFP regime. (sub. DR112, p. 17)

Infrastructure users tended to agree with these comments. For example, the EUAA stated that:

> We recognise that there are shortcomings in the existing regulatory approach and we are certainly not opposed to change. However, we would want to be certain that any change involves improvements and caution the PC [Productivity Commission] that it would be premature (and reckless) to abandon current practice without knowing more about the impacts of what would replace it. (sub. DR94, p. 12)

The Commission's assessment

The two central issues raised by reactions to the Position Paper are:

- whether costs need to play a role in setting access prices; and
- the feasibility and timing of introducing productivity-based approaches.

On the first point, the Commission remains unconvinced that prices can be fully decoupled from costs. In this regard, it concurs with the observations of Professor Forsyth (2001). While Forsyth recognises the significant limitations of cost-based approaches, he suggests that eliminating cost considerations entirely would increase risks for both regulators and providers:

> The extreme opposite to cost-plus regulation is regulation which pays no attention at all to the firm's own costs. … This form of regulation is not costless; it imposes considerable risk on the firm, and risk is costly. Since prices are not related to actual costs, there is a risk that prices will fail to cover costs and the firm will be driven into bankruptcy. (p. 18)
>
> … regulators are likely to be very risk averse, and they seek to keep the regulated firm's profits at a moderate level, by relying heavily on actual costs. While yardstick regulation provides stronger incentives for productive efficiency, it involves more risk, not just for the firm but also for the regulator. (p. 21)

Indeed, the Commission considers that it is naive to imagine in the situation Forsyth describes — whereby a productivity-based approach drove prices below a particular facility's costs — that the facility owner would not appeal to have the outcome changed on the basis of cost information.

In one sense, however, whether costs continue to play some role is not the main issue. Rather, the issue is one of whether advances are possible on the existing building block approach. The Commission acknowledges that incentive mechanisms can be included in cost-based price caps. But it notes that the purpose of these incentives is in part to overcome the tendency for cost-padding created by other elements within cost-based regimes. In this regard, Citipower claimed that efficiency carryover mechanisms designed to counteract any incentives to defer efficiency enhancements can themselves provide incentives for gaming — for instance, in timing efficiency improvements to gain maximum carryover, yet protect the cost base.

Accordingly, the Commission remains of the view that there would be value in experimenting with regimes that reduce the tension between controlling monopoly power and ensuring infrastructure services are provided efficiently.

As noted, the Position Paper canvassed making the use of productivity-based approaches a requirement for an industry regime to be considered as effective. However, in response the NCC argued that:

> … it would not be appropriate to be too prescriptive on matters such as pricing methodologies as knowledge and understanding of these areas is constantly evolving. There may be danger in locking regulators in to an approach that could, in future, be superceded. (sub. DR99, p. 49)

Consistent with the NCC's views and the discussion of the certification process in chapter 9, the Commission now accepts that certification may not be the right tool for encouraging the uptake of productivity-based approaches. Rather, it considers that there should be a two-pronged approach.

First, as outlined in section 12.4, the Commission agrees with those participants who suggested that there be an additional broad pricing principle to encourage regulators to include incentives to increase productivity within access arrangements. Such a principle in Part IIIA would provide a worthwhile signpost to regulators.

However, on its own, this is unlikely to drive experimentation with productivity-based approaches. As the ORG and ACCC pointed out, incentives for productivity gains have been incorporated in existing building block regimes.

Thus, the second element of the approach is to put in place a process which will:

- validate the importance of relying more heavily on productivity-based approaches; and
- help spur the necessary preparatory work.

In relation to the latter point, there may need to be significant work to develop the measures required to implement a productivity-based pricing regime. Indeed, the ORG suggested that an appropriate approach may be for this inquiry to:

> Urge jurisdictional regulators, regulated businesses and other bodies (such as the Productivity Commission itself) to work together to examine these issues and to develop consistent performance measurement and reporting arrangements across jurisdictions. (sub. DR112, p. 18)

Citipower also agreed with the need for further investigation stating that:

> We have long advocated a cooperative approach between regulators and industry that addresses these practical issues thoroughly and systematically. … Citipower fully supports any effort that objectively evaluates the merits and feasibility of external regulation. (sub. DR122, p. 9)

However, the Commission considers that there may be some truth in the remarks of Forsyth (2001) on the reluctance of regulators to prepare the ground for new approaches:

> Typically, when a regulator is setting new prices it will comment that it sought out benchmark comparisons during its processes. It will state that it is very difficult to make meaningful comparisons between firms, but that more thorough analysis of benchmarks should be a priority for the next round of price setting. … By the time this next round comes about, little progress on benchmarking will have been achieved. (p. 21)

Thus, the Commission considers that a concerted effort is required to enable a reduction in the explicit role of costs in setting access prices. A number of the Commission's recommendations in early chapters call for collaborative action by the Commonwealth, States and Territories. The Commission considers that this is another matter that would need to be jointly progressed. Accordingly, while not directly relating to the Part IIIA legislation, the Commission makes the following recommendation:

RECOMMENDATION 12.2

The Commonwealth, States and Territories, through the Council of Australian Governments, should initiate a process to develop further the productivity measurement and benchmarking techniques necessary for regulators to make greater use of productivity-based approaches to setting access prices.

13 Capital cost issues

While the Commission supports moves to rely more on productivity-based pricing approaches, it recognises that costs are likely to remain an important factor influencing regulated access prices. Whenever cost-based approaches are used to set access prices, regulators must estimate capital costs. Within these approaches, the rate of return allowed, and the way in which assets are valued, has a significant effect on the final access price. As Professor Parry (2000, p. 140) argues:

> Importantly, it is the capital-related costs (return on and return of capital) that dominate the total revenue requirements for the infrastructure assets involved in access to the major utilities such as electricity, gas, telecommunications and rail.

For example, in the gas industry, around 70 per cent of total revenue is required to fund capital costs (Davis 1999). Partly because of the effect on prices and returns, and partly because of the complexity of the issues involved, the rate of return calculation and asset valuation are contentious areas.

13.1 The rate of return

Most participants broadly accepted that it is appropriate to base the allowable rate of return on the weighted average cost of capital (WACC) for the infrastructure used to deliver the particular service. Infrastructure providers, however, expressed dissatisfaction with the WACCs calculated under particular industry regimes. Underlying this dissatisfaction is considerable disagreement between regulators, service providers and access seekers about the different components of the WACC.

Some of the disagreements arise from difficulties of determining what values are appropriate for the variables in the WACC formula. But at a more conceptual level, there are some unresolved issues as to how regulators should handle risk in the rate of return calculation. In particular, some access providers argue that the specific risk profile of a project should be recognised when setting the WACC (box 13.1).

Box 13.1 **The rate of return and risk**

Despite various critiques, the Capital Asset Pricing Model (CAPM) is widely used among corporate finance practitioners to set hurdle rates of return for investments. The model divides risk into two types — diversifiable and non-diversifiable. Diversifiable risks include all risks that are specific to the business or project. They are described as 'diversifiable' because an investor holding a diversified investment portfolio can potentially eliminate the effect of these risks — a poor result from one investment can be balanced by better returns from others. Non-diversifiable, or market risk, reflects the relationship between the price of a particular investment and movements in the market as a whole (denoted as the project's beta). Holding a diversified portfolio will not eliminate this risk. Importantly, individual businesses are affected differently by general market movements, meaning that the accompanying level of market risk also varies. Returns for most infrastructure services tend to fluctuate less than the market as a whole.

According to the CAPM, because an investor can eliminate the effect of diversifiable risk, it is the project's level of non-diversifiable risk that determines the return an investor will require. A high level of market risk will require a relatively high return and vice versa.

In applying the framework, it is often not possible to be precise about the appropriate beta for a particular infrastructure project. This has been one source of disagreement among providers and regulators.

However, there are also a number of unresolved conceptual issues relating to how regulators should treat risk when setting rates of return.

- First, as discussed in chapter 4, investments to provide new essential infrastructure services, will often be expected to be only marginally profitable and have high specific risks. Across a range of such projects there is likely to be significant variation in returns realised. An investor will understand that some projects are likely to be successful and earn possibly high returns while others will be unsuccessful. If an investor can diversify, he/she may be able to eliminate the effect of this unique risk and may, therefore, require a return from these projects based primarily on their market risk. But this does not mean that regulators should set a rate of return for these projects based on their market risk. To do so would reduce the attractiveness of such projects to an investor because it would eliminate the potential for the projects to be very successful, while leaving unsuccessful projects unaffected (ie the average return could be below the WACC). On this argument, where there is a degree of uncertainty in a project's expected returns, those returns should not be limited by regulators to the rate of return suggested by the project's level of market risk. This argument provides a rationale for access holidays or a 'truncation premium' in the regulated rate of return — canvassed in chapter 11 as possible instruments for facilitating efficient investment within an access regime.

(continued next page)

Box 13.1 **continued**

- Second, some infrastructure providers have pointed out that, notwithstanding CAPM theory, it is accepted practice for businesses to insure or hedge against a range of specific risks. These include the risk of catastrophic loss and hedges against movements in exchange rates or the rate of inflation. These costs form expenses in the project's cashflows. However, businesses often self-insure for these risks, in which case these costs are implicit rather than explicit. Officer (1998, p. 4) notes that:

  > Many business executives, including finance executives, often treat the cash flows without considering such risks, implicitly embedding the risks in the WACC so that the WACC is higher than that measured or estimated by the regulators.

  Officer, and some infrastructure providers, have argued that regulators should allow for these risks, either by including them as expenses in the business's operating costs, or by increasing the allowed WACC. However, if regulators set returns strictly according to CAPM theory — which implies that firms should not insure against specific risks — these costs would be excluded from both the cashflows and the allowed return. Although this issue is unresolved, the CAPM approach would appear to run counter to accepted business practice.

- Finally, the regulatory regime itself may affect the level of market risk faced by an investor since terms and conditions of access are likely to affect the variability of returns relative to the stock market. For instance, London Economics (1998) reports asset betas for international gas infrastructure regulated under incentive-based regimes averaging 0.84 compared with an average of 0.2 for assets covered by rate of return regimes. If correct, this would suggest that the type of regulatory regime should influence the rate of return allowable for the infrastructure in question and, that in setting rates of return, there is a danger in selecting average industry betas 'off the shelf'.

Regulators are now more aware of these issues and, through discussion with infrastructure providers and academics, it is likely that, over time, some will be resolved. Indeed, according to the Australian Gas Association (sub. 29, p. 14) recent decisions by the Australian Competition and Consumer Commission (ACCC) on WACCs for gas pipelines appear to have recognised, to some extent, that regulated returns need to vary according to the risk profile of the project. In the case of the Central West Pipeline decision, the ACCC recognised, in effect, that losses in early years need to be balanced by returns above the WACC in future years if the project is to break even. Moreover, the Office of the Regulator-General, Victoria (ORG) argued that is has, on occasion, provided for specific risk in the cost base when setting price caps. (sub. DR112, p. 7)

Nonetheless, given the competing considerations involved in setting access prices, the allowed rate of return will inevitably remain a contentious issue. In the

Commission's view, this serves to highlight the importance of transparency in regulatory decision-making (see chapter 15). Such transparency will at least ensure that each of the competing considerations relevant to setting the WACC will be given proper consideration.

13.2 Asset valuation

In competitive markets it is the revenue that the use of an asset generates that ultimately determines its value. However, in regulated markets the maximum allowable revenue is determined by the regulator. The circularity problem that would arise if assets were to be valued on the basis of expected cash flows means that regulators must find ways to set asset values independently of cash flows.

While there are a multitude of asset valuation methods, debate between access seekers, infrastructure owners and policy makers tends to focus on whether an historical cost approach (often termed depreciated actual cost — DAC), or a replacement cost methodology, is more appropriate. The most common replacement cost methodology used in Australia is depreciated optimised replacement cost (DORC or ODRC).

Under the DAC method, assets are valued at their net book value and depreciated in line with accounting standards or a schedule specified by the regulator. Allowance for inflation is made either through indexation of the asset base, or by adjusting the allowed rate of return.

Under DORC, assets are valued at the cost of replacing their remaining service potential. The replacement cost is 'optimised' in that replicating service potential does not necessarily involve replacing the same physical assets. Hence, if a new technology can deliver the service at a lower cost than the existing assets, those assets will be valued at the cost of the new technology. In this way, DORC is said to emulate what would happen to asset values in a competitive market.

It should be noted that when an investment is initially made, DORC and DAC valuations are equivalent. To be more precise, after an initial prudence review, DORC and Depreciated Optimised Actual Cost (DOAC) will be the same.

Over time, however, DORC and DOAC are likely to diverge. In theory, DORC values would normally be expected to trend lower than an inflation adjusted DAC value — the optimisation in DORC provides scope to lower asset values but rarely to increase them. In practice, however, DORC values can also be higher than an inflation adjusted DAC valuation. There are a range of reasons why DORC can be higher than DAC. One common reason is the somewhat arbitrary nature of depreciation schedules for assets with long lives. For example, an asset might have had a nominal expected life of 25 years when it was built, but with minor maintenance or modification may turn out to last 50 years. At, say, year 20 a DAC value will be low since the asset will be depreciated by 80 per cent. However, a DORC valuation conducted at this time would be based on an engineering assessment of the asset with a remaining life of 30 years.

In Australia, access regulators have used DORC in the electricity, gas and telecommunications sectors. Indeed, with the exception of the Gas Code, which contains some elements of a DAC approach, there are few cases where DAC valuations have been used to set regulated access prices. By contrast, in the USA, historical cost valuation methods are used almost exclusively.

In the Position Paper, the Commission suggested that the additional cost and uncertainty seemingly inherent in the DORC approach may not have resulted in better outcomes and sought more information from participants on the advantages and disadvantages of the different valuation methods.

The following discussion builds on the analysis in the Position Paper on the merits of the DORC and DAC approaches as applied to infrastructure, using the significant number of responses received by the Commission.

Depreciated optimised replacement cost

Somewhat surprisingly, neither infrastructure users nor service providers fully supported the DORC approach as currently applied by Australian regulators. This apparent paradox can partly be explained by the different reasons various service providers and access seekers had for criticising DORC and the different circumstances that exist across infrastructure sectors.

For example, the Network Economics Consulting Group (NECG, sub. DR113, p. 2), representing infrastructure providers, argued that although DORC is a valid valuation method, optimisation often increases risks to owners without a sufficient offsetting benefit to the community. This criticism drew mainly on the optimisation process as applied in the telecommunications sector. Optimisation in that sector appears to be more prevalent than in other sectors and has led to regulated reductions in values because of the emergence of cost-reducing technologies. Moreover, the access regime for telecommunications, unlike that in some other sectors, offers little scope for facility owners to provide their own valuation estimates to regulators.

In contrast, infrastructure users' concerns related mainly to DORC as applied in the energy sector. In this sector, optimisation has been less extensive and there appears to be considerable scope for infrastructure providers to influence DORC valuations. Users of energy infrastructure considered that DORC valuations are highly subjective and non-transparent which has allowed providers to earn monopoly rents.

Conceptual issues

The issue of ex post optimisation is multifaceted and complex. Nevertheless the Commission does not see an *a priori* case for optimisation in all cases. Rather, the decision as to whether the benefits of optimisation will outweigh its costs can only be made with reference to the specific circumstances of each case.

Costs of optimisation

The potential for regulators to undertake ex post optimisation will increase the risks involved in holding infrastructure assets with high sunk costs, relative to a regime which does not provide for such optimisation. In elaborating on this point the NECG said :

> … [access regulation] leaves open to the regulator the ability to strand part or all of an asset if market circumstances have changed, or if changes in technology would result in a different investment today (stranding through optimisation). … The extent of the risk involved, and the likelihood of its deterring investment, is made all the greater by the informational uncertainties inherent in attempting to derive optimised costs. (sub. DR76, pp. 33-34)

Increased risk from optimisation will be manifested either as a lower expected level of cashflow from a given project, or a higher hurdle rate to attract investment. Either way, the increased risk will be paid for by consumers in higher prices (or through reduced access to services if failure to reflect this increased risk in regulated rates of return leads to reduced new investment). In this respect, the NECG commented that:

> … the key to the DAC vs DORC debate is really the difference in the cost of capital associated with the two methodologies, and the extent to which any differential is justified in terms of offsetting benefits to customers. (sub. DR113, p. 8)

As such, optimisation does not constitute a 'free lunch'. It therefore becomes an empirical issue as to whether the added risk under ex post optimisation and the DORC approach (and hence a higher hurdle rate of return for new investment) is justified by other benefits — such as a reduced capacity to engage in cost padding.

Benefits of ex post optimisation

The strong intuitive appeal of DORC rests on parallels between DORC and asset values in competitive markets.

In particular, it is claimed that DORC will ensure that prices would never be above those that would prevail were a new network to be installed. As the ACCC (1998, p. 33) has argued:

> Another justification for DORC setting the upper limit to valuations comes from what a DORC valuation actually is attempting to measure. This is the maximum price that a firm would be prepared to pay for 'second hand' assets with their remaining service potential, higher operating costs, and (old) technology given the alternative of installing new assets which embody the latest technology, generally have lower operating costs, and which will have a greater remaining service potential. Therefore, if prices reflect a value that is in excess of DORC, then users would be better off were the existing system scrapped and replaced by new assets.

However, while a DORC valuation represents the amount someone would be prepared to pay for the second hand asset, it does not necessarily follow that users would be better off with new assets if prices were in excess of this amount. As Professor Johnstone notes with respect to energy transmission:

> A new entrant in the market for energy transmission services would have to pay full, (undepreciated) ORC [optimised replacement cost] to duplicate or bypass existing infrastructure. There is no second hand market on which one can buy a used, *in situ* electricity grid or a gas pipe network, or even the individual components thereof. Hence provided that DORC value claimed by the existing asset owner is less than the actual (ie, "true") ORC, there is no possibility of competition. (sub. DR74, pp. 13-14)

In a similar vein, the NECG commented that:

> … the competitive threat is therefore one that exists only in the mind of a regulator seeking to secure productive efficiency (that is, trying to minimise the total costs of production). Of course, duplication of natural monopoly assets cannot, by definition, be productively efficient. (sub. DR113, p. 6)

And:

> No valid inferences can be drawn, at least in any simple way, from the workings of contestable markets to those of markets where economic behaviour is shaped by the existence of substantial sunk investments. (sub. DR76, p. 35)

On the other hand, the Centre for Economic Studies in a paper prepared for the Energy Users Association of Australia (sub. DR101, p. i) saw some merit in the competitive market analogy. Nevertheless, it considered that:

> The value of an asset in competitive markets is given by deprival value, which must lie somewhere between scrap value and DORC. There is no basis to say that DORC would prevail in competitive markets.

Collectively, these comments highlight two implications that the characteristics of infrastructure have for the choice of asset valuation method:

- to the extent that the assets are sunk, the facility owner will continue to supply infrastructure services so long as the regulated value exceeds scrap value (the next best alternative use); and
- if the facilities providing these services are natural monopolies, inefficient duplication is likely to occur only rarely regardless of the asset valuation method.

This suggests that a range of valuation methods could reasonably be used and that no method is likely to be intrinsically superior. Indeed, at least conceptually, both DORC and DAC would appear to be equally able to deliver outcomes which are allocatively and productively efficient.

That said, DORC does have some advantages over DAC at the *investment* stage. With regulators having imperfect information about the merits of an investment, optimisation can make it more difficult for a project's proponents to 'game' the regulator. For example, without the threat of ex post optimisation the infrastructure owner may have an incentive to cost pad or over-engineer the asset in order to secure higher returns. However, if the owner knows that the asset value can be written down if it becomes apparent that the investment was imprudent, this strategy is far more risky.

The extent of this benefit from ex post optimisation is likely to vary across infrastructure sectors. It is likely to be greater the more difficult it is for a regulator to determine whether a proposed investment is prudent. Unfortunately, where the potential benefits from optimisation are high, the potential costs are also high. For instance, in industries with rapidly changing technology, the difficulty of determining whether investment costs are efficient means that while there is considerable risk of gaming, there is also an attendant risk of asset stranding. Conversely, in industries where technologies are relatively stable (and the prudence of investments is therefore easier to judge) the risk of asset stranding is also much lower.

Moreover, as discussed below, a number of participants pointed to the ability of infrastructure owners to manipulate DORC valuations to secure higher returns. Thus, DORC does not overcome all 'gaming' problems.

So why the general presumption for DORC?

In the Commission's view, the preceding considerations suggest that, even at the conceptual level, the decision about whether to provide for ex post optimisation in an access regime is not clear cut, and can only be made on a case-by-case basis. This does not appear to be the current practice. Rather, there appears to be a general presumption in favour of DORC.

The ACCC justified the use of DORC on the basis that:

> Rather than being the regulator's tool of choice, the ODRC has largely become the technique of choice by the government owners of the assets. This preference stems back to the "red book" which was published by a committee comprising the representatives from the Commonwealth, State and Territory governments and chaired by the Productivity Commission's predecessor, the Industry Commission. The ODRC methodology is seen as a pragmatic alternative to the "red books" preferred use of deprival valuation. (sub. DR93, p. 35)

The issue of whether the deprival value approach requires the use of a DORC valuation aside, the Commission acknowledges that the 'Red Book' has been influential in framing regulators' views. What is less clear is the extent to which the analysis in the Red Book is applicable to the issues that arise in regulating access prices. It is important to note that the use of deprival value was initially recommended to address specific concerns with the monitoring of government business enterprises — see box 13.2. Underlying the Red Book exercise was governments' desire to improve the generally *inadequate* returns earned by government businesses. In contrast, regulators concerns are, by and large, to prevent *excessive* returns. That is, rather than using asset values as a monitoring tool, regulators use it to control returns. For the reasons outlined above, it does not follow that a valuation method appropriate for measuring performance is appropriate in all cases for controlling monopoly power.

Practical implementation of DORC

Many participants pointed to the subjectivity and lack of transparency in the implementation of DORC valuations.

For instance, WMC Resources Limited noted that the Commission's Position Paper:

> … rightly points out the many problems with the DORC valuation methodology, including the scope for a wide range of outcomes depending on the assumptions made, and the generally inadequate and ineffective optimisation step. (sub. DR71, p. 4)

Box 13.2 **The 'Red Book' and asset valuation**

The 'Red Book' was developed in the 1990s against a backdrop of generally poor financial performance of government business enterprises (GBEs). A central theme of the process of the Steering Committee on National Performance Monitoring of Government Trading Enterprises was, therefore, to improve the efficiency of GBEs through detailed performance monitoring. One element of this process was to devise techniques to accurately measure the performance of GBEs.

The Steering Committee considered that performance monitoring of GBEs required measures of economic performance — such as the economic rate of return (ERR) or the Economic Value Added (EVA) rather than the more traditional, but partial, accounting measures. In the absence of market valuations, economic measures of performance require, in turn, an asset valuation method that approximates changes in market values of the assets. For example, the accounting measures may not have accurately reflected true performance since it would have been possible for GBEs to write down asset bases in order to achieve an acceptable accounting rate of return.

Accordingly, the Committee recommended the use of deprival valuation techniques to address such problems. (In its submission to this Inquiry, the ACCC argued that DORC is a practical alternative to deprival valuation.)

In sum, the background to the adoption of these methods was not a consideration of how to develop a regime to prevent monopolies earning excessive returns, but a performance measurement exercise to assist governments to secure better returns from their businesses.

The NECG noted that the Australian Communications Authority and the ACCC have calculated widely different estimates of the optimised line costs for Telstra's public switched telephone network (sub. DR76, p. 36). Additionally, the Energy Markets Reform Forum provided examples of the variability of DORC and ORC estimates of AGLGN's gas network (table 13.1).

Table 13.1 **Variability of ORC and DORC for AGLGN's gas distribution network**

Date	*Author*	*ORC ($ billion)*	*DORC ($ billion)*
1996	JP Kenny	2.44	1.45
1999	AGL	2.56	2.01
1999	Ewbank Preece	1.80	
1999	Kinhill	3.10	
2000	GCI-Kenny	2.30	1.60

Source: Energy Markets Reform Forum (sub. 7, p. 26)

A number of user groups singled out DORC valuations of easements as being especially problematic. For instance, BHP Billiton cited two valuations of easements for New South Wales electricity networks where the higher valuation was more than double the lower one (table 13.2).

Table 13.2 **Variability of easement valuations for two New South Wales electricity networks**

Valuer	*Easements ($ million)*	
	Energy Australia	*Integral Energy*
Chesterton	2 054	3 537
State Valuer	848	1 643

Source: Information tabled by BHP Billiton at the Sydney public hearings

According to Professor Johnstone, the subjectivity in DORC valuations renders them unauditable:

> No two firms of valuers working independently can be expected to come up with equal or even nearly equal DORC valuations. The problem is that DORC valuations embody multiple subjective and at worst completely arbitrary choices, and can only be verified when these are specified and then taken as given. In the end, the only independent verification is of the arithmetic. (sub. DR74, pp. 8-9)

BHP Billiton (sub. DR79) suggested that the costs of rigorous DORC valuations would be high, so they are rarely done well — compounding the subjectivity problems.

Infrastructure users considered this subjectivity provides scope for regulated firms to inflate the regulated asset base in order to achieve a higher return. BHP Billiton maintained:

> A further problem with DORC is its susceptibility to gaming. Every element of the calculation is both information intensive, and is open to a wide range of interpretations. (sub. DR79, p. 7)

Further, as noted previously, in contrast to telecommunications, some commentators have suggested that the extent to which optimisation of asset values actually occurs in the energy sector under DORC approaches is low. Davis (1999, p. 5) describes DORC as:

> … in effect, the current dollar amount which would be required to replace the existing assets with identical assets except to the extent that the current physical configuration of the assets is non optimal.

And, according to Zauner (2000, p. 4):

> The optimisation approach is necessarily subjective and receives much debate even though it typically only results in a write-down of the order of 5-10% of the un-optimised asset value.

Finally, BHP Billiton commented that:

> … in all the cases that BHP has reviewed, it has been assumed that the existing system design and layout is the optimised design and layout. (sub. DR79, p. 5)

Yet, if optimisation has relatively little effect on the value of a particular facility, it is questionable whether the subjectivity and additional transaction costs of the DORC methodology can be justified.

Depreciated actual cost

The main advantages of DAC approaches is that they are relatively simple, transparent and objective, which can lower regulatory costs. As stated by Bonbright (1988, p. 224):

> … among the most important virtues of an original-cost rate is that of relative ease of administration in terms of speedier disposition of rate cases, definiteness of decision, and minimum expense to all parties and to the [regulator].

The ACCC (1999, p. 46) has similarly commented that:

> The cost information needed to calculate the rate base is usually readily available from the service provider's existing accounting and financial systems. Inflation adjustment, say on a CPI base, can be constructed, and [a] depreciation schedule can be superimposed.

Additionally, as discussed, a number of commentators argue that DAC will often provide efficient incentives for investment and efficiency. For example, although concluding that the choice of asset valuation method should be a case-by-case decision, King (1997, p. 19) nevertheless suggests that there is a broad case for:

> … the use of historic or original cost asset valuation for access purposes. … It involves less subjective assessment and guesswork and usually will provide adequate incentives for investment and equivalent operational incentives compared with alternative valuation procedures.

Against this, as part of a building block approach, DAC could create an incentive to cost-pad assets (see above). Unlike firms in competitive markets using historical cost valuations, the returns to the bottleneck facility will depend crucially on the value of its assets. In this situation, as the ACCC (1999, p. 46) notes:

> Historical cost gives the investor the incentive to choose the asset with the highest current cost subject to regulatory approval since a larger rate base gives the potential for higher profits.

To reduce this problem, it is well accepted that regulators need to ensure that proposed new investments are efficient, or prudently incurred. For this reason the DAC approach is often described as DOAC (depreciated optimised actual cost). Thus, regulators can refuse to approve the cost of an investment if it considered its purpose was simply to inflate the facility's capital base.

A prudence review (or similar process) would be undertaken only once under a DAC regime rather than regularly as can occur under the DORC methodology. However, DAC loses some of its apparent simplicity and objectivity once account is taken of the potential for regulators to place a different initial valuation on a facility than the provider.

The ACCC also argued that DAC valuations could be problematic in situations where an asset is fully depreciated, yet still has some remaining economic life:

> … if a business values its assets on a historical basis and those assets are fully depreciated, then access prices and revenues based on those asset values would be very low. The business would have an incentive to invest in replacement assets in order to raise their revenues and may even over invest in additional capacity because of the high demand stimulated by the low prices. As a consequence, prices could jump once revenues are determined on the new asset values, and it is even possible that fully depreciated assets could be replaced, even though they may still have a substantial remaining economic life. (sub. DR93, p. 36)

However, in the Commission's view these sorts of investment outcomes are unlikely to occur. As noted, so long as an asset is valued above its scrap value (and the value of the land it occupies) the owner has an incentive to maintain it and to continue to provide services. Further, in situations where such an asset has excess capacity, 'low' regulated access prices are likely to be efficient. On the other hand, if the asset is operating at full capacity, higher prices which signal the opportunity cost of using the service, may be more appropriate.

It appears that revising asset values upwards using the DORC approach is one of a number of methods that regulators have used to counteract the effect of depreciation in order to 'smooth' the price path. For instance, the ACCC (1998, p. 32) has stated that a:

> … DORC valuation may act to reduce shocks to reference tariffs as the replacement of assets becomes necessary.

While such smoothing may help to avoid major fluctuations in prices, it can often have the effect of providing windfall gains to the infrastructure owner. In the example cited by the ACCC, assuming that prices had been set to achieve the regulated risk-adjusted level of returns, if the asset is near to fully depreciated the facility owner will have recovered the cost of its investment. A DORC valuation that then increased returns would provide an element of economic rent to the facility owner.

Summing up

Clearly, the myriad of specific issues that arise across infrastructure sectors means that regulators should not be bound to use one particular asset valuation approach in all situations. Rather, the Commission considers that the approach used should have regard to specific circumstances.

In examining current practice, however, it is not apparent that such analysis has underpinned the choice of valuation methodologies. The origins of the widespread use of DORC valuations appear to lie in the 'Red Book' process which, as discussed, was intended to address a different set of policy issues from those facing regulators of infrastructure with market power. Adopting such an 'off-the-shelf' solution may not have been appropriate in all cases.

The Commission further considers that there is evidence that, as currently implemented for some industries, the DORC approach creates considerable additional costs and uncertainty for regulated firms and access seekers alike. Yet evidence of DORC's conceptual superiority is not often evident in these cases.

