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Productivity Commission review of the national access regime: APA Group response to issues paper

The APA Group (APA) welcomes the opportunity to respond to the Productivity Commission's (PC's) issues paper for the review of the national access regime.

APA is a major ASX-listed gas transportation business with interests in energy infrastructure across Australia, including over 14,000 km of natural gas pipelines, gas storage facilities and a wind farm. APA is Australia's largest transporter of natural gas, delivering about half of Australia's annual gas use through its infrastructure. APA owns and operates a diverse portfolio of energy infrastructure assets across Australia, with a value of approximately \$12 billion. These assets include investments in two interstate electricity interconnectors which operate in the National Electricity Market.

APA's focus is as a long term investor in infrastructure assets. APA therefore has a keen interest in ensuring that the gas and electricity access regimes deliver outcomes that not only foster efficient new investment in energy infrastructure, but safeguard the business interests of existing investors in energy assets.

APA would be pleased to discuss its submission, and its experience as an owner and operator of both regulated and unregulated assets, in more detail during the course of the review.

Yours sincerely

Peter Bolding
General Manager
Regulatory and Strategy



1 Introduction

1.1 About APA

APA plays a pivotal role in Australia's energy sector. APA is Australia's largest natural gas infrastructure business, transporting about half of the nation's natural gas usage through the assets it owns or operates, alongside other energy infrastructure investments in the electricity sector.

APA has extensive experience with regulation under the gas and electricity access regimes. APA's assets are subject to industry-based access regulation as both an access provider (as the owner and operator of electricity and gas transmission and distribution assets) and as an access seeker (for example as the owner of the Emu Downs wind farm). An overview of APA's history and a summary of assets are provided at Attachment A to this submission.

1.2 APA's role in the gas market

APA, like the majority of the industry, transports gas for other parties, not on its own behalf. Thus, APA's success depends essentially on its ability to efficiently haul more gas, and ultimately the success of APA's customers in their own markets.

In addition, APA must work closely with users of its pipeline to secure capacity expansions. It is therefore not in APA's interest to impose uneconomic pipeline tariffs that would limit its growth potential, and ultimately undermine its end market. This is particularly the case where gas transportation is subject to competitive pressures from alternate fuel sources, and its industrial end users must remain internationally competitive.

While APA actively seeks to transact with small market players, overwhelmingly APA does business with large market aggregators in the form of energy retailers, producers and major resource companies: in 2011/12 APA hauled 75% of its gas throughput for only 5 customers. These customers have significant knowledge of the gas industry and gas transmission in particular, and also have significant countervailing market power. In many cases, such as in APA's negotiations with integrated energy companies and multinational resource companies, their available resources to devote to negotiations far outweigh those available to APA.

2 National Access Regime objective and pricing principles

2.1 Objective

2.1.1 Focus on economic efficiency

APA supports the maintenance of the current objective of the national access regime. The focus on economic efficiency is appropriate and provides guidance to decision-makers as to the intent of the regime, with sufficient scope of application so that further subordinate or competing objectives are unnecessary.

APA does not support changing the objective to refer to the long term interests of consumers. Changing the objective at this stage would undermine the guidance provided by regulatory precedent, without discernible gain. Indeed, the diversion of objectives between the national



access regime and the electricity and gas access regimes was not supported by APA, and arguably detracts from certainty by limiting the potential for decisions across the regimes to provide guidance as to interpretation.

In APA's view, the case to move away from a direct efficiency objective and refer to the long term interests of consumers in the gas and electricity regimes was never convincingly made. Policy-makers were at pains to point out, despite the difference in language, that long term efficiency was ultimately the goal, to wit, the Second Reading Speech for the National Gas Law included the following guidance:

The national gas objective is to promote efficient investment in, and efficient use of, natural gas services for the long term interests of consumers of natural gas with respect to price, quality, reliability and security of supply of natural gas.

The national gas objective is an economic concept and should be interpreted as such.

