Vector Policy Forum, New Zealand

A Regulatory Framework for the 21st Century

Ed Willett, ACCC Commissioner and AER Member

23 March 2007

Introduction

It is a pleasure to be invited to this policy forum and to be able to share some of the Australian experience with regulating infrastructure industries with you.

The Australian experience with regulation of natural monopoly infrastructure is fairly recent. We recently celebrated ten years since the implementation of competition policy. Despite its relatively recent history, there has been considerable transformation of Australian infrastructure since its introduction. To give you a flavour:

- The energy sector has been substantially restructured from vertically integrated, state owned energy businesses to disaggregated businesses with a mix of ownership structures;
- Victoria and South Australia have privatised their electricity supply industries and most of the gas supply sector is in private hands;
- Competition has been introduced into the generation and retail sectors;
- The national electricity market (NEM) is well established.

In addition, there have been substantial changes to the way that regulation is applied and to regulatory institutions. In particular:

- Access regulation has been introduced for the transmission and distribution sectors;
- The Australian Energy Regulator (AER) was established in 2005 as a constituent part of the Australian Competition and Consumer Commission (the ACCC) but one that operates as a separate legal entity to the ACCC.

Nevertheless, the regulatory environment, including the way that regulation is designed and applied, continues to evolve. In particular, the question of what are the characteristics of a good regulatory framework is one that frequently occupies the minds of regulated firms, policy makers and regulators. Of course, it is entirely appropriate for this to be the case since regulation is not costless. We should be frequently reviewing what we are doing, and how we are doing it, to ensure that the costs imposed by regulation do not exceed the benefits of that regulation.

Despite the success of infrastructure regulation over the past decade or so, there are four key issues that remain contentious:

- Achieving a consistent approach to regulation;
- The impact of regulation on investment decisions;
- The role and design of light-handed regulation; and
- Regulatory timelines and the review of decisions.

I will discuss each of these in the context of an overview of developments in Australia. I will then turn to some of the outstanding market structure issues that are particularly relevant in the Australian energy sector.

Consistency in regulation

Competition reforms during the past decade have transformed the Australian gas and electricity sectors into essentially national markets. It has become apparent, however, that the plethora of existing regulatory regimes and regulators is an impediment to the development of truly national markets for significant infrastructure.

The key principle behind the establishment of the AER was that a national energy market needs a national, rather than state by state, approach to regulation. It is intended that the AER will adopt a consistent approach to regulation thus reducing regulatory costs and uncertainty to business. In doing so, it will eliminate the potential for inconsistent regulatory approaches to distort investment and impose unnecessary costs and barriers for utilities operating across state boundaries.

The AER will have responsibility for the economic regulation of the energy sector (gas and electricity) on a national basis with the exception of Western Australia by 1 July 2007. Distribution and retail consumer protection functions will be transferred to the AER by 1 January 2008.

COAG has also addressed the issue of consistency in regulation. In February 2006, COAG agreed to establish a simpler and consistent approach to economic regulation of significant infrastructure by ensuring that all third party access regimes include consistent regulatory principles and times frames for making regulatory decisions.

Changes to Part IIIA

Reflecting this, a number of amendments to Part IIIA of the *Trade Practices Act 1974* (the TPA) were made last year. The amendments give specific direction to the ACCC about the principles that should be taken into account when making regulatory decisions. Specifically, the amendments introduced:

- An objects clause that makes it clear that the focus of Part IIIA is the promotion of efficient operation of, use of and investment in regulated infrastructure to promote competition in upstream and downstream markets through the encouragement of a consistent approach to access regulation in each industry;
- Pricing principles to which the ACCC is to have regard when making arbitrations, undertakings and access code decisions;
- A range of timelines and a requirement for the ACCC to report on the time taken to make arbitrations, access code and competitive tendering decisions.

These changes do not mean that there will be a 'one size fits all' approach to regulation. Rather the regulatory frameworks that apply to Australian natural

monopoly infrastructure are tailored to the particular market failures that economic regulation is trying to fix having regard to the characteristics of the regulated sector. The ACCC endorses this approach. While minimalist regulation remains the ideal, the individual and sometimes unique characteristics of different markets require a range of approaches to achieve the best outcomes for industries and consumers.

