

Our ref: E002246

Mr Tony Hinton
Presiding Commissioner
Review of the Gas Access Regime
Productivity Commission
LB2, Collins Street East
MELBOURNE VIC 8003

Dear Mr Hinton

**REVIEW OF THE GAS ACCESS REGIME – WESTERN AUSTRALIAN
GOVERNMENT SUBMISSION**

Western Australia thanks the Productivity Commission for providing this opportunity to comment on the Review of the Gas Access Regime draft report.

As our previous submission stated, the Western Australian Government considers that overall the Gas Access Regime is sound, and broad economic benefits have been realised as a result of the regime. Appropriate improvements to the Code will ensure the continuing relevance, efficiency and effectiveness of the Gas Access Regime as market dynamics change and the gas industry within Australia develops.

Western Australia acknowledges that the Commission has endeavoured by its recommendations to improve key aspects of the Gas Code, including simplification of its objectives, tightening of the coverage criteria, a process for assessing whether covered pipelines would be regulated by way of reference tariffs or a lighter-handed monitoring regime, and mechanisms to facilitate investment in greenfields transmission pipelines and distribution networks.

However, the Commission is encouraged to further develop a number of its proposals and the following submission sets out Western Australia's comments in this regard.

Western Australia would be pleased to expand or clarify further any of the issues set out in this submission and looks forward to the release of the Commission's final report.

Yours sincerely

**ERIC RIPPER MLA
DEPUTY PREMIER; TREASURER;
MINISTER FOR ENERGY**

Att.

**GOVERNMENT OF WESTERN AUSTRALIA SUBMISSION to the
PRODUCTIVITY COMMISSION
REVIEW OF THE GAS ACCESS REGIME**

INTRODUCTORY COMMENTS

The Western Australian Government considers that overall the Gas Access Regime is sound and broad economic benefits have been realised as a result of the regime. However, some improvements are desirable to clarify its interpretation, improve transparency, and reduce the costs associated with regulation.

Appropriate improvements to the Code will ensure the continuing relevance, efficiency and effectiveness of the Gas Access Regime as market dynamics change and the gas industry within Australia develops.

The Western Australian Government welcomes this opportunity to comment on the Productivity Commission's draft report. Rather than respond to each of the Commission's draft recommendations, the following submission provides commentary on some key aspects of the draft report.

General Comments

- With the introduction of National Competition Policy and third party access, there was an expectation that the Gas Access Regime would be one akin to a 'negotiate and arbitrate' model.
- However, this is dependent on the ability for negotiations to, as far as possible, replicate what would take place in a competitive market between willing buyers and sellers. That is, it is dependent on there being a degree of balance between the bargaining powers of the service provider and access seekers. Furthermore, in the circumstances of disagreement, there must be unrestricted access to arbitration, where all efforts must be expended to ensure that the outcome is fair and reasonable.
- In relation to the Code itself, the Western Australian Government believes it is critical for the Code to be based on a two stage process:
 - the coverage criteria need to provide an appropriate regulatory filter to ensure only those pipelines that need to be regulated are covered by the Code; and
 - regulation under the Code should then be developed to suit those pipelines meeting the coverage criteria.

This approach should minimise the costs and maximise the benefits of regulation. It should also simplify the development of the regulatory framework in the Code, as its development will only need to consider pipelines where material market power exists and regulation is required, not those operating in a competitive market.

- As a general comment, it is important to recognise the interdependence between Part IIIA of the *Trade Practices Act 1974*, Clause 6 of the Competition Principles Agreement and the Gas Access Regime. The comments in this submission are provided to further inform debate. However, any recommended changes would have to be carefully considered within the context of this three-part framework.

Objectives and Objects clause

- There is merit in simplifying the objectives of the Gas Code, and the rationale behind the overarching objects clause proposed for the Code is supported. Having said this, the Western Australian Government would like to fully appreciate the potential impact of removing the public interest criterion from the Code. In this regard, it would be useful for the Commission to identify and consider the benefits, as well as any unintentional consequences of removing the public interest criterion.