The long term interest of consumers of gas requires the economic welfare of consumers, over the long term, to be maximised. If gas markets and access to pipeline services are efficient in an economic sense, the long term economic interests of consumers in respect of price, quality, reliability, safety and security of natural gas services will be maximised. By the promotion of an economic efficiency objective in access to pipeline services, competition will be promoted in upstream and downstream markets.¹

Further, in response to issues raised in submissions on the National Gas Law, officials stated:

Issue: The intent of the objective should be clarified in the NGL explanatory memorandum

SCO Response: Accepted. The primary intent of the objective is economic efficiency in investment in, and use of, natural gas infrastructure. This will work in the long term interests of consumers.²

Therefore, despite the different language, it is clear that policy makers did not intend to imbibe into the national gas and electricity regimes a different objective to that in the national access regime, and APA does not consider that there is anything to gain from changing the objective of the national access regime to refer to the long term interests of consumers in place of its current direct reference to economic efficiency.

2.1.2 Inclusion of social or environmental objectives

APA does not support the inclusion of further objectives under the national access regime as it considers that having multiple objectives removes clarity and increases uncertainty in regulatory decision-making. Regardless of the guidance provided as to weightings of multiple objectives, the task of balancing competing objectives necessarily creates a degree of regulatory discretion that is likely to detract from economic efficiency, which is appropriately the overarching objective.

APA considers that inclusion of social policy or environmental goals within the national access regime would direct the regime towards trying to achieve policy outcomes that it is not designed to address. Further, it is not clear what specific policy outcomes such objectives would lead to, in particular the potentially competing goals on carbon abatement, land use allocation, social distribution and alleviation of hardship. While important, these goals

¹ National Gas (South Australia) Bill 2008, *Second Reading Speech*, p 4

² Ministerial Council on Energy Standing Committee of Officials 2007, *SCO response to issues raised in submissions on the National Gas Law*, 1 March, p 1



potentially conflict with economic efficiency, and ought to be addressed through specific and targeted regulation instead of being made part of generic access regulation.

2.2 Pricing principles

As noted in the Issues Paper, both the electricity and gas access regimes now incorporate pricing principles that, amongst other things:

- Ensure that regulated access prices are set so they are sufficient to at least cover the efficient costs of providing access to the service; and
- Include a return on investment that is commensurate with the regulatory and commercial risks involved.

APA considers that both of these principles are very important in guiding the regulator as to its pricing decisions, in particular in relation to ensuring that regulated rates of return reflect current market conditions for debt and capital, and do not lead to a truncation of returns for riskier projects.

3 Regulation and investment

3.1 Gas industry investment

3.1.1 Historic investment model

The gas pipeline industry is founded on bilateral negotiation and agreement. This is a feature of the global industry that pre-dates the Australian third party access regime. All of Australia's key pipelines were built on the basis of this investment model. This model also allowed the sizing and configuration of pipelines to meet expected future flows, even where these flows were many years in the future. Importantly, third party access regulation has had little influence on this process.

3.1.2 Investments in new capacity under the gas access regime

As foundation contracts expire, previously contracted capacity has become available at regulated tariff rates. Further, pipelines have become more constrained, and require additional investment to increase capacity. This has put the gas access regime to the test as, for the regime to support investment, regulated tariffs must be able to fund these capacity increases. This has not proved to be the case.

In general, pipelines are long-lived assets with high upfront investment and low operating and maintenance costs, so as pipelines age, the capital base diminishes, and the tariffs resulting from that diminished capital base do not provide a signal as to the cost of new capacity. On the face of it this is not a problem as the original cost of the pipeline has largely been recovered in the earlier years of its life. It is a problem, however, where, as is the case under the gas access regime, the regulatory regime requires that new capacity be justified on the basis of the diminished tariff, as this tariff is unlikely to be sufficient to underpin investment in costly options such as looping.



In addition, the regulatory regime introduces risks for new investment, largely associated with inadequate rates of return and the risk of asset stranding, meaning that investments on the basis of regulated tariffs are difficult to support.

