Productivity Commission Review of the National Access Regime – Position Paper

Submission by the Australian Pipeline Industry Association

Summary of APIA Conclusions and Recommendations

APIA emphasises that Part IIIA of the Trade Practices Act represents a mechanism to ensure a right of access under circumstances where access could otherwise be denied.

Whilst this policy intent has been incorporated into industry-specific regimes such as the National Third Party Access Code for Natural Gas Pipelines Systems (the Code), the title of this regime belies the fact that, in practice, the policy intent behind Part IIIA has been extended considerably because of the very wide discretionary powers given to regulators to determine outcomes.

In practice, regulators have applied their various discretions under the Code to replicate the outcomes expected from detailed consumer legislation based on prescriptive "cost of service" regulation. In this process the original policy intent of Part IIIA has been effectively overridden, with a current focus on very short term consumer price benefits rather than consideration of longer term consumer interests relating to infrastructure investment and reinvestment.

APIA strongly supports the overall conclusion that regulation of Australia's infrastructure industries, including gas transmission pipelines, must be modified to enhance its benefits and reduce its potential costs. In particular, regulatory arrangements must:

- Avoid promoting competition and lower prices at the expense of necessary investment – otherwise consumers could become worse off over time; and

- Ensure greater emphasis on incentives to invest.

APIA believes that more effort needs to be expended to ensure that the Part IIIA review delivers the desired outcomes for new development activity and effective regulation of existing assets.

The final balance in the overall package could lead to only marginal improvements, further concentrate regulatory powers and limiting important appeal rights to the detriment of the legitimate property rights of asset owners and developers. If this

were to happen, the overall outcome to the gas transmission industry would be negative, not positive.

In the submission APIA stresses the importance of an effective two-stage process:

- To determine whether coverage is justified through judicious application of a test for major, essential infrastructure; and

- For infrastructure that passes the test, an effective regime governing terms and conditions of access that provides certainty in advance of investment decision making, recognises the value of regulatory settings which facilitate infrastructure development and creates genuine incentives for improved performance.

Accordingly APIA recommends that the Commission support the right to full merit appeal against both the decision to declare (cover) as well as undertakings entered into under Part IIIA (and Access Arrangements under the Code).

APIA strongly supports the timely realignment of industry specific regimes to the Part IIIA principles through a process operating in parallel with development of a revised Part IIIA. This process must be independent of government and existing regulatory agencies. APIA believes that the Productivity Commission is well placed to fulfil this independent review role.

It is essential that the regulatory framework take into account the specific details of the industry concerned. The circumstances faced by the gas transmission sector, set out in section 3 of this submission, include:

- normal private sector requirements to secure capital for new investment;
- an industry that operates unbundled from upstream or downstream interests;
- strong competition between companies at the pre-development phase of pipeline development;
- strong competition between fuels at the project development stage;
- the fact that transmission pipeline customers are very small in number, are very informed buyers and often have (eg producers who are also owners and developers of pipeline assets) more market power than the pipeline companies themselves;
- the marginal nature of many pipeline developments;
- the fact that the Code allows regulators to intervene in virtually all aspects of pipeline activities, leading to substantial regulatory risks and uncertainties for new developments; and
- the availability of rights to bypass existing pipelines and the non-exclusive nature of pipeline licences for new development imposes an important discipline on the pricing behaviour of pipeline companies.

Other major comments on the Proposals contained in the Position Paper are outlined in Section 4 of this Submission.

1. *Introduction and Purpose of Submission*

Position Paper is a welcome first step

The APIA welcomes the Position Paper as an important development in recognising the importance of a National Access Regime that facilitates, and does not hinder, investment in essential infrastructure including gas transmission pipelines.

APIA strongly supports the overall conclusion that regulation of Australia's infrastructure industries, including gas transmission pipelines, must be modified to enhance its benefits and reduce its potential costs. In particular, regulatory arrangements must:

- Avoid promoting competition and lower prices at the expense of necessary investment – otherwise consumers could become worse off over time; and

- Ensure greater emphasis on incentives to invest.