Coverage issues

- The Western Australian Government appreciates the rationale behind the proposal to tighten the coverage criteria. However, consideration needs to be given to the potential for ambiguous interpretations of terms contained within the revised criteria.
- Recognising the difficulties associated with interpretation of terms, it may be useful for the Commission to consider whether there is scope to simplify the proposed coverage criteria, by retaining section 1.9(a) in its current form and examining whether other criteria can adequately address the Commission's concerns by incorporating an assessment of the costs of regulation.

Access arrangements

- Cogent, self-contained pricing principles should assist service providers and regulators to develop balanced, robust access arrangements that facilitate investment in capital-intensive assets. The approach taken here by the Commission is consistent with recommendations made in respect to the review of the National Access Regime, and is generally supported.
- It is considered that the Commission's recommendations regarding improvements to competitive tendering and capacity trading processes require further practical consideration and the development of more concrete proposals.
- The Western Australian Government supports the recommendation regarding automatic coverage of expansions of already covered pipelines. This would improve clarity for service providers and users.

Lighter-handed regulation

- The Western Australian Government supports the notion that lighter-handed regulatory approaches may, in appropriate instances, provide satisfactory outcomes to service providers and customers at little cost. Notwithstanding this, the benefits of lighter-handed regulation need to be weighed against the potential for a service provider to exploit market power under less onerous regulation.
- The Western Australian Government does not envisage that pipelines would have an automatic right to non-price, lighter-handed regulation. Any move to implement lighter-handed regulation would need to be based on appropriate criteria, and the two-stage process proposed in the Commission's draft report may provide for adequate assessment in this regard.

Investment

- Western Australia supports the introduction of mechanisms that will facilitate efficient investment in greenfields transmission pipelines and distribution networks.
- However, the Western Australian Government would not support automatic access holidays being granted to any new pipeline. Automatic holidays raise issues of market power and the impact on dependent markets. In addition, automatic holidays may distort investment decisions by favouring investment in new pipelines over expansions. As a result, the Government is more comfortable with the recommendation of the Commission whereby a pipeline investor can seek a fixed-term binding coverage ruling from the National Competition Council. Further information and analysis on the proposed 15-year term would also be appreciated.
- The Western Australian Government considers that imposition of a truncation premium may be a second best solution. It is attempting to compensate for the risk of regulatory error by imposing further regulation. Hence, it may be preferable to investigate more market-based solutions, such as incentive mechanisms.

Administrative and process appeals

- The Western Australian Government notes concerns about the timeliness of regulatory decisions under the Gas Access Regime. However the recommendation regarding backdating powers for regulators requires careful evaluation.

**GOVERNMENT OF WESTERN AUSTRALIA SUBMISSION to the
PRODUCTIVITY COMMISSION
REVIEW OF THE GAS ACCESS REGIME**

OBJECTIVES AND OBJECTS CLAUSE

Draft Recommendation 5.1

The following overarching objects clause should be inserted into the Gas Access Regime:

To promote the economically efficient use of, and investment in, the services of transmission pipelines and distribution networks, thereby promoting competition in upstream and downstream markets.

Draft Recommendation 5.2

With the implementation of draft recommendation 5.1, the following objectives in the preamble to the existing legislation and the related objectives in the introduction to the Gas Code should be deleted:

- (a) facilitates the development and operation of a national market for natural gas
- (b) prevents abuse of market power
- (c) promotes a competitive market for natural gas in which customers may choose suppliers, including producers, retailers and traders
- (d) provides for rights of access to natural gas pipelines on conditions that are fair and reasonable for the owners and operators of gas transmission and distribution pipelines and persons wishing to use the services of those pipelines
- (e) provides for the resolution of disputes.

Draft Recommendation 5.3

The following elements of section 2.24 of the Gas Code should be deleted:

- (a) the Service Provider's legitimate business interests and investment in the Covered Pipeline
- (d) the economically efficient operation of the Covered Pipeline
- (e) the public interest, including the public interest in having competition in markets (whether or not in Australia)
- (f) the interests of Users and Prospective Users
- (g) any other matters that the Relevant Regulator considers are relevant.