For example, new rules for the economic regulation of electricity transmission revenues have recently been written by the Australian Energy Market Commission (AEMC). These Rules introduce a more prescriptive approach to regulation although they largely reflect the AER's Statement of Regulatory.

'Light-handed' regulation

A number of reports and reviews released over the past two and a half years have emphasised the role of 'light-handed' regulation. The ACCC notes, however, that the phrase 'light-handed' does not have a widely accepted meaning, and is not associated with any particular regulatory framework.

It is not particularly helpful to describe a regulatory regime as 'light' or 'heavy' handed because any regulatory regime can have characteristics that are thought of as 'heavy' or 'light' in certain circumstances. Rather it is better to ask whether a particular regulatory regime is *effective* in constraining market power in the particular circumstances.

I will be spending more time shortly considering the issue of effective regulation. Before I do that, however, I would to briefly describe two of the ACCC's regulatory tools that have often been described as 'light-handed' because they give primacy to commercial negotiations as a means of determining prices and returns.

Price monitoring

Price monitoring regimes typically impact on regulated firms' pricing decisions through moral suasion, adverse publicity and the explicit or implicit threat of stricter forms of price regulation if that moral suasion fails to curb the misuse of market power. There is little direct regulatory impact on the pricing decisions of regulated firms.

Part VIIA of the TPA sets out the ACCC's prices surveillance powers and functions. Among other things, it allows the Minister to direct the ACCC to undertake monitoring of prices, costs and profits of a particular firm or industry. The ACCC has some power to obtain information and documents relevant to its monitoring role and there is a requirement that the validity of the information is confirmed by the regulated firm.

However, in isolation, this monitoring function allows only for the collection and publication of price, cost and profit information. There is no provision for the ACCC to provide guidance to monitored firms about how to set prices or to set thresholds beyond which prices, costs and profits might be considered unreasonable and warrant further investigation. Importantly, the price monitoring powers do not enable the ACCC to assess whether observed

movements in prices, costs and profits are the result of the exercise of substantial market power that may justify more direct regulatory intervention, rather than, for instance, the legitimate result of superior efficiency or productivity. Nor is there provision for a threat of re-regulation in response to unacceptable behaviour by the monitored firms.

At the risk of spoiling my punch-line, I consider that the design of the price monitoring regime contained in Part VIIA means that it is unlikely to be effective in constraining monopoly power. But I'll say some more positive things about price monitoring later.

Negotiate-Arbitrate Access Model

Part IIIA of the TPA sets out a generic regulatory framework for access to the services of certain facilities of national significance.

Access may be provided in a number of ways under Part IIIA. Under the so-called 'negotiate-arbitrate' process for declared services, access consists of two main steps:

- The access provider and access seeker attempt to negotiate a commercial agreement; and
- If commercial negotiations fail, the regulator is generally required to arbitrate an outcome. This may require the determination of both price and non-price terms and conditions for the access.

The ACCC does not have an immediate role in setting prices under a 'negotiate-arbitrate' framework. The emphasis is on commercial negotiations to determine the terms and conditions of access. The ACCC only has a role in the arbitration process if negotiations fail. This approach is intended to minimise regulatory intervention in the market place.

Although price monitoring and 'negotiate arbitrate' regimes potentially allow considerable scope for market forces to determine prices, there are clear differences between the two approaches. In particular, monitoring does not provide a mechanism for adjusting behaviour and facilitating access on reasonable terms and conditions. Nor does it provide a mechanism for reducing prices if costs are falling. Thus price monitoring cannot be an effective substitute for a negotiate-arbitrate access regime where there is bottleneck market power that may impact on upstream and downstream markets. The Australian experience to date tends to endorse the view of the National Competition Policy Review that the negotiate/arbitrate model is the 'lightest' form of potentially effective access regulation.