To overcome investment problems under the regulated tariff, investments in new capacity are largely underpinned by bilateral contracts. These contracts reflect the unit price of new capacity (that is, the marginal cost), and as such are on the whole higher than the regulated tariff applying to existing capacity. This fact presents a clear risk to the investing user: any spare capacity arising from their investment on a regulated pipeline would be available to other users (usually competitors) at a lower tariff than they are paying as it would reflect the average costs of capacity rather than marginal costs of capacity. The response is either not to invest, or to mitigate the risk that a competitor has access to a lower tariff by ensuring that there is either no spare capacity arising from their investment, or that the risk of lower tariffs is shifted on to the service provider by requiring 'most favoured nation' clauses in contracts. The result of the latter option is that the service provider is now incentivised not to include spare capacity as doing so could mean that it did not recover the costs of its investment in the new capacity should an unacceptably low regulated tariff apply to the new capacity.

3.2 Impact of regulation on APA investment

APA's pattern of investment demonstrates the impact of regulation on investment. APA has a preference towards capacity investment in unregulated pipelines, and where additional capacity is installed for a regulated pipeline, that capacity (and the associated tariff), is negotiated on commercial terms rather than at the regulated tariff.

One would not expect to see users entering into bilateral agreements for new capacity on commercial terms if that capacity could be built or made available at a regulated tariff – in those cases one could expect users to seek expansion through regulatory review processes instead. This is not the pattern that we see, however.

This pattern also means that for regulated pipelines, capacity investments are likely to only match immediate needs – prospective or speculative investment is all but eradicated by the threat of lower regulated tariffs. This threat is faced by both the service provider (through insufficient rates of return and most favoured nation clauses) and by the user (through capacity being available to competitors at lower prices and with less contracting risk).

A clear driver of this bias is the threat of insufficient rates of return for new capacity where it is subject to a regulated tariff.

To be clear, this pattern is not a case of a monopoly service provider restricting capacity to drive up prices. Under the gas access regime, available existing capacity must be offered to users and potential users at the regulated tariff. Queuing arrangements mean that there may be many users waiting for capacity at the regulated tariff. There is therefore no scope for a service provider to increase charges on existing capacity by creating constraints.

Nor is this a case of an integrated provider limiting access to its competitors in upstream or downstream markets. APA (like most of the transmission sector) is not vertically integrated and would gladly transport more gas for other users if the opportunity arose. The risk of competitors gaining access is instead faced by the investing user who must enter into a long term contract to underpin investment, compared to a later access seeker that may gain access to that capacity on regulated terms and conditions (between 1 to 5 years) at a lower (averaged) regulated tariff.



3.3 Insufficient and truncated returns

A key constraint to investment in the current environment is how Australian energy regulators recognise and price risk.

While the PC's earlier review of the national access regime emphasised the risk of insufficient rates of return and the truncation of returns, it is clear that Australian energy regulators have not taken heed: regulated rates of return for transmission pipelines have dropped to historical lows in the past 12 months despite significant risks in the global economy that have the potential to significantly impact pipeline demand. This is demonstrated in Figure 1 below, which shows regulated vanilla post tax rates of return decisions for electricity and gas networks business over the last 5 years.

These regulated rates of return are plainly insufficient. In the past year APA has divested the majority of its ownership in Allgas distribution network on the basis that it would provide an insufficient return to the business. The AER's decision in respect of the Allgas access arrangement was made in April 2012. More recently, APA advised the market that the AER's draft decision in respect of the Victorian transmission system was insufficient to justify further investment, and should the draft decision rates be confirmed, APA will make minimal further investments in the Victorian system, only spending enough to keep assets in a "safe operating mode".³