It is acknowledged that in its current form there is no overarching objects clause defined within the Gas Code, and this potentially gives rise to uncertainty, ambiguity and hinders regulatory accountability. A clear objects clause would provide greater clarity for decision makers and other parties, and enhance the transparency and timeliness of decisions, particularly if there is consistency with other second tier criteria in the Code.

Consequently, there is merit in amending the Code to include a clear objects clause. Simplifying the Code so that other references to objectives, which are overlapping and conflicting, are deleted would also appear sensible. This may partly resolve the

issues of uncertainty raised in the Epic Energy Supreme Court Decision in relation to section 2.24 and 8.10 of the Code.

In relation to the proposed objects clause, the Western Australian Government appreciates the Commission's rationale that the Gas Access Regime focus on economic efficiency. An access regime that is genuinely based on the principles of economic efficiency should encourage efficient competition, promote efficient use of pipeline infrastructure and encourage efficient investment.

Having said this, the Western Australian Government would like to fully appreciate the potential impact of removing the public interest criterion from the Code. In this regard, it would be useful for the Commission to identify and consider the benefits, as well as any unintentional consequences of removing the public interest criterion.

COVERAGE ISSUES

Draft Recommendation 6.1

The first criterion for assessing coverage with the current approach to regulation (access arrangements with a reference tariff) (that is, section 1.9(a) of the Gas Code) should be amended such that the National Competition Council would need to be satisfied:

- **that access (or increased access) to Services provided by means of the Pipeline would be likely to have the effect of increasing competition to a substantial degree in at least one market (whether or not in Australia), other than the market for the Services provided by means of the Pipeline.**

Clear and appropriate coverage criteria are essential for the effective operation of the Code.

Given that regulation may be costly and intrusive, it is highly desirable to limit its application to those cases where it is necessary. Regulating a pipeline when there is no justification will produce net costs for society, most simply through the costs of the regulatory process, but more importantly through the potential for introducing market distortions and adverse impacts on investment decisions. Conversely, if a pipeline is not regulated where it is warranted, it will also create significant costs in terms of market distortions and inefficiencies. Furthermore, if the coverage criteria are appropriate and only those pipelines that should be regulated are covered, then this should simplify the development of regulation under the Code.

The Commission indicated that the current criteria gives little consideration to the costs of regulation and a situation may arise where the criteria is satisfied, but the benefits from the increased competition in an alternative market do not overcome the substantial costs of regulation. The Commission has proposed that the caveat 'to promote competition' is too low a threshold to rationalise coverage, and that it should be replaced with the term 'substantial increase in competition'.

The Western Australian Government appreciates the rationale behind the proposal to tighten the coverage criteria. However, consideration needs to be given to the potential for ambiguous interpretations of terms contained within the revised criteria. The Australian Government Solicitor noted that there is potential for differing interpretations of the term 'substantial'. Hence, the Commission should define the terms in the revised criterion in order to clarify the interpretation of these terms.

Recognising the difficulties associated with interpretation of terms, it may be useful for the Commission to consider whether there is scope to simplify the proposed coverage criteria, by retaining section 1.9(a) in its current form and examining whether other criteria can adequately incorporate an assessment of the costs of regulation. For example, the Commission may wish to consider whether Draft Recommendation 6.4 (discussed below) would provide a sufficient regulatory filter for those pipelines where the costs of regulation would outweigh the benefits.

Draft Recommendation 6.4

The coverage criteria in section 1.9 of the Gas Code should include a new test — namely, that coverage of the pipeline is likely to improve economic efficiency significantly.