Effective regulatory regimes

As I have mentioned, I consider that it is more important to ask whether a particular regulatory regime is effective, rather than whether it is 'light' or 'heavy' handed. I would now like to spend some time discussing the issue of whether a price monitoring regime can be an effective way to constrain monopoly market power. I will focus on price monitoring because that is the only economic regulatory tool currently applied in Australia that does not

specify a direct role for the regulator in setting prices in clearly defined circumstances (either immediately or after the failure of commercial negotiations).

As a starting point, it is necessary to keep in mind that regulation essentially involves a trade-off between maintaining prices in line with costs and preserving incentives for cost reduction going forward. When choosing between regulatory alternatives, the objective is to optimise this trade-off relative to the alternative of no regulation at all. This ensures that the chosen regulatory regime, whether it is a price monitoring regime or one that more directly controls prices, addresses the market power problem in the most efficient way possible.

Rationale for regulation

A review of the rationale for regulation is a useful starting point in the discussion of effective regulation and whether price monitoring can be an effective regulatory instrument.

The rationale for access regulation is to constrain the ability of bottleneck infrastructure with substantial market power to:

- Set prices considerably above the level that would prevail in a competitive market; and
- Restrict the entry and expansion of rivals upstream and or downstream of the bottleneck.

If the bottleneck's market power is not constrained, either by rivals or regulation, there will be allocative and dynamic efficiency losses in upstream and downstream markets. Overall economic welfare is therefore reduced.

As a general proposition, the greater the potential efficiency loss arising from the exercise of market power, the stronger is the rationale for regulatory intervention. The promotion of efficiency is the main benefit of regulation.

But of course, regulation is not costless. Nor can it perfectly replicate competitive market outcomes. The best that can be hoped for is that regulation will reduce the efficiency loss compared to the 'no regulation' scenario in such a way that the costs of regulation do not outweigh the benefits to be achieved.

Therefore, the choice of regulatory regime essentially involves a trade-off between the minimisation of efficiency losses arising from the exercise of market power on one hand, and the regulatory costs on the other. An effective regulatory regime is one that minimises this trade-off and maximises efficiency overall. This is consistent with the principle of 'minimum effective regulation'.

In Australia, the push to apply price monitoring, or other 'light handed' regulatory regimes is lead by stakeholders who argue that more direct forms of regulation:

- Impose higher administrative and compliance costs on regulated firms and the regulator than lighter alternatives; and

- Can themselves create high efficiency losses associated with inefficient investment decisions as a result of regulatory error or ex post adjustment of actual returns. If this is the case, it is feasible for these regulatory-induced efficiency losses to offset the efficiency gains sought to be achieved by regulation.
- Further by allowing the regulated firm more discretion over pricing decisions, it is, according to proponents, more likely that commercially negotiated outcomes will be reached under 'light handed' regulatory regimes.

It is implicit in these views that 'light' touch regulatory regimes are also able to constrain the exercise of market power by the regulated firm.

If all of these claims are true, then 'lighter' regulatory regimes might be an effective solution to the market power problem. However, as I will now explain, I do not agree that these propositions are true in all situations, so that a presumption that 'light-handed' regulation is always more effect than 'heavier' alternatives is not valid.

There are four conditions that are necessary for a threat of re-regulation to be credible:

- The regulator must be able to assess when market power is being abused;
- There must be clear trigger for re-regulation when market power is being abused;
- Re-regulation must remove from the firm any excess returns earned in the period prior to re-regulation; and
- The threat must be a continuing one.

Difficulties arise in designing an effective monitoring regime with a credible threat of re-regulation because:

- The information that is gathered as part of the monitoring process is unlikely to be sufficient to enable the regulator to assess whether market power is being abused;
- Clearly defining the boundaries that will trigger re-regulation can be difficult, as can assessing whether those boundaries have been breached, because of the exercise of market power. Pricing principles can be helpful in this regard. However, I note that the interpretation of these principles can be contentious, particularly if terms such as 'efficient' or 'reasonable' are used. The use of thresholds may be helpful in some instances, although such thresholds can also create uncertainty which may distort the regulated firm's investment decisions;
- It is unlikely that re-regulation would be able to clawback excess returns earned during the monitoring period so that efficiency losses during the price monitoring period may be high and enduring; and
- The effectiveness of monitoring regimes is usually reviewed a few years after introduction. However, if the information gathered as part of the monitoring exercise is the key source of information about whether re-regulation is justified there are likely to be concerns about the suitability of

the information for that purpose, as I've just mentioned. Furthermore, it is likely that there will be an insufficient time between the commencement of monitoring and the review to draw conclusions about its effectiveness. In this case, the most likely scenario is a 'wait and see' approach that substantially dilutes the credibility of the threat of re-regulation.