Changing the valuation methodology for existing assets could create unwarranted uncertainty. For new assets, however, such a shift in emphasis would offer the prospect of simpler processes and more certain outcomes, although it would still involve considerable regulatory involvement to ensure that new investments are prudent. The case for a shift to DAC valuations is likely to be stronger for new assets in sectors such as energy where technological change is incremental and somewhat predictable. In these sectors, the benefits from optimising assets seem unlikely to justify the added uncertainty and transaction costs of a DORC approach. Indeed, the Gas Code already has some elements of a DAC regime.

By contrast, for a sector where technical obsolescence is a key feature of the market, such as telecommunications, an optimised approach may be preferable in some circumstances.

However, within a broad-ranging inquiry of this kind, it is not possible for the Commission to provide more specific guidelines on when a particular approach is likely to be superior. Indeed, the problems surrounding asset valuation provide yet another illustration of the complexity, and lack of real precision, in cost-based processes for regulating access prices. This reinforces the earlier conclusion that there would be value in experimenting with approaches that did not rely so heavily on cost data (including asset values).

That said, in the short to medium term, asset valuation will remain a critical component of many cost-based access regimes. The Commission therefore considers that where DORC methodologies are applied, there would be value in regulators setting out the reasons for using the approach rather than a potentially simpler DAC valuation. In relation to Part IIIA, the proposed post-arbitration reports (see chapter 15) would provide an appropriate vehicle for this.

RECOMMENDATION 13.1

When arbitrating a dispute for a service declared under Part IIIA, the Australian Competition and Consumer Commission should outline the reasons for its choice of asset valuation methodology in the post-arbitration report (see recommendation 15.6)

14 Institutional arrangements

In examining ways to improve Part IIIA, it is important to look beyond the regime's broad architecture. In particular, the efficacy of administrative structures and processes and accountability requirements can have an important bearing on outcomes. This is reflected in the terms of reference, which direct the Commission to examine a number of these matters (see chapter 1).

In making its assessments, the Commission has not attempted to scrutinise every detailed aspect of Part IIIA processes. Rather, in this and the following chapter, it has focussed on some higher level issues likely to impinge upon the effectiveness and timeliness of those processes. Specifically, this chapter examines the efficacy of the institutional arrangements that govern decision making under Part IIIA.

As described in chapter 2, a number of entities are involved in Part IIIA decision making — the National Competition Council (NCC), government Ministers from all jurisdictions, the Australian Competition and Consumer Commission (ACCC), the Australian Competition Tribunal, and various State and Territory regulators charged with administering industry-specific regimes which operate under the Part IIIA umbrella.

During this inquiry, there has been no suggestion that the role of the Tribunal should be modified (although participants such as the Australian Council for Infrastructure Development (AusCID, sub 11, p. 15) suggested that inadequate resourcing is a constraint on its effectiveness). Moreover, the roles and responsibilities of State and Territory regulators in relation to certified industry regimes lie largely outside the purview of the inquiry. Hence, in looking at decision making structures, the Commission has focussed its attention on two aspects: the role of Ministers and whether there is a need for both the NCC and the ACCC to be involved.

Assessment of these matters raises a range of complex and contentious public policy issues and engendered considerable debate during the inquiry. A number of the considerations involved extend well beyond narrow concepts of benefit and cost. For example, Commonwealth-State jurisdictional issues are central to the current decision making structures. Thus, in responding to preliminary proposals aired in the Position Paper to reduce the number of parties involved in Part IIIA decision making (and to strengthen the framework role of Part IIIA), the Western Australian Government stated:

> Western Australia is concerned that these proposals depart from the Competition Principles Agreement and would result in a considerable shift in powers from the States and Territories to the Commonwealth in respect of access regulation. (sub. DR69, p. 1)

Such wider dimensions highlight the need for caution in making changes to the established administrative structures.

14.1 The role of Ministers

As discussed in chapter 2, Ministers are responsible for declaring services and certifying regimes under Part IIIA. For declaration decisions involving infrastructure owned by a State or Territory, the responsible Minister is the State Premier or Chief Minister. Responsibility for other declaration decisions and for certification decisions lies with the Commonwealth Treasurer.

The involvement of Ministers in Part IIIA decision making is consistent with the Hilmer Committee’s proposals. The Committee argued that because a decision to provide for a right of access rests in part on the evaluation of important public interest considerations, that decision should be made by government rather than by a court, tribunal or other unelected body.

Importantly, however, the Committee saw this responsibility as a Commonwealth one, even for infrastructure owned by the States and Territories:

> Access rights [should] be created by a process of declarations made by the designated Commonwealth Minister …
>
> The proposed general access regime [should] be capable of application to facilities owned by State or Territory Governments. As a measure of comity to other governments in the federal system, the Commonwealth should place primary emphasis on cooperative approaches to the declaration of access, based on the agreement of the owner of the facility. Where that cooperation is not forthcoming, however, the Committee considers the important national interests at stake in some circumstances may be sufficient to justify unilateral action. (1993, pp. 266-8)

As it transpired, an emphasis on cooperation was not seen as sufficient to safeguard jurisdictional interests. Hence, State and Territory Ministers were given a formal decision making role in Part IIIA processes. In this regard, the ACCC observed:

> One reason all governments have wanted to have an involvement in the declaration process is the privatisation or potential privatisation of some state owned facilities or businesses is likely to be affected by declaration. (sub. 25, p. 92)

The Position Paper proposals

First round submissions to the inquiry contained diverse views on the future role of Ministers in Part IIIA decision making. The New South Wales and Western Australian Governments expressed strong support for continued Ministerial involvement in the process, with the latter arguing that:

> Maintaining Ministerial responsibilities for declaration is seen as an important check in the process. Ministers are subject to requirements of due consideration and natural justice, which are important constraints on their exercise of administrative power. (sub. 38, p. 4)

The Queensland Mining Council also argued that, while some 'fine tuning' may be required, the current role for Ministers is broadly appropriate.

However, a number of other participants argued that the role for Ministers should be downgraded or ended. Of particular concern to these participants was the additional uncertainty that accompanies Ministerial involvement in the declaration process. Synthesising these views, the Law Council argued:

> Ministerial involvement in the process seems to add no value whatsoever. In many cases under Part IIIA to date, the Ministers have not even made a decision in the required time period. Ministerial reasons have been scanty and poorly explained, if provided. State Ministers appear to ignore the NCC's reasons and do not follow its recommendations. Ministerial involvement appears to be simply a time-wasting element in the whole lengthy process.
>
> The Law Council recommends that all Ministers should be removed from the declaration process. State and Federal governments already have some input through their appointments to the NCC and ACCC. (sub. 37, pp. 24-5)

Similarly, AAPT Limited (sub. 42, pp. 5-6) argued that Ministerial involvement makes the declaration and certification processes 'convoluted and unpredictable', while Rio Tinto said that such involvement gives rise to a potential conflict of interest. It claimed that this conflict of interest is illustrated by the fact that:

> … of the … applications to date, three have resulted in recommendations by the NCC for declaration of services provided by State-owned rail systems but none have been declared. (sub. 15, p. 15)

For its part, the Commission emphasised that the future role of Ministers in Part IIIA was a complex issue. It acknowledged that the property right implications of access disputes raise important 'due process' considerations, including whether decisions affecting those rights should be ceded to unelected officials. It also noted the jurisdictional sovereignty concerns that have influenced the current arrangements.

However, it went on to argue that:

- It is hard to find evidence that Ministerial involvement to date has improved decision making by a sufficient amount to justify the extra steps and delays in the process.
- Ministerial involvement in declarations and certifications, but not in undertakings, introduces an element of inconsistency.
- Privatisation of State and Territory infrastructure since the inception of Part IIIA has weakened the jurisdictional ‘safeguard’ rationale for the involvement of State and Territory Ministers.
- In areas such as mergers policy or land use and pollution controls, where substantial property right issues also arise, formal responsibility for decision making often lies with the regulator, subject to legislative standards and specified appeals processes.

Given these considerations and the widely acknowledged need to improve the timeliness of access processes and reduce their costs, the Commission went on to propose that the role for Ministers in Part IIIA decision making be ended.

Accepting that a continued role for Ministers might nevertheless be judged worthwhile, the Commission also proposed modifications to their current role to encourage more timely decision making and enhance accountability:

- extension of the current 60 day time limit for Ministerial decisions on declaration applications to certification decisions;
- a requirement for Ministers to publish reasons for their decisions; and
- deeming of a non-decision within the 60 day limit as acceptance of the NCC’s recommendation.

Responses to the Position Paper proposals

The Commission’s preliminary proposal elicited views from a wide cross section of participants, many of whom had initially been silent on the issue.

Amongst those who supported the Commission’s proposal to end Ministerial involvement in decision making, concerns about the potential for State Ministers to frustrate efficient outcomes were clearly evident. For example, the Chamber of Minerals and Energy of Western Australia said that it:

> … agrees with the proposal to remove the decision making role of ministers in Part IIIA declaration processes. Provided the current appeals mechanisms are retained, it is not clear that the ministerial role adds anything to the process. Indeed, the Chamber

> notes that a not unusual pattern has been for an NCC recommendation for declaration, [followed by] a rejection by the relevant State premier … (sub. DR66, p. 4)

Similarly, WMC Resources said that it 'agrees with the Commission that the discretionary role of the State Ministers and Premiers needs to be removed'. It went on to note that, but for the recent change of government in Western Australia, were the NCC to find in favour of the current declaration application for certain services provided by Western Power:

> … the recommendation would be subject to the effective veto of the same State Government who had established the regime and previously refused to submit the regime for certification. This is not satisfactory. (sub. DR71, p. 4)

And the Australian Rail Track Corporation (ARTC) — which had previously endorsed the Hilmer Committee's approach of making the Commonwealth Minister responsible for deciding on all declaration as well as certification applications — said that:

> The Commission has gone further by proposing to remove Ministerial involvement in Part IIIA processes altogether … ARTC does not see this measure as detracting from the consistency aspects of the processes, and should provide some advantages with respect to the efficiency and certainty of the process. ARTC would therefore see some merit in the proposal. (sub. DR64, p. 3)

Other participants to indicate support for the Commission's proposal to end the decision making role for Ministers in Part IIIA included Freight Australia (transcript, p. 4), Specialised Container Transport (sub. DR85, p. 6), the Institute of Public Affairs on behalf of United Energy, Citipower and TXU Networks (transcript, p. 65) and the Energy Users Association of Australia (sub. DR94, p. 37).

However, an equally significant group of participants were opposed to the Commission's proposal.

In the first instance, this opposition reflected the significant public policy judgements involved in decisions to make infrastructure subject to access regulation. Typifying these views, the NCC argued:

> The Council considers that ministerial involvement reinforces the policy nature of the coverage process, clearly distinguishing it from the more technical regulatory role of determining or approving terms and conditions of access. (sub. DR99, p. 53)

Similarly, the Northern Territory Government observed:

> The criteria for declaration and certification involve the exercise of a considerable degree of judgment. Accordingly, the criteria are open to considerable interpretation, and decisions can have considerable impacts on the economy. Ministers, as elected representatives, would appear best placed to assess these impacts. Therefore, such

> decisions should be made by governments rather than by unelected bodies. (sub. DR111, p. 12)

A number of participants went on to emphasise that wider public interest considerations involved in coverage decisions make Ministerial input particularly important. The Australian Gas Association said:

> Ministerial representation in regulatory decision making is important from the point of view of public accountability. It is also important that given the generic assessments of public interest that current legislation requires, and which ought to be part of future access regimes, an identifiable public representative makes a transparent decision. Conversely, regulators with specific mandates under legislation should not be put in the position of making unappealable 'public interest' decisions with significant national consequences. (sub. DR84, pp. 2-3)

The NCC argued that:

> … Ministers, as elected representatives, may have particular insights into the criteria, especially those related to national significance and public interest that could differ from the advisory body. In relation to both the Carpentaria and [Specialised Container Transport] (Western Australia) declaration applications, the public interest criterion featured in the Ministers' reasons for [a decision different] from the Council's recommendations. (sub. DR99, pp. 53-4)

In an airports context, Australian Pacific Airports Corporation commented that:

> … in our industry, which is so bound up with safety issues, with environmental issues and so on, the imposition of other areas of government policy on our business is quite profound. We think there needs to be retained a residual role for Ministers to make sure that those other public policy issues are properly recognised and dealt with by the regulator. (transcript, p. 109)

And, introducing a regional perspective, the Balanced State Development Working Group (sub. DR110, p. 4) argued that regulatory bodies such as the NCC and the ACCC do not have experience in living and working in country areas.

Some participants also noted that removing Ministers from Part IIIA decision making could have adverse flow-on effects for industry regimes. Thus the Australian Pipeline Industry Association (APIA) said:

> … the removal of Ministerial involvement would have significant implications for industry specific regimes such as the [Gas] Code which were designed with the specific objective of ensuring Ministerial consideration of recommendations brought forward by an advisory committee … which includes regulatory representatives. The removal of Ministerial involvement would increase the influence of regulators in the Code change process and this is undesirable. It is also essential that Ministers continue to be key decision makers on changes to access regimes such as the Code to avoid de-facto changes to the law by non-elected government officials. (sub. DR70, pp. 16-7)

Further, as previously noted, the Western Australian Government (sub. DR69, p. 1) saw the removal of State and Territory Ministers from the declaration process as contributing to a fundamental shift in the balance of the access framework. The NCC (sub. DR99, p. 53) similarly observed that the current arrangements ‘reflect a wider balance of interests, including the interests of States and Territories in participating in the regulatory decisions affecting their own infrastructure’.

Summarising these views, the South Australian Government concluded that:

> No convincing argument has been presented as to why decision making powers (particularly with respect to policy changes) should be removed from elected Ministers and given to unelected officials. (sub. DR121, p. 6)

At the same time, there was widespread acceptance among participants supporting the retention of Ministers in the decision making process for them to be made more accountable for their decisions. In this regard, the Australian Chamber of Commerce and Industry commented that:

> … while [it] broadly considers that Ministerial discretion should remain as a step in the declaration of an essential service, it should be noted that care needs to be taken to ensure that such decisions are taken for reasons of national not sectional or political interest. (sub. DR67, p. 19)

Accordingly, many participants supported the Commission’s proposals to increase Ministerial accountability in the event that a role for them was retained.

The Commission’s assessment

Participants’ arguments in response to the proposal in the Position Paper serve to reinforce the element of judgement involved in deciding on the appropriate future role for Ministers in Part IIIA decision making.

The significance of the benefits from Ministerial involvement in decisions to date is clearly debatable. Indeed, as noted, some user interests have argued that it has compromised good decision making. The Commission also observes that, in the case of the undertaking used to implement the National Electricity Code, the decision on an apparently satisfactory framework for access to State and Territory electricity transmission assets was made by the ACCC rather than a Minister.

Moreover, in the case of declaration applications, the role of Ministers often may not be decisive. This is because the ‘unsuccessful’ party in a declaration decision can appeal against a Minister’s decision to the Australian Competition Tribunal. For such appeals — which, on the basis of experience to date, appear likely in most cases — the Tribunal assumes the decision making powers of the Minister.

However, in the light of the responses to the Position Paper, the Commission is now of the view that much stronger weight should be given to the broader public policy considerations that underpin the current arrangements. In particular, notwithstanding the Commission's proposals to tighten the Part IIIA declaration criteria (recommendations 7.1 and 7.2), their application will inevitably involve a substantial element of judgement. The exercise of such judgement will in turn involve trade-offs between the need to provide appropriate protection for private property rights and wider efficiency and public interest considerations that might warrant regulatory intervention to facilitate third party access. The Commission concurs with the widely held view that such trade-offs are generally more appropriately made by elected officials than by regulators.

The Commission further observes that Ministerial involvement in decision making has clearly been an important part of the access compact between the various Australian governments. Elsewhere in the report, it is advocating that this compact be used to progress a number of important changes to the national access framework. It therefore considers that institutional changes which could have the effect of undermining the prospect of such cooperative policy development would be counterproductive.

For these reasons, the Commission has concluded that Ministers should retain responsibility for deciding on Part IIIA declaration and certification applications.

The Commission notes that limiting Ministerial responsibility to declaration and certification applications might be seen as giving rise to some anomalies in respect to decisions on certain types of undertaking application. For example, while the Gas Code is being implemented through certifications of State and Territory access regimes incorporating the Code's requirements, the National Electricity Code was implemented via an industry undertaking. Similarly, while the access arrangements for the Tarcoola to Darwin rail link are covered by a certified regime, there was initially exploration of achieving a similar outcome through an undertaking.

However, notwithstanding the potential for blurring of the distinction between certifications and undertakings in particular circumstances, the Commission accepts the validity of the broad division between high level coverage issues and the determination of detailed terms and conditions for access that underpins the current role for Ministers in Part IIIA decision making. Indeed, the Commission's recommendation (10.1) to provide for post-declaration undertakings would reinforce this division.

Thus, the Commission is not recommending an extension of the decision making role of Ministers under Part IIIA. It has, of course, recommended that Ministers be responsible for making decisions on applications for binding rulings that services provided by proposed essential facilities do not meet the declaration criteria (recommendation 11.2). However, as discussed in chapter 11, this proposed new mechanism simply involves resolution of the coverage question prior to investment.

FINDING 14.1

Ministers should continue to be responsible for making decisions on applications under Part IIIA to have services declared or existing access regimes certified as effective.

That said, the Commission continues to see a need to ensure that there are adequate incentives for Ministers to give due regard to the wider national interest when making decisions on declaration and certification applications.

As the Chamber of Commerce and Industry Western Australia observed, the potential loss of competition policy payments will be one constraint on inappropriate declaration decisions by State and Territory Ministers (transcript, p. 420). Clearly, it is these decisions, rather than decisions on the certification of existing access regimes as effective by the Commonwealth Treasurer, which have been of most concern to access seekers and end users.

However, in the Commission's view, this discipline may not always be sufficient. Moreover, it does not extend to decisions made at the Commonwealth level. Accordingly, as foreshadowed in the Position Paper, the Commission has recommended specific measures to ensure the formal accountability of Ministers for their decisions on declaration and certification applications — see section 15.3.

14.2 Who should administer Part IIIA?

As noted, a significant number of bodies are involved in administering Part IIIA and the various State and Territory access regimes that operate under its umbrella.

Several participants expressed concern about the number of access regulators. For example, BHP Billiton stated that:

> … the proliferation of State based regulators administering energy specific access codes is inefficient and a result of State parochialism rather than catering to any need to deal with unique State specific issues. (sub. 48, p. 73)

BHP Billiton went on to argue for the establishment of a 'well-resourced, specialist energy regulator.' This approach was endorsed by some other user groups, including the Energy Users Association of Australia (sub. DR94, p. 4).

Other participants acknowledged that, given the number of State and Territory access regimes, the involvement of multiple regulatory bodies is inevitable. A few even saw such multiplicity as promoting, rather than hindering, efficient regulatory outcomes. In this regard, Energex argued that centralised administration provides little scope for sensitivity to the needs of individual industries and concluded that:

> … all moves to centralisation and consistency will have negative effects under command and control regimes. What is required is competition not cooperation in these circumstances. (sub. 14, p. 40)

The merits of, and scope for, rationalisation of the bodies involved in administering industry access regimes lie well beyond the purview of this inquiry. And, as noted at the outset of this chapter, the current basis for, and the nature of, the Australian Competition Tribunal's involvement in Part IIIA processes is seemingly not an issue. Thus, the key matter for this inquiry in relation to the administration of the national access regime is whether both the NCC and the ACCC need to be involved in Part IIIA decision making processes.

The current administrative structure emanates from the Hilmer Committee's proposals, although the precise delineation of responsibilities differs somewhat as a result of the multiple access routes embodied in Part IIIA. While the Committee considered that Ministers should be responsible for decisions to grant access (see above), it argued that they should be obliged to seek 'independent and expert' recommendations on terms and conditions from the NCC. The Committee further proposed an arbitration role for the ACCC. This proposed structure reflected both a distinction made between policy decisions and administrative functions, and the Committee's view that there was a need for an independent advisory body sensitive to the views of all levels of government:

> … the Committee recommends that a National Competition Council be established jointly by the Commonwealth, State and Territory Governments to play a key role in policy decisions. … While the composition of the body would be settled by all governments, the objective is to provide a high level and independent analytical and advisory body in which all governments would have confidence. (1993, p. xxxvi)

The Position Paper proposal

In first round submissions to the inquiry, there was little explicit expression of support for continuation of a dual administrative/regulatory structure. However, this was seemingly predicated on the presumption by many participants that the current division of responsibilities between the NCC and the ACCC would continue. This may have partly reflected the affirmation at the November 2000 meeting of the Council of Australian Governments of a continuing role for the NCC in relation to the administration of National Competition Policy (CoAG 2000, pp. 4-5).

Conversely, a number of participants advocated 'rationalisation' of the current arrangements. For example, the Queensland Mining Council commented that:

> It would be preferable to have one body rather than two performing all functions, which should be more efficient and promote greater consistency of decisions and recommendations across the various processes. (sub. 27, p. 12)

Similarly, AAPT Limited observed:

> The involvement of up to three entities in declaration and certification matters will increase complexity and the risk of inconsistency — whether between the entities responsible, or between declaration or certification inquiries. AAPT's experience under [the telecommunications access regime] shows that it is practicable, and indeed preferable, for one body to [process] all declaration applications and assessments. (sub. 42, p. 6)

The South Australian Government (sub. 36, p. 9) referred to issues of consistency that arose in relation to the certification of the Tarcoola to Darwin rail link. In this context, it noted that the ARTC is currently negotiating an undertaking for other significant parts of the interstate rail network with the ACCC. It went on to suggest that 'Consistency then relies on the NCC and the ACCC working cooperatively, and agreeing on the handling of critical issues, which can not be guaranteed.'

Most of those participants advocating a single Part IIIA regulator considered that it should be the ACCC. In this regard, the ARTC raised concerns about the effectiveness of the NCC, suggesting that:

> The NCC was initially intended to have a role of providing a transitory vehicle for state based government entities to move into the same market framework as private sector participants. This transitory role is now becoming entrenched in the competition reform process and is now tending to be played off by participants to assist private sector owners or operators of monopoly assets to circumvent ACCC jurisdiction. This activity is having the effect of slowing down the progress of competitive reform in the states. (sub. 46, p. 2)

It went on to argue that making the ACCC the single adjudicator of access regimes would facilitate a more 'coherent and consistent framework for the application of access principles within like industry sectors'. The New South Wales Government (sub. 44) and the Bunbury Port Authority (sub. 4) were amongst others to argue that the ACCC should be the sole regulator.

APIA cautioned, however, that the ACCC's multiple roles, including as a consumer advocate, potentially give rise to conflicts of interest and that:

> This provides the opportunity for the ACCC to use the access dispute to force its own agenda as an active player, rather than as a disinterested judge. (sub. 32, p. 11)

Similarly, AusCID (sub. 11, p. 15) said that the 'ACCC is perceived by business and investors to be a consumer focussed organisation'.

Further, not all of those advocating a single Part IIIA regulator thought it should be one of the incumbents. For example, Stanwell Corporation (sub. 3, p. 9) expressed support for the Essential Services Commission approach being implemented in Victoria.

For its part, the Commission acknowledged the validity of the separation between responsibility for 'policy making' — the broad coverage decision — and administration of Part IIIA's detailed regulatory requirements. It observed that, especially where considerable judgement is involved in decisions about whether a regulation should apply in a particular case, the argument for separation of responsibilities is strong.

The Commission further commented that:

- Serious inconsistency in decision making is not an inevitable outcome of having two bodies involved in administering sometimes overlapping elements of Part IIIA. That is, if the decision making criteria are broadly consistent across the various Part IIIA access routes, then problems need not arise. The Commission went on to note that given that some of its other proposals would increase the consistency of the various Part IIIA decision making criteria, the disruption and uncertainty resulting from a shift to a single regulator model might outweigh any resulting benefits.
- Its proposal to end the formal role for Ministers in Part IIIA decision making could further strengthen the case for retaining dual Part IIIA administrator/regulators, so as to avoid too much concentration of decision making power.

However, the Commission also argued that the degree of judgement involved in coverage decisions under Part IIIA is limited to a significant extent by the various criteria that must be met before a service can be declared, or a regime certified as effective. In this context, it noted that some of its proposed changes to the declaration criteria would reduce further the scope for the exercise of regulatory discretion.

Moreover, it observed that the current administrative structure is not without costs. Apart from any potential for inconsistent interpretation, the Commission noted that:

- Public sector expertise on access matters is not unlimited, implying that consolidation of that expertise in a single regulatory body may be beneficial.

- Separation of responsibilities is likely to increase the time taken to establish prices and conditions of access for declared services. In this regard, it suggested that an application for declaration will potentially require both the NCC and the ACCC to form a view on the same issues.

The Commission said that setting these considerations against the concern about increased concentration of decision making power under a single regulator model involved considerable judgement. On balance, it concluded that there was a case for making a single body responsible for administering Part IIIA.

The Commission indicated that it was not attracted to the notion of establishing a new regulatory body. In this context, it raised particular concerns about the uncertainty a new body would create.

On balance, it considered that, under a single regulator model, the regulator should probably be the ACCC. This view was based largely on the ACCC's acknowledged expertise in the detailed administration of access regulation, and its wider role in the administration of a number of the industry regimes.

The Commission acknowledged, however, that this would focus decision making power in a body widely perceived to give too much weight to short term consumer interests. Accordingly, it emphasised the importance of having criteria and pricing principles that give appropriate recognition to the needs of investors and long term efficiency. Moreover, the Commission accorded the proposal tier 2 status — as it was not convinced that the benefits of making the ACCC solely responsible for administering Part IIIA would necessarily outweigh the costs.

Responses to the Position Paper proposal

There was some support in responses to the Position Paper for making the ACCC solely responsible for administering Part IIIA. In elaborating on its earlier submission, the ARTC (sub. DR64, p. 2) argued that the concentration of decision making power would offer significant benefits by promoting greater coherence and consistency in the application of access requirements. At the public hearings, it suggested that the 'perverse' increase in charges for access to the existing Tarcoola to Alice Springs line as part of the certified agreement underpinning the construction of the Alice Springs to Darwin rail link would not have occurred in an 'ACCC environment' (transcript, p. 157).

Likewise, consistent with its earlier submission, the New South Wales Government commented that:

> … the NCC's role should be restricted to compliance assessment. However, this recommendation should only proceed in the light of other recommendations to clarify the scope of the access regime and to improve the accountability of the regulator. (sub. DR109, p. 14)

The Energy Users Association of Australia (sub. DR94), WMC Resources (sub. DR71) and Stanwell Corporation (sub. DR90) were among other participants to express support for the Position Paper proposal.

However, a large majority of participants rejected the suggestion of moving to a single Part IIIA regulator. Amongst these were some such as the Western Australian Government which had previously seen merit in a single regulator model (sub. 38, p. 4).

While there were several strands to participants' arguments on this matter, the desirability of maintaining separation of responsibility for advising on coverage from responsibility for regulation of covered services was the dominant theme. Typifying these views, the Network Economics Consulting Group (NECG) stated:

> The current division of powers correctly recognises the need to distinguish between the policy decision (whether to regulate or not) and the regulatory process (on what terms and conditions should access be provided). The separation of functions currently operating under Part IIIA avoids the perceived conflict of interest that arises when the entity that will have powers to shape an activity, also has the power to determine whether it should or should not be placed in a position where it can do so …
>
> An instructive illustration of the dangers of combining the policy and regulatory decisions in the one body may be found in the operation of Part XIC of the Trade Practices Act.
>
> One of the direct consequences of handing the powers of declaration to the ACCC under that Part has been regulatory creep. The ACCC has the ability – if so-minded – to extend its own powers in terms of the determination process by declaring whatever eligible service it believes should come within the purview of Part XIC. The ACCC can effectively decide what it wants the market structure to look like and then implement this by controlling both declaration and determination. (sub. DR76, p. 55)

Similarly, APIA argued:

> In order to protect the integrity of access regulation, it is important that the roles of determining:
>
> (a) <u>if</u> access is regulated; and
>
> (b) the terms and conditions of that access
>
> be in the hands of completely separate bodies who also operate independently from each other. (sub. DR70, p. 17)

The NCC contended:

> The Council regards access legislation design and coverage issues to be inherently quite distinct from regulation functions under Part IIIA. It is important that the regulatory framework recognises this fact. To institutionally merge these functions … could compromise the independence of the regulatory framework, and ultimately, weaken market perceptions of the independence of Part IIIA processes. The Council notes that every coverage matter it has considered has been vigorously contested. As such, it is important to have a decision making body that is independent and perceived to be independent.
>
> Should coverage decisions be placed in the hands of the regulator/arbitrator, there is a risk that some participants may feel constrained in their ability to participate, for fear of alienating the potential future arbiter. There is also a danger that the regulator/arbitrator may be perceived as having an inherent bias in favour of coverage. (sub. DR99, p. 6)

And Mr Ian Tonking appearing on behalf of the Law Council, while questioning the need for Ministers in the decision making process, said that 'there are different roles at the declaration stage and at the regulation stage and we're of the view that those two roles ought to be kept in separate hands' (transcript, p. 267). The Law Council endorsed this position in a subsequent submission (DR108, p. 5).

Some submissions introduced a Commonwealth-State dimension to the issue. The Western Australian Government said its previous argument for considering a single regulatory body for Part IIIA was premised on the view 'that there would continue to be State based regulators for those services that fall under States' regulatory responsibilities'. It went on to argue that:

> … the role of the NCC is considered to be an important one in supporting both Commonwealth and State Ministers in their decision-making responsibilities. A single regulatory body may not be compatible with Western Australia's preference for retaining Ministerial decision-making … (sub. DR69, p. 3)

The Queensland Treasury (sub. DR105, p. 12) and the South Australian Government (sub. DR121, p. 7) also expressed concern that any extension of the single regulator approach to State and Territory regimes could compromise the rights afforded to the States and Territories in the Competition Principles Agreement to develop their own access regimes. More generally, the NCC (sub. DR99, p. 6) contended that moving to a single regulator model could threaten the maintenance of a clearly delineated role for certification of State and Territory access regimes.

Finally, a number of participants questioned whether the costs identified by the Commission in the Position Paper of having two administrative/regulatory bodies are significant. For instance, the NCC (sub. DR99, pp. 58-9) argued, among other things, that:

- the skills required to advise on coverage decisions are different from those involved in setting terms and conditions of access, meaning that the current division of responsibilities does not lead to inefficient dispersal of expertise; and
- the fundamental difference in the purpose of the certification and undertaking mechanisms limits the risk of materially significant inconsistencies arising from the separation of responsibility for administering these two access routes.