Economic efficiency is a primary policy objective of Gas Access Regime and drives the rationale for regulation. It is therefore, a necessary factor for consideration in the assessment of coverage applications. The Code currently accounts for economic efficiency through criterion section 1.9(d), as it is a key element of ‘public interest’. However, the Western Australian Government concurs with the Commission’s finding that a separate criterion may be appropriate given its relevance. There may be benefit in adding a separate efficiency criterion as:

- economic efficiency is a primary driving factor behind the access regime, and should therefore be specified appropriately in the coverage criteria. The term also implies a consideration of the costs of regulation against the potential benefits of coverage; and
- it is desirable when compared to the alternatives such as a size test. While some may argue that a pipeline may not be substantial in national terms, it may be strategically important to the Western Australian economy. Hence, the economic efficiency test is preferable to remove any ambiguity.

Inclusion of this new test would ensure that regulation would only be imposed where the benefits significantly outweigh the costs. However, the term ‘significance’ is open to interpretation and as with the changes to criterion (a), it may be preferable to set parameters around what constitutes a ‘significant’ improvement in economic efficiency.

Draft Recommendation 6.5

Section 1.9(a) of the Gas Code (the first of the coverage criteria) should be amended such that access (or increased access) to Services provided by means of the Pipeline would be likely to have the effect of increasing competition to a material degree in at least one market (whether or not in Australia), other than the market for the Services provided by means of the Pipeline.

Draft Recommendation 6.6

The Gas Access Regime should be modified such that the National Competition Council, in making a recommendation that a pipeline should be covered, should also recommend the form of regulation to apply to the pipeline. The monitoring regime should be applied if one of the following applies:

- if access (or increased access) would be likely to have the effect of increasing competition to a material, but not a substantial, degree (and if the other tests are met)
- if access (or increased access) would be likely to have the effect of increasing competition to a substantial degree, but applying the monitoring regime (with its lower costs) would improve economic efficiency more than would an access arrangement with reference tariffs (and if the other tests are met).

The current regulatory approach (access arrangements with reference tariffs) should be applied if access (or increased access) would be likely to have the effect of increasing competition to a substantial degree, and if such regulation would improve economic efficiency more than would the monitoring regime (and if the other tests are met).

The Commission has recommended that the extent to which access (or increased access) is likely to have the effect of increasing competition should dictate the form of regulation, as it determines the potential benefits from regulation. As noted under recommendation 6.1 the proposed threshold for coverage is a 'substantial' increase in competition. The Commission has proposed that the threshold for applying a lighter-handed monitoring regime is that coverage would be likely to have the effect of increasing competition to a 'material', but not 'substantial' degree.

Establishing an appropriate regulatory filter for those pipelines where full regulation may be unnecessary and potentially costly, but where some oversight is still considered appropriate, may be a positive contribution to the Code. However, the Western Australian Government would appreciate further information on how the National Competition Council (NCC) would, in practice, make an assessment of 6.6, especially in relation to the second filter. In addition to this, as noted above in the response to recommendation 6.1, there is potential for ambiguity in the interpretation of some amended terms. As advised by the Australian Government Solicitor in some contexts 'substantial' can be taken to have the same meaning as 'material'. Therefore, to ensure clarity and consistency in the application of these terms when coverage criteria is assessed, there may be merit in defining these terms.

Draft Recommendation 6.2

The Gas Access Regime should be amended to give guidance on matters to consider in assessing the 'promotion of competition' test in coverage decisions.

The Commission proposes that the following matters should be taken into account:

- a) ***The nature and demand for the commodities and services of end users of gas***
- b) ***The actual and potential level of competition from substitutes such as gas from other sources delivered through other pipelines, and other forms of energy such as electricity***
- c) ***The nature and extent of any barriers to entry in the market***
- d) ***The degree of countervailing power in the market***

e) The likelihood that rejection of coverage would lead to significant and sustainable increases in prices or profit margins

There has been significant debate over the interpretation of criterion section 1.9(a) and the matters that should be considered in its assessment.

In general, the Western Australian Government is satisfied that the NCC has established an informal process for the assessment of criterion section 1.9(a), which has been comprehensively followed in coverage assessments. Nevertheless, some formal guidance in the Code may provide for greater regulatory certainty in decision making. The amendment has the potential to facilitate greater transparency and consistency in the regulatory process, thus reducing the scope for conflict and improving the timeliness of the regulatory process.