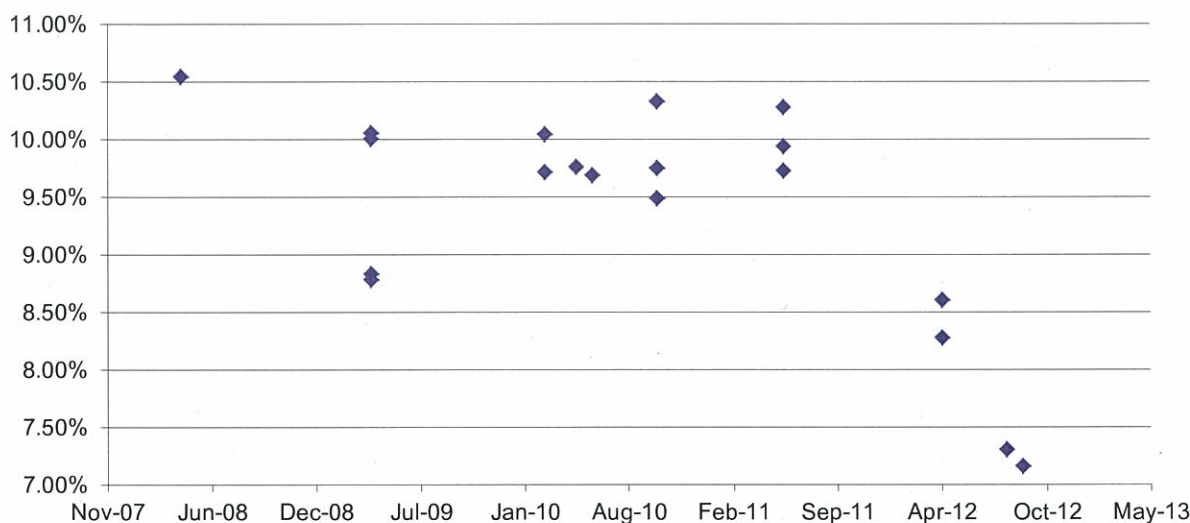
APA considers that further guidance is required in the national access regime, as well as in industry-specific regimes, as to *how* the regulator should ensure sufficient returns and address the risk of truncation of returns. It is clear that the gas access regime is not delivering appropriate outcomes where the following occurs:

- specialised gas infrastructure businesses are divesting regulated assets in favour of non-regulated assets;
- the regulated returns available for new capacity investment lead to tariffs that are below those which users are prepared to pay for that capacity (and which would support the investment required); and
- the threat of these lower regulated tariffs being available to other users (competitors) means that investment does not proceed.

³ Macdonald-Smith, Angela 2013, *Energy rules 'will stunt investment'*, Australian Financial Review, 20 February



Figure 1 –Cost of capital decisions for gas and electricity networks (Vanilla post tax rate of return)



3.4 Support for negotiate/arbitrate regime

A key feature of the national access regime is the focus on individual access negotiations, with intervention only occurring after those negotiations have failed, and only to the extent of disagreement between the parties. This approach allows market processes to predominate, and delivers a clear incentive to the facility owner to negotiate in good faith in order to reach a commercial agreement with an access seeker without the cost and uncertainty of regulatory intervention through arbitration. This approach also most closely resembles how APA negotiates with access seekers for the construction of new capacity.

By contrast, full regulation under the gas access regime regulates services up front by requiring covered pipeline service providers to have in place an approved access arrangement setting out the terms and conditions of regulated access to the relevant pipeline. Under this approach, regulated service providers are subject to the full costs of regulation regardless of their behaviour. APA considers that this approach under the national access regime is preferable and more suitable to the gas transmission sector.

4 Declaration

4.1 Support for greenfields investment

The prospect of declaration of greenfields developments can make such developments too risky to pursue, due to the risk of the investment business case being judged by the regulator, with hindsight, as being too generous and as a result returns being truncated. By including scope for some projects to be deemed ineligible for declaration for at least 20 years, the national access regime seeks to address this problem, by removing the risk of regulation of such assets for a period.



While APA supports the inclusion in the access regimes of mechanisms to support greenfields developments, APA considers that ineligibility criteria (or regulatory holidays as they are termed in the gas access regime) are treating the symptoms of inappropriate regulation rather than treating the problem directly. In other words, the existence of regulatory holidays effectively admits the failure of the regime to be appropriately targeted and to ensure appropriate returns.