The NECG similarly questioned whether the potential for inconsistency is significant, suggesting that the argument is 'simply expedient, rather than substantive'. It went on to contend that while the dual regulatory system does involve some additional costs:

> … considerations of cost *per se* should not cause this review to shrink from the accepted goal of having sound policy decision-making processes supported by appropriate checks and balances. (sub. DR76, p. 58)

Summarising these various views, the Australian Gas Association contended that:

> … the benefits of a move to a single body administering Part IIIA have [not] been convincingly demonstrated. Given the concentration of decision making power in the proposed model, where the same body could determine whether a gas transmission pipeline was to be declared, and also set the terms and conditions for access seekers, more evidence is needed of the inadequacies of the present approach. (sub. DR84, p. 12)

The Commission's assessment

As noted, the tier 2 status attached to the Position Paper proposal to make the ACCC solely responsible for administering Part IIIA was indicative of uncertainty on the Commission's part about the likely benefits of such a change relative to the potential costs. Significantly, the responses from participants have clearly outlined the potential costs of moving to a single regulator model. In so doing, they have led the Commission to reassess carefully the judgements that underpinned the proposal in the Position Paper.

The Commission notes that, in a practical sense, it is debatable whether the outcomes of declaration and certification applications to date would have been any different had the ACCC rather than the NCC been advising Ministers. Thus, like many other aspects of this inquiry, the relative merits of having one or two bodies involved in the administration of Part IIIA must be resolved largely at the conceptual level.

In this context, it is relevant to note that the operation of many regulatory arrangements involves coverage issues as well as the application of specific requirements to activities encompassed by the regulation in question. There are no hard and fast rules for determining whether more than one administrative body is required in these circumstances and, if so, precisely where the boundaries between their respective responsibilities should be drawn.

However, other things equal, the greater the degree of judgement involved in the coverage decision, the stronger will be the case for separation of administrative responsibility. As the NECG (sub. DR76, p. 55) argued, conflicts of interest can emerge when 'the entity that will have powers to shape an activity, also has the power to determine whether it should or should not be placed in a position where it can do so'. In the Commission's view, therefore, the appropriateness of the single regulator model for Part IIIA will depend in large measure on the degree of judgement involved in coverage decisions.

As the Commission argued in the Position Paper, the degree of judgement required is constrained by the criteria that must be met before a service can be covered under Part IIIA. Indeed, as noted in chapter 7, these constraints are much tighter than under the telecommunications access regime — referenced by some participants as illustrative of the dangers of a single regulator model.

Nonetheless, as discussed in the previous section, the Commission accepts that, within a workable access regime, the exercise of a substantial element of judgement is unavoidable. In conjunction with the significant property right issues involved, this factor alone might reasonably be seen as justification for retaining Part IIIA's dual administrative structure.

It is relevant to note that the Commission is now proposing to retain both the role for Ministers as the decision makers on declaration and certification applications and provision for appeals against accepted declaration applications (see chapter 15). Even with advice coming from the ACCC, the review of coverage questions by Ministers, and possibly the Tribunal, would constrain inappropriate regulatory judgements.

However, even if Ministers and the Tribunal were highly effective in this regard, it seems clear that making the ACCC solely responsible for administering Part IIIA would create significant apprehension amongst service providers. Irrespective of the validity of such concerns, any perception of heightened regulatory risk would be likely to have some adverse effects on investment.

Moreover, notwithstanding continued Ministerial involvement, a Commonwealth body would be responsible for recommending on the application of Part IIIA to significant State and Territory assets. Again, this could weaken the access compact between the Commonwealth and the States and Territories which the Commission sees as important in progressing important reforms to the national access framework.

For all of these reasons, the Commission has come to the view that the costs of making the ACCC solely responsible for administering Part IIIA would almost certainly outweigh the benefits.

FINDING 14.2

The current division of administrative responsibility in Part IIIA between the National Competition Council and the Australian Competition and Consumer Commission is appropriate.

15 Procedural and administrative matters

Beyond the role of Ministers in Part IIIA decision making and the efficacy of the dual regulatory structure, the administrative issue of most concern to participants was appeal rights attaching to Part IIIA determinations. This chapter commences with a discussion of those rights.

However, participants also drew attention to a range of other matters impinging upon the effectiveness and timeliness of Part IIIA processes:

- the absence of time limits or targets for most aspects of Part IIIA decision making;
- the lack of accountability attaching to some Part IIIA determinations;
- the short duration of some determinations;
- overlaps between Part IIIA and other parts of the Trade Practices Act (TPA); and
- constraints on the ability of consumer bodies to participate in Part IIIA decision making.

These matters are also addressed in the chapter.

15.1 Appeal arrangements

A range of appeal rights apply to Part IIIA decisions:

- Ministerial decisions on declaration applications are appellable to the Australian Competition Tribunal.
- Decisions by the Commonwealth Minister not to certify a State or Territory regime as effective are also appellable to the Tribunal, as are:
  - arbitrations by the Australian Competition and Consumer Commission (ACCC) on terms and conditions for declared services;
  - decisions by the ACCC not to register privately arbitrated contracts; and
  - decisions by Ministers not to accede to requests from access providers to revoke declarations.

- In contrast, there is no provision for merit review of decisions by the ACCC on applications for undertakings.

There was consensus amongst participants about the need for Part IIIA to have effective appeals processes, particularly given the property rights issues involved. Typifying these views, Energex stated:

> … a robust appeals mechanism based on merit or the 'correctness' of determinations is an essential pre-requisite … ensuring the accountability of regulators and providing for greater stability in regulatory decisions. (sub. 14, p. 37)

Similarly, the National Competition Council (NCC) commented:

> Another important dimension of effective access regulation is the availability of effective review mechanisms to test the efficacy of decisions by regulatory institutions. Effective review mechanisms help to ensure that access regulation meets its identified objectives, through, in particular, enforcing process requirements and ensuring appropriate use of regulator discretion. (sub. 43, p. 69)

And, in a paper prepared for BHP Billiton, National Economic Research Associates (NERA, 2001b, p. 9) emphasised the importance of an effective appeals system for investor confidence:

> Appeal of regulatory decisions to a credible and independent judiciary is the test of a regulatory regime. Unless such provisions exist, and until they have been used, a regulatory regime remains uncertain. A regulatory regime that lacks a clear path of reliable appeal to an independent judiciary will fail to gain investor trust.

In keeping with these views, most suggestions for changes to appeals arrangements involved adding to current rights. For the most part, these related to the introduction of merit review of ACCC decisions on undertakings. However, the possibility of extending general appeal rights in Part IIIA beyond the immediate parties involved in a particular access dispute or arrangement was also canvassed.

At the same time, there was recognition that overly elaborate appeals processes can be costly and time consuming. As the NCC observed:

> Review mechanisms can … exacerbate problems associated with undue delays in regulatory processes. An appropriate balance, therefore, needs to be struck between the aims of timely processes which minimise the direct costs of regulation, and the aim of ensuring the efficacy of regulatory processes and decisions, including through the availability of appeal mechanisms. (sub. 43, p. 69)

In pursuit of such balance, there were some proposals to streamline current appeal arrangements.

Merit review of undertakings

With declaration, certification and arbitration decisions subject to merit review, the absence of a similar right for decisions on undertakings might be viewed as an anomaly in the current Part IIIA arrangements. Like arbitrations for declared services, assessments of proposed undertakings are sometimes likely to entail examination of detailed access terms and conditions. And, as noted, the experience to date is that, in particular situations, the certification and undertaking mechanisms can be substitutable.

In its Position Paper, the Commission proposed addressing this apparent anomaly by extending provision for full merit review to ACCC decisions on proposed undertakings. As well as promoting transparency and regulatory accountability, the Commission noted other possible benefits of such an extension:

- It could help to foster use of the undertaking route. As AAPT Limited argued:

  > Such an amendment would tend to encourage access providers to give undertakings, as they would know that, in the event the ACCC made a decision unfavourable to them, they would be able to seek a review. Would-be access seekers would similarly have the opportunity to seek the rejection of undertakings that they believed to be unreasonable. (sub. 42, p. 11)

- It could help to clarify the meaning of the undertaking criteria. In this regard, the NCC observed:

  > As the Sydney Airport decision highlights, the review process can make for clarification of the relevant criteria, thereby enhancing the efficiency of the regime as a whole. [An appeal right] would also be consistent with the existing right of a State or Territory Government to apply for a review of a decision of the Commonwealth Minister not to certify a state regime as effective. (sub. 43, p. 43)

The Commission acknowledged that the introduction of appeal rights for undertakings would carry with it some risk of encouraging strategic behaviour by service providers. For example, provision for appeal might increase incentives for a provider to lodge a clearly unacceptable undertaking as a means of delaying an imminent declaration.

However, the Commission argued that, at least for the sort of ‘residual’ services likely to be declared under Part IIIA, this would not be a material concern. It also noted that:

- the introduction of indicative time limits for the various steps in the Part IIIA process (see section 15.2) would limit the protection against declaration provided by the lodgement of a strategic undertaking; and

- the assessment of a proposed undertaking, even if the proposal was clearly unacceptable, would facilitate speedy arbitration in the event that the service concerned was subsequently declared.

Further, the Commission proposed that this new right should not be limited to appeal by a service provider against the rejection of a proposed undertaking. It argued that an access seeker should also have the right to appeal against proposed terms and conditions accepted by the ACCC.

Not surprisingly, this proposal received widespread support. Typifying these views, the Network Economics Consulting Group (NECG) stated:

> In our view, review rights impose a significant discipline on arbitrary and poorly founded decisions. In doing so, such rights reduce the very risk of such decisions occurring. Over time, then, the mere existence *per se* of such review rights may be seen to increase the level of regulatory certainty.
>
> Indeed, in our view, the existence of full merits review is so fundamentally important it is difficult to conceive of any proper justification for failing to have such a process in place. (sub. DR76, p. 46)

Some user interests also expressed support for that element of the proposal that would allow access seekers to appeal against accepted undertakings.

Indeed, the only participant to oppose the proposal was the Queensland Treasury, which was concerned about the additional delays that would accompany this new appeal right. It stated:

> The proposal for a merits review of access undertakings is strongly opposed on the grounds the potential costs (through lengthy legal processes and delaying tactics) will more than outweigh any benefits. The costs and time involved in establishing and approving access undertakings are substantial and the introduction of merits review will unduly extend the process. The avenue of appeal by way of judicial review, or other administrative remedies, is sufficient to ensure a regulator confines its deliberations to relevant considerations and conducts a process based on natural justice and fairness. (sub. DR105, p. 10)

While a number of other participants also acknowledged that provision for merit review of undertakings would involve some additional costs and delays, they contended that these costs would be more than outweighed by the benefits of promoting thorough analysis of the issues at hand. Moreover, some went on to suggest that other mechanisms could and should be used to limit these additional costs. Thus, the Australian Gas Association commented that:

> Any concerns regarding the timeliness of decision making which arise from the proposal to allow reviews of undertaking decisions should be addressed through tighter rules on decision making not through retaining restrictions on access to merits reviews. (sub. DR84, p. 11)

The Commission agrees with this argument. Its proposal for time limits on the various steps in Part IIIA processes (see recommendation 15.3) is germane in this context.

In the Commission's view, the fact that undertakings are a voluntary instrument does not diminish significantly the case for rights of appeal against regulatory decisions. As the NECG argued, such rights can be an important discipline on inappropriate decision making and a means to promote regulatory accountability. Moreover, to the extent that the current lack of appeal rights discourages use of the undertaking mechanism, it may force access disputes into the potentially more cumbersome declaration process. This would seem to be counterproductive.

In sum, the Commission sees a strong case for extending appeal rights to ACCC decisions on access undertakings. As a general right to seek merit review, the provisions should not be limited to appeals by service providers against rejected undertaking proposals. They should also encompass appeals by access seekers against accepted undertakings. The Commission considers that symmetrical treatment is important in helping to promote the integrity of the appeals system.

RECOMMENDATION 15.1

Part IIIA should include provision for merit review by the Australian Competition Tribunal of decisions by the Australian Competition and Consumer Commission on proposed undertakings.

Other possible extensions to appeal rights

The Commission's suggestion that access seekers should have a right to appeal against accepted undertakings would represent a departure from the current limitation of Part IIIA appeal rights to service providers and/or applicants for a determination under the regime. At present:

- The service provider or the applicant for a declaration can appeal against the Minister's decision, but not other access seekers.
- Only the State or Territory Government concerned can appeal against a decision by the Commonwealth Minister in relation to a certification application.
- Appeal rights against arbitrated determinations are limited to the parties to the particular dispute.

In the Commission's view, the arguments favouring symmetrical appeal rights for decisions on proposed undertakings raise questions about the efficacy of some of these limitations. In particular, those same arguments might suggest that a potential access seeker should have the opportunity to test whether the provisions of a regime certified by the Commonwealth Minister are unduly favourable to the service provider.

The Commission notes that certain appeal rights in the telecommunications access regime are couched in terms of persons ‘whose interests are affected by a decision’. Such a formulation in Part IIIA would clearly cater for situations where an extension of appeal rights beyond the service provider and/or applicant for a determination might be contemplated.

Equally, however, this sort of formulation would most likely extend appeal rights too widely. For example, in combination with the proposed introduction of post-arbitration reports (see recommendation 15.6), it could give rise to the possibility of appeals against arbitrations for declared services by parties other than those in dispute.

Also, it would open the door for appeals by user/consumer organisations across the full range of Part IIIA decisions. In principle, this would not necessarily be inappropriate — indeed, the Energy Markets Reform Forum explicitly raised this possibility (transcript, p. 287). But, in practice, it could lead to further delays in the process, while adding little to the quality and integrity of decision making. As discussed in section 15.4 in relation to the possibility of assisting consumer groups to participate in Part IIIA decision making, the Commission considers that the interests of access seekers and users of final services will usually be concordant.

Further, provision for appeals by user interests aside, the possible extension of appeal rights attaching to declaration, certification and arbitration decisions was not canvassed by participants. As a result, the Commission did not have the opportunity to test the benefits and costs of altering the service provider/applicant approach underpinning current appeal arrangements. For example, an extension of appeal rights attaching to certification decisions could give rise to concerns about the rights of State and Territory governments within the national access framework.

Thus, more analysis and discussion would be required before the sort of extensions canvassed above could be seriously contemplated. That said, the Commission notes that the issue is also relevant in the context of any appeal rights that might attach to the proposed binding rulings mechanism (see recommendation 11.2).

Options for streamlining appeal rights

The Position Paper proposal

During the early part of this inquiry, a wide cross section of interests expressed concern about the cumbersome and time consuming nature of Part IIIA processes, including the appeal provisions. With these concerns in mind, the Commission sought views on whether there was scope to streamline any aspects of the appeal arrangements.

A number of participants raised the possibility of introducing time limits for the processing of appeals (see section 15.2). Also, AAPT Limited (sub. 42, p. 11) suggested that a declaration could take effect after 21 days, irrespective of any appeal against the decision by the service provider.

Notably, in first round submissions, only the ACCC (sub. 25, p. 93) suggested a possible curtailment of existing appeal rights. Specifically, it canvassed the possibility of winding back appeal rights for arbitration decisions which have been the subject of a public inquiry process. It said that its experience with arbitration in the telecommunications access regime is that merit review by the Australian Competition Tribunal adds to what is already a time consuming and resource intensive process and 'reduces the potential advantages of the negotiate-arbitrate model'. (In a submission lodged in response to the Position Paper, the Queensland Treasury (sub. DR105, p. 13) similarly suggested that merit review of arbitrations was unnecessary.)

However, in the Position Paper, the Commission argued that any change to the appeal rights attaching to Part IIIA arbitrations would be premature. It noted that there have been no arbitrations under the regime so far and that therefore any scope to streamline the associated appeal rights would be better addressed once there is some case history.

That said, the Commission observed that while target time limits may help to speed up the appeals process, it was hard to see how significant time could be saved without reducing current appeal rights. Emphasising that retaining adequate protection for the property rights of service providers should be the dominant constraint on any reduction in these rights, it went on to argue that the least risky area for doing so would be in relation to *accepted* declaration applications. Amongst other things, it noted that:

- The implications of a declaration are unlikely to be fully evident until terms and conditions are established for particular access seekers. Hence, it could be inferred that regulatory errors will have the greatest potential to harm one or other of the parties at the arbitration stage — where appeal rights would remain.

- Its proposals to tighten the declaration criteria would reduce the scope for inappropriate declarations.

Given these considerations, the Commission saw a possible case for removing appeal rights in this one area. However, as with the proposal for a single Part IIIA regulator, it was not convinced that the resulting time savings and reductions in administrative costs would be sufficient to justify the attenuation of service providers' property rights. Accordingly, it attached a tier 2 status to the proposal.

Responses to the Position Paper

This proposal was viewed with great concern by service providers. Moreover, unlike the proposals to end Ministerial involvement in decision making and to make the ACCC solely responsible for administering Part IIIA, support from access seekers and user interests was largely absent. Summarising service providers' views on the proposal, the NECG said that:

> In our strongly-held view, the Commission's proposal to abolish appeals against decisions to declare services should not be pursued under any circumstances. We consider that the high burden of proof resting on those who consider that appeal rights should be removed has not been met. (sub. DR76, p. 49)

At a broad level, opposition to the proposal reflected a concern to ensure adequate protection for private property rights. For example, Mr Ian Tonking argued that:

> The Commission should, I suggest, abandon this proposal on the basis that it conflicts with the broad principles adopted by the Position Paper in relation to interference with property rights and the preservation of rights of appeal. (sub. DR58, p. 3)

The Law Council (sub. DR108, p. 5) made an identical observation.

Similarly, the Chamber of Minerals and Energy of Western Australia contended:

> Regardless of whether they can be justified on utilitarian grounds, declarations are necessarily an infringement of property rights and must have adequate means of review. (sub. DR66, p. 5)

The Australian Rail Track Corporation (sub. DR64, p. 18), amongst others, said that the successful appeal by Duke Energy against coverage of the Eastern Gas Pipeline under the Gas Code, 'provides a compelling argument for the retention of appeal rights on both sides of a Part IIIA decision'.

More specifically, participants challenged the view that regulatory errors in the establishment of terms and conditions for declared services are likely to cause more harm than inappropriate coverage decisions. Thus, Duke Energy International argued that:

> … the single most critical factor in the national access regime is to ensure application is limited to circumstances where there is clear misuse of market power and therefore, where there will be significant net economy wide efficiency benefits. (sub. DR95, p. 1)

Participants went on to emphasise that declaration fundamentally changes market relationships and adds a new dimension of uncertainty to a service provider's operations. In this regard, the NCC observed:

> … few infrastructure owners would regard the ready imposition of declaration without the availability of review as 'the least risky area for removing appeal rights'. Declaration is a serious step that (quite deliberately) changes the nature of access negotiations between the parties by providing access seekers with a 'legal right to negotiate access'. (sub. DR99, p. 62)

And, appearing on behalf of the Australian Council of Infrastructure Development (AusCID) at the public hearings, Mr Mundy from Australian Pacific Airports Corporation said:

> The problem and issue then, if you're declared you're just not declared in the matter, the dispute, you're declared for the full duration of the declaration. We have a declaration in place for certain road systems [around Melbourne Airport's] terminal complex … The people who sought that declaration are now no longer in business. … [However], the presence of that declaration immediately distorts all subsequent negotiations vaguely related to the services in question … (transcript, p. 245)

A number of participants also argued that greater timeliness should not be pursued at the expense of good decision making. In this regard, the NECG stated:

> … we are extremely concerned that the emphasis upon speed is at the expense of recognising the very high economic costs to society that arise from incorrect regulatory decisions. (sub. DR76, p. 50)

Some participants went on to note that, in any event, the recent Eastern Gas Pipeline case suggests that appeals against declaration are unlikely to add unduly to delays in Part IIIA processes.

Finally, the NCC suggested that the removal of appeal rights in relation to accepted declaration applications would:

> … increase incentives for jurisdictional challenges (such as in the Hamersley and Western Power Federal Court proceedings). The proposal also increases the likelihood of applications to review declaration decisions on questions of law under the ADJR Act. (sub. DR99, p. 63)

It contended that such reviews would be more time consuming than appeals to the Tribunal, while providing less of a check on the inappropriate use of administrative discretion.

The Commission's assessment

In assessing participants' responses, the Commission observes that concerns about the delays associated with appeals seem to have diminished somewhat during the course of the inquiry. This may partly reflect the fact that the recent appeal against the coverage of the Eastern Gas Pipeline under the Gas Code was processed much more quickly than the appeal against the declaration of certain cargo handling services at Sydney Airport.

As the Commission emphasised in the Position Paper, appropriate protection for property rights must be the pre-eminent consideration in formulating a system of appeal rights for access regimes. Thus, its tier 2 proposal in the Position Paper to abolish appeal rights for accepted declaration applications was not about trading off timeliness against good decision making. Rather, the Commission saw a possibility of providing a concrete response to the then evident concerns about timeliness, while still retaining adequate protection for service providers' property rights.

However, in doing so, it underestimated the shift in bargaining power associated with the coverage decision. As AusCID (sub. DR80, p. 5) pointed out, the prospect of exposure to fallible regulators and imperfect regulatory instruments 'has led infrastructure owners to focus attention on staying outside the scope of any form of regulatory intervention'. The fact that Duke Energy and the Sydney Airports Corporation were prepared to expend considerable time and resources in seeking to avoid coverage under the relevant access provisions serves to illustrate this point. Significantly, Duke Energy's position was vindicated by the Tribunal.

Moreover, the Commission acknowledges the concern raised by the NCC that abolition of provision for merit review of accepted declaration decisions could increase the prospect of challenges to the jurisdiction of Part IIIA in respect of particular access disputes. As the Council noted, such a shift in the basis of appeals may not be conducive to timely or efficient outcomes.

In sum, the Commission accepts that the potential costs of abolishing appeal rights for accepted declaration applications would outweigh any benefits from a more expeditious process.

FINDING 15..1

The current rights of appeal attaching to Part IIIA declaration decisions should be retained.

15.2 Time limits on Part IIIA decision making

Subject to providing for due process, effective regulation should promote timely decision making. As the NCC observed in spelling out requirements for an effective access regime:

> The costs of slow processes are substantial. Overly lengthy processes increase uncertainty for business and may distort decision-making, including decisions on investment by infrastructure owners and access seekers.
>
> Consequently, timeframes for regulatory decisions should be as short as possible, while being sufficient to address all regulatory tasks and provide affected parties with adequate opportunity to provide input. (sub. 43, p. 68)

The protracted nature of Part IIIA decision making to date has clearly detracted from its capacity to deliver efficient outcomes. In this regard, the Australian Wheat Board commented:

> The time frame that is required to declare, certify or establish an undertaking to provide an access regime is financially impacting Australian grain growers. There is the potential for AWB to increase the number of rail operators in a number of states to reduce freight costs. Access regime definition delays are delaying this expansion. (sub. 16, p. 3)

And, in commenting on the applicability of Part IIIA to telecommunications access matters, PowerTel argued:

> The Sydney Airport's declaration took [several] years to come into effect and even then the parties were still only at the stage of negotiating terms and conditions of access. Such a timeframe [would render] the process wholly ineffective in a fast moving industry such as telecommunications. (sub. 8, p. 4)

Box 15.1 outlines the lengthy time frames involved in securing access via Part IIIA to railway services in New South Wales. (A further example relating to the assessment of an access arrangement under the Gas Code was provided in box 4.1.)

Such delays are not unique to Part IIIA. For example, in announcing measures to streamline the telecommunications access regime, the Minister for Communications, Information and the Arts recently said:

Box 15.1 Delays in obtaining access to rail services in New South Wales

The New South Wales Minerals Council provided a chronology of events associated with applications to have particular rail services in that State declared under Part IIIA:

- In August 1996, the State Government established a regime to regulate access to rail infrastructure owned by, or vested in, the Rail Access Corporation (RAC). The regime was developed without public consultation.
- In February 1997, Specialised Container Transport sought declaration of the Sydney-Broken Hill rail service under Part IIIA, followed in April 1997 by an application from the New South Wales Minerals Council for declaration of the Hunter Railway Line service.
- In June 1997, the State Government lodged an application with the NCC for certification of its rail access regime.
- In September 1997, the NCC recommended declaration of the Hunter rail service, but a non-decision by the Premier meant that he was deemed not to have declared.
- In November 1997, the New South Wales Minerals Council lodged an appeal against the non-declaration with the Tribunal. The RAC contested the appeal.
- In April 1998, the NCC issued a draft recommendation on certification of the New South Wales rail access regime indicating that modifications would be necessary before certification could occur.
- In November 1998, in response to the NCC's concerns, the Premier directed the Independent Pricing and Regulatory Tribunal (IPART) to investigate and report on cost definitions, asset valuation methodologies and appropriate rates of return.
- In February 1999, the State Government gazetted a substantially modified rail access regime. The terms of gazettal made provision for incorporation of IPART's recommendations.
- In March 1999, the NCC recommended certification of the regime, on the presumption that IPART's final recommendations would be incorporated in it.
- At a fifth 'directions hearing' of the declaration appeal later that month, the Tribunal was advised that the NCC had made a formal recommendation to the Minister on certification of the regime, but was not told what the recommendation was.
- In November 1999, following further directions hearings on the declaration appeal, the Minister for Financial Services and Regulation announced his decision to certify the regime until the end of 2000. The appeal on the Hunter rail service declaration decision was then withdrawn.

The New South Wales Minerals Council concluded its chronology by noting that some of IPART's recommendations have yet to be incorporated in the regime and that the process to determine an appropriate asset valuation methodology has still to be finalised.

Source: NSW Minerals Council (sub. 22)

> Protracted delays in the arbitration of access disputes are impeding competition in the telecommunications sector, and delaying lower cost and higher quality services to consumers. (Alston 2001, p. 1)

Nonetheless, protracted decision making under Part IIIA will clearly be a disincentive for access seekers to pursue declaration of services. As the Queensland Mining Council commented:

> The appeal of the national access regime as an alternative to ineffective state arrangements is lessened by the expectation that it involves a minimum three year, and more likely five year, process. (sub. 27, p. 11)

It is also likely to reduce the incentives for States and Territories to seek certification for their industry regimes and for other access providers to lodge undertakings. This is because the full impact of any declaration of the services concerned might not be felt for a number of years.

Equally, delays in the certification process can be a source of frustration for State governments. The New South Wales Government pointed out that certification of its rail regime had taken more than two years, with certification granted for only 13 months. It concluded that:

> NSW found the process to be totally unsatisfactory. Considerable effort went in to obtaining an outcome that resulted in marginal benefit. (sub. 44, p. 5)

In the light of these delays, a number of first round submissions supported the introduction of legislated or target time limits for the various steps in the Part IIIA process. (At present, the only time limit is the 60 day period for Ministerial decisions on declaration recommendations before the decision is deemed not to declare.) Examples of this support included the following:

- The NECG (sub. 39, p. 15) advocated the imposition of 'reasonable' time limits on Ministers and decision making bodies. It also canvassed the possibility of providing more resources to the NCC and the ACCC to expedite the decision making process.
- The Law Council (sub. 37, p. 24) said that 'it would give applicants more certainty if the NCC and the Tribunal had limited amounts of time in which to assess matters and hand down their decisions'. It went on to propose 'strict but appropriate' time limits that reflect the complexity of cases for all those involved in decision making.
- The Ports Corporation of Queensland (sub. 47, p. 2) similarly suggested that mandated limits would improve the timeliness and transparency of decision making. And in regard to Part IIIA appeals processes, AusCID stated:

> Decisions regarding appeals processes should be made in a timely fashion with strict time limits applying to the appeals body. The situation where businesses must keep investments on hold for years awaiting the outcome of an appeal is clearly unsatisfactory. If necessary, additional resources should be allocated to appeals bodies to allow timely review of decisions. (sub. 11, p. 15)

Significantly, the NCC (sub. 43, pp. 51-2) also endorsed the concept of target time limits, outlining some indicative targets for the declaration and certification processes (with provision for extension in complex cases):

- a four month limit on Council processes for declaration applications, with a similar limit on the Tribunal if the Minister's decision is the subject of an appeal; and
- a six month limit on Council processes for certification applications, with a four month limit on the Tribunal if the Minister's decision is the subject of an appeal.

The Council further proposed that a 60 day limit for Ministerial decisions be retained for the declaration process and extended to certification.

In the light of its experiences in securing certification of its rail regime, the New South Wales Government (sub. 44, p. 5) recommended a similar arrangement for the processing of certification applications to that proposed by the NCC.

The Commission's assessment of the case for time limits

To some extent, protracted time frames for Part IIIA decision making are inevitable given the complexities of the issues involved and the newness of the regime. Moreover, as the ACCC argued (sub. 25, p. 73), given the intrusive nature of access regulation and its implications for property rights, avoiding a rush to judgement is no bad thing. Indeed, the benefits attaching to a thorough process underscored the widespread concerns about the Commission's tier 2 proposal in the Position Paper to remove appeal rights for accepted declaration applications (see section 15.1).

The Commission notes that a number of its recommendations elsewhere in this report would help to improve timeliness, including:

- provision of greater guidance on the pricing principles that should underpin Part IIIA determinations (recommendations 6.3 and 12.1), which should in turn help to confine the scope of negotiations;
- a requirement for an exchange of information between the provider of a declared service and those parties seeking access to the service (recommendation 8.1), which should facilitate more effective and timely negotiation;

- constraints on the scope for the ACCC to revisit matters not in dispute when conducting an arbitration for a declared service (recommendation 8.2); and
- provision for post-declaration undertakings (recommendation 10.1);

Nonetheless, it concurs with participants that some sort of time limits on the various components of Part IIIA decision making would be an appropriate discipline on decision makers. In coming to this view, support for such limits from the NCC, as one of those decision makers, was particularly influential.

Time limits on Ministerial decision making

As noted, there is currently a legislated 60 day limit on Ministerial decisions on declaration recommendations from the NCC. If a decision is not made within 60 days, the decision is deemed 'not to declare'. This deeming provision was the subject of considerable debate (see section 15.3). In the Commission's view, changes to it are warranted to enhance Ministerial accountability (see recommendation 15.5).