Given these difficulties, the ACCC doubts that a credible threat can ever be designed. This view was given support by a recent decision by the Australian Competition Tribunal to declare Airside Services at Sydney Airport under Part IIIA of the TPA.

In making this declaration, the Tribunal rejected the airport operator's contention that its market power was effectively constrained by any of:

- The countervailing power of airlines;
- The ability to derive non-aeronautical revenues; or
- The threat of re-regulation.

In relation to the threat of re-regulation, the Tribunal was satisfied that any such threat is, in reality, quite limited. It noted that even if regulation was reintroduced, it could not operate retrospectively and would therefore allow Sydney Airport to retain any excess returns earned prior to reintroduction of regulation.

Compliance Costs

Price monitoring regimes are also meant to impose lower compliance costs on regulated firms than traditional forms of regulation.

The compliance costs of a particular regulatory regime will depend to a large extent on the regime's design. For instance, the ACCC has found that it requires just as many regulatory resources to conduct an annual monitoring exercise as it does to administer a price capping regime. Moreover, experience from other jurisdictions suggests that attempts to alter monitoring arrangements and improve their effectiveness are likely to result in regimes which expand the scope of data collected and are high in compliance costs, contrary to the intention of the regulatory regime. More regulatory resources would also be required to assess this extra data.

Finally, the costs of determining whether more 'heavy-handed' regulation should be reinstated if a firm subject to 'light-handed' regulation appears to be acting to undermine upstream or downstream competition are likely to be quite substantial to both the regulated firm and the regulator.

While it may be the case that price monitoring regimes initially impose fewer compliance costs on regulated firms than some alternatives, it is by no means certain that this is the case over the longer term.

Furthermore, if as I believe, price monitoring is an ineffective tool to apply to bottleneck infrastructure to ensure appropriate access, then any compliance costs may be imposed without an offsetting efficiency benefit.

Encourage Commercial Agreements

The evidence as to whether 'light-handed' regulatory regimes encourage improved commercial agreements is not clear. The likelihood of such agreements is largely determined by the bargaining strengths of the respective parties. This may be unaffected by regulatory arrangements but may be a factor in choosing an appropriate regulatory regime. Further, in my view, where an infrastructure owner has substantial market power, it is only the prospect of intervention by the regulator that will effect a rebalancing of bargaining strength, and increase the prospects of commercial resolution.

When might light-handed regulatory regimes be effective?

COAG has recently considered the role of price monitoring in the context of the regulation of significant infrastructure facilities. According to COAG, price monitoring should be considered:

- Where it can improve the level of price transparency;
- As a first step where price regulation may be required; or
- When scaling back from more intrusive regulation.

Where these approaches are not possible access regimes should promote efficiency and should also try to achieve national consistency.

Improve level of price transparency

The ACCC agrees that monitoring can be important in providing the community with certain types of price and other financial information. It can also provide information to government about, for example, structural changes in particular sectors of the economy. Monitoring of quality of service can also provide a gauge of performance of firms with market power.

Uncertainty about size and/or durability of market power

Price monitoring might be effective when there is less need or concern to reduce the efficiency loss from market power. This might occur where there are doubts about the size and durability of market power, or the persuasiveness of its influence throughout the economy. In this case, the efficiency losses from exercising market power might be small and thus there is less justification for direct intervention in the regulated firm's pricing decisions.

As recognised by COAG, price monitoring might be an appropriate first step towards price regulation or a final step as regulation is unwound.