ACCESS ARRANGEMENTS

Draft Recommendation 7.1

Section 8.1 of the Gas Code should be replaced with the following:

The relevant regulator must have regard to the following principles when approving a reference tariff or reference tariff policy:

(a) that reference tariffs should:

- (i) be set so as to generate expected revenue across a service provider's regulated services that is at least sufficient to meet the efficient long-run costs of providing access to those 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 reference tariff structures should:

- (i) allow multi-part pricing and price discrimination when it aids efficiency**
- (ii) not allow a vertically integrated service provider to set terms and conditions that disadvantage competitors of its associated businesses in upstream or downstream markets, except to the extent that the cost of providing access to these competitors is higher.**

(c) that reference tariffs should be set so as to provide incentives to reduce costs or otherwise improve productivity.

The Western Australian Government agrees that the principles guiding regulators in approving reference tariffs need to be consistent with the proposed objectives clause (recommendation 5.1). The focus of the recommended objective is on promoting economic efficiency, and as such access prices should promote the efficient use of, and investment in, pipelines.

A number of the major criticisms of the Code relate to the pricing principles. Hence, cogent and self-contained pricing principles should assist service providers and regulators to develop balanced, robust access arrangements that facilitate investment in capital-intensive assets.

The pricing principles proposed by the Commission parallel the pricing principles proposed for inclusion in Part IIIA of the *Trade Practices Act 1974* (TPA) in the National Access Regime Review. It is noted that the Commonwealth's final response to the National Access Regime Review makes some changes to the pricing principles proposed by the Commission. While consistency between the two regimes is important, it is recognised that the broad principles established for the TPA may not be sufficient for the Gas Access Regime. Hence, general consistency, rather than uniformity may be appropriate.

The Commission's rationale for principles a(i) and a(iii) are supported. Similarly, pricing principles (b)(i), (b)(ii) and (c) appear suitable. It is noted that there was some debate over pricing principle (b)(i) *price discrimination when it aids efficiency*. It is acknowledged that price discrimination can lead to more efficient outcomes, and it is often applied in competitive markets. Further, it is considered that price discrimination was always envisaged under the Code given the reference to, and potential allowance of, prudent discounts.

Draft Recommendation 7.2

The Gas Code's competitive tendering provisions should be simplified to make them more flexible and less costly.

The Western Australian Government is aware that some parties have perceived the Code's competitive tendering processes to be overly complex and difficult to implement. While the rationale for this recommendation is appreciated, the Western Australian Government would like to see the development of some concrete amendments in this regard. Improvements of the competitive tendering provisions could, for instance, be considered in the context of encouraging expansions and extensions of existing pipelines.

Draft Finding 7.4

Service providers could facilitate capacity trading by posting information on their websites regarding unutilised capacity that shippers want to trade.

Capacity trading may provide benefits through more efficient use of pipeline capacity, efficient investment decisions, and increased competition. However, as mentioned in the Western Australian Government's previous submission, the concept of capacity trading needs to be carefully considered in practical terms. In addition, the Commission may wish to assess whether capacity trading should be overseen by a responsible body.

Draft Recommendation 7.4

Section 3.16 of the Gas Code should be amended so that any expansion of a covered pipeline will be treated as part of the covered pipeline, unless the service provider nominates otherwise and the regulator agrees.

The Western Australian Government supports this recommendation as it would improve clarity for service providers and users.

LIGHTER-HANDED REGULATION

In the interests of providing feedback and encouraging debate, some comments on the Commission's proposal on lighter-handed regulation are provided in the following section. However, given that these recommendations propose fundamental changes to the Code, the Western Australian Government believes that it is worthwhile providing some general comments in relation to this issue.

In its analysis of the Gas Access Regime, the Commission notes the difficulties associated with identifying the various costs and benefits associated with the regime. Nevertheless, the Commission will need to be satisfied that a comprehensive, balanced and objective analysis of the regime has been conducted, before proposing a move towards a lighter-handed regulatory approach.