As regards the time allowed for Ministers to reach a decision, the Position Paper argued that a limit of 60 days was seemingly more than adequate for a review of an NCC recommendation. Accordingly, the Commission proposed that if a decision making role for Ministers were retained, the 60 day limit should continue. To provide a symmetrical discipline, it further proposed that the same limit should be introduced for decisions by the Commonwealth Minister on recommendations from the NCC on certification applications.

This proposal received general support. In effect, it would merely extend a widely accepted part of the declaration arrangements to the certification process.

A notable exception was the Queensland Treasury (sub. DR105, p. 23) which said that 60 days was too short a period, given the need for a Minister to review all material independently and consult with interested parties. It went on to express a preference for a 90 day limit.

However, in the Commission's view, such an increase in the limit is not warranted. It considers that the role of Ministers should be confined to assessing the NCC's findings, rather than involving a more extensive 're-trying' of the case. As noted, 60 days is seemingly enough time for this more limited assessment.

FINDING 15..2

The 60 day limit on Ministerial decisions on declaration recommendations from the National Competition Council should be retained.

RECOMMENDATION 15.2

A 60 day limit should be introduced for decisions by the Commonwealth Minister on certification recommendations from the National Competition Council.

Time limits for other Part IIIA processes

For other aspects of Part IIIA decision making, the Commission sees the potential for significant problems with binding/mandatory limits:

- At a practical level, the scope to impose binding limits on those parts of the process that involve the courts could be problematic. Given possible incentives for access providers to stall negotiations (see chapter 8), there might also be problems earlier in the process.
- More fundamentally, binding time limits could compromise good decision making in complex cases — a particularly important consideration in this area.

Nonetheless, to increase the prospect of timely decision making, the Commission does see a case for introducing the sort of indicative time limits proposed by the NCC. With this in mind, the Position Paper sought participants' views on the NCC's suggested target time limits for declaration and certification processes, and whether such indicative limits should also apply to the assessment of undertakings and to arbitrations for declared services. The Commission noted that the sort of limits suggested by the NCC would ostensibly lead to faster decision making than has been evident in a number of declaration and certification applications to date.

The Commission received only limited response to this request for input. Based on its recent experiences, the Sydney Airports Corporation Limited (SACL) voiced support for target time limits for the declaration process:

> … the *Sydney International Airport* case … amply demonstrates the ponderously slow pace at which the declaration process can proceed. SACL certainly endorses the recommendation by the NCC itself that an extendable time limit of four months be imposed on both it and, on review, the Australian Competition Tribunal … (sub. DR114, p. 64)

However, the ACCC raised a number of cautions about extending such indicative limits to either arbitrations or the assessment of proposed undertakings:

> … arbitrations will usually involve holding hearings and providing an opportunity for the parties to make written submissions on various matters. These matters may not always be clear at the outset of an arbitration. Consequently, arbitration of access disputes will usually involve parties being given a number of opportunities to make

> submissions. It is not always easy to predict how long this process will take and the timing is not always within the control of the regulator.
>
> In relation to undertakings, the ACCC is required to publish the undertaking and invite submissions thereon. In order that submissions received address the issues the ACCC perceives to be important, the ACCC has found that it is useful to also publish a discussion paper. In addition, the ACCC considers that the most effective way to comply with its obligation to provide procedural fairness is to publish a draft decision and seek further comments thereon. In making a decision it may also be necessary to obtain technical, economic, legal or other independent advice. It is difficult in the abstract to determine what a reasonable time limit would be for the completion of such a process. … It would also be difficult to impose a threshold test requiring that a matter be "complex" before an extension would be permitted. (sub. DR93, p. 24)

That said, the ACCC noted that non-binding time limits apply under the Gas Code to both coverage decisions and arbitrations — with provision for extensions 'not limited by the need to demonstrate any specific level of complexity'. (p. 25)

The Northern Territory Government (sub. DR111, pp. ii-iii), while suggesting that time limits would assist in preventing unnecessary delays, said that 'the Commission should be mindful not to recommend unrealistic or inflexible deadlines'. In this context, it raised a particular concern about the possibility that too tight a deadline to assess a certification application could lead to non-certification and the requirement for a second application. The New South Wales Government (sub. DR109, p. 13) expressed the same concern, while the New South Wales Minerals Council (sub. DR63, p. 8) suggested that time limits on the assessment of proposed undertakings could similarly prevent adequate consideration of all the issues.

The Commission accepts that there will be instances where a particular access issue cannot be handled adequately within a generally applicable time frame. In essence, this is the advantage of non-binding target time limits. That is, they provide scope to exceed the limit where circumstances warrant. The Commission therefore remains of the view that the implementation of non-binding time limits for the various steps in the Part IIIA process — other than Ministerial decisions (see above) — could provide a valuable discipline on decision makers without compromising thorough assessment of the issues involved.

As regards actual processing times, the Commission has no reason to dispute the target limits proposed by the NCC for the processing of declaration and certification applications. As noted above, the Council has proposed a four month limit for its processing of the former and a six month limit for the latter, with a further four month limit applying to the processing of appeals against Ministers' decisions by the Tribunal.

A six month limit would also seem broadly appropriate for arbitrations for declared services and the processing of undertaking applications. The Commission acknowledges that a requirement for the ACCC to seek public comment on proposed undertakings adds to the time taken to reach decisions. However, as discussed in section 15.3, the NCC operates a public process for declaration and certification applications — which it evidently considers can be handled within four and six month time frames, respectively. Although the need to assess possibly more detailed terms and conditions arguably makes assessments of undertaking applications more complex than those for declaration applications, an extra two months would make allowance for this.

Similarly, the suggested four month limit on the hearing of appeals against declaration and certification decisions would also appear to be broadly appropriate for appeals against arbitrated determinations and decisions on proposed undertakings. Significantly, even if all of these target limits were met, in conjunction with a 60 day limit on Ministerial decisions and the time involved in post-declaration information exchange and negotiation, it could still take more than 20 months to work through the declaration and arbitration process.

The Commission considers that these target time limits would have more force if they were implemented legislatively rather than through a general statement of intent. The legislative approach was adopted in the Gas Code.

There would also have to be legislative provision for the extension of those time frames where circumstances warranted. Scope for the relevant body to notify such an extension in a national newspaper — the approach adopted in the Gas Code — would seemingly meet this need. The Commission notes that such notification could reasonably be accompanied by a brief explanation of the reasons for the extension. A requirement for the NCC and the ACCC to provide information in their annual reports on their performance against the relevant limits would provide a further incentive for timely decision making.

RECOMMENDATION 15.3

In addition to a 60 day limit for Ministerial decisions on declaration and certification applications (see recommendation 15.2), target time limits should apply to the other steps in the Part IIIA process:

- ***For assessments by the National Competition Council of declaration applications, the target time limit should be four months.***
- ***For assessments by the Council of certification applications and by the Australian Competition and Consumer Commission of undertaking applications, the target time limit should be six months.***

- ***For arbitrations for declared services by the Commission, the target time limit should be six months.***
- ***For the processing of appeals on any of these matters by the Australian Competition Tribunal, the target time limit should be four months.***

These targets should be specified legislatively, along with a provision that if the Council, the Commission or the Tribunal wishes to extend a target limit in a particular case, they be required to publish notification to that effect in a national newspaper. The annual reports of the Council and the Commission should contain information on the actual time taken to deal with matters subject to these time limits.

15.3 Transparency issues

Open and transparent processes have an important role to play in enhancing regulatory accountability, reducing uncertainty for market participants and generally promoting confidence in a regulatory regime. As the NCC remarked:

> Sound regulatory processes that adhere to [the principles of transparency and independence] help to ensure that:
>
> — regulatory outcomes reflect, as closely as possible, the efficiency objectives of the regulatory regime; and
>
> — parties with an interest in regulatory processes have confidence in those processes. (sub. 43, p. 65)

Part IIIA contains a number of provisions to promote transparency, including requirements for:

- Ministers to give reasons for their decisions on applications for declaration, certification and revocation of declarations to the parties concerned;
- the ACCC to maintain a public register of certifications, declarations and revocations and accepted access undertakings and codes;
- the ACCC to publish proposed undertakings and invite public comment on them; and
- the ACCC to publish decisions not to register negotiated contracts for declared services.

Further, as noted, the NCC has chosen to operate publicly when assessing applications for declaration and certification. Thus, it has typically invited submissions on applications and released draft recommendations seeking further comment. The principle of transparency also underscores various requirements for an effective access regime in Clause 6 of the Competition Principles Agreement.

Nonetheless, there are a number of areas where transparency might be increased further.

Codifying public inquiry processes

While the NCC has chosen to assess declaration and certification applications in an open fashion, there is no legislative requirement for it to do so. This is in contrast to the requirement for the ACCC to invite public comment on proposed undertakings.

The Commission notes that the different roles of the two bodies may be relevant in explaining this divergence in approach. The NCC is only an advisory body, whereas the ACCC is responsible for deciding on whether a proposed undertaking should be accepted. Arguably, the latter's decision making role increases the importance of an accompanying public process.

Nonetheless, in the Commission's view, there would be merit in making it a legislative requirement that an opportunity for public comment should generally apply to all of the Part IIIA access routes. As the Commission's own inquiry experience has demonstrated, public input can often be crucial to the development of effective and practical proposals. Similarly, in a paper prepared for BHP Billiton, Fitzgerald (2001, p. 16) argues that 'regulators will perform closer to the public interest if they are informed by the participation of all the interested parties'. Given the significance of the infrastructure services involved and the magnitude of the associated investments, public input may be particularly useful in this area.

That said, there may be circumstances when a public process will not be justified on time or cost grounds. This could be the case, for example, where a declaration or undertaking application is made for a service that has strong similarities with a service that has been assessed previously.

The Commission therefore considers that the 'reasonable and practical' caveat attached to public inquiry requirements in the telecommunications access regime should be used to provide appropriate balance between the promotion of transparency and other considerations. In the case of applications for undertakings, this would replace the current blanket requirement for a public process. There was some support for (and no opposition to) a proposal to this effect in the Position Paper.

RECOMMENDATION 15.4

Part IIIA should make legislative provision for public input on declaration and certification applications, and proposed access undertakings, where it is 'reasonable and practical' to do so.

The Commission notes that the target time limits proposed in recommendation 15.3 have been set to allow for such public comment. However, if evidence were to emerge that those limits were generally insufficient to allow for public input, then they should be increased.

Publication of decisions

The principle of transparency also suggests that those involved in Part IIIA decision making should be obliged to publish reasons for their recommendations and decisions.

For the NCC, the ACCC and the Tribunal, such a requirement would seem to be uncontroversial — again, it would simply codify current practice.

In contrast, the requirements that should apply to decisions by Ministers on declaration and certification applications engendered some debate among participants. Part IIIA currently places no onus on Ministers to give reasons for their decisions *other than to the parties directly concerned*. Moreover, for deemed 'not to declare' decisions where Ministers do not respond to recommendations from the NCC within 60 days, there is no requirement for them to provide reasons even to the parties to the application.

A few participants argued that these arrangements do not detract substantially from transparency. For instance, the New South Wales Government (sub. 44, p. 13) said that there is no need for a legislative requirement for Ministers to justify their decisions because those decisions are appellable to the Tribunal.

Other participants, however, considered that there should be a greater level of scrutiny of Ministerial decisions. For example, the NECG contended that:

> … the Minister should be required to provide reasons for all decisions under Part IIIA. (sub. 39, p. 11-2)

Similarly, the Law Council advocated that:

> If the Ministers must retain their present roles in the declaration process, they should be required to consider the NCC's recommendation and to give reasons for their decision. If they fail to give a reasoned decision within the time period specified, they should be deemed to have declared the service. (sub. 37, p. 3)

Rio Tinto (sub. 15, p. 16) noted that two reports on rail services (HOR 1998, CofA 1999) had advocated this same approach.

Against this backdrop, the Position Paper proposed that Part IIIA decision makers should be required to publish reasons for all of their determinations on applications for declaration and certification and proposed undertakings. In this regard, the Commission placed particular emphasis on the need to make Ministers more accountable for their decisions, arguing that this should entail two changes:

- Ministers should be obliged to publish reasons for their decisions on declaration and certification applications, rather than simply providing reasons to the parties directly involved; and
- if Ministers do not make a decision within the 60 day limit, they should be deemed to have accepted the NCC's recommendations.

In practical terms, the latter requirement would align closely with the suggestion from a number of participants that a non-decision be treated as a 'deemed to declare.' That is, non-decisions are unlikely to be an issue if the NCC has recommended against declaration. Conversely, where the NCC has recommended declaration of a service, this change to the deeming arrangements would greatly increase the incentives for Ministers to make decisions within the 60 days. In turn, this would trigger the first requirement for Ministers to publish reasons for their decisions. Thus, together, these requirements would add considerably to the transparency of the decision making process.

There was again considerable support for this approach in responses to the Position Paper, including from the South Australian Government (sub. DR121, p. 8).

However, the New South Wales Government (sub. DR109, p. 13) repeated its earlier view that a requirement for Ministers to give reasons for their decisions is unnecessary. Also, the Western Australian Government raised concerns about decisions occurring by default. It argued that default decisions are inappropriate where significant property right issues arise and might increase the prospect of subsequent appeals (transcript, pp. 459, 469). The Queensland Treasury (sub. DR105, p. 24) similarly opposed deeming in relation to certification decisions.

In the Commission's view, these latter concerns do not invalidate the rationale for the approach in the Position Paper. Appeals against Ministers' decisions are an ever present possibility, whether or not that decision is explicit or deemed. Moreover, the Commission's approach does not represent the replacement of an active decision with deeming. Rather, it is the substitution of the present form of deeming arrangement with another. Arguably, a deemed decision based on a balanced assessment of the issues by the NCC is preferable to an automatic presumption in one direction without regard to the facts of the matter.

The Commission therefore sees no reason to resile from its Position Paper proposal. Indeed, given that it now considers that Ministers should retain responsibility for deciding on declaration and certification applications, these transparency requirements become a primary, rather than a subsidiary, recommendation.

RECOMMENDATION 15.5

Ministers, the National Competition Council and the Australian Competition and Consumer Commission should be required to publish reasons for their decisions or recommendations relating to applications for declarations and certifications and proposed undertakings.

If Ministers fail to make a decision on a declaration or certification recommendation within the 60 day time limit, this should be deemed as acceptance of the National Competition Council's recommendation.

In relation to reporting by the ACCC on accepted undertakings, the Commission's proposed public disclosure requirements for completed arbitrations (recommendation 15.6) are also relevant.

Transparency of the arbitration process

Part IIIA specifies that arbitrations for declared services are to be private, unless the parties agree otherwise.

While there have yet to be any arbitrations under Part IIIA, a number of participants made the case for greater transparency in this area. The Queensland Mining Council argued that:

> Disclosure of access arrangements is the surest way of guarding against … provider/user collusion … and other forms of special deals and discriminatory treatment of users to which monopolists are naturally inclined. (sub. 27, p. 8)

It suggested that a high degree of disclosure of costs and performance indicators should be a condition for any approved access arrangement, with such information to be made available through 'access agreement libraries'.

AAPT Limited argued that any confidentiality claims in relation to arbitrations should be treated with caution. It said that greater disclosure under the telecommunications access regime would have facilitated speedier resolution of the various PSTN arbitrations with flow-on information benefits to future access seekers. It suggested that confidentiality issues arising in bilateral arbitrations could be at least partially overcome by making commercially sensitive information available to a designated representative of a subsequent access seeker, subject to a confidentiality undertaking. (sub. 42, p. 10)

Significantly, while adopting a more cautious stance, the NCC still saw scope for public disclosure of some information arising from arbitrations:

> There are clearly issues that operate for and against a more overtly public process given the commercially sensitive nature of the prices which are being determined and also which limit the desirability of combining arbitrations even where common issues arise. Nonetheless, there appears to be some scope to consider whether current arbitration arrangements strike the appropriate balance between commercial confidentiality (especially for the infrastructure owner) and providing information to the market on likely arbitration outcomes in the future. (sub. 43, p. 47)

The Council went on to suggest that following an arbitration, the ACCC could publish a report:

- specifying the methodology used to make its determination;
- incorporating any non-confidential information from the parties relevant to the determination; and
- detailing any guidelines for future decision making that emerge from the particular arbitration.

In the Position Paper, the Commission argued that while there is clearly an argument for protection of commercially sensitive material, the confidential nature of arbitrations is likely to detract from more timely access outcomes. It noted, for example, that if some information was publicly available on the parameters governing the terms and conditions of a bilateral arbitration, negotiations with subsequent access seekers would occur on a more equal information footing and possibly within narrower price bands.

The Commission therefore endorsed the concept of post-arbitration reports and sought participants' views on the approach proposed by the NCC and whether other information could be added to the Council's list. In this context, it raised the question of how much detail of the arbitrated terms and conditions such reports could contain without breaching legitimate confidentiality concerns.

Responses to the Position Paper provided only limited feedback on these matters. The ACCC (sub. DR93, p. 19) said that precise description of what information could be published in a post-arbitration report would be difficult, meaning that it, as the body responsible for producing the report, would need to have some discretion in this regard. It went on to note provisions in the Gas Code which allow for the disclosure of information unless, in the regulator's opinion, disclosure could be unduly harmful to the legitimate business interests of the facility owner.

However, the major concern raised about the proposal was that the prospect of a post-arbitration report could limit the information provided to the ACCC during the arbitration process. Thus, the Australian Gas Association commented:

> … a requirement for the ACCC to publish a post-arbitration report creates a significant risk of participants in arbitration being reluctant to provide adequate information for initial arbitration. This could occur because of the knowledge that information provided, with the potential to impact on future access negotiations, may be disclosed at a future stage. This would in turn tend to result in a reduction in the efficiency and effectiveness of regulatory outcomes. (sub. DR84, p. 12)

More generally, the Association argued that public disclosure has the potential to frustrate rather than promote efficient outcomes by revealing service providers' future business plans to competitors and inhibiting efficient price discrimination between access seekers (p. 18).

For its part, the Commission acknowledges that public disclosure of *certain types* of information could have deleterious effects. Chapter 10 of the Commission's report on telecommunications competition regulation (PC 2001c) discusses the nature of those effects in some detail, including the potential for the disclosure of commercially sensitive information to harm the interests of access seekers by revealing their business plans to competitors.

Equally, however, a closed arbitration process will be an impediment to efficient negotiation. As the Minister for Communications, Information Technology and the Arts recently argued when announcing the Government's intention to make provision for post-arbitration reports as part of a suite of measures to 'streamline' the telecommunications access regime:

> Publication of arbitration outcomes would … enable the disclosure of key information to the market which would in turn promote commercial resolution of future disputes in relation to the same declared service. (Alston 2001, p. 3)

The requirement, therefore, is to strike an appropriate balance between the competing considerations.

In the Commission's view, a post-arbitration report should principally be a vehicle for informing other access seekers about the broad parameters within which an arbitration has occurred and the methodologies underpinning the determination of terms and conditions. It should not be a vehicle for providing detailed information on those terms and conditions. Were it to be so, the scope for negotiation between the service provider and other access seekers could be greatly curtailed. In effect, the terms and conditions determined in the first arbitration could become little different from a binding set of terms and conditions. If this were the desired outcome in relation to a particular infrastructure service then, in the Commission's view, it would be best pursued transparently and directly, rather than through a post-arbitration report system.

This in turn suggests that the sort of framework approach embodied in the NCC's proposal is broadly appropriate. Moreover, in providing valuable information to future access seekers, the approach could be tailored to give the ACCC some discretion as to the precise nature of the material disclosed in any particular circumstance.

Like the publication of reasons for other Part IIIA determinations, the Commission also sees post-arbitration reports as a vehicle for promoting regulatory accountability. Thus, in chapter 8, it has recommended that certain actions by the ACCC in arbitrating disputes for declared services would require justification in the post-arbitration report. Similarly, in chapter 12, it has recommended that, via the post-arbitration report, the ACCC explain its choice of asset valuation methodology in any arbitrated determination of access terms and conditions.

RECOMMENDATION 15.6

The Australian Competition and Consumer Commission should be required to publish reports on completed arbitrations for services declared under Part IIIA. Subject to the proviso that any information disclosed does not unduly harm the legitimate business interests of parties to the dispute, these reports should generally include the following:

- ***an outline of the decision making framework and methodologies underpinning the arbitrated outcome, including the reasons for the choice of asset valuation methodology (see recommendation 13.1);***
- ***any non-confidential information provided by the parties to the dispute which has implications for the framework and methodologies adopted; and***
- ***discussion of any implications of the determination for parties seeking access to the service, or a similar service, in the future.***

The reports should also include justification for any of the following actions taken by the Commission as part of the arbitration process:

- ***reassessment of matters agreed between the parties to the dispute (recommendation 8.2);***
- ***the introduction of non-efficiency considerations (recommendation 8.3); and***
- ***decisions on whether or not to engage in multilateral arbitrations which are against the wishes of the parties to the dispute (recommendation 8.5).***

The Commission notes that a parallel case for disclosure would logically extend to the framework and methodological aspects of the terms and conditions for Part IIIA undertakings accepted by the ACCC. However, this could be accommodated as part of the requirement for the ACCC to publish the reasons for its decisions on proposed undertakings (see recommendation 15.5), rather than requiring a separate report.

15.4 Other matters

Revocation arrangements and the duration of Part IIIA determinations

All declarations, certifications and undertakings under Part IIIA must have expiry dates. In addition, there are various possibilities for early expiry, or variations to agreed arrangements, should circumstances change:

- The NCC can recommend to the relevant Minister that a declaration be revoked if changes in circumstances mean that the declaration criteria are no longer met.
- The ACCC can vary arbitrated terms and conditions for declared services if both parties agree.
- Undertakings can be modified or withdrawn with the consent of the ACCC.
- If a State or Territory ceases to be a party to the Competition Principles Agreement, its existing certifications lapse immediately and the services concerned become liable for declaration.

In the Commission's view, such provisions are an important part of the Part IIIA architecture. In particular, they provide the scope to respond to changes that can occur in the contestability of infrastructure markets. As the NCC commented:

> An effective access regime should provide for a periodic review of the need for access regulation to apply to a particular service. For example, while a facility might not be economically feasible to duplicate at present (and so might warrant an access regime), market evolution and technological innovation might change this situation over time and remove the need for access regulation in the future. (sub. 43, p. 100)

The Sydney Airports Corporation further suggested that the possibility of revocation may encourage access providers to behave 'responsibly':

> … as a matter of discipline, continued regulatory intervention would only be sustained where, industry by industry, it was clear that there was an ongoing need. Significant infrastructure owners would thereby be provided with still further positive incentive to grant access responsibly on agreeable terms and conditions, knowing that a sustained record of doing so would see an otherwise significant regulatory burden and cost lifted and not later reimposed. (sub. DR114, pp. 69-70)

The requirement that all Part IIIA determinations have an expiry date is in contrast to the declaration provisions in the telecommunications access regime which are currently open-ended.

Commentary in submissions on the detailed operation of revocation and review arrangements related mainly to corresponding coverage provisions in the Gas Code. The lack of comment on the Part IIIA revocation and review architecture was hardly surprising given that, for the most part, the first tranche of determinations under the regime is still current.

In contrast, the duration of Part IIIA determinations was the subject of some discussion. As noted, the New South Wales Government raised concerns about the 13 month duration of the certification for its rail regime. It argued that:

> [Thirteen] months is too short a period for certification, given the amount of effort that goes into an application. A five year period would be more appropriate.
>
> Part IIIA should be amended to allow for a 'simple' process for extending certification once it has expired. This extension should apply where there has been no material changes to the regime, or underlying market conditions. (sub. 44, p. 5)

Numerous concerns were also raised about the duration of determinations under the Gas Code. The Australian Gas Association, amongst others, said that these have typically been for too short a period to provide certainty to investors:

> Prior to the current regulatory model a project had a much longer time frame and opportunity to recover costs and achieve a return for investors, this period could extend anywhere up to twenty years. This contrasts with today's position where a regulator determined return under an access arrangement mostly only provides for a five-year period before a required reset. Clearly in this instance the regulatory instruments are acting as a disincentive to newer, longer-lived and more marginal projects. (sub. 29, p. 15)

For its part, the NCC argued that the duration of determinations must have regard to market circumstances. It went on to say that the short certification period for the New South Wales rail access regime took account of related regulatory developments in regard to interstate rail access. Nonetheless, it acknowledged a need to provide stability and certainty to market participants:

> In general, the Council is aware that infrastructure owners/operators and users have a need for stability and certainty in the regulatory environment, especially in the development of new infrastructure. (sub. 43, p. 125)

The Commission strongly endorses the need for a stable and certain regulatory environment. Such an environment can play a crucial role in facilitating efficient investment in essential infrastructure — an outcome which the Commission has argued should be given much greater emphasis in the Part IIIA regime. Frequently repeated reviews of regulatory arrangements can also be costly for both the regulatory body and business. Further, while the duration of determinations under the Gas Code is not an issue for this inquiry, the Commission notes that relatively short timeframes for these determinations have been one reason why some pipeline owners have sought to submit access undertakings under Part IIIA, rather than operate under the Code (see chapter 10).

The Commission's recommendations directed at giving more emphasis to investment in the Part IIIA architecture should help, over the medium term, to guard against unduly short determinations. To the extent that these recommendations were picked up in future revisions to industry regimes, they would also help to address the concerns of particular groups of service providers.

The Commission also sees merit in the New South Wales Government's suggestion that there be capacity to expedite the extension of certification arrangements where market circumstances have not changed significantly. This same approach might also extend to undertakings.

It may well be that such an approach will be implemented by default when some of the current determinations expire. Indeed, the NCC has indicated that 'second-round' certifications should be much less complex and time consuming than the initial assessments.

Nonetheless, there may be value in codifying an arrangement to encourage expeditious processing and to reduce the risk of regulatory-driven 'change for the sake of change'. Accordingly, in the Position Paper, the Commission outlined how such an arrangement might operate:

- Prior to the expiry of a certification or undertaking, the NCC or the ACCC would seek public comment on whether changes to the existing arrangements were required.
- On the basis of that input, the Council or the ACCC would have the option of making a case for any changes.
- If they did not do so (and the service provider did not wish to make changes), extension of the certification or undertaking for the same period as the initial determination would be automatic.

In its response to the Position Paper, EnergyAustralia expressed strong support for such an approach:

> Where there have been no significant changes that would warrant a whole re-assessment of the agreements, there is no valid reason why extending them cannot be much less complex and time consuming than the initial assessments. EnergyAustralia supports all endeavours to make this a reality. (sub. DR106, p. 7)

The South Australian Government (sub. DR121, p. 9) similarly endorsed the approach, referring also to the possibility of extending certifications by 'mutual agreement.'

The Australian Rail Track Corporation (sub. DR64, p. 19) said that the approach might provide some 'cost-effectiveness' benefits, particularly for the service provider 'that faces the greatest disruption and cost in applying for approval of an access regime.' However, it argued that where a determination has been in force for a period of more than ten years, a full review would still be warranted. It also contended that the duration of an expedited extension should be left to the discretion of the regulator/Minister rather than automatically being the same as the initial determination.

These comments have served to reinforce the Commission's view that there would be value in codification of an arrangement to expedite extensions of certifications and undertakings. While, in practical terms, such an arrangement may not constitute much of a departure from the approach that would otherwise be followed by the relevant decision makers, its mere existence could provide a degree of reassurance to service providers. Indeed, an explicit provision for low cost 'roll-overs' may have helped to assuage the New South Wales Government's concern about the short certification period for that State's rail access regime.

The Commission gave some consideration to the suggestion for extension by 'mutual agreement'. Clearly, this would offer the prospect of even speedier extensions. However, it would be a looser, and therefore less certain, approach. Moreover, it would not explicitly require the regulator/Minister to seek public comment on the merits of an extension to an existing arrangement. This would be an obvious concern for service users and raise more general accountability issues.

The Commission accepts the argument that the duration of an extension under the sort of arrangement it is recommending should be left to the discretion of the regulator/Minister. Were the duration to be necessarily the same as the initial determination, the prospect of objection to semi-automatic roll-over would increase — particularly if the duration of the initial determination was lengthy. Thus, such a requirement could operate to undermine the arrangement.

The Commission does not, however, see the need to limit the arrangement to determinations of short duration. Its approach makes provision for the NCC or the ACCC to make a case for change — which in turn would precipitate a more extensive treatment of the issues concerned. Other things equal, the longer was the initial determination, the greater would be the case for the Council or the ACCC to take such action.

RECOMMENDATION 15.7

Part IIIA should include explicit provision to expedite extensions of certifications and undertakings as follows:

- ***Six months prior to the expiry of a certification or undertaking, the National Competition Council or the Australian Competition and Consumer Commission would be required to seek public comment on the need for any change to the existing arrangements.***
- ***On the basis of that input and other relevant information, the Council or the Commission would have the option of making a case for change.***
- ***If the Council or Commission did not do so, and the service provider did not wish to make changes, extension of the arrangement in question would be automatic.***
- ***For certifications, the duration of the extension would be determined by the Minister on advice from the Council. For undertakings, the duration would be determined by the Australian Competition and Consumer Commission. Standard appeal rights would apply to these determinations.***

Overlaps between Part IIIA and Part IV of the Trade Practices Act

Access arrangements sanctioned under Part IIIA are not shielded from action under the provisions of Part IV of the TPA dealing with anti-competitive behaviour (ie. Sections 45, 46 and 47). If an access arrangement could be considered as anti-competitive under Part IV, the parties must then consider whether to apply to the ACCC for an authorisation under Part VII to 'validate' the arrangement.

There have been suggestions that this overlap creates uncertainty for investors, service providers and access seekers. Pengilley (2001, p. 166) commented that:

> The interaction of the Access Regime and s46 is completely unaddressed. It is extraordinary that many lawyers are advising their clients, that even if such clients are acting in accordance with an Access Regime order, they still need an authorisation to protect their conduct. Surely it is basic that somewhere in the Act, there should be something which says what protection an access order gives. The Act is as barren as the Central Nullabor on this obviously basic issue.