This is a particular problem as, while the ineligibility criteria address regulatory risk for some greenfields developments, the issues discussed above of inappropriate regulation and the truncation of returns equally applies to brownfield developments and already sunk investments, for which the ineligibility criteria has no remedy. A superior approach would address the problem of regulatory risk *within* the regime, rather than relying on mechanisms that exclude assets from the regime as a way of bypassing that risk.

4.2 Declaration criteria

APA considers the declaration criteria as interpreted by the Courts and Australian Competition Tribunal, and applied by the National Competition Council, to be appropriate in achieving the objective of declaring those natural monopoly bottleneck facilities where to do so will make a difference by resulting in increased competition in a dependent market.

In relation to criterion (b), the recent change in interpretation by the High Court of this criterion to a privately profitable test is a significant shift from the prior social costs approach. As with any change to a settled interpretation, infrastructure service providers such as APA will need time to assess the impact of the change on their respective businesses.

5 Certification

5.1 Certification of state and territory regimes

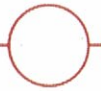
Certification of state and territory access regimes is important in ensuring that there is consistency between these regimes and the national regime.

Neither the national electricity nor national gas access regimes have been certified. APA considers that this has the potential to introduce uncertainty for both electricity and gas infrastructure service providers that they may be subject to conflicting regulatory regimes. APA considers that this is a particular risk in the electricity sector where there is a very high level of prescription contained in the National Electricity Law and Rules, which would continue to apply to service providers regardless of the outcomes of an arbitration process.

5.2 When is an industry specific regime appropriate?

There are no clear policy principles in place to govern where an industry specific regime may be preferable to reliance on the national access regime.

This is of particular concern as industry-specific regimes tend to err on the side of more intrusive regulation (compared to the national access regime), despite the significant risks associated with inappropriate regulatory intervention. As the PC found in its earlier review of



the national access regime, access regulation, while providing benefits, also had significant costs which warranted ensuring the regime only applied in situations where significant monopoly power is likely to be present.⁴

APA considers that there would be benefit in establishing a clear set of principles setting out the circumstances where an industry specific regime may be appropriate. APA considers that a key consideration should be whether the industry-specific regime better contributes to economic efficiency compared to relying on the national access regime. This principle clearly links with the regime objective and would ensure that industry-specific regimes are only introduced where there is a clear economic benefit in doing so.

6 Institutions and processes

6.1 Decision making framework

6.1.1 Decision-making roles

APA considers that the decision-making roles under the national access regime are appropriate. In particular, APA considers that it is critically important to maintain a separation between the decision to regulate and regulation itself, as is the case in relation to the separate roles of the ACCC and the responsible Minister. APA also considers that it is important that the responsible Minister be advised by a knowledgeable and well-resourced body, as is the case with the NCC.

6.2 Review of decisions

6.2.1 Importance of merits review

APA considers that access to an effective merits review regime is critical to the operation of the regulatory regimes to which it applies. It is not surprising that a decision maker, even one with considerable resources at its disposal, may occasionally make errors when addressing complex technical questions. It is most important to the effectiveness of the regulatory regime that there is a mechanism to correct these errors when they are identified.

The risk of error, no matter how well resourced a decision-maker is, will never be completely eliminated – a mechanism to correct errors is still required due to their potentially significant impact on investment.

To highlight the importance of merits review, APA participated in research commissioned by the Financial Investors Group (FIG) into the AER's performance in merits reviews under the respective National Gas and Electricity Laws to date. This review highlighted that the AER has indeed made reviewable errors in the performance of its duties, and that, in the majority of cases, the Australian Competition Tribunal (ACT) has required that these errors be rectified.