In essence, the Commission will need to be satisfied that the application of a monitoring regime to networks assessed as meeting the 'increasing competition to a material but not substantial degree' test will be sufficient to meet the overall objective of the Code. That is, economically efficient use of, and investment, in pipeline infrastructure.

Draft Recommendation 8.1

The Gas Access Regime should be amended to provide for a lighter-handed form of regulation whereby the application of the alternative regulation involving an access arrangement with reference tariffs would only occur in the more extreme circumstances. The lighter-handed alternative should be a monitoring regime. It is important that the monitoring regime not develop into an intrusive and costly form of regulation.

The Western Australian Government supports the notion that lighter-handed regulatory approaches may, in appropriate instances, provide satisfactory outcomes to service providers and customers at little cost.

With the introduction of National Competition Policy and third party access there was an expectation that the Gas Access Regime would be one akin to a 'negotiate and arbitrate' model with the access arrangement as a safety net. Regulatory costs would be minimised where service providers and users are able to satisfactorily negotiate commercial outcomes without regulatory price setting. However, in practice, a reliance on the Code's access arrangement approval process appears to have developed.

Regulating a pipeline when there is no material justification produces net costs for society, most simply through the costs of the regulatory process but more importantly through the potential for introducing market distortions and adverse impacts on investment decisions. Given the significant costs regulation involves, it is highly desirable to limit its application to those cases where it is necessary.

Notwithstanding this, the benefits of lighter-handed regulation need to be weighed against the potential for a service provider to exploit market power under less onerous regulation. The Western Australian Government does not envisage that pipelines would have an automatic right to non-price, lighter-handed regulation. Any move to implement lighter-handed regulation would need to be based on appropriate criteria, and the two-stage process proposed in the Commission's draft report may provide for adequate assessment in this regard, whereby:

- a pipeline would be assessed against all coverage criteria stipulated in section 1.9 of the Code;
- only if the coverage assessment finds that the costs of full coverage under the Code would outweigh the benefits, should a pipeline become eligible for lighter-handed regulation.

Draft Recommendation 8.2

The monitoring form of regulation to be implemented under the Gas Access Regime should have the following features:

- **a third party access policy formulated by the service provider**
- **separation of pipeline operations from associated businesses in upstream and downstream markets**
- **public disclosure of information by the service provider (which would be well short of the ‘access arrangement information’ currently required under the Gas Code)**
- **scope for the service provider to adopt, at its discretion, additional pro-competitive features, such as a code of conduct.**

The proposed features of the monitoring regime provide a solid basis for development. The provision of a third party access arrangement developed by the service provider, and scope to adopt other competitive features, should serve to enhance commercial negotiations under a monitoring regime. Less onerous and intrusive information requirements that maintain the accountability and transparency of service provider operations are also desirable features.

Nevertheless, the details of the regime and how it would operate are still at the early conceptual stage, which makes it difficult to draw definitive conclusions.

In relation to the issue of ring fencing, it is assumed that any vertically integrated service provider with the ability to exert substantial market power would be excluded from lighter-handed regulation under the coverage process. Even still, the Western Australian Government believes transparency between the service provider and operations in dependent markets is critical to promote competition, both in terms of perception and the actual transactions. Hence, the Commission will need to be comfortable that any proposed ring fencing policy adequately balances the obligations on service providers with the provision of sufficient oversight to avoid adverse outcomes.

Draft Recommendation 8.3

In making a coverage decision to apply the monitoring regime, the National Competition Council should specify what information the service provider is required to disclose to the relevant regulator. Implementation of the information disclosure requirements would involve:

- **the regulator focusing more on trend performance, including in relation to profitability**
- **reporting and monitoring after the event, without any need for prior endorsement by the regulator**

- **the regulator particularly monitoring cases where access negotiations have been unsuccessful.**

Western Australia supports the development of information disclosure guidelines for a monitoring regime by the NCC. The NCC should be best placed to undertake this assessment given the relevant expertise and access to information. In addition, the proposal for open and transparent consultation with interested parties is supported.