A first round submission from the Law Council similarly argued:

> Facility owners and access recipients must be given certainty about whether their actions in agreeing to terms and conditions of access breach other Parts of the TPA. (sub. 37, p. 28)

It proposed that:

> If access to an activity is obtained under Part IIIA through a determination by the ACCC, a registered contract or an undertaking, then no other access regimes should apply, and Parts IV and VII of the TPA should not apply in respect of conduct covered by the determination, registered contract or undertaking. (sub. 37, p. 28)

AAPT Limited, on the other hand, supported the current overlap arguing that:

> AAPT's view is that an access regime alone will not always prevent misuse of market power. This is both for legal reasons, namely the misuse of market power is defined in different terms from a guaranteed right of access, and for practical ones in that it is very difficult to obtain evidence to show a breach of section 46. (sub. 42, p. 13)

In the Position Paper, the Commission acknowledged the possibility that negotiated access agreements under Part IIIA could contain anti-competitive elements not emanating from the regime's requirements as such. However, it said that the protection against such outcomes afforded by the overlapping exposure to Part IV comes at some cost. In this regard, it noted that the overlap might create uncertainty — particularly for the access provider — as well as increasing the costs of establishing an access arrangement.

The Commission went on to argue that the involvement of the NCC in recommending on the application of the Part IIIA framework, and of the ACCC in establishing the detailed terms and conditions of access, should often be sufficient to guard against anti-competitive outcomes. It further noted that the Hilmer Committee (1993, p. 260) had proposed that declaration under the national access regime should provide protection against claims under Section 46.

Given these considerations, the Commission proposed that a range of access agreements reached under the Part IIIA framework with the involvement of a regulator should be exempt from exposure to Part IV of the TPA:

- arbitrated determinations for declared services;
- agreements reached under certified regimes with the involvement of the relevant regulator;
- agreements negotiated under accepted undertakings; and
- private agreements for declared services covered by registered private contracts.

However, the Commission stressed that such exemption should only extend to the terms and conditions established via the Part IIIA framework, and that other contract conditions should continue to be subject to Part IV.

Responses to the Position Paper proposal

A number of participants — including both of the Part IIIA administrators — raised objections to the proposal. There were a number of strands to their arguments.

The NCC said that there is little risk that agreements on access terms and conditions reached under Part IIIA will breach the provisions of Part IV. However, it went on to contend that, in principle, the application of Part IV to access arrangements should not be precluded simply because those arrangements were reached within the national access regime:

> … the Council believes it is not appropriate to exempt conduct that would ordinarily be in breach of Part IV from the operation of Part IV simply because it arises out of or in connection with an access arrangement. Fundamentally the focuses of Part IIIA and Part IV of the TPA are different. Whilst the terms and conditions of an access arrangement are unlikely to involve a breach of Part IV of the TPA, related conduct may do so and should not be excluded from consideration under Part IV. (sub. DR99, p. 22)

Similarly, the Queensland Treasury argued that:

> It may still be possible for a breach of Part IV to occur. Access regulators are not regulating competitive conduct except to ensure the access provider is not hindering access. There are many possibilities for misuse of market power to occur. (sub. DR105, p. 24)

The ACCC recognised that the Position Paper proposal would involve exemption only for the terms and conditions established by the Part IIIA framework and not for other elements of an access agreement. While stressing that this limitation is essential, it said that it did not 'oppose amendments that would offer access providers and access seekers limited protection from Part IV'. That said, it opposed offering a limited exemption to one of the categories of agreement in the Position Paper proposal — namely, agreements reached under certified regimes with the involvement of a State or Territory regulator. It stated that:

> The ACCC is the statutory body charged with enforcement of Part IV of the Trade Practices Act and it would not be appropriate for regulators other than the ACCC to have the power to provide such protections to access providers and access seekers. (sub. DR93, p. 39)

Finally, the Law Council (sub. DR108) reiterated its earlier contention that the overlap between Part IIIA and Parts IV and VII should be addressed, but suggested that the approach proposed in the Position Paper to achieve this was not appropriate:

> … we do not consider that the removal of the overlap between these provisions is best addressed by 'exempting' Part IIIA arrangements from Parts IV and VII. To 'exempt' suggests that no regard need be had to whether the determination or agreement impacts on

competition. It also suggests that a determination or an agreement may be reached that offends Part IV, or that would offend Part IV if not for the exemption. (p. 5)

The Law Council proposed, instead, that a form of 'deemed compliance' be used:

> We prefer an approach which provides that … the entry into and compliance with the arrangements within their terms is deemed compliance with Part IV. The Council suggests the Commission recommends language similar to Section 51(3) namely:
>
> A contravention of a provision of Parts IV or VII shall not be taken to have been committed by reason of:
>
> (a) the ACCC making a determination in respect of declared services;
>
> (b) the [Minister on advice from the] NCC certifying a regime; or
>
> (c) the registration of private contracts in respect of declared services.
>
> The approach recognises the continued relevance of Part IV in relation to access arrangements. It also provides some encouragement to the parties to consider the breadth and on-going competitive impact of their arrangements. (pp. 5-6)

The Commission's assessment

The responses to the Position Paper proposal have left the Commission uncertain as to whether any action is required to address the overlap between Parts IIIA and IV of the TPA and, if so, how the overlap might be best addressed.

As the Commission emphasised in the Position Paper, the only element of the overlap which is potentially of concern involves the exposure to Part IV of access terms and conditions that have been sanctioned under Part IIIA. The exposure of other aspects of these arrangements to Part IV is generally agreed to be appropriate.

Also, the practical significance of the overlap in relation to terms and conditions is far from clear. Indeed, the Law Council was the only participant to suggest that a material problem exists.

Further, those parties best placed to determine how the overlap could be addressed proposed different courses of action. The ACCC suggested that a limited exemption for certain terms and conditions reached within the Part IIIA framework could be contemplated, whereas the Law Council opted for a 'deemed compliance' approach.

Given these uncertainties, the Commission is now of the view that this is a matter which requires further exploration before any changes to the current arrangements should be contemplated.

FINDING 15.3

The materiality of any problems arising from the current overlap between Parts IIIA and IV of the Trade Practices Act is not clear. The issue might usefully be the subject of further investigation and discussions between the National Competition Council, the Australian Competition and Consumer Commission and the legal profession. Those investigations and discussions should also help to clarify what is the most appropriate way of addressing the overlap, if a consensus emerges that action is required.

The Commission notes that such investigations and discussions would need to have regard to the proposed introduction of measures to facilitate efficient investment within the Part IIIA framework. It is conceivable that the implementation and application of such measures could increase the likelihood of actions under Part IV. For example, some of the instruments canvassed in chapter 11 would sanction the denial of access by service providers. As discussed in that chapter, if there was a prospect that actions under Part IV might be used to frustrate the intent of the new measures, then the Commission would see a case for explicit provisions in Part IIIA to quarantine *sanctioned* arrangements from exposure to Part IV.

Consumer funding issues

In first round submissions, a few participants raised concerns about the limited opportunity for consumer interests to participate in access decision making. For instance, the Energy Action Group (EAG) stated:

> The most important standout issue for the EAG is the failure by the jurisdictions to adequately resource the demand side. The small number of demand side submissions to this Inquiry will strongly reflect this point. The vast majority of submissions will come from the supply side or industries/professions that receive the majority of their revenue from the supply side. The bulk of submissions will reflect a strategy to increase the costs to consumers via increased revenue for regulated entities. (sub. 30, p. 2)

In a similar vein, Energex (sub. 14, pp. 39-40) noted that the participation of consumer interests in the decision making process is hampered by a lack of funding and expertise. It said that in the UK and the USA, much greater attention has been given to encouraging the participation of consumer groups. Energex went on to advocate that funding be provided to residential and disadvantaged groups ‘so that their cases can be made.’ In responding to the Victorian Government’s consultation paper on establishing an Essential Services Commission, the Office of the Regulator-General, Victoria similarly supported financial assistance for ‘consumer representatives and other advocacy groups’ (ORG 2001, p. 2).

In the Position Paper, the Commission made a number of observations on this issue:

- While *direct* participation by consumer groups in access determinations and policy making is often limited, consumers will usually have a strong indirect voice. This is because access seekers can be a powerful agent for user interests. In essence, an access seeker's success in the market depends on it being able to secure access at a price which allows it to offer a lower cost or better value for money service than an incumbent provider. Thus, the interests of access seekers and users will often be common.
- Funding for consumer groups raises questions of which groups, how much, and who should pay.
- Increased funding is not the only way to facilitate the participation of consumer groups. The nature of regulatory bodies' public inquiry processes, the extent to which they actively seek input from these groups and the consultative practices of service providers are all relevant in this regard.

The Commission went on to seek further views on ways to facilitate the participation of consumer interests in Part IIIA (and other access) decision making.

Not surprisingly, user groups that responded to the Commission's invitation were strongly supportive of financial support to foster the participation of consumer interests. As well as reiterating the difficulties consumers face in having their voices heard, user groups contended that consumers are disadvantaged relative to service providers who can recoup the costs of participating in the regulatory process through customer charges. The Energy Users Association of Australia commented:

> End-users have a legitimate right to participate in regulatory price reviews given that it is they that must pay these charges. But they are not able to participate as effectively as regulated businesses.
>
> This situation is made worse because the costs of regulatory compliance for every regulated business are paid for by customers out of regulated charges. This threatens the credibility of the regulatory process and leads to situations where regulators are forced to become *de facto* 'consumer advocates', leading to frequent accusations of 'consumer bias' by regulated businesses. (sub. DR94, p. 34)

The Association recommended that the Commission support the establishment of 'a broad-based end-user funding mechanism, based on user-pays, to apply to all aspects of energy regulation and reform, with levels and allocations to be determined by an independent panel(s)'. The Energy Markets Reform Forum (transcript, pp. 281-3) similarly raised the possibility of some specific consumer funding requirement in access codes.

Also predicably, service providers were less enamoured by the prospect of consumer funding. The Australian Gas Association (sub. DR84, pp. 22-3) argued that:

- access seekers will serve as a proxy for the final user;
- regulators will usually be more than adequately motivated to achieve the lowest possible cost for users; and
- enhanced consumer input into regulatory processes would require mechanisms to establish the preferences of consumers — for example, the value they put on security of supply and reliability of service.

It went on to question whether 'extracting a premium via taxes or the final price of infrastructure services to fund separate representation in the regulatory process for consumers would be of any practical benefit'.

In an extensive critique of consumer funding, the Institute of Public Affairs made similar observations, as well as disputing the representativeness of consumer bodies and their capacity to participate meaningfully in detailed access decision making:

> … determining the prices and/or revenues for these natural monopoly facets of supply is a matter of estimating costs of supply and putting in place appropriate incentives to ensure efficiency. It is not obvious that consumer representatives have expertise in these matters. (sub. DR57, p. 4)

The Institute concluded that it saw:

> … no reason to support the proposal that the bodies claiming to represent consumers be afforded rights, in excess of those they already have, to be involved in the decision making process. (p. 1)

The Commission also is not convinced that funding to support consumer group participation in access decision making would lead to more efficient outcomes. Access seekers and regulators will usually have incentives that align with the interests of users. Hence, the case for such measures would seemingly rely on there being additional benefits in having broadly-based input into the decision making process.

Such an argument clearly has limited relevance to Part IIIA as a residual access route. Further, the terms of reference mean that its applicability to specific industry regimes is not an issue for this inquiry.

16 Implementation issues

In this report, the Commission has made findings and recommendations covering both general aspects of the national access framework and specific elements of Part IIIA and Clause 6 of the Competition Principles Agreement (CPA). The Commission's recommendations are summarised in table 16.1.

This final chapter of the report looks at a number of issues that would arise in implementing those recommendations.

A well-staged implementation process would help to maximise the benefits that the Commission's recommendations would bring. It could also help to reduce the uncertainty and transactions costs that inevitably accompany changes in important pieces of legislation. Indeed, given the nature of the national access regime and the range of significant investments and services it covers, effective implementation of the changes proposed in this report would be very important.

Some of the issues that would need to be addressed in implementing the recommendations are of a generic nature. That is, they arise whenever changes are made to significant pieces of regulation. They include the timing and sequencing of the proposed changes to Part IIIA and Clause 6 of the CPA, the scope to implement particular changes on a stand-alone basis and monitoring and review requirements.

However, the relationships between Part IIIA, Clause 6 and industry access regimes raise some specific implementation issues. In particular, there is a need to have regard to the Commonwealth-State dimension which underpins important aspects of the national access framework. Accordingly, this chapter begins by looking at the ramifications of the Commission's recommendations for Clause 6 and industry access regimes.

16.1 Implications for Clause 6

As discussed at length in earlier chapters, Clause 6 of the CPA is an integral part of the national access framework. In addition to providing the imprimatur for the enactment of Part IIIA, it spells out the principles with which an effective State or Territory access regime must comply. Part IIIA in turn requires the National Competition Council (NCC) to draw on these principles when assessing applications for certifications of State or Territory access regimes. Given that certification removes the possibility of declaration of the services in question, the Clause 6 principles in that respect serve to place certified State and Territory regimes at the top of the access hierarchy.

Table 16.1 **Summary of the Commission's recommendations**

6.1	Inclusion of an objects clause in Part IIIA relating to the promotion of efficient use of, and investment in, essential infrastructure facilities and recognising the regime's role in discouraging unwarranted divergence in industry regimes.
6.2	A requirement for decision makers to have regard to the objects clause in all determinations and coverage decisions made under the regime.
6.3	Inclusion in Part IIIA of pricing principles to apply to arbitrations for declared services, assessments of proposed undertakings and evaluations of whether existing access regimes are effective.
6.4	Retention of the current exclusions from Part IIIA, but with monitoring of developments in relation to the 'production facility' exclusion.
7.1	Modification to the first declaration criterion to require that provision of access would deliver a *substantial* increase in competition.
7.2	A requirement for the next scheduled review of Part IIIA (see recommendation 16.2) to review declaration decisions to assess whether further strengthening or recasting of the declaration criteria is needed.
8.1	A requirement for an exchange of specified information between the provider of a service declared under Part IIIA and an access seeker to facilitate negotiation of specific terms and conditions.
8.2	A requirement for the Australian Competition and Consumer Commission (ACCC), when arbitrating a dispute for a service declared under Part IIIA, to justify consideration of matters not in dispute between the parties.
8.3	A requirement for the ACCC, when arbitrating a dispute for a declared service, or assessing a proposed undertaking, to justify the introduction of non-efficiency considerations.
8.4	Clarification that the ACCC, when arbitrating a dispute for a declared service, can require a service provider to permit interconnection to its facility.
8.5	Introduction of provision for the ACCC to conduct multilateral arbitrations for declared services.
9.1	Removal of immunity for Commonwealth access regimes from Part IIIA, with the Commonwealth Government to have the option of submitting those regimes for certification. Also a requirement for the NCC to comment on the consistency of any proposed Commonwealth industry regimes with Part IIIA.
9.2	Negotiation between the Commonwealth and States and Territories with a view to aligning the Clause 6 principles for assessing the effectiveness of industry regimes with comparable principles and criteria in Part IIIA.
9.3	Negotiation between the Commonwealth and States and Territories and the NCC to determine how best to provide for interim and conditional certifications.

Table 16.1 **continued**

10.1	Introduction of scope for service providers to lodge post-declaration undertakings.
10.2	Alignment of the criteria for assessing proposed undertakings with those applying to arbitrations for declared services and the Clause 6 principles for certification.
10.3	Amendment to the Gas Code such that an undertaking application under Part IIIA for a pipeline potentially covered by the Code would trigger an assessment of whether the Code should apply.
10.4	Amendment to Part IIIA to make it explicit that the ACCC cannot accept an undertaking for a service covered by a certified regime.
11.1	Provision for investors to seek binding rulings on whether services provided by proposed infrastructure facilities would meet the Part IIIA declaration criteria.
11.2	Provision to provide immunity from Part IIIA for projects where construction and the price of access has been determined by an appropriately constituted competitive tender.
11.3	A requirement for the Commonwealth Government to initiate, through the Council of Australian Governments, a process to refine generally applicable mechanisms to facilitate efficient investment within Part IIIA and industry access regimes.
12.1	Details of the pricing principles to be incorporated in Part IIIA.
12.2	Initiation of a process to develop the instruments and measurement techniques necessary to make greater use of productivity-based approaches to setting access prices.
13.1	A requirement for the ACCC, when arbitrating terms and conditions for a declared service, to explain its reasons for the asset methodology employed.
15.1	Provision for full merit review of ACCC decisions on undertaking applications.
15.2	Extension of the 60 day limit for Ministerial decisions on declaration applications to decisions on certification applications.
15.3	Introduction of non-binding target time limits for other aspects of Part IIIA decision making.
15.4	Legislative provision for public input on declaration, certification and undertaking applications.
15.5	A requirement for Ministers, the NCC and the ACCC to publish reasons for their decisions or recommendations on declaration, certification and undertaking applications. Non-decisions by Ministers on declaration and certification applications to be deemed as acceptance of the recommendations from the NCC.
15.6	A requirement for the ACCC to publish post-arbitration reports.
15.7	Introduction of an explicit provision to expedite extensions of certifications and undertakings.
16.1	A requirement for the NCC to report annually on the operation and effects of the revised Part IIIA arrangements.
16.2	Provision for an independent review of the revised Part IIIA arrangements five years after the first group of changes is introduced.

During the inquiry, the appropriate configuration of this hierarchy, and the precise relationship between Clause 6, Part IIIA and industry access regimes, were the subject of considerable debate.

As discussed in chapters 5 and 9, a significant number of participants argued that greater reliance should be placed on Part IIIA to achieve efficient outcomes. A common theme was that the requirements of industry regimes should only differ from those in Part IIIA where industry-specific circumstances make this absolutely necessary. Such an approach — which the Commission endorsed in the Position Paper — would have the effect of downgrading the position of industry access regimes in the access hierarchy and, by implication, the stature of Clause 6.

However, in the light of responses to the Position Paper, the Commission has modified its stance on this matter. In particular, it has affirmed the important role of Clause 6 in conjunction with Part IIIA in setting the parameters of the national access framework. This, in turn, caused the Commission to abandon the (tier 2) proposal in the Position Paper to house the principles for assessing the effectiveness of State and Territory access regimes within Part IIIA (see chapter 9). It was also a factor contributing to the Commission's decision not to persist with the Position Paper proposals to end the decision making role of Ministers in Part IIIA and to make the ACCC solely responsible for administering the regime (see chapter 14).

However, these modifications to the Commission's approach and recommendations do not mean that the specific provisions of Clause 6 should be regarded as immutable.

As discussed in chapter 9, there are divergences between Clause 6 and parallel parts of Part IIIA. Some of the Commission's recommendations for changes to Part IIIA would result in greater convergence between the two. For example, the proposed inclusion of a requirement that declaration of a service would promote a *substantial* increase in competition in at least one other market (recommendation 7.1) would see the criterion concerned more closely parallel the requirement in Clause 6 that access is *necessary to promote effective competition in a related market*. But others would increase current divergences — for instance, recommendations 6.3 and 12.1, relating to the inclusion of generic pricing principles in Part IIIA, and recommendation 11.2 relating to exemptions from Part IIIA for government-sponsored projects to build and operate new essential facilities awarded through an appropriately constituted competitive tender.

It would be possible to leave these divergences unaddressed. Indeed, as noted in chapter 9, amendments made to the Part IIIA legislation in 1998 have clarified the status of the Clause 6 principles as guidelines rather than binding requirements.

In these circumstances, however, the provisions attaching to the 'default' declaration route in Part IIIA would become increasingly important in setting the parameters for effective State and Territory access regimes.

Thus, if Clause 6 is to continue to play a guiding role in the national access framework, it would be highly desirable to align the principles for assessing the effectiveness of State and Territory access regimes as closely as possible with the requirements attaching to the declaration provisions under Part IIIA. Accordingly, the Commission has outlined changes to Clause 6 which would help to deliver such alignment and proposed that the Commonwealth and the States and Territories jointly agree to implement those changes (recommendation 9.2).

In their responses to the Position Paper, some State Governments indicated a willingness to participate in such a process. For example, in stressing that any framework changes that affect industry-specific regimes should be matters for further negotiation between jurisdictions under a revised Competition Principles Agreement, the Western Australian Government said that:

> Western Australia would remain open to considering and negotiating any changes that the Productivity Commission recommends to Clause 6 as the cornerstone of the national access regime. (sub. DR69, p. 3)

In the Commission's view, such a cooperative approach would have significant benefits. In particular, it could deliver a fully consistent as well as efficient access framework and, in the process, provide greater certainty to service providers and access seekers. Just as importantly, it would serve to focus again the attention of all Australian Governments on a regulatory issue of considerable importance to the Australian economy.

16.2 Implications for industry-specific access regimes

The immediate implications for industry-specific regimes of the Commission's proposed changes to Part IIIA and Clause 6 would be limited:

- The terms of reference specify that there is no intention for the inquiry to lead to changes in existing or pending access arrangements under Part IIIA. Such arrangements include certifications of industry regimes and the undertaking giving effect to the National Electricity Code.
- Services covered by industry access regimes which are not the subject of an existing or pending Part IIIA arrangement, would be less exposed to the threat of declaration under the Commission's proposals. In particular, the proposed requirement that declaration of a service should promote a *substantial* increase in competition in at least one other market (recommendation 7.1) would raise the declaration hurdle.
- And, while recommendation 9.1 — that services covered by legislated Commonwealth access regimes no longer be shielded from declaration — could

in theory have immediate implications, in practice this is unlikely to be the case. This is because the declaration criteria in existing and proposed Commonwealth regimes appear generally easier to satisfy than the Part IIIA criteria. Hence, access seekers are unlikely to use the latter route.

Conversely, implementation of the Commission's recommendations could have more significant ramifications for future certifications and undertakings. That is, some access arrangements that satisfy current requirements might not comply with the modified arrangements suggested by the Commission. More broadly, the proposed changes to the access framework could influence the way that any new industry regimes were configured. However, detailed assessment of the likely implications for particular industry regimes is beyond the purview of this inquiry.

Further, some of the changes that the Commission has proposed to Part IIIA would create pressure for similar changes to industry regimes. Indeed, in supporting many of the proposals in the Position Paper, gas pipeline interests argued strongly for parallel changes to the Gas Code (see chapter 5). While possible changes to industry regimes are not generally a matter for this inquiry, the Commission has emphasised the importance of minimising unwarranted divergences in the requirements of individual access arrangements. A number of its recommendations have been framed with this objective in mind.

In terms of creating pressure for parallel change in industry regimes, any inclusion in Part IIIA of measures to facilitate new investment in essential infrastructure (see chapter 11) would be particularly significant. A major criticism of current access arrangements is that they are focussed too heavily on existing infrastructure and give inadequate regard to investment needs. Thus, the inclusion in Part IIIA of measures to improve incentives for investment could make the regime much more attractive to service providers than certified industry access arrangements.

Under the current arrangements, the upshot might be that service providers would seek to lodge 'pre-emptive' Part IIIA undertakings in an effort to avoid coverage under 'less generous' certified industry regimes. As discussed in chapter 10, this approach has recently been explored by some gas pipeline owners.

However, the Commission is proposing that the undertaking option no longer be available where there is a certified regime covering (or potentially covering) the services in question (see recommendations 10.3 and 10.4). With this change also in place, the pressure for the inclusion in certified industry regimes of comparable measures to facilitate new investment would most likely be overwhelming. Effective management of such change would again require cooperation between the various jurisdictions.

16.3 Some generic implementation issues

Beyond the specific implementation issues ensuing from the relationships between Part IIIA, Clause 6 and industry access regimes, the Commission's recommendations would give rise to a number of generic implementation matters.

Timing issues

While the Commission considers that its recommendations would yield significant benefits, there is no imperative for very rapid implementation. As noted, the intention is that existing or pending access arrangements will not be affected by changes arising from the inquiry. More generally, given that the Commission's recommendations involve some significant changes to the basic architecture of Part IIIA, careful rather than speedy implementation is the imperative.

Implementing some of the Commission's recommendations would inevitably be time consuming:

- Some substantial revisions to parts of the legislation would be required. Further, some of the Commission's recommendations are expressed in ways that emphasise the intent of the proposed changes, rather than in language which could be imported immediately into legislation. Thus, some legislative drafting work would be entailed before implementation could occur.
- A number of the Commission's other recommendations and findings would require further refinement before specific changes to Part IIIA (and/or Clause 6) could be implemented. Arguably the most important recommendation in the report — namely, that the Commonwealth Government initiate a consultative process to refine mechanisms to facilitate efficient new investment within Part IIIA and industry access regimes — falls into this category. Other matters on which the Commission has suggested that further exploration or work is required include:
  - productivity-based price caps (recommendation 12.2);
  - asset valuation methodologies (recommendation 13.1); and
  - the overlap between Parts IIIA and IV of the Trade Practices Act (finding 15.3).
- Implementation of yet other recommendations for specific changes to Part IIIA would still require prior consultation with the States and Territories (see above), regulators and other interested parties. In expectation of such a need, the terms of reference note the Government's commitment to consult as appropriate on the Commission's recommendations.

Given these inevitable delays, the Commission considers there would be value in the Commonwealth and the States and Territories providing an early indication of their position on the broad thrust of the recommendations. This could help to condition:

- proposed investments in infrastructure that might be subject to the revised regime;
- the expectations of access seekers on the likely market environment once existing determinations expire; and
- the development of any new industry-specific regimes, or modifications of current regimes.

An early indication of support for measures to facilitate efficient investment within the national access arrangements would be particularly helpful. Such guidance might also usefully extend to the provision of some indicative timetables for implementing changes.

Implementation as a package

Many of the Commission's recommendations could be implemented on a stand-alone basis. This is especially true of the recommendations dealing with the administrative aspects of Part IIIA. However, recommendations such as the inclusion of an objects clause and pricing principles in Part IIIA could also be implemented individually.

Conversely, some recommendations could only be implemented as part of a package. Those designed to achieve greater alignment in the principles governing the various Part IIIA access routes are cases in point.

Further, even where stand-alone implementation would be possible, the maximum benefit from the Commission's recommendations is likely to accrue if they were introduced as a package. For example, there would be synergies between some of the Commission's administrative recommendations. More importantly, a package approach would enhance the role of Part IIIA and Clause 6 in setting the framework for industry-specific access arrangements. That is, securing greater consistency across the various access routes will be much easier if changes can be made to the requirements applying to each of those routes.

Monitoring and review

Given the complexity of the access problem and the imperfect nature of the solutions to it, ongoing monitoring and periodic review of the national access regime is likely to be particularly beneficial. As experience with access issues in general, and the Part IIIA regime in particular grows, further changes to the regime might be required. In this regard, recommendation 7.2 recognises explicitly that there may be a need for more substantial revisions to the declaration criteria than the change proposed in this report.

More generally, the Commission has emphasised the value of a 'learning by doing' approach in this very complex area. A process that provided a means for assessing and filtering emerging information could therefore help to condition not only the future development of Part IIIA, but also of the various industry regimes that operate under its umbrella.

With these considerations in mind, the Position Paper sought further input on what sort of monitoring arrangement would be most appropriate.

Only one participant — the Energy Users Association of Australia — provided a specific response. Also, its proposal related more to the establishment of a research program than an arrangement for monitoring a regime already in place:

> The EUAA … suggests that a national program be established to monitor and publicly report on the performance of and research into possible future directions for monopoly regulation, including Total Factor Productivity and Data Envelopment Analysis. It considers that this would best be achieved through a PC research program and/or through the Regulators' Forum. (sub. DR94, p. 4)

(The Commission notes that its recommendation in chapter 12 for the initiation of a process to progress issues relating to the greater use of productivity-based price caps would go some way to meeting the Association's request.)

In the absence of any suggestions to the contrary, the Commission considers that the NCC, in its role as the primary adviser on the application of Part IIIA, should be given the task of monitoring the regime. The Commission notes that the Council's annual reporting function and its assessments of jurisdictions' progress in implementing the National Competition Policy Package already give effect to this requirement to some extent. However, there would be value in providing for a dedicated monitoring function in this area and detailing some specific matters that this monitoring should address, including:

- impediments to efficient outcomes; and
- evidence of benefits and costs associated with particular access determinations.

RECOMMENDATION 16.1

The National Competition Council should be required to report annually on the operation and effects of the national access regime. Reporting by the Council should contain information and commentary on:

- ***statutory and judicial interpretation of the (strengthened) declaration criteria;***
- ***any factors that have impeded the regime's capacity to deliver efficient access outcomes;***
- ***evidence of benefits arising from access determinations under the regime;***
- ***evidence of associated costs, including any evidence of disincentives created for investment in essential infrastructure; and***
- ***implications for the national access framework in the future.***

The Commission acknowledges that few would view the NCC as a completely impartial commentator on the efficacy or otherwise of Part IIIA.

However, given the NCC's current policy advising role, the Commission considers that the Council would be better placed to undertake the monitoring function than, say, the ACCC. Indeed, the discussion in chapter 14 on Part IIIA administrative structures suggests that making the ACCC responsible for monitoring the impacts of the regime would cause considerable disquiet.

That said, possible concerns about the impartiality of the NCC in a monitoring context reinforce the case for a further independent review of the national access regime further down the track. Such a review would provide an opportunity to consolidate experience over a longer period — particularly in relation to coverage decisions — as well as to evaluate the impact of the specific changes emerging from this inquiry. Information assembled by the NCC as part of its monitoring of the regime in the intervening period would be one input available to the review.

Clearly, the impacts of changes emerging from this inquiry may take considerable time to become apparent. For example, as discussed in the previous chapter, even with the indicative time limits proposed by the Commission, a 'test case' for the strengthened declaration criteria could take close to two years to finalise. It could take several more years for a significant case history to develop.

At the same time, the potential costs of improperly applied access regulation are so significant that it would be unwise to leave the next review of the regime for too long. On balance, the Commission considers that a further review should take place five years after the first group of changes to Part IIIA resulting from this inquiry is put in place.

RECOMMENDATION 16.2

There should be a further independent review of the national access regime five years after the first group of changes to Part IIIA resulting from this inquiry is put in place.

APPENDIXES

A Public consultation

Following receipt of the terms of reference on 11 October 2000, the Commission placed advertisements in major newspapers inviting public participation in the inquiry and circulated information about the inquiry to a range of potentially interested parties. Soon after, it released an Issues Paper (PC 2000) to assist those intending to make written submissions on the matters under review.

The Commission received 54 submissions prior to the release of the Position Paper in March 2001 and a further 72 submissions in response to the paper. Those who made submissions are listed in section A.4. (Submissions with the prefix 'DR' were received after the release of the Position Paper.)

To help it understand the key issues, the Commission also held:

- informal discussions with a range of interested parties in most States and Territories;
- roundtable discussions in Sydney and Melbourne during November 2000 with a variety of relevant organisations, companies and individuals; and
- public hearings in Sydney, Melbourne, Brisbane and Perth during May and June 2001 to provide interested parties with an opportunity to comment on the Position Paper.

