AGL

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Address by
Greg Martin, Managing Director
Australian Gas Light Company

"The Path to Better Regulation – An Australian Perspective"

I read an article in the Financial Review the other day, headed "Regulators not in the real world"

Allow me to quote.

"Over regulation is a terrible force, a destructive force. And there is the danger that Australia will not be seen as an attractive destination, because of it.

"Investors don't like over-regulated markets, particularly where they seem to be unfairly or haphazardly regulated.

"The regulators are saying business should earn the cost of capital; that's rubbish.

"The purpose of business is to earn more – if the purpose is to just make the cost of capital, then the entire stock market is 2 and a half times overvalued. So we have regulators arguing the stock market is too expensive.

"Companies are about creating intangible value – 60 percent of the value in the market is intangible and to not include that is to not be in the real world."

Now that's a powerfully stated view of the problems of over-regulation and I'm sure many in our industry have similar views, but they are not from our industry.

They are the words of John McFarlane, the head of ANZ Bank. We are not alone.

At this conference we are dealing with the real world of an over-regulated energy industry, a world where in many aspects the key issue is the ongoing debate about the concept that competition produces better outcomes than regulation.

As much as I am concerned about both political and regulatory interference in the truly competitive retail energy markets – and in that area I am deeply concerned – today I'm going to concentrate my comments on one part of our industry where regulation is inescapable – an area of natural monopoly, the energy distribution sectors.

But what is the real and most valuable contribution regulation can make to our society as a whole? Surely that is the right question?

The National Access Regime is the critical element in where we go from here. What is the right answer?

Well, this is one of those stories like that breakfast cereal - not to light - not too heavy, but Just Right!

Above all we must get regulation back to the goal of light-handedness. There can never be any justification for the cumbersome heavy-handed processes that have emerged over recent years.

I'm not here to bash regulators – the fact is that regulators generally have a strongly theoretical background and little hands on experience with the realities of the market place.

This places them in a strange position wherein they are forced to make commercial judgements about the business of others, without hands on experience and without access to all the facts. And for that they have my sympathy.

But as I plan to demonstrate to you today, if their focus was on ensuring fair business practice and creating predicability and certainty for all the interested parties – and not just focusing on their role as the consumers representative – that would be a far more productive outcome for society and would also give far more satisfaction to regulators.

It can't be much fun always being the centre of continuing and mounting criticism.

Let me return to my sales pitch for a regulated product called – "Just Right".

Prices cannot be too high - seems obvious? – not only would regulators and governments not like that, but the inevitable result would not be windfall profits – but instead – the loss of custom, leading to loss of profits.

But equally, prices cannot be too low – under those circumstances the results are once again obvious – prices that are too low stifle innovation and deter investment. When prices are too low the business follows the now familiar track – out the back door! Or sometimes just back to the USA!

The price must be just right. By that of course I mean there must be a balanced outcome, one that delivers a service at a fair and affordable cost to the public but allows fair returns for the asset owners and their asset operators over both the short and long term.

As usual in this debate, views vary on that balance depending on ones commercial interests. Typically, the regulator will say "I've got it just right" the user will say "Its way too expensive" and the owner will say "Its ridiculously low!"

And so it is very interesting to find the ACCC claiming that current access arrangements are providing a healthy investment environment while the Productivity Commission has observed that the ACCC does not provide evidence to support this claim.

The ACCC seems to be comparing apples and oranges – on the one hand, projected returns for successful projects, an apple, with an average of actual returns from a mix of successful and unsuccessful projects, a basket of oranges. Not a meaningful comparison and certainly unreliable. Sorry Mr Fels.

In fact the Productivity Commission Report is a good read in its draft form, but even though I understand the final went to the Treasurer in November, us owners and users of infrastructure have yet to see it. However I have no reason to expect it will differ much from the draft.

If we don't improve access regulation by getting the right balance in prices, we are likely to end up with under investment resulting in shortages and interruptions in the supply of essential services.

Getting the balance right is not simple, especially given the informational uncertainties facing regulators.

The cure is for governments to provide clearer guidance to regulators, including the principles governing regulatory intervention. I repeat this is fundamentally an issue for Governments, the rule setters, not the Regulators, the keepers of the rules.

Writing on the current regime, the PC says, "The approach to regulation in Australia is highly information intensive and intrusive, which participants claim reduces incentives for good performance." How true!

This debate is not limited to the PC v the ACCC.

Nearly a decade ago now the Hilmer Committee cautioned that poorly designed and overly intrusive regulatory approaches can reduce incentives for investment and efforts to improve productivity.

More recently IPART said much the same thing with even more vigour, "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."

IPART was commenting on cost plus regulation but as the PC has pointed out even more recently there is a tendency for price caps to merge into rate of return regulation anyway, particularly with the heavy handed nature of the current regulatory environment.

Once upon a time, it was accepted wisdom that regulators couldn't ever fully understand another's business and therefore the old pricing regimes didn't make sense. The corollary was, and still is, that incentive based regulation did make sense.

In my view incentive-based regulation is the only way to go. While it is perhaps possible to mount the case that we do have incentive-based regulation – I'm sure most in today's audience would agree what we really have at present is actually dis-incentive regulation! However we describe it, there is a great deal of mystery and uncertainty surrounding the process of regulatory price setting and I think is well worth exploring that issue today.

The uncertainty undermines the incentive to invest in anything that doesn't have an immediate payback.

Most of the mystery and uncertainty arises from the significant discretion given to regulators under access regulation. Again, I will quote the PC. "An important step is for government's to provide clear guidance to regulators ". I would add – especially if that clarity spills over to investors and investment decision making.