However, APIA believes that more effort needs to be expended to ensure that this review process delivers the desired outcomes for new development activity and effective regulation of existing assets.

APIA cannot support some aspects of the Commission's approach

Notwithstanding the many positive initiatives outlined in the Position Paper, there is a real risk that the final balance in the overall package could lead only to marginal improvements and further concentrate regulatory powers by limiting important appeal rights to the detriment of the legitimate property rights of asset owners and developers. If this were to happen, the overall outcome to the gas transmission industry would be negative, not positive.

APIA stresses the importance of an effective two-stage process:

- To determine whether coverage is justified through judicious application of a test for major, essential infrastructure; and

- For infrastructure that passes the test, an effective regime governing terms and conditions of access that provides certainty in advance of investment decision making, recognises the value of regulatory settings which facilitate infrastructure development and creates genuine incentives for improved performance.

For example, the Commission argues for full merit review of decisions on undertakings (Proposal 9.4), at the same time indicating (albeit as a Tier 2 recommendation) that provisions for appeal against decisions to declare services under Part IIIA should be abolished (Proposal 9.5). APIA urges the Commission to reconsider this policy rationale in view of the consequences for industry specific regimes.

The majority of natural gas transmission pipelines are regulated under a highly intrusive industry specific regime created by the National Third Party Access Code for Natural Gas Pipeline Systems (the Code). This Code already extends well beyond the policy intent of the access regime created under Part IIIA of the Trade Practices Act and represents a set of market rules driven by cost of service regulation.

Until the recent Australian Competition Tribunal decision to reject coverage of the Eastern Gas Pipeline under the Code, policy makers, the NCC and regulators were operating on the presumption that all new major pipelines (and regional pipeline extensions) would in fact become covered (a process which is analogous to a Part IIIA declaration) under the Code. The Tribunal decision has confirmed this not to be the case.

Industry has always argued that the coverage question must be resolved on a case by case basis, taking all the specific circumstances into account. As the situation currently stands, the coverage test (and access to effective appeal mechanisms through the Tribunal) represents an important constraint against inappropriate regulatory intervention (regulatory creep).

Coverage under the Code is a pre-requisite for development of an Access Arrangement (which represents a compulsory undertaking which regulators have interpreted as applying cost of service methodologies to the asset in question).

Against this background the industry strongly supports the Tier 1 recommendation to introduce full merit appeal rights to undertakings under Part IIIA (on the basis that the same policy principle must also apply to Access Arrangements under the Code which have only limited appeal rights). However, the most appropriate means of ensuring that regulatory creep is minimised is to ensure access to full merit appeal of the decision to declare (cover) the asset in the first place.

Accordingly APIA recommends that the Commission support the right to full merit appeal against both the decision to declare (cover) as well as undertakings entered into under Part IIIA (and Access Arrangements under the Code).

The approach recommended by the Commission (notwithstanding the proposals to strengthen the Part IIIA declaration (Code coverage) test as envisaged in the Report), whilst strengthening the ability to appeal undertakings (Access Arrangements), would in fact erode important rights to appeal inappropriate declaration (coverage) decisions made by the NCC.

Industry Specific Regimes (the Code) Need to be Reviewed Urgently

APIA strongly supports the timely realignment of industry specific regimes to the Part IIIA principles through a process operating in parallel with development of a revised Part IIIA. This process must be independent of government and existing regulatory agencies. APIA believes that the Productivity Commission is well placed to fulfil this independent review role.

Whilst the pipeline industry was advised in mid-2000 that both the Minister for Industry, Science and Resources and the Treasurer support, in principle, a review of the Code, there has been no action to date.

The Code was developed with a policy rationale based on Part IIIA of the Trade Practices Act and should therefore be reviewed concurrently with implementation of any changes to Part IIIA itself.

APIA believes that:

- the government should respond to the Part IIIA final report within three months of its completion;

- the review of the Code should be fast-tracked to commence within one month of this response; and

- the review of the Code be completed within six months of its commencement and recommendations implemented without delay.