The Commission also contracted Professors Stephen King and Joshua Gans from CoRE Research to provide comments on various options for facilitating investment in essential infrastructure within the national access framework.

A.1 Meetings with interested parties

Informal discussions were held with the following individuals and organisations.

Australian Capital Territory

Australian Competition and Consumer Commission
Australian Gas Association
Australian Pipeline Industry Association

Commonwealth Treasury
Minter Ellison
Network Economics Consulting Group

Victoria

Australian Competition and Consumer Commission
Australian Council for Infrastructure Development
Esso (ExxonMobil Gas Marketing)
Freight Victoria
Professor Philip Williams, Melbourne Business School
Ms Frances Hanks, University of Melbourne
National Competition Council
Office of the Regulator-General, Victoria
Professor Stephen King, University of Melbourne
Victorian Department of Infrastructure
Victorian Department of Treasury and Finance
Victorian Premier's Department

New South Wales

Allen, Allen & Hemsley
New South Wales Independent Pricing and Regulatory Tribunal
New South Wales Cabinet Office
New South Wales Department of Treasury
Qantas Airways Limited
Sydney Airports Corporation Limited

Western Australia

Bunbury Port Authority
Chamber of Commerce and Industry Western Australia
Chamber of Minerals and Energy of Western Australia Inc
Epic Energy
Rio Tinto/Hamersley
Western Australian Department of Resources Development
Western Australian Department of Transport
Western Australian Department of Treasury
Western Australian Office of Energy
Western Australian Office of the Gas Regulator

Western Power
WMC Resources Ltd

South Australia

National Electricity Code Administrator Limited
National Gas Pipelines Advisory Committee
Rail 2000
South Australian Department of Premier and Cabinet
South Australian Department of Transport
South Australian Department of Treasury and Finance
South Australian Office of Energy Policy
South Australian Water
TransAdelaide

Queensland

Allgas Energy Limited
Duke Energy International
Energex Limited
Ergon Energy Corporation Ltd
Ports Corporation of Queensland
Queensland Competition Authority
Queensland Department of Mines and Energy
Queensland Department of Natural Resources
Queensland Department of State Development
Queensland Mining Council
Queensland Transport
Queensland Treasury
Santos Ltd
Stanwell Corporation Limited

A.2 Roundtables

The Commission held roundtable discussions in Melbourne and Sydney during November 2000. Those organisations and individuals which accepted the Commission's invitation to participate are listed below.

Melbourne, 13 November 2000

Rob Albon	Australian Competition and Consumer Commission
Bob Baxt	Arthur Robinson and Hedderwicks
Maureen Brunt	Melbourne Business School
Anthony Callinan	BHP Petroleum Pty Ltd
Brian Cassidy	Australian Competition and Consumer Commission
Deborah Cope	National Competition Council
Stephen Corones	Queensland University of Technology
Roman Domanski	Electricity Users' Group
David Evans	Water Services Association
Stephen King	University of Melbourne
Rodney Maddock	Business Council of Australia
Warren Mundy	Australian Pacific Airports Corporation
Michael O'Bryan	Minter Ellison
Alan Reichel	Australian Gas Users Group
John Tamblyn	Office of the Regulator General, Victoria
Ed Willett	National Competition Council

Sydney, 17 November 2000

Trish Benson	Public Interest Advocacy Centre
Louise Castle	Allen, Allen and Hemsley
Kenn Clacher	Consultant to Hunter Taskforce
Bruce Connery	AGILITY Pipelines
Joe Dimasi	Australian Competition and Consumer Commission
Henry Ergas	Network Economics Consulting Group
Linda Evans	Clayton Utz
Susan Fairbairn	National Rail
Ross Farmer	Rail Access Corporation
Dereck Francis	Cable and Wireless Optus
Roger Featherston	Mallesons Stephen Jacques
Stephen Fitzgerald	Sydney Airports Corporation Limited
Antra Hood	Queensland University of Technology
Robert Jeremy	Toll Holdings
Stephen Kates	Australian Chamber of Commerce and Industry
Bob Lim	Energy Markets Reform Group

Graeme Samuel	National Competition Council
Deena Shiff	Telstra Corporation Ltd
Ed Willett	National Competition Council

A.3 Public hearings

The following 28 individuals and organisations presented evidence at the public hearings.

Melbourne 28 May

Freight Australia

BHP Petroleum Pty Ltd

Institute for Public Affairs

United Energy, CitiPower and TXU Networks Pty Ltd

Electricity Markets Research Institute

Melbourne 29 May

Energy Users Association of Australia

Australia Pacific Airports Corporation

Sydney 6 June

Professor David Johnstone – University of Wollongong
also appeared for BHP Petroleum Pty Ltd

Australian Rail Track Corporation Ltd

Associate Professor Phillip Laird — University of Wollongong
also appeared for the Railway Technical Society of Australasia

Australian Pipeline Industry Association

Sydney 7 June

Networks Economics Consulting Group

Australian Chamber of Commerce and Industry

Australian Council for Infrastructure Development

Law Council of Australia

Energy Markets Reform Forum

Sydney 8 June

New South Wales Minerals Council Ltd

Brisbane 13 June

Australian Gas Association
AGL
Specialized Container Transport
Energex Limited

Brisbane 14 June

Stanwell Corporation
Queensland Mining Council

Perth 18 June

Chamber of Commerce and Industry Western Australia
Epic Energy
Tap Oil Limited
Western Australian Department of Treasury
National Competition Council

A.4 List of submissions

The following table lists the submissions received over the course of the inquiry.

Participant	Sub No.
AAPT Limited	42
AGL	DR86, DR87, DR92, DR124
Aldrich, Dr Barry	31
Australia Pacific Airports Corporation	10, DR60
Australian Chamber of Commerce and Industry	DR67
Australian Competition and Consumer Commission	25, DR93
Australian Council for Infrastructure Development	11, DR80, DR117, DR119

Australian Gas Association	29, DR84, DR119
Australian Petroleum Production & Exploration Association Limited	35, DR65
Australian Pipeline Industry Association	32, DR70, DR119
Australian Rail Track Corporation Ltd	28, 46, DR64
Avis Australia	40
AWB Limited	16
Balanced State Development Working Group	DR110
BHP Petroleum Pty Ltd	48, DR79, DR88
Board of Airline Representatives of Australia Inc.	49
Brunt, Dr Maureen	21
Bunbury Port Authority	4
Chamber of Commerce and Industry Western Australia	12, DR103
CitiPower	DR61, DR73, DR96, DR122
Commonwealth Department of Transport and Regional Services	52
Crown Castle Australia Pty Ltd	DR77
Duke Energy International	DR95
Dwyer, Dr T, and Lim, Mr R.K.H	53, DR100
Electricity Markets Research Institute	DR75
Electricity Supply Association of Australia Limited	DR119
Energex Limited	14, DR81
Energy Action Group	30
EnergyAustralia	DR106
Energy Markets Reform Forum	7, 45
Energy Users Association of Australia	DR94, DR101
Esso Australia Pty Ltd	13
F.C.L Interstate Transport Services Pty Ltd	2
Freight Australia	19, DR62, DR82
Goldfields Gas Transmission Pty Ltd	DR104
Great Northern Rail Services Pty Ltd	20
Institute of Public Affairs Ltd	18, DR57
Johnstone, Professor David, University of Wollongong	DR74
King, Professor Stephen, University of Melbourne	1
Laird, Assoc. Prof. Philip PhD., University of Wollongong	6, DR83
Law Council of Australia	37, DR108
MIAB Technology Pty Ltd	DR56

Motor Trades Association of Australia	9, DR115
National Competition Council	43, DR99, DR125
National Economic Research Associates	DR120
National Electricity Code Administrator Limited	50
National Farmers’ Federation	26
Network Economics Consulting Group	39, 54, DR76, DR107, DR113, DR116, DR123, DR126
New South Wales Government	44, DR109
New South Wales Minerals Council Limited	22, DR63
Northern Territory Government	DR111
Office of the Regulator-General, Victoria	DR112
Ports Corporation of Queensland	47
PowerTel Limited	8
Qantas Airways Limited	51
Queensland Mining Council	27
Queensland Treasury	DR105
Railway Technical Society of Australasia	23, DR72, DR91
Rio Tinto Limited	15
Santos Ltd	34
South Australian Government	36, DR121
Specialized Container Transport	DR85, DR102
Stanwell Corporation Limited	3, DR90
Sydney Airports Corporation Limited	DR114
Tap Oil Limited	DR59
Tasmanian Government	DR118
Telstra Corporation Limited	DR78
The Chamber of Minerals and Energy of Western Australia Inc.	DR66
Tonking, Mr A I	5, DR58
TransGrid	17, 55, DR68, DR98
TXU Networks Pty Ltd	DR61, DR89
United Energy	DR61
VENCorp	24
Victorian Department of Infrastructure	DR97
Western Australian Government	38, DR69
WMC Resources Ltd	DR71

B Industry-specific access regimes

There are three groups of industry-specific access regimes:

- State and Territory regimes (some of which are certified under Part IIIA);
- Commonwealth regimes operating under specific legislation; and
- the regime governing access to the national electricity market, which operates as an industry code approved as an undertaking under Part IIIA.

This appendix outlines some of the key features of these regimes and points to their similarities and differences.

B.1 Electricity

As well as the industry code applying to the national market, there are also access regimes covering transmission and distribution services provided outside that market.

The national electricity market

The national electricity market, encompassing New South Wales, Victoria, Queensland, South Australia and the Australian Capital Territory (ACT) is governed by the National Electricity Code (NEC). Tasmania intends to join the national market through the construction of Basslink, which will link the State to the national grid.

The code, which makes provision for access to the transmission and distribution network, was accepted by the Australian Competition and Consumer Commission (ACCC) as an industry undertaking in 1998. Network operators participating in the national electricity market are required to comply with the access arrangements in the code. However, operators have the option of submitting individual undertakings.

The access arrangements in the code cover:

- the framework for achieving a secure power system;

- the framework to be followed by generators and users regarding connection to an electricity transmission or distribution network;
- pricing arrangements; and
- the transitional arrangements for each participating jurisdiction.

Overall, these arrangements constitute a more prescriptive approach to the provision of access than regimes in some other sectors that rely more on commercial negotiations between the parties.

Regulatory responsibility

The code is jointly administered by the ACCC, the NEC administrator and State regulators:

- The ACCC is responsible for:
  - assessing applications for changes to the access provisions of the code under Part IIIA;
  - assessing undertakings submitted by individual network service providers;
  - approving changes to undertakings; and
  - regulating network pricing for transmission services.
- The NEC administrator is responsible for the development and enforcement of the access provisions through its overall supervision and enforcement of the code, managing any changes to the code and liasing with the ACCC.
- The State regulators, such as the Independent Pricing and Regulatory Tribunal (IPART) in New South Wales and the Office of the Regulator-General (ORG) in Victoria, are responsible for distribution networks, retail licences, safety and environmental standards and regulating network pricing for distribution services.

Vertical structure

The transmission networks in all the jurisdictions participating in the national electricity market operate as vertically separate entities. In contrast, the distribution and retailing of electricity is integrated in all jurisdictions except South Australia (see table 2.1).

Access pricing under the NEC

The ACCC (for transmission services) and the relevant State or Territory regulators (for distribution services) are required to determine an annual revenue requirement for the regulated assets under the principles set out in the code and approve prices for the use of networks by third parties within that revenue requirement.

The code requires the regulator to value the network's assets and then determine a return on the assets, based on the cost of securing capital from debt and equity markets. The final revenue caps are derived by factoring in 'efficient' depreciation rates and operating and maintenance costs.

The code also requires the regulators to incorporate CPI-X or some incentive-based variant in the revenue caps to encourage network service providers to improve productivity (ACCC, sub. 25).

Access arrangements for jurisdictions outside the national electricity market

Western Australia, Tasmania and the Northern Territory — which do not currently participate in the national electricity market — have developed, or are developing, separate access arrangements.

Western Australia

The Western Australian power utility, Western Power, is currently a vertically integrated organisation, with power bought and sold through bilateral contracts, rather than through a wholesale market. Third party access arrangements are accommodated through the 'ring fencing' of the utility's transmission and distribution networks.

The (non-certified) access regime makes provision for a negotiation process and requires the utility to make spare capacity and new capacity available to access seekers on a 'first come, first served' basis. The regime also requires the utility to provide new capacity if requested by an access seeker, so long as such investment is commercially viable.

The regime further requires the utility to provide a publicly available schedule of indicative access prices that enable it to recover the capital costs of providing the transmission and distribution network, capital investment in new works and a reasonable rate of return on capital investment. The previous Western Australian Government had also foreshadowed the establishment of an independent Energy Access Regulator to regulate access to the transmission and distribution network.

Notably, two developments may impinge on these arrangements in the near future:

- First, an application by Normandy Power, NP Kalgoorlie and Normandy Golden Grove for declaration of the transmission and distribution services provided by Western Power Corporation in the south west of Western Australia is currently being assessed by the National Competition Council (NCC). However, Western Power is seeking a ruling in the Federal Court that the service subject to the application for declaration is not a service for the purposes of Part IIIA.
- Second, the incoming Western Australian Government has announced that an Electricity Reform Taskforce is to be established to examine a range of matters, including the disaggregation of Western Power, the structure of the electricity market in Western Australia and arrangements for implementing full retail contestability (Minister for Energy 2001).

Northern Territory

The Northern Territory power utility, the Power and Water Authority (PAWA), is also vertically integrated with power bought and sold via bilateral contracts. Access to PAWA's networks is governed by the Electricity Networks (Third Party Access) Code. As in Western Australia, there is 'ring fencing' of transmission and distribution networks to accommodate third party access. Further, the code provides for a mechanism to resolve access disputes and pricing principles for access to transmission and distribution networks.

A Utilities Commissioner has been established with responsibility for the regulation of PAWA's transmission and distribution businesses. Amongst other things, the Commissioner is responsible for conciliating and arranging arbitration in any access dispute, monitoring compliance with the code, registering access agreements and determining a revenue cap that will apply to the regulated businesses. The revenue cap is set to enable an efficient supplier of regulated services to raise sufficient revenue to meet its operating costs, finance necessary new investment and provide an adequate return on past efficient investment.

From this, PAWA must produce a set of reference tariffs for standard network access services which are approved by the Utilities Commissioner. Individual access charges are left to commercial negotiation, within limits set by the annual revenue cap and subject to the ceiling prices (reference tariffs) (Northern Territory Government 1999).

In late 1999, the Northern Territory Government lodged an application to have the access regime certified. Changes to aspects of the regime have since been approved by the Northern Territory Government to meet concerns raised by the NCC. However, in its submission, the Government said that:

> … the NCC has indicated that it would require all amendments to the Code and related legislation to be in effect before it would finalise its recommendation on certification. A final recommendation is therefore unlikely before late July or August 2001. (sub. DR111, p. 6)

Tasmania

The Tasmanian electricity code sets out the basis of operation of the local electricity market, including the access arrangements to apply to transmission and distribution networks. The formerly vertically integrated provider has been separated into generation, transmission and distribution entities. However, there is only one generator, the Hydro Electricity Corporation.

The code provides that each transmission and distribution entity is required, as a condition of its licence, to provide an access undertaking to the ACCC. Tasmania has not lodged an application to have its regime certified by the NCC as it will join the national market when the interconnection to Victoria occurs.

B.2 Gas

The access regime for gas is based on the National Gas Access Code. Unlike the NEC, the gas code is not an industry code provided as an undertaking to the ACCC. Instead, it operates through each State and Territory's gas access regime.

The National Gas Access Code

The Natural Gas Pipelines Agreement, embodying the national access code, was approved by the Commonwealth and the States in November 1997.

It provides for right of third party access to natural gas pipelines under terms and conditions approved by an independent regulator, and for binding arbitration to resolve disputes. It also requires that regimes include reference tariffs to provide access to specific services at a known price.

The National Gas Pipelines Access Code is being implemented through the States' and Territories' access regimes. Each jurisdiction's supporting legislation, known as the Gas Pipelines Access Law (GPAL), incorporates key elements of the national access code to provide consistency across jurisdictions.

The enactment of the code involved an initial determination of which existing pipelines it would cover, as well as provision for exemptions or so called ‘derogations’. The code provides for new (or other) pipelines to be covered on a case-by-case basis. Anyone is able to apply to the NCC for coverage of a specific pipeline under the code, or revocation of a coverage decision. The NCC assesses such applications and makes recommendations to the relevant Ministers. To date, all but one of these applications have been to revoke coverage.

The *Gas Pipelines Access (Commonwealth) Act 1998* extends the code to external territories, offshore pipelines and the Moomba-Sydney pipeline system.

Progress in implementing the code

The South Australian, Western Australian, ACT, Victorian and New South Wales gas access regimes have been certified as effective.

The Queensland regime’s derogations from the code’s pricing principles for a number of major pipelines for several years, has resulted in delays to certification of the regime. Queensland’s certification application argued that the derogations are necessary to protect the commercial interests of the pipeline’s owners. The certification application for the Northern Territory’s regime is also still under consideration.

Regulatory arrangements

The ACCC is the regulator for all transmission pipelines, except in Western Australia where the State regulator undertakes this function. State regulators deal with the distribution networks in their respective jurisdictions, except in the Northern Territory where the ACCC administers the regulation.

Some jurisdictions have established new regulatory bodies to oversee the national gas code, for example, the South Australian Independent Pricing and Access Regulator. In other jurisdictions, regulatory responsibility for the relevant part of the access regime has been conferred on an existing body. For example, in Victoria, additional powers were provided to the Office of the Regulator-General. Similarly, regulatory responsibility for Queensland’s gas access regime was given to the Queensland Competition Authority.

Access pricing under the code

The use of reference tariffs under the code is a more prescriptive approach than the negotiate-arbitrate approach applying under regimes such as Part IIIA. In this regard, the South Australian Government said:

> The aim of the reference tariff approach is to both limit monopoly rents and facilitate the ability of shippers to negotiate from a base of public tariffs. It is considered that this approach lowers transaction costs and speeds up the ability of shippers to gain a fair and reasonable access to pipeline services. (sub. 36, p. 5)

Specifically, pipeline owners are required to establish reference tariffs for services likely to be sought by a significant part of the market. Reference tariffs are determined on the basis of the charges needed to meet the total revenue requirement of each service provider or pipeline owner. However, the code does not limit the parties from agreeing to price outside the reference tariff.

The total revenue requirement and the proposed reference tariff for each service provider is assessed against the code's pricing principles. This involves the relevant regulator assessing submissions from the service provider or pipeline owner and the public on issues such as asset values, capital costs, depreciation rates and operating and maintenance costs.

The code specifies that reference tariffs should:

- provide the service provider or pipeline owner with the opportunity to earn a stream of revenue that recovers the costs of delivering the service over the expected life of the assets used in service delivery;
- replicate the outcome of a competitive market;
- ensure the safe and reliable operation of the pipeline;
- be efficient in level and structure; and
- provide an incentive for the service provider to reduce costs and to develop the market for the service.

Also, reference tariffs accepted by the regulator must include incentive mechanisms to encourage improved service and the sharing of any efficiency gains with consumers (ACCC, sub. 25).

B.3 Rail

There are various State rail access regimes, some of which have been certified or are the subject of a certification application. An undertaking to cover the interstate rail network has also been proposed.

Access to the interstate network

At present, the New South Wales and Western Australian regimes (see below) cover the interstate networks in their respective jurisdictions. In addition, the Northern Territory and South Australian Governments' access regime for the Tarcoola to Darwin rail line will provide access to a specific part of the interstate network.

All transport Ministers (except the Northern Territory Minister) have agreed to develop a mechanism for rail operators to gain access to the entire interstate network through the Australian Rail Track Corporation (ARTC). A draft discussion paper for an undertaking covering access to the interstate mainline standard gauge track linking Kalgoorlie in Western Australia, Adelaide, Wolseley and Crystal Brook in South Australia, Broken Hill in New South Wales and Melbourne and Wodonga in Victoria is being reviewed by the ACCC.

However, it is not currently possible for the ARTC to submit an undertaking on its own that would cover the entire interstate network. This is because it is not the service provider in New South Wales, Queensland or parts of Western Australia (see chapter 10).

Thus, the ARTC has negotiated a wholesale access agreement with Westrail to allow the ARTC to provide a 'one-stop shop' for access seekers to the interstate network in Western Australia. This has since been assigned to the new owner of Western Australia's rail freight infrastructure, WestNet Rail. Negotiations are progressing with the Rail Access Corporation in New South Wales and Queensland Rail to obtain similar agreements (ARTC, sub. 28).

But according to the ACCC (sub. 25), there are doubts that these agreements will provide the ARTC with the necessary degree of control over the operation of the facilities to qualify it as a service 'provider' under Part IIIA. Elaborating on this concern, the ARTC said that:

> … the difficulty arises in that the provider is defined as the owner or operator of the facility that is used to provide the service. In some cases, the party that provides the service (has an agreement of access with the user and is obliged to provide and manage access to the facility for payment) [but] may not be the owner or operator of the facility. (sub. DR64, p. 12)

The Railway Technical Society of Australasia (sub. DR72) expressed concern about the lack of progress to date.

However, a review planned for 2002 — and required under the Inter-governmental Agreement — will develop a new institutional framework if the ARTC is not able to establish effective access arrangements for the interstate network by mid-2001. If necessary, a national regulatory regime based on Commonwealth legislation will be implemented (Department of Transport and Regional Development, sub. 52).

Access to the intrastate networks

The State rail regimes are similar in that the terms and conditions of access are in all cases determined through a process of negotiation and arbitration. However, there is variation across the jurisdictions in the independence of the arbitrator, the transparency of the arbitrator's decision and the scope to appeal against decisions. The regimes also differ in respect of the pricing principles underpinning the negotiate-arbitrate approach and the mechanisms used to resolve disputes.

New South Wales

The New South Wales Government has split the former State Rail Authority into a number of separate businesses providing track infrastructure, and freight, passenger and maintenance services.

The New South Wales Access regime operates under the *Transport Administration Act 1988* and is administered by the Rail Access Corporation (RAC). The regime features:

- a requirement that prices for general use are negotiated between a 'floor' and 'ceiling';
- a requirement for the RAC to provide specified information to the access seeker;
- a compulsory dispute resolution process with a nominated arbitrator — IPART; and
- 'passenger priority' provisions meaning that passenger trains have priority over freight trains when negotiating access to the network.

In relation to the pricing principles, the floor test requires that:

- any access revenue must at least meet the direct costs imposed by the access seeker(s); and
- all sectors should recover their incremental costs, including incremental fixed costs.

The ceiling test requires that:

- any access revenue must not exceed the full economic cost of the sector(s) for which access is required on a stand-alone basis; and

- the ceiling is calculated on a combinatorial basis so that no combined group of users pays more than the relevant ceiling for that group.

The cost definitions for asset valuation and permitted rates of return on assets are published by IPART.

The New South Wales Regime was certified as effective by the NCC in November 1999 (see box 15.1). This certification expired in December 2000. The regime has not been resubmitted for certification. The short duration of the certification was intended to enable the NCC to examine how the New South Wales regime, which covers the interstate track within the State, meshes with the proposed national interstate rail regime as that regime is further developed (Cope 1999).

Victoria

Victoria's regime covers a mix of privatised and franchised rail services and operates under the *Rail Corporations (Amendment) Act 1998*. Suburban track in Melbourne is leased to private entities and Victoria's rail freight operations have been sold. Non-urban track is owned by the Victorian Rail Access Corporation and leased to Freight Australia.

Responsibility for determining that a rail transport service is subject to the regime resides with the Transport Minister. Other key features of the regime include:

- a requirement that users have fair and reasonable access to declared services;
- a requirement that the access provider supply specified information to the access seeker;
- a compulsory dispute resolution process with a nominated arbitrator; and
- a requirement that terms and conditions not vary simply because of the identity of the access seeker.

If a dispute arises, the matter can be referred to the ORG which can require that access to the service be granted and also set the terms and conditions of access. Determinations by the ORG are not appellable.

Negotiation and arbitration of access prices are underpinned by gazetted pricing orders. These cover a range of matters, including the treatment of sunk costs and rates of return on service provision.

While Victoria has signalled that it will not submit its regime for certification, Freight Australia has applied for declaration under Part IIIA of a number of the services that it provides under the leasing arrangement for the intra-state rail track network. Freight Australia claims that the Victorian regime does not allow it to recover its full costs (NCC 2001a).

Queensland

In contrast to other jurisdictions, Queensland's rail access arrangements are being developed under that State's generic access regime, rather than through industry-specific legislation.

This generic regime is modelled on Part IIIA and contains most of the features of the national regime (with some modifications) including:

- a declaration process to determine whether services ought to be subject to an access regime. A service can be declared by the Premier or Treasurer on the recommendation of the Queensland Competition Authority (QCA) if both the Minister and the QCA are satisfied that certain threshold criteria have been met, or by regulation without the application of the criteria. The criteria are similar to the declaration criteria in Part IIIA, but without a 'national significance' test;
- a requirement for the access provider to negotiate with an access seeker and, in doing so, to satisfy the reasonable requirements of the access seeker in relation to information required for negotiations;
- provision for undertakings setting out terms and conditions under which the infrastructure owner is willing to provide access. (Under the Queensland regime, undertakings can be submitted for a declared service);
- a requirement for the QCA, in deciding whether to accept an undertaking, to consider the legitimate business interests of the owner, the interests of third parties seeking access and the public interest.
- a compulsory dispute resolution process with a nominated arbitrator; and
- scope for the responsible Minister (the Premier or Treasurer) to 'tailor' the access regime by making an 'access code' that applies to a class of infrastructure.

The Queensland Rail undertaking

In 1998, the Queensland Government approached the NCC to consider the effectiveness of Queensland's rail regime. The application for certification was subsequently withdrawn.

Queensland Rail (QR) — a vertically integrated entity — then submitted an undertaking under the generic Queensland regime. In December 2000, the QCA issued a draft decision which rejected the proposed undertaking and called for submissions from interested parties on the decision. The QCA issued a final decision in July, 2001 rejecting the undertaking. However, the Queensland Government has indicated a desire to have an undertaking in place for the rail services declared under the Queensland legislation by the end of 2001. Consequently, the QCA has issued a notice requiring QR to provide a draft undertaking within specific timeframes as provided for under the legislation. The Queensland Government has signalled that an application will be made to the NCC to have the regime certified as effective once the undertaking is accepted by the QCA.

South Australia

The South Australian rail access regime operates under the *Railways (Operations and Access) Act 1997*. Separate entities provide intrastate freight operations (Australian Southern Railroad) and passenger services (TransAdelaide). The key features of the South Australian regime are:

- a requirement that the owner/operator make available information on the terms and conditions on which it is prepared to allow others to use the infrastructure;
- a dispute resolution and arbitration process; and
- pricing principles established by an independent regulator (the Executive Director of the Department of Transport).

To facilitate negotiation, there is provision for the independent regulator to fix a floor and ceiling price arrangement for access to general or specific rail services. The floor price reflects ‘the lowest price at which the operator could provide the relevant services without incurring a loss’. The ceiling price reflects the ‘highest prices that could fairly be asked by an operator for the provision of the relevant services’. While the service provider and the access seeker can agree to a price outside the floor and ceiling band, arbitrated prices must fall within the band.

South Australia has signalled that it will not apply to have its rail regime certified as effective.

Western Australia

The Western Australian Rail Access Regime, which comprises the Railways (Access) Act 1998 and the Railways (Access) Code 2000, is expected to be implemented by September 2001 with the proclamation of the remaining sections of the Act. Amendments were made to the Act in 2000 to improve the regime and to take into account the sale of the Westrail freight business in December 2000.

The key features of the regime are:

- a negotiate-arbitrate framework, with parties seeking access required to make a proposal to the service provider;
- provision for an independent regulator to carry out monitoring and enforcement;
- specification of the type of administrative arrangements to be used for 'ring-fencing' Westrail's activities;
- a requirement for the service provider to respond to an access seeker with a range of information, including floor and ceiling prices for the route over which access is sought. (The floor price is equal to the incremental cost of making access available, while the ceiling price is equal to the total costs, including a return on the capital investment, on a defined route section); and
- a requirement for the parties to negotiate a price for access in this price range.

The Western Australian Government has withdrawn its application to have the regime certified (see chapter 2).

Tasmania

Tasmania does not have a rail access regime.

B.4 Victorian shipping channels

The Victorian Government has legislated a regime for access to commercial shipping channels in the ports of Melbourne, Geelong, Hastings and Portland. The regime has been certified as effective for five years until 2002. There are no other legislated regimes covering shipping channels or port services in Australia. (However, under Victoria's *Grain Handling and Storage Act 1995,* the ORG is required to conduct periodic reviews of whether grain handling facilities at the Portland and Geelong terminals 'continue to be significant infrastructure facilities, requiring access to third parties'(sub. DR112, p. 3).)

Access arrangements under regime

The Victorian shipping channels regime uses a negotiate-arbitrate approach within a framework of regulated prices for access to shipping channels. Under the regime, a channel operator is required to make all reasonable endeavours to meet the requirements of a third party seeking access to a prescribed channel. If a negotiated outcome is not reached within 30 days, a dispute may be referred to the ORG for binding arbitration.

Appeals against a determination resulting from the arbitration may be referred to an Appeals Panel under the ORG Act and to the Supreme Court for matters of judicial review (NCC 1997).

Pricing

Charges for the use of channels are regulated. Pricing orders relating to these charges have been established by the Victorian Treasurer under the Port Services Act and are administered by the ORG. Under these pricing orders, channel operators must, if requested, provide current or potential customers with details of the regulated charges applying for channel access. As lower negotiated prices are not precluded, these regulated prices act as 'posted ceiling prices'.

There is also provision for a channel operator to post a 'general determination' accepted by the ORG. Somewhat similar to an undertaking under Part IIIA, this provides a channel operator with a degree of flexibility and removes uncertainty about the terms and conditions of access. Acceptance of a general determination by the ORG does not preclude case-specific negotiations.

B.5 Airports

The Commonwealth Government has leased a number of the airports previously owned and operated by the Federal Airports Corporation (FAC) to private operators. These airports are Alice Springs, Adelaide, Brisbane, Canberra, Coolangatta, Darwin, Hobart, Launceston, Melbourne, Perth and Townsville airports.

Services provided by these airports are covered by the declaration provisions of the *Airports Act 1996*. If declared under the Airports Act, the services are then subject to the negotiate-arbitrate provisions of Part IIIA. The non-privatised airports — Kingsford Smith, Bankstown, Camden and Hoxton Park airports in the Sydney basin and Essendon airport — are subject to Part IIIA. The Commonwealth Government has indicated that Kingsford Smith airport is to be privatised.