⁴ Productivity Commission 2001, *Review of the National Access Regime: Inquiry Report No 17*, 28 September, p 94



This report is attached to the joint submission from the Financial Investors Group on the AEMC Review of the AER's Cost of Capital Rule Change proposal.⁵

APA has commissioned research into the financial impact of the AER's identified errors. This research indicates that the impact of correcting the AER's errors in WACC has been approximately \$725 million per year, or \$3.6 billion in aggregate across the electricity and gas networks over a five year regulatory period. This research was provided to the Standing Council on Energy and Resources' Expert Panel in its review of the energy limited merits review regime, and is also provided to the PC with this submission.

Clearly the financial impact to investors of the identified errors is significant, and left uncorrected, could well have a chilling effect on investment in infrastructure. However, because of the broad base of end users for infrastructure assets, recovery of this 'lost' revenue results in very small price impacts to end use customers. For example, this research found that the additional revenue, if fully recovered, is equivalent to approximately \$0.13 per gigajoule (GJ) on consumer prices, on average across the gas network industry. Of this indicative increase in gas consumer prices, approximately \$0.02 is attributable to the gas transmission network.

The benefits of having an effective mechanism to address regulatory error is therefore very important, as errors have a disproportionate short term negative impact on investors compared to the impact on end users, and potentially lead to longer term significant negative impacts for end users through the chilling of investment.

6.2.2 Is judicial review sufficient?

It is because of the risk of regulatory error that it is critically important that merits review of decisions is and remains available to infrastructure owners and access seekers.

APA does not consider that judicial review is sufficient to address the range of errors that could and have been made by regulatory decision makers. Restricting the availability of review to matters of law would risk significant errors in the exercise of regulatory discretion being left unaddressed, with associated impacts on investment confidence. Such an outcome is not desirable given the importance of infrastructure investment to Australia's economy.

Regulatory error that leads to artificially low returns to regulated businesses can have far reaching implications for investment, particularly where long term contracts with shippers are not in place. APA therefore considers that scope to correct regulatory error through merits review provides an essential foundation for achieving the levels of investment in essential infrastructure required in the coming decades.

⁵ The Financial Investor Group report can be accessed here <http://www.aemc.gov.au/electricity/rule-changes/erc0134--initiation-documents.html>



ATTACHMENT A

About APA Group

APA Group history

APA Group was created when AGL floated its gas transmission assets in a separated company, Australian Pipeline Trust (as APA was called at the time). Australian Pipelines Trust was listed in the Australian Stock Exchange on 13 June 2000, and comprised of six independent pipelines. The APA business model at that time was as an asset owner – APA employed only 6 staff and all assets were operated through external asset management agreements.

In the period between 2004 and 2007, APA underwent a rapid expansion period, acquiring or developing a number of pipelines and other energy assets (see further details of APA's assets below). In this time APA also internalised its asset management arrangements.

From being solely an asset owner, APA now also operates and manages all of its pipelines, as well as providing asset management services to other pipelines and assets. This has led to a significant increase in staffing numbers, growing to more than 1,500 people.

Current energy infrastructure investments

Overview of assets and investments

APA is Australia's largest natural gas infrastructure business. It owns and/or operates approximately \$12 billion of energy infrastructure, which includes over 14,000 kilometres of gas transmission pipelines that span every state and territory on mainland Australia and delivers about half the nation's natural gas usage.

In addition, APA has an ownership interest in, and operates, the Envestra and Allgas gas distribution networks, which together have approximately 25,000 kilometres of gas mains and approximately 1.2 million gas consumer connections.

APA also owns related energy infrastructure assets such as gas storage facilities and a wind farm. In addition to the Envestra and Allgas gas distribution networks, APA also has equity interests in a number of energy infrastructure enterprises, including SEA Gas Pipeline, Energy Infrastructure Investments, EII2 and the Ethane Pipeline Income Fund.

APA is listed on the Australian Stock Exchange and is included in the S&P ASX 100 Index. Since listing in June 2000, its market capitalisation has increased nine-fold to approximately \$4.5 billion, and is one of Australia's top 70 firms on the ASX.

The map below shows APA's assets and investments.