The sector or firm is not nationally significant

Even if market power is substantial, in a competition law sense, the costs of traditional price regulation may outweigh the associated benefits from alleviating market power concerns if either the regulated firm or the industry in

which it operates is relatively small. Thus the regulatory regimes applied by the ACCC are generally limited to sectors that are “nationally significant”. This does not mean that the industry or sector has to operate on a national basis but that it must be nationally significant having regard to the size of the facility, its importance to interstate trade or commerce or the importance of the facility to the national economy.

’Light-touch’ regulation might be also be the most effective response to the market power problem if the firm or sector is not ‘nationally significant’, Alternatively, it may be more effective to have no regulation at all.

Summing Up

Summing up, if the purpose of regulation is to provide for appropriate access to bottleneck infrastructure, price monitoring is unlikely to be an effective regulatory tool. The incentives of a monopolist are such that they are unlikely to be substantially affected by largely non-financial impact of monitoring regimes, while activities designed to suppress competition in dependent markets may be difficult to detect.

When there is substantial market power, regulation that influences prices more directly is likely to be a better regulatory tool. Even if the threat of re-regulation under a price monitoring regime is carried out in response to the exercise of market power by the monitored firm, the response will not be immediate. In the interim, the firm will effectively be able to act in an unconstrained manner with little incentive to undertake efficient investments and operation of infrastructure services.

Furthermore, the regulator will not be able to ‘clawback’ the high prices and returns, and associated inefficiencies, arising from the exercise of market power. If the market power is large, then the efficiency losses arising from the exercise of that power prior to the re-introduction of regulation are likely to be large. Under well designed incentive regulation, the constraint will be immediate while the regulated firm will retain incentives for efficient investment and cost reduction.

This is not to say that monitoring is not a useful tool available to governments. It just doesn’t constitute, and can’t substitute for access regulation. Rather, the purpose of monitoring needs to be understood so that it can be applied to situations fit for that purpose and not applied to situations where more direct forms of regulation are likely to be more effective.

Airports Monitoring Regime

I would like to illustrate my comments about the effectiveness of price monitoring as a constraint on monopoly market power in bottleneck infrastructure by talking briefly about the ACCC’s experience with price monitoring of major Australian airports.

Price regulation used to be applied to major Australian airports prior to 2002 in recognition of those airports’ significant market power. However, following the Government’s acceptance of recommendations arising from a Productivity

Commission review in 2002, the number of regulated airports was reduced and price regulation was essentially replaced with the monitoring of charges and quality of service for aeronautical and related services at Adelaide, Brisbane, Canberra, Darwin, Melbourne, Perth and Sydney Airports. Price-monitoring arrangements would apply for a period of five years, with a review of the arrangements to be completed towards the end of the five-year period.

The monitoring regime includes a threat of re-regulation. Specifically, the re-introduction of price control would be considered if the Government formed the view that an airport had operated in a manner inconsistent with 'review principles' specified by the Government.

Price monitoring was intended to remove regulatory intrusion into the commercial dealings of airports and airlines, while still maintaining a constraint on any misuse of market power by the airports. It was anticipated that the provision of aeronautical services would be determined primarily by commercial agreements and that price monitoring would be transitional rather than a permanent feature, notwithstanding the inclusion of a threat of re-regulation in the event of identified abuse of market power. Again, this highlights the main weakness of price monitoring where there is substantial bottleneck market power.

Monitoring outcomes

The ACCC's monitoring of airports has shown that there were substantial increases in airport charges, asset valuations, and indicators of short-term profitability following the removal of price regulation and the introduction of the current monitoring arrangements. The monitoring indicates that there have been no significant changes in quality of service outcomes over the same period.

However, it is very difficult to say whether these observed prices, costs and profits are consistent with the long-run costs of efficiently providing aeronautical services or instead reflect the exercise of market power.

Regulation and Investment

As I have mentioned, the relationship between regulation and investment remains a contentious issue in Australia and is one that has been considered in detail by the ACCC in recent years.

There is a risk of *regulatory error* in price cap and 'building block' regulation that is applied by the ACCC and AER to natural monopoly infrastructure sectors, particularly in relation to a project's cost of capital. However, the ACCC and AER are well aware of the scope for regulatory error and consequently tend to be conservative in their selection of parameter values for key cost of capital components.