The Airports Act provided for a 12 month post-lease period during which undertakings could be submitted to the ACCC. After that time, airport services meeting specific declaration criteria under the Airports Act were deemed as declared services for the purposes of Part IIIA, except where an undertaking had been accepted.

The declaration criteria in the Airports Act (Section 192(5)) are different from those in Part IIIA, namely:

> … a service provided at a core regulated airport, where the service:
>
> a) is necessary for the purposes of operating and/or maintaining civil aviation services at the airport; and
>
> b) is provided by means of significant facilities at the airport, being facilities that cannot be economically duplicated;
>
> and includes the use of those facilities for those purposes.

These tests might potentially cover some services that would not meet the declaration criteria under Part IIIA.

The 'airport services' that were deemed as declared by the Minister are not listed. Instead declaration is by reference to the criteria in the Airports Act (ACCC, sub. 25) According to the ACCC, the services likely to be declared under the Airports Act are:

- airside facilities (eg runways, taxiways, aprons);
- passenger processing areas (eg check-in, holding lounges, immigration and customs services);
- land for providing fuelling services;
- sites for storing ground service and freight handling equipment; and
- landside vehicle facilities.

Under the Act, the ACCC is required to perform the assessment role in the declaration process that would otherwise be undertaken by the NCC and the designated Minister. The ACCC's assessment of whether a service should be declared is reviewable by the Federal Court.

As only the declaration process is subject to the Airports Act, the terms and conditions of access for any declared service are established through the negotiate-arbitrate provisions of Part IIIA.

To date, only two applications have been made to have airport services declared under the Airports Act:

- Delta Car Rentals applied to have landside roads and vehicle facilities for dropping-off and picking-up passengers at Melbourne Airport declared. The subsequent ACCC decision held that the airport road system as a whole was declared; and

- Virgin Blue has applied to have the use of the Melbourne Airport domestic terminal for processing passengers and their baggage declared. The ACCC has not reached a decision on this matter (sub. DR60).

Aeronautical services (including aircraft movement facilities and activities and passenger processing facilities) at the leased airports and Sydney airport are subject to price notification under the Prices Surveillance Act (PSA). Although the PSA does not contain powers of price control, it has been used for this purpose in the form of a price cap for airport services at the leased airports (PC 2001b). In this regard, QANTAS Airways (2000, p. 3) noted that:

> … the PS Act is being used to control and regulate prices for airport services. Under instruments issued pursuant to the PS Act, all major Australian airports (other than Sydney Airport) are subject to a price cap of the CPI-X form. Although the ACCC does not have the express legislative power to enforce the price cap, the conduct of airports indicates that they accept the price cap as binding. Most of the services likely to be declared under the Airports Act are also subject to price notification and a price cap under the PSA.

B.6 Postal services

The *Australian Postal Corporation Act 1989* exempts postal services from the Part IIIA regime and establishes specific access arrangements for a limited number of services.

The Government has tabled the *Postal Services Amendment Bill 2000* in Parliament to create a new section in the TPA (Part XID). The Bill provides that, within six months of commencement, bulk mail services and post office boxes would be determined by the Minister to be declared services.

The Bill further provides for undertakings for other postal services to be submitted to the ACCC. The ACCC would also have the power under the proposed legislation to declare other postal services and arbitrate terms and conditions of access to a declared service if commercial negotiations between Australia Post and an access seeker failed.

The declaration criteria for the proposed regime incorporate the concept of the long-term interests of consumers. In this respect, the proposed regime more closely resembles the telecommunications access regime than Part IIIA. The *Postal Services Amendment Bill 2000* was rejected by the Senate in late 2000.

B.7 Telecommunications

Part XIC of the TPA establishes a telecommunications-specific regime for regulated access to carriage services. (For a detailed description of the regime, see the Commission's report on Telecommunications Competition Regulation (PC 2001c).)

Arrangements for access

While declaration is the only mechanism available under Part XIC to obtain access, there are three processes that may lead to declaration: a recommendation by the Telecommunications Access Forum (TAF); an ACCC public inquiry (either prompted by a public request or initiated by the ACCC); and deeming (which was a transitional measure).

A facility owner may submit an undertaking to the ACCC setting out terms and conditions of access, but only after a service is declared. If the undertaking is approved by the ACCC and registered, those terms and conditions apply to all access arrangements negotiated for the service in question.

Criteria for declaring a service

The ACCC may declare a service if it is satisfied that declaration will promote the long-term interests of end users. In order to determine this, the ACCC examines the effect of declaration on the following matters:

- competition in markets for listed services;
- any-to-any connectivity; and
- the economically efficient use of, and the economically efficient investment in, infrastructure.

These declaration criteria are broader than those in Part IIIA.

What a declaration entails

Declaration under Part XIC results in a mandatory right of access under the standard access obligations (SAOs) and the right to negotiate backed by provision for ACCC arbitration.

The SAOs require the access provider to:

- supply a declared service to an access seeker (or permit interconnection to the access provider's facility) so that the access seeker can provide carriage and/or content services;

- ensure that the technical and operational quality of the declared service (or interconnection) is equivalent to that which the access provider offers to itself;
- ensure that the access seeker receives, in relation to the supply of the declared service (or interconnection), fault detection, handling and rectification of a technical and operational quality and timing that are equivalent to that which the access provider offers to itself; and
- provide sufficient billing information to an access seeker.

The access provider is required to provide the SAOs under terms and conditions as commercially agreed and specified in a contract (which may then be registered with the ACCC), in accordance with an undertaking, or through arbitration.

Arbitration

If the provider and access seeker are unable to agree on terms and conditions of access to a declared service, the ACCC is required to arbitrate. In making a determination, the ACCC must take the following matters into account:

- whether the determination will promote the long term interests of end users of carriage services or of services supplied by means of carriage services;
- the legitimate business interests of the carrier or provider, and the carrier's or provider's investment in facilities used to supply the declared service;
- the interests of all persons who have rights to the service;
- the direct costs of providing access to the service;
- the value to a party of extensions, or enhancement of capability, whose cost is borne by someone else;
- the operational and technical requirements necessary for the safe and reliable operation of a carriage service, a telecommunications network or facility;
- the economically efficient operation of a carriage service, telecommunications network or a facility; and
- any other matter the ACCC considers relevant.

The ACCC may make an interim determination on terms and conditions. The interim determination is not appellable, but is subject to administrative review.

The ACCC's final determination may backdate the provisions to the date of notification of the access dispute. A final determination is appellable to the Tribunal and on matters of law to the Federal Court.

Pricing

In its role as the telecommunications regulator, the ACCC has favoured a version of total service long run incremental cost (TSLRIC) to determine access prices in the telecommunications industry.

TSLRIC is defined as the incremental or additional costs which the firm incurs in the long term of providing the service, assuming all its other production activities remain unchanged. It consists of the operating and maintenance costs which the firm incurs in providing the service, as well as a commercial rate of return on capital. The ACCC also includes some other items in its determination of TSLRIC — including a contribution towards the ‘access deficit’ (the difference between retail connection revenues and costs).

B.8 Financial payments clearing system

This system allows institutions other than banks, building societies and credit unions to apply for exchange settlement (ES) accounts with the Reserve Bank of Australia (RBA). These arrangements allow eligible institutions to settle their own payments (ie cheques, consumer and bulk electronic payments) without relying on another institution that may be a competitor.

These arrangements were implemented by the RBA following a recommendation from the Financial System Inquiry in 1997 to make RBA exchange settlement accounts more widely available. They operate quite separately from Part IIIA.

Under the arrangements, announced by the Payments System Board in 1999, all providers of third party (customer) payments services that have a need to settle clearing obligations with other providers are eligible to apply for an ES account. Applicants need to demonstrate that they have the liquidity necessary to meet their settlement obligations under routine, seasonal peak and stress conditions. Institutions authorised and supervised by the Australian Prudential Regulation Authority (APRA), and applicants proposing to operate exclusively on a real-time gross settlement basis, are not required to lodge collateral. Institutions not supervised by APRA, or operating in deferred net settlement systems, may be required to lodge collateral on an ongoing basis.

In November 1999, the Sydney Futures Exchange Clearing House was the first organisation to be granted an ES account under the new arrangements (NCC, sub. 43).

C International approaches and experiences

In other countries, two broad approaches have been used to regulate access to essential infrastructure services. These are:

- court-based rights of access relying on the provisions of general competition legislation; and
- legislated access rights, usually of an industry-specific nature.

By way of illustration, this appendix summarises the approaches in the USA, Europe and New Zealand.

C.1 Access via the courts

Court-based regimes, based on general competition legislation, have a long history in the USA, where a succession of legal precedents has established an ‘essential facilities doctrine’ (EFD). The very long history of court involvement stems from the fact that most infrastructure facilities in that country have been privately owned. (In contrast, much of Australia’s infrastructure has, until recently, been built and owned by the public sector.)

In Europe, court-based provisions for third party access have come about as part of the measures to foster cooperation between the various national economies. So, while there is still extensive public ownership of essential facilities, there has been a need to cater for access claims spanning national borders. The courts have become involved in interpreting the scope of the resulting legislative provisions, bringing about a European version of the EFD.

In New Zealand, court-based arbitration of access disputes has only arisen in the last decade. Hence, there are fewer legal precedents.

The essential facilities doctrine in the USA

The legal basis for mandated access in the USA began with Sections 1 and 2 of the Sherman Act 1890 — the first piece of federal legislation regulating anti-competitive behaviour by firms and individuals. The development of access regulation has also been influenced by the Fifth Amendment of the US Constitution, which refers in part to the property rights of private individuals (box C.1). Through the Constitution and the Sherman Act, US courts have developed what is generally referred to as the 'bottleneck' or 'essential facilities doctrine'.

Box C.1 **Laws and Constitutional amendments underpinning the development of access regulation in the USA**

The right of parties to seek access to the services of 'essential facilities' through the US court system stems primarily, though not exclusively, from Sections 1 and 2 of the *Sherman Act 1890*. Section 1 reads in part:

> Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is declared to be illegal.

Section 2 states:

> Every person who shall monopolise, or attempt to monopolise, or combine to conspire with any other person or persons, to monopolise any part of the trade or commerce among the several States, or with foreign nations, shall be deemed guilty of a felony ...

Drafted in very broad terms, the Sherman Act was subject to interpretation by the courts, which were in turn influenced by the US Constitution. In particular, the Fifth Amendment states in part:

> ... Nor shall private property be taken for public use without just compensation.

Therefore, while courts may declare a right of access to certain facilities based on their interpretation of Section 1 or Section 2 of the Sherman Act, the owners of such facilities are entitled to 'just' compensation. The courts have equated 'just' compensation with the economic impact on the access provider of a decision to mandate access (Behr 1999).

The EFD was developed and reinforced by cases such as *United States v St Louis Terminal Railroad Association* (1912)[1] and *Otter Tail Power Co. v United States* (1973)[2].

MCI Communications Corp. v American Telephone and Telegraph (AT&T) Co. (1983)[3] was the first case to apply definitively the essential facilities doctrine to single-firm conduct under Section 2 of the Sherman Act (Behr 1999). MCI's claim for access to essential facilities owned by AT&T arose from a dispute over

1 224 U.S. 383 (1912)

2 410 U.S. 366 (1973)

3 708 F.2d 1081 (7th Cir. 1983)

interconnection. In finding in favour of the plaintiff, the courts determined that a plaintiff seeking to gain access to essential facilities must show that:

- a monopolist controls the essential facility;
- the competitor(s) is unable ('practically or reasonably') to duplicate the essential facility;
- use of the facility has been denied to the competitor; and
- it is feasible for the monopolist to share the facility.

The court observed that local telephone services were generally regarded as a natural monopoly and were regulated as such and that 'it would not be economically feasible for MCI to duplicate (AT&T's) local distribution facilities'. The court also noted that there were no legitimate business or technical reasons that would justify the refused interconnections (Kench 2001, pp. 139-140).

Alaska Airlines Inc. v United Airlines Inc. (1991) is also considered to be an influential subsequent access case. The central issue in this case was that of reasonable access to a computerised reservation system, which the plaintiffs complained had been denied to them by United Airlines.

The court rejected the claim arguing that, in order to sustain a Section 2 essential facilities argument, the plaintiff had to show that the defendant's monopoly control of the upstream market (airline reservations) had the power to eliminate competition in the downstream market (airline transportation). The court argued that prior claims for relief under Section 2, notably in the Otter Tail case, involved firms that had this ability. Behr (1999, p. 8) argues that the Alaska Airlines case thereby added a new dimension to Section 2 essential facilities' claims.

Recently, the focus of the EFD has expanded to include the information technology industry. For example, in *The David L. Aldridge Co. v Microsoft Corp.* (1998)[4], Aldridge unsuccessfully argued that Windows 95 was an essential facility and his cache program had been denied access to the software.

There have also been cases that have raised concerns about the inappropriate application of the EFD. For example, in 1977, a claim by an American Football League team that a National Football League team had engaged in illegal and monopoly conduct, by arranging on an exclusive basis to use the only stadium in Washington DC suitable for the exhibition of professional football games, was upheld. Similarly, in 1985, the Supreme Court affirmed the Aspen Skiing Case, in which the defendant that controlled three of the four skiing mountains in the Aspen

4 995 F.Supp. 728 (S.D. Tex. 1998)

area and had ceased cooperation with the plaintiff in marketing a multi-day four-mountain ticket, had been found in violation of Section 2 of the Sherman Act. (Kench 2001, pp. 138–140). It is these types of outcomes that the architects of Australia's Part IIIA regime sought to avoid by the inclusion of the national significance clause in the declaration criteria.

It is also relevant to note that, according to some observers, a lot of 'gaming' takes place in order to avoid coverage by the EFD. For example, the Australian Competition and Consumer Commission (ACCC) (sub. 25, p. 102) indicated that facility owners have used various means to prove that their facilities are not strictly essential — either by demonstrating that there are practical alternatives or that access is not feasible for 'legitimate' business reasons.

Perhaps not surprisingly, therefore, many of the main essential facilities in the USA are now covered by industry-specific regulatory regimes, as outlined in section C.2. This leaves the EFD to play a similar role to the declaration route under Part IIIA — namely, addressing 'residual' access claims. The role of the courts is further diluted by the delegation of responsibility for setting access terms and conditions to specialist regulatory bodies, such as Federal Energy Regulatory Commission (FERC).

The essential facilities doctrine in Europe

The European Commission and the courts have been developing their own version of the EFD based on Articles of the Treaties of Rome. Under Articles 81 and 82 of the Treaty Establishing the European Community (EU 1997), the European Commission can decide on access issues within Member States that are brought to it by aggrieved parties. Article 82 states that a dominant position within the common market may not be abused by 'applying dissimilar conditions to equivalent transactions with other trading parties thereby placing them at a competitive disadvantage'. In addition, Article 86 has been interpreted as prohibiting the owner of a significant infrastructure facility from denying access in order to suppress competition, at least where capacity is available and a reasonable price is being offered.

The Court of Justice of the European Communities has ruled that Article 82 prohibits essential facility owners from restricting access if such restriction has significant effects on competition. In fact, Lang argues that rulings by the court in early cases under Article 82 meant that:

> … the principle of a general duty of dominant companies to supply [goods and services] was so well established that it was not necessary later to distinguish essential facility cases from other cases of exclusionary abuse. (Lang 1994, p. 445)

For example, in *Commercial Solvents* (1974)[5], the Court held that Commercial Solvents held a dominant position in the production of a raw material used to produce ethambutol. The abuse of this position was to refuse to supply a downstream competitor, which it had previously tried to acquire, with the raw material required to enable it to compete with Commercial Solvents. In its judgement, the court argued:

> ... it follows that an undertaking which has a dominant position in the market in raw materials and which, with the object of reserving such raw material for manufacturing its own derivatives, refuses to supply a customer, which is itself a manufacturer of these derivatives, and therefore risks eliminating all competition on the part of this customer, is abusing its dominant position within the meaning of [Article 82]. (As quoted in Lang 1994, p. 445)

Later cases relating specifically to essential facilities have reinforced the generally interventionist approach taken by European courts to monopolists who use their market power in related markets. For example:

- In *London European* v *Sabena* (1988)[6], the European Commission ruled that the refusal of Sabena — the dominant provider of computer reservation services in Belgium — to grant London European access to its system was in breach of Article 82. According to Lang, the European Commission's decision treated Sabena's behaviour as a refusal, for anti-competitive reasons, to supply an essential service in a situation where there was limited competition on the Brussels–London route and Sabena's reservation system had spare capacity (Lang 1994, p. 458).
- *B&I Line v Sealink* (1992)[7] centred on the actions of Sealink which was both a car ferry operator and the owner of Holyhead Harbour in Wales. Sealink's car ferry service faced competition from B&I, whose berth was in the harbour mouth. The mouth was so narrow that, when a Sealink vessel went by, the B&I vessel had to stop loading or unloading to lift the ramp connecting the ship to the dock. Sealink altered its schedule of sailing in such a way that B&I's loading was interrupted more frequently. This improved Sealink's schedule but harmed B&I. The case brought a clear enunciation of the European Union stance relating to essential facilities when the European Commission stated that:

  > A dominant undertaking which both owns and controls and itself uses an essential facility, ie. a facility or infrastructure without access to which competitors cannot provide services to their customers, and which refuses its competitors access to that facility or grants access to competitors only on terms less favourable than those

[5] *Instituto Chemioterapico Italiano SpA Commercial Solvents Corp. v Commission*

[6] Commission Decision No. 88/589/EEC, O.J. L 317/47 (1988) (as cited in Lang 1994).

[7] *B&I Line plc v Sealink Harbours Ltd and Sealink Sterna Ltd* (European Commission, June 1992).

> which it gives its own services, thereby placing the competitors at a competitive disadvantage, infringes Article 86 ... (as quoted in Miller 1999, p. 119)

Most recently, a 1998 European Commission decision finding that Frankfurt airport was abusing its dominant position by not giving access to other companies wishing to provide ground handling services, further extends the essential facilities doctrine[8]. Prior to this decision, the essential facilities doctrine applied only to the primary function of the infrastructure in question. Armani (1999, p. 17) argues that the decision extends that obligation to operators wishing to render services to the users of the essential infrastructure.

The origin of the case was a complaint lodged by three European carriers (Air France, KLM and British Airways) that the operator of Frankfurt Airport (Flughafen Frankfurt AG (FAG)) had monopolised the market for the provision of ground handling services. Having found that Frankfurt Airport constituted a substantial part of the Common Market, the European Commission argued that two markets were involved:

- the market for the provision of airport facilities for the landing and take-off of aircraft; and
- the market for the provision of ramp handling services.

The European Commission concluded that FAG held a dominant position in the first market and had abused that position in order to reserve the ramp handling services market for itself. Since the European Commission considered that FAG's decision to reserve the ramp handling services market for itself could not be justified objectively, it argued that the action constituted an abuse of a dominant position within the meaning of Article 82. FAG was required to submit a plan for opening up the market to independent third party handlers and self-handling airlines.

The preceding discussion indicates that, in cases decided to date, the European Commission has adopted the principle that operators of essential infrastructure have an obligation to grant access to potential users of that infrastructure on a non-discriminatory basis.

However, according to Lang (1994), that obligation to provide access is subject to various qualifications:

- The facility owner must be dominant in at least a 'substantial part' of the European Community market.

[8] Commission Decision 98/190/EC, OJ L72.

- There must be an insurmountable barrier to entry for competitors of the dominant enterprise and/or competitors without access must be subject to a serious competitive handicap.
- Refusal by a dominant enterprise to grant access would have to have *significant* effects on competition. Where there are a number of competitors in a downstream market, a refusal to supply one or more of them would not have a significant effect on competition unless that firm(s) provides a materially different product or service.

Further, Lang observes that the imposition of an obligation to deal does not preclude the infrastructure owner charging a premium for the use of the facility, provided its charges do not discriminate against competitors.

This led the ACCC to conclude that the development of the EFD in Europe:

> … only addresses the initial question of whether access should be granted at all. It is relatively powerless to deal with the crucial questions of whether sufficient capacity is available, and, if so, the terms and conditions (including price) pursuant to which access is to be provided. (sub. 25, p. 108)

In addition, the ACCC argued that, because the European Commission, their courts and the Member State courts are all reluctant to enter into pricing matters:

> … there is little guidance in the general competition case law as to what levels or structures of prices are regarded as excessive or discriminatory, and little indication of what sort of cost calculation methodologies should be used. (sub. 25, p. 108)

According to the ACCC, these deficiencies in the court-based approach help to explain the development of industry-specific regimes in Europe.

Court-based regulation in New Zealand

As in Australia, the majority of infrastructure in New Zealand was built and owned by the government, so there is little history of court involvement in access issues.

However, as part of the microeconomic reforms begun in the mid 1980s, there was a move to 'light-handed' regulation of utilities (New Zealand Ministry of Commerce 1995, p. 1). Part of the approach involved reliance on general competition law, especially Section 36 of the *Commerce Act 1986* (which is essentially analogous to Section 46 of Australia's Trade Practices Act), to facilitate access to essential services.

Section 36 forbids the use of a dominant market position for the purpose of:

- restricting the entry of any person into that or any other market; or

- preventing or deterring any person from engaging in competitive conduct in that or any other market; or
- eliminating any person from that or any other market.

The courts have made it clear that any firm refusing to provide access under conditions that would enable an equally efficient firm to compete in a related market would be in breach of Section 36.

Significantly, judicial interpretation of Section 36 has had important implications for the pricing of access to natural monopoly facilities in New Zealand. A landmark decision by the Privy Council in *Telecom Corporation v Clear Communications* held that charging according to the Baumol–Willig pricing rule (also known as the efficient component pricing rule – ECPR) does not constitute use of a dominant position under Section 36 (see box C.2).

Box C.2 **Telecommunications access in New Zealand**

The telecommunications sector provided an early precedent regarding the prices that a dominant firm could charge for access to an essential facility without breaching Section 36 of New Zealand's Commerce Act. Litigation followed an attempt by Clear Communications (Clear) to interconnect with Telecom's local loops in order to provide a local telephone service for its central business district clients.

Telecom argued that the ECPR should be adopted in setting the interconnection price. Under the ECPR, service providers are entitled to charge the 'opportunity cost' of providing access, reflecting the direct costs plus an allowance for any revenue forgone in the downstream market.

The ECPR was accepted by the High Court only to be rejected by the Court of Appeal, before being finally sanctioned by the Privy Council in 1994. As New Zealand law currently stands, a dominant firm using the ECPR to formulate its access price cannot be in breach of Section 36.

However, Clear was not prepared to pay the ECPR-determined access price. Government threat of 'heavier' regulation led Telecom and Clear to settle their interconnection dispute in September 1995 with access charges substantially below ECPR prices.

Source: Pickford (1996a)

C.2 Access via regulation

Notwithstanding any court-based statutes facilitating access to essential facilities, most countries have seen the need for often detailed industry-specific access regimes. In many cases, these regimes involve price regulation of some kind.

Notably, ‘generic access’ regimes like Part IIIA do not appear to have been used elsewhere.

What follows is a brief synthesis of the industry regimes applying in some particular sectors. A more extensive description of these regimes, and those applying in other sectors, is contained in a report by National Economic Research Associates (2000b) for the ACCC submitted to the inquiry.

The USA

Many US infrastructure facilities, including those in telecommunications, gas, railways and electricity, are subject to industry-specific access regulation. In some cases, such regulation has coexisted with the EFD for many decades. In other cases, access regulation is a more recent development. The following section briefly describes access arrangements in the telecommunications, gas, rail and electricity transmission sectors.

Telecommunications

The Telecommunications Act 1996 (US) introduced new regulatory and institutional arrangements for the telecommunications industry, mandating interconnection through the unbundling of networks and the resale of services provided by local exchange operators (Sidak and Spulber 1997). Thus, the 1996 Act introduced competition to those areas of the industry still characterised by monopoly — in particular, local telephone exchange services (PC 1999b). The arrangements provide for negotiated agreements between parties on interconnection and resale, with provision for State regulators to arbitrate if parties cannot agree on price and conditions (ACCC, sub. 25, p. 105). To facilitate a consistent approach to pricing by State regulatory commissions, the Federal Communications Commission has established national pricing principles.

Gas

In its early stages of development in the late nineteenth century, the US natural gas industry was dominated by the private sector, almost completely vertically integrated and unregulated. Regulation was introduced in the 1930s by way of the Public Utility Holding Company Act (US) and the Natural Gas Act (US). This legislation not only encouraged the separation of pipeline ownership from the ownership of production facilities and/or distribution channels, but also led to regulation of interstate pipeline tariffs (IC 1995).

The emphasis in the Natural Gas Act on ‘contract’ as opposed to ‘common’ carriage regulation gave pipeline operators considerable freedom in relation to their dealings on access matters with particular access seekers. On the other hand, it empowered the former Federal Power Commission (FPC) and the FERC to play an active role in the industry — for example, through approving all applications to build new pipelines to areas already serviced by an existing pipeline or ordering companies to extend existing pipelines so long as the extension would not diminish service to existing customers. Pipeline companies were also forbidden from abandoning facilities or services without the approval of the FPC (NERA 2001b).

The introduction of mandated access to the gas industry occurred gradually by means of Orders developed by the FPC and the FERC. The transition to open access was completed in 1992 with FERC Order 633. This provides for the mandatory separation of pipeline transportation services from the sale of natural gas (IC 1995).

The FERC has the responsibility for setting charges for interstate gas transmission. The pricing guidelines include a legal obligation (arising from two Supreme Court decisions) to set a rate of return that will allow the transmission entity to continue to attract capital and maintain its financial integrity (ACCC, sub. 25, p. 103). Recently, the FERC has made further orders in a bid to increase competition for pipeline capacity and reduce access prices.

Rail

Railways in the USA are vertically integrated and separated horizontally by function and geography. Mandated access in the US rail industry dates from the Supreme Court case *United States v St Louis Terminal Railroad Association* (1912). Currently, the US Surface Transportation Board supervises access regulation, and can intervene where arrangements are discriminatory.

Businesses may use either of two mechanisms to gain access to the services provided by US railways. First, they can use the common carrier obligations laid down in 49 USC 11101. These require track owners to provide access to train operators serving destinations other than those served by the track operator itself. Under 49 USC 10742, the track owner must accept traffic from an origin carrier willing to pay a rate that covers the cost of access (STB 1997). Second, under the ‘competitive access’ provisions of 49 USC 10705, a train operator can ‘obtain the prescription of a new route from an origin that is served by a bottleneck carrier if it shows that the carrier has used its market power in an inappropriate way’ (STB 1997).

The arrangements do not, however, introduce competition into all segments of the market and there is apparently growing concern about bottleneck rail facilities.

Electricity

Regulation of the US electricity industry is the joint responsibility of the FERC, which regulates interstate and wholesale markets, and fifty State-based bodies, which regulate retail and intrastate markets (CRS 2000). Due to the complicated nature of electricity flows, the FERC has effective responsibility for all transactions on the transmission grid, including prices.

The regulatory arrangements for third party access to transmission networks are detailed in Orders 888 and 889 developed by the FERC. The orders apply only to electricity utilities that are engaged in interstate commerce. Order 888 (the Open Access Rule) establishes the right of access to transmission networks and pricing arrangements for those networks. In general, the Order requires that transmission prices filed with the FERC are comparable with those that the utility charges itself, allowing for any stranded costs (CRS 2000). Under the Order, each utility must file a single open access tariff with the FERC (FERC 2000).

Order 889 (the Open Access Same-time Information System Rule) establishes standards of conduct for utilities. The Order requires utilities to separate their wholesale power marketing and transmission operation functions, but does not require corporate unbundling or divestiture of assets. Utilities are allowed to own transmission, distribution and generation facilities, but must maintain separate books and records (CRS 2000).

Separation of the generation and transmission components of electricity companies has also been employed in States such as California in an effort to prevent discrimination against competitors via access charges and conditions. In some cases, utilities have been permitted to delegate the operation of their transmission networks to an independent system operator instead of pursuing full separation.

Further refinement of access arrangements was included in Order 2000, issued by the FERC in 1999. This Order requires the development of Regional Transmission Organisations (RTOs), one aim of which is 'to eliminate any residual discrimination in transmission services when the operation of the transmission system remains in the control of a vertically integrated utility' (NERA 2000b, p. 6). It is also hoped that the RTOs will facilitate less intrusive regulation.

In mid-2000, the FERC conducted a formal review of bulk power markets in various regions of the USA. Concerned about the state of the Californian market, it issued an order in November 2000 that required fundamental changes to rectify what FERC described as a 'dramatic market meltdown'. Importantly for this inquiry, these problems appear to reflect the way that markets have been designed, rather than any problems related to access regulation as such (Bardak 2000).

Europe

In Europe, access to essential infrastructure facilities is often subject to EU Directives aimed at facilitating the development of 'internal markets'. To give effect to these Directives, as well as to pursue other regulatory objectives, individual Member States have established a range of industry-specific regulatory agencies. For example, the UK has separate agencies to regulate the telecommunications, gas, electricity, water and rail sectors. Also, Ministers may sometimes direct that access be provided to specific infrastructure. This approach is particularly common in France.

Overlaying these arrangements is the role of the European Commission in administering the relevant articles of the EC Treaty. These articles aim to promote a consistent approach across Member States to competition issues and to help ensure that the actions of individual States are not contrary to the common aim of Community-wide competition (EC 2000).

Electricity

An EU Directive (96/92/EC) enacted by the European Parliament and Council in 1996, instituted 'common rules for the internal market in electricity'. The terms of this Directive are in various stages of implementation by Member States. One set of rules encompassed by the Directive relates to third party access, which, according to NERA (2000b pp. 10–11), has the following features:

- Either 'negotiated' or 'regulated' access for electricity distribution and transmission systems are allowed.
- Access must be granted to eligible customers and access arrangements must not discriminate between system users, particularly in favour of subsidiaries or shareholders of the system operator. Prices must be based on objective, transparent and non-discriminatory criteria.
- With negotiated access, parties are obliged to negotiate access in good faith, on the basis of voluntary commercial agreements. An indicative/average range of prices must be published. Under regulated access, eligible customers are given a right of access, on the basis of published tariff terms.
- During the transitional period, EU countries can apply for derogations from the terms of the directives, where agreements signed before the implementation of the directives would be undermined.