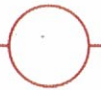
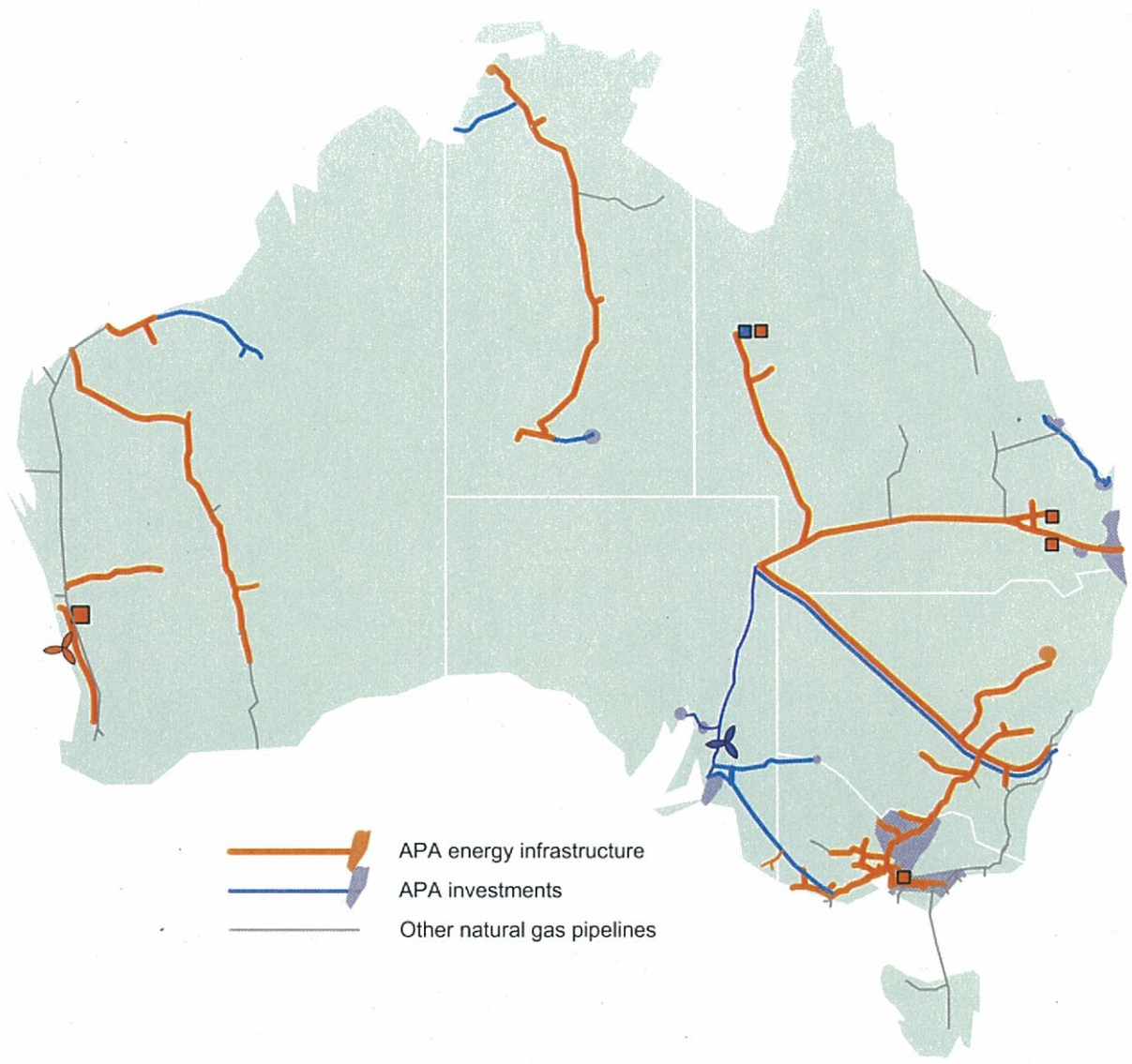





Figure - APA Group assets and investments



 APA energy infrastructure
 APA investments
 Other natural gas pipelines