One of the major problems encountered by asset owners under the Code is that regulators have to date exercised their considerable discretion in a manner that clearly reflects their desire to ensure short term gains to consumers, rather than consider the needs of investors.

Whilst many of the Productivity Commission's recommendations would be valuable in redressing the current lack of focus on new investment, reinvestment and the dubious concept that "new investment" can switch to "old investment", the practical value to this industry will be very limited unless the Productivity Commission also acknowledges the need for an urgent realignment of the Code to the revised Part IIIA principles.

APIA supports NECG submission

The report raises many issues of general regulatory principles that would apply to a wide range of infrastructure (eg public/private; unbundled and vertically integrated; negotiate/arbitrate model vs intrusive industry Codes).

APIA supports the general approach adopted in the whole of infrastructure industry submission made by Network Economics Consulting Group Pty Ltd (NECG). This submission is therefore specific to a number of major concerns of the natural gas transmission sector, reinforcing the need to consider the specifics of the industry concerned in framing the details of access regulation.

The remainder of this submission is divided into five sections
- The importance of objective, declaration (coverage) criteria that are applied transparently and include full merit appeal rights [Section 2]
- The need to consider the specifics of the regulated industry sector in framing the regulatory regime for those projects that are declared (covered) [Section 3]
- APIA's response to the major recommendations contained in the Position Paper [Section 4]
- Requests for further information [Section 5]
- Conclusions [Sections 6]

2. *Core Principle – The Coverage Test and Full Merit Appeal Rights are Essential Elements of the Access Regime*

As indicated in Section 1, the declaration (coverage) test is critical, with effective appeal mechanisms representing an important constraint on inappropriate declaration (coverage). These principles must be preserved and should not be diluted in the interests of expedience.

As an overarching consideration, all access regimes, whether Part IIIA or the Code, should operate on the presumption that detailed regulation would only apply in the event that "market failure" has been clearly demonstrated. In particular, the NCC as the coverage body, should be required to clearly demonstrate (not simply assert) that

market failure has occurred and that regulation is the most effective alternative (ie after the broadest consideration of options) to redress that failure.

The threat of declaration (coverage) represents a very under-valued tool available to regulatory bodies to give market participants the opportunity to ensure no "market failure" in their commercial dealings with customers and potential customers.

Our reading of the decision of the Australian Competition Tribunal in relation to Duke Energy International's recent successful appeal against the Minister's decision (based on advice from the NCC) that the Eastern Gas Pipeline should be covered under the Code leads us to believe that the declaration (coverage) test is essential for all infrastructure classes.

Equally, access to full merit appeal against the Minister's decision should be viewed as the primary mechanism to mitigate against regulatory creep and inappropriate decisions to impose detailed regulation on gas transmission pipelines under the Code.

As noted in the Tribunal's Decision (paragraph 110)

> *"…. regulation is a second best option to competition. The complex nature of the tariff-setting process, the number of assumptions it relies on, and the fact that the reference tariff is a publicly available price which may be varied by negotiation between the pipeline owner and user depending on the user's requirements and conditions in the marketplace, all point to the fact that the reference price is not necessarily the price which would result from competition."*

In the case of the Eastern Gas Pipeline coverage appeal, the Tribunal concluded that coverage of the pipeline will not promote competition in either upstream or downstream markets over the existing voluntary access offered by Duke. The Tribunal (Paragraph 133) said:

> *"The most important factor which underlies that conclusion is our view that EGP does not have, and will not have market power. The arguments advanced by NCC and AGL were largely based upon a contrary assumption as to the existence of market power. The Tribunal is not satisfied that criterion (a) is met either in relation to the pipeline, or in relation to that part of the Pipeline that is south of Canberra."*

The Tribunal concluded (paragraph 116) that whether competition will be promoted by coverage is critically dependent on whether EGP has power in the market for gas transmission which could be used to adversely affect competition in the upstream or downstream markets and that determining this issue required consideration of industry and market judgement on their effects on the promotion of competition. Following consideration of the specific circumstances faced by the EGP, the Tribunal concluded (paragraph 124) that EGP will not have sufficient market power to hinder competition based on the:

- Commercial imperatives it faces;
- Countervailing power of other market participants; and
- Existence of spare pipeline capacity and the competition it faces from the MSP and the Interconnect.