Gas

As with electricity, an EU Directive (98/30/EC) was enacted by the European Parliament and Council in 1998, to institute 'common rules for the internal market in natural gas'. Again, the terms of this Directive are in various stages of implementation by Member States.

The rules specified under this Directive relating to the negotiation of access and the use of 'reference tariffs' are very similar to requirements under the Electricity Directive. Also, as under the Electricity Directive, access may be denied for legitimate reasons — such as a lack of capacity, where access would prevent a service provider from performing its legitimate public service obligations, or on the basis of supply requirements under existing contracts. While no rules relating to access pricing in the gas industry have been specified thus far, the European Commission is coordinating discussions to develop harmonised rules and procedures for pricing (ACCC, sub. 25, p. 110).

Rail

Since 1990 there has been a series of EU Directives providing for access to track services under certain conditions. Their application is quite narrow, applying only to international services provided by either international groupings of train operators, or multimodal freight services. They require, at a minimum, accounting separation between infrastructure provision and train operation.

Some Member States have established wider access rights. In the UK, for example, an independent agency, the Rail Regulator, is responsible for supervising access to tracks and more generally enforcing domestic competition policy. Unlike other Member States, rail infrastructure in the UK is privately owned, with access provided through agreements between the private track owner and train operators. All access contracts must be approved by the Rail Regulator, who can also arbitrate terms and conditions where agreement cannot be reached. It has specified certain terms and conditions which must be included in all contracts.

Pricing of access differs across Member States, from close to marginal cost in the Scandinavian countries to much higher levels of cost recovery in France and Germany.

New Zealand

Until recently, New Zealand had no regulatory provisions providing for mandated third party access to essential facilities. Nonetheless, there have been a number of regulatory arrangements aimed at facilitating access to essential services. These include:

- requirements for structural or accounting separation of natural monopoly elements from contestable elements of service provision. (While New Zealand's policy of encouraging vertical separation is similar to that in Australia, the New Zealand regime appears more permissive of vertical integration. Consequently, utilities in sectors such as electricity, telecommunications and natural gas reticulation remain vertically integrated); and
- industry-specific regulation requiring the disclosure of defined financial information. In the case of electricity, for example, service providers are required to publish line charges to all customers, line and energy components of customer's accounts, detailed costs and revenues, as well as financial and performance measures. Such requirements are designed to make the operation of companies possessing market power more transparent, discourage cost shifting between natural monopoly and contestable components of service delivery, and help access seekers determine whether access charges are reasonable.

Moreover, there has always been an implicit threat of additional regulation, such as price control, if market dominance was abused (Pickford 1996b, p. 202).

Notably, access has been provided within this 'light-handed' framework. In the New Zealand postal industry, for instance, several private firms collect mail from customers, sort the mail and then pass it on to New Zealand Post for final delivery. In the case of rail, access obligations are defined in the lease between the private monopoly provider of train services, Tranz Rail, and the government track owner. These requirements stipulate threshold levels of freight and passenger traffic below which the government may allow access to other operators.

However, for a number of years, questions have been raised about the effectiveness of the light-handed approach. For example, Pickford (1996b) noted that potential entrants to the electricity distribution industry had raised concerns that power companies were incorrectly allocating billing costs to their distribution businesses, thereby raising the cost of distribution and the access price.

Recently, the New Zealand Government has seen the need to realise the threat of more explicit regulation in the electricity industry. Under reforms announced in October 2000, an independent Electricity Governance Board will be established to develop industry rules, including in the area of transmission and distribution access and pricing. The Government has also indicated how it expects transmission and distribution services to be priced.

Moreover, in response to the threat of price regulation, many network industries have implemented their own *voluntary* industry codes — though these are not necessarily legally binding. The New Zealand Gas Pipeline Access Code, for example, defines standards of behaviour and information disclosure with respect to access to gas transport systems.

C.3 Summing up

From this brief summary it is clear that there is no obviously superior or even settled method for establishing and administering access to essential facilities overseas. There are differing concepts of what constitutes ‘bottleneck’ or ‘essential’ infrastructure, different ways of administering access, and much iteration and ‘learning-by-doing’.

Nonetheless, the issues of concern overseas are much the same as those central to this inquiry, and include:

- identification of the entities to be subject to access regulation;
- the most appropriate form of government involvement;
- access pricing; and
- the role of structural separation.

D Significant access cases

There have been a number of significant access cases in Australia which have shaped the development of the national access regime as it is today. This appendix summarises and explains the implications of five such cases:

- *Queensland Wire Industries Pty Ltd v Broken Hill Proprietary Ltd* (1989);
- *Pont Data Australia Ltd v ASX Operations Pty Ltd and Australian Stock Exchange Ltd* (1990);
- *Hamersley Iron Pty Ltd v National Competition Council and Robe River Mining Co Pty Ltd and Mitsui Iron Ore Development Pty Ltd and North Mining Ltd and Nippon Steel Australia Pty Ltd and Sumitomo Metal Australia Pty Ltd and Hope Downs Management Services Pty Ltd* (1998);
- *Re Application for Review of the Declaration by the Commonwealth Treasurer published on 30 June 1997 of certain freight handling facilities provided by the Federal Airports Corporation at Sydney Airports Corporation Limited* (2000); and
- *Re Application under Section 38(1) of the Gas Access Pipelines Law for review of the decision by the Minister for Industry, Science and Resources published on 16 October 2000 to cover the Eastern Gas Pipeline pursuant to the provisions of the National Third Party Access Code for Natural Gas Pipeline Systems and Gas Access Pipelines Law (2001).*

The first two of these cases predate the introduction of Part IIIA and shaped the debate on the need or otherwise for such a regime. The next two cases were brought under the Part IIIA regime and have served to clarify some of its provisions. The final case was brought under the industry-specific regime applying in the gas sector. However, given the parallels between the coverage criteria in the Gas Code and the Part IIIA declaration criteria, the case has significant implications for the national regime.

D.1 Access cases prior to the national access regime

As discussed in the body of the report, the Hilmer Committee saw problems in relying on Section 46 of the Trade Practices Act (TPA). This thinking appears to have been heavily influenced by the following two cases — and particularly *Queensland Wire*.

Queensland Wire

Queensland Wire was notable because it led some to conclude that 'importing' the US court-based essential facilities doctrine into Australian jurisprudence was no longer feasible.

At the time, BHP produced 97 per cent of Australian steel and supplied its wholly owned subsidiary, Australian Wire Industries (AWI), with wire rod for fencing and also with a Y-shaped section (Y-bar) to make fence posts (star pickets). Queensland Wire Industries (QWI) also purchased wire rod from BHP. However, as it did not produce fence posts, its customers had to purchase the posts from AWI. QWI had sought to purchase Y-bar from BHP so that it could manufacture posts. BHP refused, 'responding that its policy was to refuse supply of Y-bar, or to offer supply only at an uncompetitive price' (Williams 1994, p. 151).

Thus, BHP had both the ability to supply a complete fencing system and the capacity to prevent its distributors from obtaining their fencing requirements from another potential supplier. QWI made an application under Section 46 against BHP and AWI, claiming that it had taken advantage of its market power by refusing to sell it Y-bar.

In order to successfully undertake an action under Section 46, QWI had to satisfy the courts that:

- BHP possessed a substantial degree of market power;
- it had taken advantage of its power; and
- that it had done so for one of the following proscribed purposes:
  - eliminating or substantially damaging a competitor;
  - preventing the entry of a person into any market; or
  - deterring or preventing a person from engaging in competitive conduct in any market (TPC 1993, p. 21).

The Federal Court

The Federal Court was satisfied about QWI's claims except for the 'taking advantage' aspect. Justice Pincus considered that taking advantage required some reprehensibility of conduct. He added that refusal to supply a competitor in order to keep an entire product in-house was not deserving of criticism. Proceedings were dismissed.

The Full Federal Court

The Full Federal Court in turn dismissed the subsequent appeal on the ground that 'because Y-bar had never been sold outside of BHP, there was no market for it; and, because there was no market, there could be no market power' (Williams 1994, p. 152).

According to the (former) Trade Practices Commission (TPC), the Full Federal Court noted that the US system (see appendix C) was not of any 'compelling guidance' in the construction of Section 46 and that it had 'some difficulty in seeing the limits of the concept of the essential facility', at least in cases where 'electric power, transport, communications or some other "essential service" is not involved' (TPC 1990, p. 40).

The Hilmer Committee (1993, p. 243) interpreted this to mean that the Federal Court had specifically rejected the essential facilities doctrine. Pengilley, on the other hand, argues that:

> … the judgement does not rule out the application of the doctrine in those very areas where the Part IIIA Access regime primarily applies. There is in my view, nothing in the Full Federal Court decision which would prevent s.46 applying in those fields. (Pengilley 2001, p. 162)

The High Court

The High Court unanimously upheld the appeal by QWI and rejected the trial judge's argument that taking advantage required the defendant to be doing something reprehensible. The key interpretation by the High Court was that taking advantage of market power is doing something that one would not do in a competitive market:

> In effectively refusing to supply Y-bar to the appellant, BHP is taking advantage of its substantial market power. It is only by virtue of its control of the market and the absence of other suppliers that BHP can afford, in a commercial sense, to withhold Y-bar from the appellant. If BHP lacked the market power — in other words, if it were operating in a competitive market — it is highly unlikely that it would stand by, without any effort to compete, and allow the appellant to secure its supply of Y-bar from a competitor. (Judgement from the High Court, p. 50,011)

Thus an important message from the Queensland Wire case is that Section 46 relates to economic conduct rather than 'moral' conduct. It opened the door for arguments premised on economic efficiency — BHP was found to have taken advantage of its market power because it behaved in a way that would be unlikely in a competitive market.

Williams (1994, p. 611) reports that the High Court interpretation in the Queensland Wire case corresponds closely to interpretations by US Courts of Section 2 of the Sherman Act. For example, in *Aspen Skiing Co. v Aspen Highlands Skiing Corp.*, the judgement stated that ‘If a firm has been attempting to exclude rivals on some basis other than efficiency, it is fair to characterise its behaviour as predatory’. And, in *Berkey Photo v Eastman Kodak*, the judgement made reference to ‘an action that a firm would have found less effective, or even counterproductive, if it lacked market power’.

Importantly, the High Court’s judgement on Queensland Wire made no reference to the essential facilities doctrine — it therefore neither affirmed nor rejected the Full Federal Court view. Thus, the matter was left unresolved. As the TPC subsequently commented in its submission to the Hilmer Committee:

> The Federal Court in QWI felt that the essential facilities doctrine should not be applied in the context of that case. However, the Court left intact the possible relevance of the doctrine to electricity, transport, and communications natural monopolies or other ‘essential services’. The High Court did not comment on the doctrine in the QWI case and, accordingly, the application of the doctrine in Australian law must remain uncertain. (TPC 1993, p. 88)

Pont Data

Pont Data Australia Ltd v ASX Operations Pty Ltd and Australian Stock Exchange Ltd (1990) was also significant as a case based on Section 46 that was the subject of an appeal to the Full Federal Court. However, while the Queensland Wire judgement raised the prospect that Section 46 cases would subsequently have an efficiency focus, the Pont Data case was one of several ensuing cases which bypassed this issue.

Australian Stock Exchange Ltd (ASX) was the supplier of stock exchange information — such as pricing of bids and trades and volume information — to a number of data suppliers, including Pont Data and ASX Operations Pty Ltd (ASXO). Pont Data objected to the ASX’s terms and conditions of supply. It alleged that the ASX had abused its market power as the provider of stock exchange information to the electronic share market data service.

In finding that the ASX’s conduct contravened Section 46, the trial judge focussed on two of the terms and conditions:

- the condition that Pont Data on-sell the data only to final customers; and

- the price at which the input was to be supplied.

And, in hearing an appeal against the finding, the Federal Court held that ASX had taken advantage of its market power for the purpose of preventing the ‘wholesaling’ of stock market data and of deterring competition with ASXO, and had done so by imposing unfair fees and terms on parties to the agreement.

Significantly, however, neither the trial judge nor the Full Federal Court gave reasons why they considered that ASX’s behaviour involved the use of market power. Subsequent analyses of the case have criticised this aspect of the judgements. O’Bryan, for example, argued that the courts should have asked whether:

> …the ASX took advantage of its market power. The question should be answered by considering whether ASX would have licensed the trading information with a restriction on wholesaling in a competitive market. (O’Bryan 1993, p. 10, quoted in Williams 1994)

O’Bryan went on to contend that a restriction on wholesaling might also be a characteristic of licensing agreements in competitive markets.

In its submission to the Hilmer Committee, the TPC (1993) noted that the Queensland Wire and Pont Data cases were important because they involved the application of Section 46 in an access context and, in the Queensland Wire case, represented the first interpretations by the High Court on Section 46 matters. The TPC went on to conclude that the use of market power by an unregulated essential facility owner to eliminate or reduce competition would most likely be in contravention of Section 46.

However, the TPC noted that, because most utilities were (then) publicly owned and regulated by statutes outside competition law, there had been limited opportunities to observe how the courts would treat access to essential infrastructure services. Moreover, it argued that, as Section 46 was not drafted to deal with natural monopolies or public utilities, a high burden of proof is placed on plaintiffs to prove anti-competitive purpose. In addition, the TPC (1993, p. 88) submitted to the Hilmer Committee that:

> … the uncertainty, time and cost involved in conducting litigation could present a practical obstacle to the use of s.46 in dealing with access questions. Effective regulation of access may require ongoing oversight, particularly where the natural monopolist is vertically integrated into adjacent markets.

The Hilmer Committee report

The Hilmer Committee considered the possible role of Section 46 in addressing access to essential facilities, given its views on the direction in which case law seemed to be heading. In its report, the Committee's discussion of the application of Section 46 to essential facilities was quite brief:

> Section 46 is potentially applicable in essential facility situations. If a facility is truly essential, its owner will always have a substantial degree of market power within the meaning of s.46. There should also be little difficulty in establishing that a refusal to deal in an essential facility context constitutes a 'taking advantage' of that market power, given that in the absence of such market power access to the facility would be available. (Hilmer 1993, p. 243)

However, Williams (1994, p. 622) argued that the Committee wrongly assumed that *any* refusal to supply by an essential facility would constitute a taking advantage: '[The Hilmer Committee's] view is a clear misinterpretation of the High Court in Queensland Wire.' Hanks (1996, p. 6) also contends that the Committee did not understand the Queensland Wire case:

> The Committee assumed that the 'take advantage' element of the section will easily be established because, it said simply, in the absence of market power access will be available. The Committee … was not alert to the factors that determine whether dealing will occur under competitive conditions.

This issue aside, perhaps the more important judgement by the Committee was that the importation into Australia of the US essential facilities doctrine through judicial interpretation of Section 46 was unlikely without amendment to the section because 'the High Court had not embraced such a doctrine and the Federal Court had specifically rejected it [in the Queensland Wire case]':

> … unless s.46 were amended in some way, access would only be available where a firm was able to prove that it had been denied access, or access on reasonable terms, because of a proscribed purpose. (Hilmer 1993, p. 243)

The Committee also pointed to other problems in using Section 46 in an essential facilities context. These included:

- difficulties for the courts in determining the terms and conditions, particularly the price, at which access should be provided; and
- the slowness of the courts in imposing on the parties 'a regime which could not represent a bargain they would have struck between them'.

These perceived problems led the Hilmer Committee to conclude that Section 46 alone would not be sufficient to address access to essential infrastructure facilities, and that a legislated national access regime was therefore necessary. (The efficacy of Section 46 in an essential facilities context is discussed further in chapter 5 of the report.)

D.2 Access cases under the national access regime

This section discusses three cases involving access-related issues brought after the introduction of the national access regime. The first of these involved the testing of a policy significant definitional aspect of Part IIIA. The other two cases — one of which was bought under the Gas Code rather than Part IIIA — have helped to clarify the interpretation of the Part IIIA declaration criteria.

The Hamersley rail access dispute

This case, which commenced in 1998, centred on the definition of a production process for the purposes of Part IIIA. As noted in chapter 2, production processes are exempt from coverage under the regime (unless they are a subsidiary part of the service).

The case began with an application to the National Competition Council (NCC) by Robe River Iron Associates in September 1998 that rail track services operated by Hamersley Iron Pty Ltd be declared under Part IIIA. Hamersley operates a railway from its five iron ore mines in the Pilbara region of Western Australia to its port at Dampier. Robe River planned to develop a new mine at West Angelas, which is located less than 50 km from the line. It sought access to the line to transport ore and connect to its own railway from an existing mine at Pannawonica to its port at Cape Lambert.

In October 1998, while the NCC was still assessing the application, Hamersley brought an action in the Federal Court against the NCC and Robe River. Hamersley argued that the rail track service was an integral part of its production process and therefore did not constitute a service under Part IIIA.

In essence, Hamersley's argument was that the quality and composition of the iron ore from its various mines fluctuates considerably, even within the same mine, and to achieve a consistent product for export, it must therefore blend ore taken from different mines. (To this end, train loads of ore from the different mines are processed systematically at Dampier to ensure that the export blend is achieved with a minimum of handling.) Hamersley asserted that full control over the use of its rail track was therefore important, because without the ability to schedule trains when and where required, its production process would be delayed.

The Court, with Justice Kenny as trial judge, brought down a decision in June 1999 that the rail service was a production facility and therefore not within the scope of Part IIIA. Justice Kenny expressed the view that a production process is a series of operations by which a marketable commodity is created or manufactured. She found that the way in which Hamersley used the railway was essential to the 'recipe' for a batch of export product.

Some observers were sceptical of Hamersley's defence, with considerable concern expressed that the decision had set too broad a precedent for what constituted a production process. A particular concern was that the decision sent a signal that vertical integration could be used to avoid access claims under Part IIIA.

In practice, however, the case may have set only a relatively narrow precedent, because in order to avoid the provisions of Part IIIA it was necessary to show that the railway was an integral and essential part of the production of a marketable product.

Nevertheless, the NCC and Hope Downs Management Services Pty Ltd — which owned rights to an undeveloped iron ore deposit in the vicinity — appealed against the decision to the Full Federal Court. Robe River was not a party to the appeal.

Just as the appeal was scheduled to commence, Robe River withdrew its application for declaration of Hamersley's rail track services. In these circumstances, the appeal could not proceed.

However, in dismissing the appeal, some matters with broader ramifications were dealt with by the Full Federal Court. In particular, Hamersley gave an undertaking to the Court that it would not use the earlier decision on production facilities as a barrier to further applications for access to its rail services by Hope Downs and others.

Moreover, despite the fact that a precedent on the definition of a production process has been set by the decision, the NCC is not obliged to follow it when assessing future declaration applications. Likewise, the decision would not be binding on the Australian Competition Tribunal (the Tribunal) in relation to appeals against declarations, as it was made by a Judge of an equivalent level.

As a postscript to the case, in August 2000, Rio Tinto (the owner of Hamersley) acquired North Ltd (the owners of Robe River Mining Co Pty Ltd, which in turn owns 53 per cent of the Robe River operation). Rio Tinto (2001) recently announced that it has come to an agreement with the three Japanese joint venture partners in Robe River, which own the remaining 47 per cent of the operation, for Robe River and Hamersley to share the latter's rail infrastructure.

This agreement has put an end to legal action by the Japanese joint venture partners which had previously wished to pursue construction of a separate rail line to service the West Angelas mine.

Sydney International Airport

This case involved an application from Australian Cargo Terminal Operators Pty Ltd, seeking declaration of certain 'cargo handling' services at Sydney International Airport (SIA) under Part IIIA. The applicant alleged that SIA was using its monopoly control over the facility to restrict competition in the markets for those services at the airport. The specific services in question were ramp handling — involving the transportation of freight or passenger baggage between aircraft and the cargo or passenger terminal — and cargo terminal operator (CTO) services — involving the handling and processing of freight at the terminal.

The NCC recommended the declaration of the services and the Treasurer, as the designated Minister, subsequently declared the following services on 30 June 1997:

- the service provided through the use of the freight aprons and hard stands to load and unload international aircraft at SIA; and
- the service provided by the use of an area at SIA to:
  - store equipment used to load and unload international aircraft; and
  - to transfer freight from the loading and unloading equipment to and from trucks at the airport.

The Federal Airports Corporation, and its successor as manager of SIA, the Sydney Airports Corporation Limited (SACL), applied to the Australian Competition Tribunal for a review of the decision. It proposed the adoption of a tender process to allocate the right to provide the ground handling services market, as an alternative to declaration. It submitted that the principle behind the Hilmer Committee's recommendation for a national access regime was the need to control vertically integrated monopolists. SACL contended that, as it was not in the business of providing ramp handling or CTO services, it did not fall within the 'intent' of the regime.

At issue in the case were the criteria for declaring a service under Part IIIA (see chapter 7). The Tribunal's decision contained a number of elements that have helped to clarify the meaning of these criteria.

Perhaps most importantly, the Tribunal endorsed the view that Part IIIA is primarily concerned with the services provided by natural monopoly infrastructure. The Tribunal further considered that the natural monopoly test —'uneconomical to develop another facility' (criterion b) — should be interpreted from a social rather than a private perspective:

> The uneconomical to develop test should be construed in terms of the associated costs and benefits of development for society as a whole. Such an interpretation is consistent with the underlying intent of the legislation, as expressed in the Second Reading Speech of the Competition Policy Reform Bill, which is directed to securing access to 'certain essential facilities of national significance'. (ACT 2000, para. 204)

In addition, as part of its assessment under this criterion, the Tribunal was obliged to consider the closely related question of the dimensions of the facility that provided the services. Economists who gave evidence before the Tribunal offered differing versions of what was the relevant facility. The possibilities included:

- the concrete hardstands alone;
- the passenger and freight aprons adjacent to the international terminal;
- the combination of the hardstands, aprons and those aspects of the international terminal which enable the loading and unloading of freight; and
- the airport as a whole.

Having considered the alternatives, the Tribunal characterised the facility as:

> … the minimum set of physical assets necessary for international aircraft to land at SIA, unload and load passengers and freight and depart in a safe and commercially sustainable manner, that is, all the basic air-side infrastructure, such as the runways, taxiways and terminals and the related land-side facilities integral to the effective functioning of air-side services. That is, in practical terms, the whole of the airport. (ACT 2000, para. 99)

The Tribunal also elaborated on the meaning of 'promotion of competition' (criterion a), suggesting that it entails bringing about the conditions or environment for improving competition relative to what it would otherwise be. Evans (2000, p. 9) synthesised this aspect of the Tribunal's decision as follows:

> The approach of the Tribunal reinforces the notion that the promotion of competition does not depend upon establishing that there will be more participants in the market following declaration. Rather, it is the competitive environment which is created from the threat of entry which is likely to encourage increased efficiency in the operations of existing players.

Moreover, the Tribunal rejected the contention that Part IIIA should only be concerned with vertically integrated entities, notwithstanding an emphasis to that effect in the Hilmer Committee report. It did observe, however, that the behaviour of SACL, in trying to limit competition in the downstream market for ramp-handling and CTO services, was difficult to explain:

> The Hilmer Committee … noted that where the owner of a facility was not competing in upstream or downstream markets, the owner usually had little incentive to deny access, because maximising competition in vertically related markets maximised its own profits. In the present matter SACL does want to deny access, or at least regulate access, because it appears to want to control and decide itself who shall operate ramp handling activities at the airport. (cited in Gans et al. 2000, p. 16)

The Tribunal concluded that SACL still seemed to be very much influenced by the regulatory culture of its predecessor, the FAC, and if it had properly adjusted to corporatisation and the new regulatory environment of Part IIIA, it would not have acted the way it did.

In its decision, the Tribunal upheld the declarations, although the wording was altered marginally to read:

- the service provided through the use of the freight and passenger aprons and hard stands at SIA for the purpose of enabling ramp handlers to load freight from loading equipment onto international aircraft and to unload freight from international aircraft onto loading equipment; and
- the service provided by the use of an area at SIA for the purpose of enabling ramp handlers to:
  - store equipment used to load and unload international aircraft; and
  - transfer freight from trucks to unloading equipment and to transfer freight from unloading equipment to trucks, at the airport. (NCC 2000a, p. 87)

The Eastern Gas Pipeline

This case involved an appeal to the Tribunal to revoke the coverage of the Eastern Gas Pipeline (EGP) under the National Gas Code. Its significance for the national access regime lies in the fact that the criteria used to determine coverage under the Code essentially mirror the Part IIIA declaration criteria (see below). Thus, interpretations by the Tribunal in the case have served to further clarify the meaning of the Part IIIA criteria.

The EGP transports gas from the Longford gas production facility in Victoria via Orbost, Bombala, Cooma, Nowra and Wollongong to Horsley Park near Sydney. The pipeline is owned and operated by Duke Eastern Gas Pipeline Pty Ltd.

In January 2000, AGL applied to the NCC to have the EGP covered under the Gas Code. For coverage to occur, paragraph 39 of the Code specifies that *all* of the following criteria must be met:

> (a) that access (or increased access) to Services provided by means of the Pipeline would promote competition in at least one market (whether or not in Australia), other than the market for the services provided by the means of the pipelines;
>
> (b) that it would be uneconomic for anyone to develop another pipeline to provide the Service provided by the means of the Pipeline;
>
> (c) that access (or increased access) to the Services provided by the means of the Pipeline can be provided without undue risk to human health or safety; and
>
> (d) that access (or increased access) to the Services provided by means of the Pipeline would not be contrary to the public interest.

The NCC found that the EGP met all of these criteria. Acting on the NCC's recommendation, the Minister declared the pipeline covered in October 2000.

Duke Eastern Gas Pipeline Pty Ltd then lodged an appeal against the decision with the Tribunal. The company contended that the EGP should not be covered as open access to it was already provided and that the pipeline had induced a competitive response from other pipelines delivering gas to Sydney and other locations serviced by the EGP.

The Tribunal's decision

The Tribunal's focus was on criterion (a) dealing with whether access to the pipeline service would promote competition and criterion (b) dealing with whether it would be uneconomic to develop another pipeline to provide the service.

Promoting competition

In determining whether or not access would promote competition, the Tribunal found that the construction and commissioning of the EGP had resulted in increased competition in the sale of gas in New South Wales and increased competition between pipelines serving the Sydney market. In particular, the Tribunal noted that the price of gas transmission via the Moomba to Sydney pipeline (MSP) had fallen in response to the opening of the EGP.

The Tribunal further argued that the EGP did not have market power. (In this regard, the NCC's submission to the Tribunal held that there was the risk of parallel pricing behaviour between the MSP and the EGP and consequently coverage would be more likely to promote competition.)

In relation to the Sydney market, the Tribunal said:

> … EGP will not have sufficient market power to hinder competition based on the commercial imperatives it faces, the countervailing power of other market participants,

> the existence of spare pipeline capacity and the competition it faces from the MSP and the Interconnect. As EGP does not have market power, the Tribunal cannot be satisfied that coverage would promote competition in either the upstream or downstream markets. (ACT 2001, para. 124)

In the case of regional markets served by the EGP, the Tribunal found that the prices of existing energy sources and the cost of conversion to gas would limit the scope for monopoly pricing of the pipeline's services. It further suggested that the small volume of gas involved would constrain the incentives to engage in monopoly behaviour.

The Tribunal concluded that criterion (a) was not met as the coverage of the EGP would not promote competition over the existing voluntary access offered by Duke Energy and that, in any case, the EGP did not, and would not have market power.

Uneconomic to develop

As noted above, the 'uneconomic to develop' test is essentially a test for natural monopoly. Consistent with its views in the Sydney Airports case, the Tribunal argued that the test should be based on the costs and benefits to society of developing the alternative service.

Notably, however, in defining the service provided by the EGP, the Tribunal adopted a 'point to point' definition of the transport of gas between Longford and Sydney, rather than one based on the provision of gas to a particular market (Sydney or certain regional centres).

In adopting this 'point to point' definition, the Tribunal held that what constituted the service was not a matter requiring economic analysis. It said:

> The question of what constitutes the services provided by the pipeline is fundamentally a mixed question of fact and the proper construction of criterion (b), rather than a matter of economic analysis. Every haulage service will of necessity be from one point to another. That is the commercial service actually provided by the pipeline operator to its customers. That service may be of different use to the producers in the origin market or the customers in the destination market, but it is the same service. No market analysis is necessary or appropriate in the description of the services provided by the pipeline. However, questions of market definition and market power do arise in the context of criterion (a). (ACT 2001, para. 69)

Using this 'point to point' definition of a service, the Tribunal held that the MSP was not a substitute for the EGP as it did not accommodate the transport of gas between Longford and Sydney. The Tribunal canvassed the argument that the 'Interconnect' allowing for the transport of some gas from Longford to Sydney might potentially be a ‘point to point’ substitute for the EGP. However, in concluding that criterion (b) was met, it argued that:

> … it would be uneconomic in a social cost sense to develop the Interconnect to provide the services provided by means of the EGP. (ACT 2001, para. 144)

The use of a ‘point to point’ definition of a service effectively lessened the importance of criterion (b) ‘the uneconomic to duplicate test’ and increased the role of criterion (a) ‘the promotion of competition test’ in the Tribunal’s decision. In commenting on the broader implications, the Network Economic Consulting Group (NECG) said that:

> … the outcome is to alter the balance within the provisions of [Part IIIA] by putting less weight on the uneconomic to develop test making it do in a sense less work, and imposing more weight on the promotion of competition test which, in the Tribunal's decision, is the one that does virtually all of the work. (transcript, p. 213)

The implication of the adoption of a ‘point to point’ definition of a service is that the ‘uneconomic to develop’ test will rule out fewer applications for declaration/coverage. This is because fewer services are likely to qualify as substitutes than were a broader market-based definition used. The appropriateness of the ‘point to point’ approach is discussed in detail in chapter 7.

Other criteria

In respect of the ‘public interest test’, the Tribunal agreed with the NCC view that criterion (d) ‘that access to the service of the pipeline would not be contrary to the public interest’ did not constitute an additional positive requirement. As a result, it found that the ‘public interest test’ could not be used to question the result obtained from applying the other tests:

> Criterion (d) accepts the results derived from the application of paras (a), (b) and (c) [the promotion of competition, uneconomic to duplicate and heath and safety risks], but enquires whether there are any other matters which lead to the conclusion that coverage would be contrary to the public interest. (ACT 2001, para. 145)

In any case, the Tribunal argued that because coverage would not meet the ‘promote competition’ criterion, it was not necessary to give independent consideration to criterion (d).

In sum, the Tribunal found that not all the criteria had been met. It therefore revoked the coverage of the EGP under the Gas Code.

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