There is also the *theoretical* risk that regulation could distort investment if there is *ex post* adjustment of actual returns. However, this does not generally occur in Australia because the usual regulatory practice is to apply an incentive based framework where the time path of regulatory revenues are

set in advance so that the regulated firm has the expectation of achieving the allowed rate of return.

In many regulated sectors, much investment is specific, and hence sunk. For these sectors, it is very important that the regulatory framework is both stable and predictable – otherwise the risk that the regulated firm will not be able to recoup its investment is increased. The more important sector-specific investments, and hence sunk costs, are in an industry the more important it is for the firm's investment decision that the regulatory framework remains stable and predictable.

However, some so called 'lighter touch' regimes, in particular price monitoring regimes that contain a threat of re-regulation, may be highly uncertain. This is because the regulated firm may not know how the regulator will interpret substantial price and/or profit increases.

Hence a price monitoring regime that contains a threat of re-regulation could also potentially distort investment.

Further, we should not forget that an unregulated monopolist is likely to restrict output and investment in capacity or quality in order to increase prices and profits. This leads to a loss of efficiency in both the sector in which the monopolist operates as well as other sectors that use the monopolist's output as an input. Unless a light-handed regime is effective in constraining this behaviour, investment levels under such a regime may well be below that which would be achieved under other regimes.

To sum up, the forms of incentive regulation that the ACCC and the AER currently apply to regulated infrastructure sectors are unlikely to substantially reduce the efficiency gains that regulation seeks to achieve by distorting the regulated firm's investment decisions.

The ACCC's and AER's experience is that the design and ex ante application of traditional forms of regulation substantially mitigates the theoretical concerns regarding investment incentives.

Nevertheless, you may be aware that last year Telstra withdrew from discussions with the ACCC about a proposed fibre to the node (FTTN) network upgrade. Telstra estimated the capital costs of this investment at around $4 billion.

Telstra indicated that the major stumbling block was the ACCC's unwillingness to recognise the actual costs that Telstra incurs in providing its services. However, the ACCC always accepted that Telstra should be entitled to recover its actual costs arising from the FTTN upgrade and that Telstra faces a significant risk that should be reflected in the cost of capital used to calculate access prices.

Despite these disagreements, progress was made to the point where the ACCC asked Telstra to proceed to the next stage of the process – making the proposal available for public comment. Telstra did not proceed to this stage, however, preferring instead to withdraw from negotiations.

The FTTN experience in no way alters the ACCC and the AER's conviction that its regulation of infrastructure does not stifle or chill investment. This

conviction is supported by recent evidence of strong investment in Australian regulated infrastructure.

Taking energy for example, energy infrastructure investment since the implementation of the National Competition Policy has been remarkably high.

The value of regulated gas transmission pipelines in Australia is around $6 billion. Over the past four years, investment expenditure by regulated gas transmission operators has exceeded $1 billion.

Capital expenditure on new gas pipelines, which though unregulated have been constructed since the introduction of access regulation, has increased substantially, including the construction of:

- Eastern Gas Pipeline: Longford (Vic) to Sydney;
- Tasmanian Gas Pipeline: Longford (Vic) to Tasmania;
- SEA Gas Pipeline: Port Campbell (Vic) to Adelaide;
- North Queensland Gas Pipeline: Moranbah to Townsville; and
- Telfer Gas Pipeline: Port Hedland to Telfer (WA).

In June 2006, the ACCC approved $61.7million as prudent costs for the construction of the Corio Loop in Victoria by GasNet Australia. This decision provides regulatory certainty that these investment costs can be recovered by committing the ACCC to a binding, upfront agreement that the approved amount will be included in the capital base when future revisions to its access arrangements occur.

The regulatory asset base of the transmission network in the NEM was around $11.7billion in 2006. Since responsibility for transmission regulation in the National Electricity Market began being progressively transferred to the ACCC (and now the AER) in 1999, our decisions have accommodated over $4.5 billion in transmission investment. In 2002-05 alone, actual transmission investment expenditure was around $1.77 billion.