We need clarity to remove the current uncertainties that give rise to unnecessary regulatory costs and at the same time undermine the very benefits promised by a true incentive based system.

Do you remember the precautionary principle? … where scientific evidence is uncertain, decision makers should take action to limit continued environmental damage and should err on the side of caution.

Sort of "lets take action now - because we don't know what will happen but we don't like the look of what could happen."

Well I'm going to steal that idea from its environmental context and use it to explain why when things look uncertain it's easy to do nothing. Why some overseas investors are packing their bags, why new projects are either stalling or are bogged down, and why financiers are reluctant to lend ….. Too much uncertainty. The likely result for investors is "We don't know what will happen so lets put our money somewhere else instead." It's sort of the reverse case to the precautionary principle. Instead of taking action to limit damage, we take no action to limit our risk.

So I've renamed it the Uncertainty Principle.

My aim here is to demonstrate that by removing uncertainty we can increase much needed infrastructure investment.

So let me outline my Regulatory Uncertainty Principles.

Regulatory Uncertainty Principle #1

If I don't know what my projected returns are, I must not risk shareholders funds

I need to know what initial returns I can expect if market outcomes go to plan before I commit my funds to the project.

The fact is, I'm going to be very reluctant to invest if I'm continually forced to second guess the regulator.

The Answer? Regulatory provisions relating to asset valuations and cost of capital assumptions for a representative range of investments should be disclosed so investors have, at very least, a starting point for their expectations.

Regulatory Uncertainty Principle #2

If I know the regulator can change the assessment of risk factors during the life of my project then I must not proceed with the project.

I need to know if the regulators can change their minds on assessing risk factors during the life of my project when making future determinations. I need to know how long I can count on my returns.

If I'm concerned that a decision of a regulator can turn my projected good returns sour in the future, how then do I justify that risk to my shareholders?
The answer – Pre-investment commitments to set prices at subsequent reviews on the basis of the pre-investment view of risk is a necessary prerequisite to removing this barrier to investment.

Regulatory Uncertainty Principle #3

If I don't know the rules regarding how additional expenditure on a project will be treated, then I must not proceed as I cannot forecast my future returns.

Am I likely to face a future risk of stranded assets if I did not get all my projections right in the first place? Is there any one in the room who has ever managed to forecast returns on anything with a 100% accuracy?

If I'm to avoid that risk I should always and only size my investments so they are fully utilised from day 1 – and that would be a very silly decision indeed.

The Answer ? Accept the reality that it does not make sense to leave an overhanging threat of stranding investments and remove this discretion from regulators.

Regulatory Uncertainty Principle #4

If Governments offer investment incentives designed to reward investors for the risk then I must be certain these incentives will reward only my shareholders. Will the regulator continue in the mistaken belief that the effects of actions by Government to stimulate investment leaves them with the right to transfer those benefits from investors to consumers in the form of lower prices? There can be no justification for such actions, yet that is exactly the outcome of the ACCC post tax revenue model.

For a past investor, it's deplorable! For a potential investor it removes an important incentive to take risks.

The Answer? Governments must make it clear to all, that such action is inconsistent with the very idea of investment incentives.

Regulatory Uncertainty Principle #5

I must reject the view that an assessment of benchmarking against 'efficient costs' from other markets can be a more accurate reflection of appropriate costs than are my actual costs compared with the costs of my immediate peers.

There is a fetish that suggests it is possible to measure the monopoly rents of a service provider by comparing actual costs with a notional 'efficient cost', yet it has been proven time and again that benchmarking is a dangerously inexact science.

The fact is that no one has the right tools to produce a valid outcome. IPART supports this view, "No regulator can accurately assess the levels of efficiency or service an industry is capable of over time".

The Answer? IPART has already given the answer, the remainder of the quote above is "The regulatory framework should aim to create conditions where the industry itself, in response to the incentive it faces, moves towards its continually shifting performance frontier".

A form of this solution would be to allow the competitive market outcomes by out-sourcing more of this work to competitive markets.

Regulatory Uncertainty Principle #6

If benefits of future efficiency gains must be shared with others then I must know in advance how they will be shared.

It comes back to the issue of incentives. If I promise an employee a performance based incentive, then I cannot have another plan to take it or part of it away when the employee has delivered the required result. Yet we are seeing some regulatory decisions that simply pass 100% of what they see as achievable efficiency gains straight over to customers.

The Answer? A tenet of incentive-based regulation must be a clear understanding as to how efficiency gains will be shared.

Regulatory Uncertainty Principle #7

I must have long term certainty on long life projects.

If I'm given a regulatory decision with a life of only five years or so for a proposed new project with a life of fifty years on what basis can I make sensible investment decisions? I cannot take a risk in which I'll lose money for five or ten years then discover that the regulator wants to take a large share of my profits in subsequent years once the project is successfully beyond break-even.

No one is interested in sharing my early year losses are they?

The Answer? Follow the model established for Petroleum Resource Rent Tax. In that case an investor is free to set prices until the project has recovered its costs, thereafter 60% of the net benefit flows to the investor and 40% to the users.

So there are my 7 Regulatory Uncertainty Principles. In large part of AGL is in the natural monopoly business, I have to take risks and I expect to be rewarded accordingly. I expect regulation, but only to act as a substitute for competition, I don't expect regulators to try and run my business for me. If added to the normal business risks, I must add further regulatory intrusion then my level of uncertainty will simply be too high. Inevitably the result is less investment in new infrastructure.

If you've read the newspapers of late, you'll know that I'm keen to proceed with new projects, but I need to, no, I must know the rules, before kick off.

I'm sure many of you will agree. After all, that only seems fair doesn't it?

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