The Tribunal's decision in relation to the EGP reinforces the importance of careful, independent and unbiased consideration of the specific circumstances of the specific details of both the infrastructure sector concerned and the asset in question. Access to merit review imposes an important and desirable discipline on the NCC's decision making process.

Another aspect of the NCC's decision making process which attracted comment in the Tribunal's decision was the unaccountable shift in the Commission's policy between its draft and the final decision: The Tribunal, in commenting on this issue (Paragraph 123) said:

> *"The NCC Draft Recommendation did not conclude that EGP had market power and the Final Recommendation did not explicitly state the reasons for the change between the two reports. In submissions, counsel for NCC accepted that there was no explicit statement of the reasons for the change and the only material the Tribunal had to assess the reasons were the (second round) public submissions received by NCC on the Draft Recommendation. The Tribunal reviewed these submissions which contained the opinions and views of various parties but very little evidence one way or the other. Submissions from two potential users of the EGP on NCC's Draft Recommendation argued for coverage because it would provide greater price certainty. Duke submitted that this says nothing about whether coverage would promote competition and the Tribunal agrees. The Final Recommendation gives some weight to the submission from Woodside, as the developer of the Kipper gas field in Bass Strait, which argued for coverage to enable use of the EGP through a connection at Orbost rather than Longford. The transport of gas from that field is still some years away and access or connection to the EGP has not been sought by Woodside; neither of these factors weigh in favour of immediate coverage of the EGP."*

Against this background, APIA believes that the public benefit of full, independent merit appeal of declaration/coverage decisions based on advice provided by the NCC is beyond any reasonable doubt.

A further concern for the gas transmission sector is the tendency for changes in industry specific regimes (ie the Code) to be progressed without adequate reference to the Competition Principles Agreement or the Part IIIA framework. Recently, APIA proposed that the Code be amended to make it clear that in the event that a Part IIIA undertaking was accepted by the ACCC, the tariff arrangements agreed as part of the undertaking could not be unwound as a result of a subsequent decision to cover the pipeline under the Code. This amendment was brought forward by APIA in order to promote regulatory certainty for pipeline companies who may, over the next two years, wish to bring forward an undertaking under Part IIIA, an option which is within their legal rights given that Part IIIA and the Code operate in parallel. In particular, the Undertaking process described in section 44ZZA of the Trade Practices Act allows a proponent of a new pipeline to achieve regulatory certainty before the investment is made, unlike the Code which does not. The response from the National Gas Pipelines Advisory Committee (NGPAC), on which APIA is represented with no voting rights, was to recommend to Ministers that the amendment be agreed, but only on the condition that in the event that the Part IIIA undertaking was agreed then the pipeline would be automatically covered under the Code.

APIA did not agree this amendment, and the recommendation to Ministers has since been withdrawn. However, this experience reinforces the need for effective mechanisms that ensure not only that industry specific regimes are aligned with the

revised Part IIIA when it is implemented, but also that mechanisms are developed to ensure that the industry specific regime remains aligned to Part IIIA over time.

The current state of play is that the industry still faces considerable uncertainty and regulatory risk resulting from the interaction between Part IIIA undertakings and the risk of subsequent coverage under the Code. On current indications, the pipeline industry is not hopeful that this issue will be addressed expeditiously by the jurisdictional custodians of the Code.

3. *The Gas Transmission Pipeline Industry*

Part IIIA is driven primarily by a range of theoretical economic considerations designed to apply across a wide range of infrastructure assets. APIA strongly supports open, non-discriminatory third party access to gas transmission pipelines. However, we do not support all the elements of the current industry-specific framework which has never been tested, on any objective basis by an independent body such as the Productivity Commission, as to whether or not:

- any genuine "market failure" exists in the gas transmission sector;
- the regulatory regime encourages efficient behaviour;
- the regulatory framework creates disincentives to invest; and
- the costs of regulation outweigh the potential benefits given the specific circumstances faced by the gas transmission sector (eg recognising that any benefits delivered in terms of lower costs are likely to be appropriated by producers rather than being applied to the benefit of end-use customers).