Over the three years to 2008, another $1.6 billion in transmission investment is expected. Furthermore, our final revenue cap decisions for TransGrid and EnergyAustralia paved the way for $1.4 billion in new investment in electricity transmission in NSW and the ACT over the next five years.

Gas distribution and transmission will officially come under the regulatory control of the AER in July of this year. The AER will also regulate electricity distribution from July. The Ministerial Council of Energy is currently drafting reforms to Chapter 6 of the National Electricity Laws to implement a new national framework for distribution regulation.

In total the National Electricity Market has around $27 billion in electricity distribution infrastructure. Across the NEM, electricity distribution investment has risen from around $1.7 billion in 2000-01, to a forecast of around $2.7 billion in 2004-05, reflecting a real average annual growth rate of 12.3 per cent.

The regulated assets of Australia's gas distribution networks represent investment in excess of $7 billion, with typical expectations for annual investment in the sector totalling around $250 million.

Timely regulation, accountability and merit review

The final ongoing issue in Australian regulation that I would like to discuss today is the need to ensure that regulatory decision making is timely, accountable and subject to appropriate review.

Statutory time guidelines – usually of six months – are increasingly being introduced for our regulatory decisions. However, the effectiveness of these time guidelines will depend critically on whether regulated firms acknowledge and take steps to reduce:

- Information asymmetry which can critically constrain a regulator's ability to make a decision in a timely manner; and
- Ambit claims which reduce the speed of regulatory decisions.

A balance also needs to be struck between accountability in decision making (that is the ability to review a decision) and timeliness. While it is important that decision makers are accountable, multiple levels of review can delay the decision making process for years.

The declaration of airside services at Sydney airport is the most spectacular example here. This matter first began in August 2002 with a declaration recommendation in November 2003 followed by a Ministerial ruling in January 2004. However, that ruling was reviewed by the Tribunal with a decision in favour of declaration in December 2005. That decision was appealed to the Federal Court with a decision rejecting the appeal in October 2006.

The ACCC is currently arbitrating a dispute between Sydney Airport and an access seeker. If one of the parties is unhappy with our ruling they can have that reviewed by the Tribunal. Each of these steps is open to appeal by the Federal Court. Therefore, it may well be several more years before this process is complete.

Where new evidence is admissible in reviews, the ACCC considers that such new evidence, or if circumstances show that past facts are no longer relevant, the decision should be returned to the regulator for consideration of the new material.

Reviews of regulatory decisions have been available via a range of models in Australia. For example, full merits review by the Tribunal is available for all declaration and undertaking decisions, and for proponent governments adversely affected by a certification decision. On the other hand, amendments to streamline the telecommunications access provisions in Part XIC mean that merits review is only available on ACCC decisions on undertakings.

COAG has moved to streamline the review process by announcing that where merits review of regulatory decisions is provided for, the review will be limited to the information submitted to the regulator. This is already a feature of merits review of some ACCC decisions relating to gas pipelines and telecommunications networks and tends to shorten the time taken by merits review. Importantly, it prevents new evidence being considered after the decision is made and discourages forum shopping.

The National Gas Code model of limited merits review has two components:

- First, the review is ‘on the papers’; that is, the review can only consider material that was before the regulator – no new evidence is admissible;
- Second, the grounds for review are a cross between review on a question of law only and a full rehearing of the matter. Thus, reviews can be sought where it can be established that the regulator:
    - Made an error of law;
    - Made a material error of fact; or
    - Was unreasonable.

The ‘unreasonableness’ ground has generally been relied upon in reviews of ACCC regulatory decisions under the Gas Code to date. Recently, the ACCC appealed against a finding of unreasonableness by the Australian Competition Tribunal in the Moomba to Sydney pipeline matter. In allowing the appeal, the Full Federal Court found that the Tribunal had erred in finding the ACCC unreasonable. This decision has clearly raised the bar on the threshold of unreasonableness for the review of ACCC decisions under the Gas Code.