INVESTMENT

Draft Recommendation 9.1

The Gas Access Regime should be amended so that the National Competition Council, on request from a potential pipeline investor, can provide a binding ruling on coverage. A binding ruling in favour of lighter handed monitoring should be for the same duration as the minimum period for lighter handed monitoring under the regular coverage test (five years). A binding ruling that a pipeline would not be covered should apply for 15 years. These rulings should not be revoked unless the information relied on by the National Competition Council is proven to be false or intentionally misleading.

Western Australia supports the introduction of mechanisms that will facilitate efficient investment in greenfields transmission pipelines and distribution networks. It is acknowledged that in its current form the Gas Access Code may be more attuned to facilitating access and investment in existing brownfields pipelines rather than facilitating construction of new greenfields pipelines.

However, the Western Australian Government would not support automatic access holidays being granted to any new pipeline as they raise issues of market power and the impact on dependent markets. In addition, automatic holidays may distort investment decisions by favouring investment in new pipelines over expansions.

As a result, the Government is more comfortable with the recommendation of the Commission whereby a pipeline can seek a fixed-term binding coverage ruling from the NCC. Under such circumstances the provision of binding rulings has the potential to encourage new investment as it will provide greater certainty to the service provider, remove some risk related to capital intensive investment, and reduce the costs associated with regulation.

The Productivity Commission's recommended period of a 15 year binding ruling is in accordance with the Parer Report's recommendation. However, the Western Australian Government would appreciate further information and analysis on the proposed term. The term should reflect an appropriate balance between the interests of service providers in facilitating investment while protecting consumers.

Furthermore, the Western Australian Government would like to emphasise that timely and economic expansions and extensions of covered pipelines are as important to the economy as investment in new pipelines.

Draft Finding 9.6

A fixed truncation premium would at least address the asymmetric truncation of returns to some extent. A fixed premium would be a low cost mechanism to promote investment, given its low administrative costs and the limited scope for gaming.

Implementation of a truncation premium has been proposed by the Commission as a measure to reduce the 'chilling effect' of access regulation on investment. Regulatory truncation reduces investors' profits when their investment is successful, but fully exposes those same investors to any losses from unsuccessful investment. It is thought a truncation premium will counteract asymmetric returns and encourage investment as investors' downside returns are partially compensated.

While acknowledging the need for case-by-case assessment when awarding a truncation premium, the guidelines determining service provider eligibility must be on a sound economic basis, and consistent across the board. Inappropriate application of a truncation premium will distort the market, and potentially impose a moral hazard risk as it may encourage risky investment or diminish the efficiency incentive as downside returns will be partially underwritten by the premium.

A study conducted through Melbourne University¹ concluded that the implementation of a truncation premium was sub-optimal and not consistent with formal economic analysis, as it ignores the commitment issue at the heart of the truncation problem. The truncation problem is founded in the regulators' inability to commit to access prices that allow an investor an appropriate return to cover all relevant *ex ante* risk. Regulators do not know the true project risk and there is a tendency for investors to exaggerate risk in order to prop up the regulated access price. In this situation the regulator is unable to commit to such prices and an alternative mechanism for accommodating investor risk must be applied.

As a result, the imposition of a truncation premium may be a second best solution. It is attempting to compensate for the risk of regulatory error by imposing further regulation. Hence, it may be preferable to investigate more market-based solutions such as incentive mechanisms.

ADMINISTRATIVE AND PROCESS APPEALS

Draft Recommendation 11.1

The Gas Access Regime should be amended, whereby the Regulator would:

- **be able to extend the period for approval of an access arrangement by two months only once**
- **have the discretionary power to backdate reference tariffs.**

The Western Australian Government appreciates concerns about the timeliness of regulatory decisions under the Gas Access Regime.

This particular recommendation suggests backdating reference tariffs. Backdating powers for regulators may not be in the best interests of due process in decision making, particularly as not all delays emanate from the side of the service providers. This recommendation requires careful evaluation.

¹ Gans, Joshua and King, Stephen (2003) "Access Holidays and the Timing of Investment Structure," *Journal of Economic literature*, 40