It is increasingly apparent to this industry that very little regard is being given to many of the fundamentals relating to the business environment in which the gas transmission industry operates:

- **Private ownership** of virtually all transmission pipelines and potential pipeline development means that regulators must gain (and apply) a much better understanding of the factors that drive commercial decision making by boards and investors, particularly risk. Otherwise, notwithstanding the many commercial opportunities now being examined, the current pre-development effort will amount to nothing and both the nation and community will suffer.

- **The industry operates unbundled from upstream or downstream interests**; pipeline owners and infrastructure developers have every reason to service the gas haulage needs of existing and potential customers when it is economic to do so because they are driven by high capital costs and their livelihood depends on it.

- **There is strong competition between companies** in pursuing the limited number of competing market opportunities available to developers as evidenced by competing development proposals from supply sources such as Timor Sea and Victorian fields and intense competition between proposals from different basins, eg between the various Victoria-South Australia, Darwin – Moomba and existing Cooper Basin supply sources. Whilst this is recognised in a very narrow and bureaucratic sense through the role of formal "competitive tenders" in the Code, the Code arrangements do not reflect the reality of "market determined" haulage pricing which cannot be reconciled with regulatory attitudes which are based on a very narrow "cost of service" framework.

- **There is strong competition between fuels at the project development stage.** The cost of alternative fuels is a key issue in overall market development. This aspect of inter-fuel competition is always a key business consideration in market development for new pipelines and the prices of existing forms of energy as a countervailing force on the price of gas and pipeline services was a factor in the Tribunal's decision that the Eastern Gas Pipeline south of Canberra should not be covered under the Code. The Tribunal concluded (paragraph 129) that the market definition does not include other forms of energy where gas is well entrenched, but could include it in the long term when gas is used to generate electricity and that:

  > *"In the regional markets other forms of energy warrant consideration because gas is offered as an alternative to existing forms of energy. NCC gave some support to this notion in its Draft Recommendation where it said in deciding whether access to rail tracks will promote competition in the freight market it takes account of road transport. It argued that the notion is not relevant where there are not competing pipelines, but the freight comparison requires that there be competition between energy sources not pipelines."*

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

- **Pipeline developments are very marginal** in the early years of operation with revenues falling far short of costs. The risk of regulatory intervention once the shortfalls of early years of the project's life begin to be recovered (ie as volumes increase) is poorly addressed in the Code because it does not provide for regulatory certainty over the financial life of the project (typically around 20 years). Rather, regulators have adopted much shorter periods as so called "trigger events" where the entire basis for tariff setting are reviewed.

  In addition, the Code introduces strong incentives to size pipelines to today's customers (ie foundation customers), rather than create spare capacity for future development (because regulatory determinations in respect of spare capacity lead to a substantial risk that negotiated foundation contract arrangements would be undermined, to the detriment of revenue streams).

- **The Code has allowed regulators to intervene in virtually all aspects of pipeline activities**, and has extended to areas well beyond the policy intent of Part IIIA which seeks to entrench a right of access, not rate of return regulation as applied under the Code. In Victoria for example, pipeline access regulation has become a vehicle for gas market regulation more generally.

- **The right to bypass** current pipeline systems imposes an important discipline on the pricing behaviour of pipeline companies (see section below).

- **Exclusive rights** are not, contrary to popular belief, bestowed on the holder of a pipeline licence. The securing of a competitive pipeline licence is relatively easy for any party with access to technical expertise (which is readily available in Australia).

Increasingly, the management of regulatory uncertainty has become a primary preoccupation of this industry, with mounting evidence of inappropriate decision

making by both coverage advisory bodies (ie the NCC) and regulators taking up an excessive amount of senior management time.