In the ACCC’s view, this interpretation is sound and has substantially improved the effectiveness and efficiency of these reviews. The role of merits review is, under this approach, to assess whether the regulator, on the basis of evidence before it, erred or was unreasonable. Merits review ought to be used to correct errors of law, fact or reasoning, not to provide another forum for a new decision. However, the High Court has granted leave for an appeal of the Full Federal Court’s decision.

Market Structure Issues

The reforms that have been implemented or are earmarked for implementation have substantially improved the performance of the Australian energy sector. However, these improvements tell us nothing about the full productive capacity of the energy sector and mask the fact that there are significant differences in performance between the states.

COAG agreed to the formation of an Energy Reform Implementation Group (ERIG) to deal with these and other issues. ERIG was established by the Prime Minister in July 2006. ERIG is to consider proposals for:

- Achieving a fully national electricity transmission grid;
- Measures that may be necessary to address structural issues affecting the ongoing efficiency and competitiveness of the electricity sector; and
- Any measures needed to ensure transparent and effective financial markets to support energy markets.

Among other things, ERIG has also turned its attention to the most pronounced structural change in the electricity industry in recent years – the emergence of integrated generator-retailers, so called ‘gentailers’. For instance, two of the three dominant retailers in the Victorian and South Australian markets are now substantially integrated (AGL and TRU).

The original design of the NEM was based on structural separation of generators from retailers. The emergence of 'gentailers' represents a fundamental change to the original model, which was intended to encourage liquidity in contract markets and reduce barriers to entry at both generator and retail levels.

As with all structural changes, there are a number of possible costs and benefits of retailer-generator integration. The ACCC has an important role in assessing the competition effects of this integration but has concerns that the existing remedies available under the TPA will not be sufficient to ensure that markets do not become unduly concentrated. For instance, ERIG has raised concerns about the structure of the government owned generation market in New South Wales and supports disaggregation of the three generation companies into smaller ones. However, in Victoria, we are only one merger away from a market structure as concentrated as the NSW generation sector. Once an uncompetitive market structure is in place, the TPA can do little to promote a competitive market structure and a policy response may instead be needed.

Vertical integration is also occurring between natural monopoly transmission and contestable generation sectors. The ACCC has expressed its concern that TPA may not be sufficient to address concerns that a vertically integrated regulated entity might discriminate as to the terms of access for rival competitors.

The Ministerial Council of Energy (MCE) is developing cross ownership restrictions that limit the level of cross ownership of generation and transmission assets as a means of dealing with this problem. Once implemented, these rules will assist in giving effect to COAG's objective of maintaining separation between the contestable and noncontestable elements of the electricity supply industry and in doing so will foster and protect competitive pressures in the industry.

ERIG in it's draft report has similarly concluded that generation-transmission mergers are not desirable and has endorsed the COAG decision to ensure the structural separation of these assets.

The past and ongoing regulatory and market structure changes highlight the importance of competitive markets to supply consumer demand in the most efficient way possible. Where there are ongoing impediments to competition, regulatory intervention may be necessary. In this context it is essential that regulation is effective in replicating competitive markets outcomes to the greatest extent possible.

Conclusion

I have covered a lot of ground in my discussion today.

The key message that I would like to leave you with is that the Australian regulatory environment is constantly evolving. There is considerable focus on developing truly national utility markets and ensuring that regulation facilitates, rather than impedes this objective.

Regulation follows a ‘fit for purpose’ model but there is recognition of the need to ensure that regulation is applied consistently and in a timely manner. To facilitate this, changes have been made to the design and application of economic regulation as well as the institutions that apply it.

Substantial effort has also been exerted to minimise the scope for regulation to distort investment decisions. This has lead to refinements in the application of incentive regulation.

There is considerable and ongoing debate about the application of ‘light-handed’ regulation, particularly price monitoring regimes. Both the ACCC and the AER considers that price monitoring cannot be an effective way to regulate utility bottlenecks but recognises that it may be useful in some other circumstances.

The ACCC and the AER will continue to hone its regulatory practices to ensure that they are effective and ‘best practice’. It will also use the tools at its disposal to help to ensure that evolving market structures are not inconsistent with the objectives of efficient, national infrastructure sectors.