One area of concern to APIA is the Commission's continuing reliance on a model of the firm based upon instantaneous gratification, certainty and the absence of time or place utility. Figure 3.1 (p 43 of the Commission's report) is repeatedly referred to throughout the Report as the basis for interpreting the behaviour of the regulated entity and the benchmark for assessing efficiency. The analytical model contemplated in Figure 3.1 envisages a hypothetical long run average cost ("LRAC") curve which is defined as the lower envelope of an infinite number of short run average cost ("SRAC") curves. This envelope curve defines the least cost scale (SRAC curve) for producing any given output level. The implication is that each SRAC curve and the LRAC curve are known and that transition from one scale (SRAC) to another is frictionless, costless and instantaneous. Whilst this model perpetuates a convenience of presentation, APIA submits the methodology is entirely inappropriate and misleading when applied to the pipeline industry in Australia in 2001.

The decisions of investors in (and users of) natural gas pipelines are plagued with uncertainty and they traverse extended, and mutually interdependent, time periods. Further, when a pipeline investor contemplates pipeline investment, account must be taken of the fact that the forecast revenue function will shift over time and is never certain and that the transition from one scale to another is not frictionless, costless or instantaneous.

Whilst the rationale underlying Figure 3.1 offers certain salient and practical insights into the decision making process in a monopoly, it bears little relevance to the decision making of infrastructure investors. The pipeline industry relies on well established discounted cash flow ("DCF") methodologies to make critical investment decisions ranging over:

- whether to invest;
- the capacity of any investment;
- service pricing;
- risk;
- origin and destination markets; and
- other relevant investment decisions.

These DCF methodologies entail the forecasting of costs and sales over various demand scenarios and various related scale shifting scenarios (scale shifting scenarios in this sense emphasises the difference between the costless, frictionless and instantaneous moves from one cost curve to another in Figure 3.1 to the real world of defining a finite set of possible technology augmentation paths each of which is constrained by the decisions taken previously, the time taken to implement the scale shift and significant costs of transition) to produce projected revenue and sale outcomes for each period in the investment horizon. These cost and sale functions are then combined with the investor's threshold rate of return on investment and the market's or buyer's "capacity to pay" to produce a tariff.

It is temping to import the language of Figure 3.1 and apply it to this DCF environment but while concepts of LRAC and SRAC and marginal cost and marginal revenue have their analogies in real world applications of DCF models the concepts are, to varying degrees, imprecise. What is patently obvious, however, is that the Figure 3.1 concept (that output level where marginal cost equals marginal revenue is

the investor's optimum investment level) has limited relevance in the long run DCF environment over any particular time frame or in regard to any particular scale. The investor will set prices and install capacity at that level (or proceed down that technology augmentation path) which delivers its threshold return on investment over the investment horizon. The DCF decision described in the Levelised Tariff Model is based upon an assessment of total cost and total revenue over multiple periods. As such, investment decisions in markets with free entry which are based upon this model is as near as the real world gets to adopting the a decision rule based upon LRAC equalling long run average revenue.

The investor will continue to install capacity for so long as the capacity to pay of the marginal user of the asset results in a tariff which is equal to or exceeds the marginal cost (including the investor's threshold rate of return) of meeting the needs of that user. To the extent that market segmentation and price differentiation are effective this process of optimising capacity can be pursued. These capacity decisions impact and are considered over a number of time periods and scales of operation contemporaneously. In an uncertain DCF world, not blessed with the frictionless adjustment mechanisms and instantaneous gratification of Figure 3.1, an investor's decisions are as near to allocatively efficient as can be realistically achieved.

In arriving at its ultimate tariff and capacity decision in regard to any investment the investor will continue to invest until its last investment delivers its required threshold rate of return on investment. To distort this process will by definition distort investment and, provided entry of capital to the industry is not constrained by legislative or commercial barriers to entry, is unwarranted.

The Decision Rule

From this DCF view of the world we can make several key observations regarding the need for, and the effect of, regulation which are not apparent if we take a Figure 3.1 approach. First, when a pipeline investment is made the prospective users of the service can seek competitive bids or make arrangements to provide the service themselves (eg Goldfields and the initial EGP proposal). Clearly this is a competitive environment where the only rent available to a pipeline developer is a return on those of its skills which are not readily available in the market. There is no basis for regulating the provision of such competitively provided services and, provided entry of new investors is not constrained, such regulation will be distortionary.

The Australian pipeline industry stands in sharp contrast with the United States because in Australia anyone can apply for a licence to build and operate a pipeline. There is no requirement to establish the need for the pipeline and a pipeline licence can be sought irrespective of whether a pipeline already serves the same market. In Australia a pipeline investor has the right to a pipeline licence, if it is technically capable to develop and operate the pipeline safely and if it has the necessary funds. Indeed there is a clear tradition in Australia where pipeline users (with no pipeline experience) have entered the market to invest when they formed the view that pipeline investors have not met their commercial and strategic needs.

Contractual Structures

Second, gas pipeline developers and gas pipeline users have fashioned contractual structures which minimise:

- risk by allocating market and cost risk where it can best be managed; and

- the risk that the expected revenue function of the users (in regard to their down stream investments) or the revenue function of pipeline developers will be undermined by subsequent users of the pipeline facility.

Intuitively such arrangements may be judged to be not in the interests of the market. However, it is appropriate to recognise that these contractual arrangements are necessary to warrant investment in essential infrastructure and the dynamic consequences of frustrating their operation far outweigh any potential negative impact. It serves no one in the community if a pipeline developer and pipeline user enter into a service agreement which underwrites the construction of essential infrastructure only to find that a competitor of the pipeline user is granted access to the pipeline on more favourable terms. Such an outcome would undermine the revenue function of the initial pipeline user and eventually undermine the investment of the pipeline developer, but more importantly the risk of such an outcome would preclude the development of the infrastructure. Recognising the necessity of such arrangements is not tantamount to accepting the abuse of such arrangements. This issue of abuse is further discussed below.

Operating in the Short Term

It is one thing to accept that at the time investments in pipeline capacity are made the unfettered right of investors to compete will ensure that the price paid for pipeline services, and the level of service, will approach, as far as the real world can, an allocatively efficient outcome. It is another thing however to argue that the allocation of installed but uncommitted or developable pipeline capacity, will always be efficient. Nor, however, can it be argued that the pricing and allocation of this capacity is innately anti-competitive.

Pipeline investment, by definition, is capital intensive and the economics of any given investment is critically tied to capacity utilisation. Provided therefore that a pipeline investor:

- does not stand to gain from restricting the size of down stream markets; and
- does not undermine the stability of its existing contracts by selling capacity to competitors of its existing counter parties at discounted prices,

it will be in the interests of the investor to maximise utilisation of its existing capacity (by increased capacity utilisation) and its sunk cost (by capacity expansion).

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

Capacity to Pay

One aspect of the current regulatory environment is that the market is denied vital information regarding the value of pipeline services to pipeline users. In a contractual environment the user of a pipeline and the pipeline service provider negotiate an access arrangement at a level which lies between the buyer's capacity to pay and the service provider's underlying costs. The parties to this negotiation send significant signals to the market regarding the cost and value of pipeline services.

In the current regulatory environment the regulator stands in for the user and "negotiates" the terms of access in an approved access arrangement. The problem

is that the regulator has no capacity to pay and is motivated to drive the terms of access down to the cost of providing the service. Even if the regulator had a good insight into these costs, and it does not, the market is deprived of any insight into the value of pipeline service to the market. As such the regulated outcome is prone to produce the under provision of services.
In conclusion, whilst pipeline companies are fully aware of the complexities brought about by these real life situations, their significance and relevance has totally eluded the practitioners of the Code, who rely on theory, rather than reality, as the basis for their determinations.

4. *Comments on key recommendations*

As noted above, the final form of the reform "package" will be important for infrastructure developers to determine their positions on specific recommendations. APIA requests that the Commission keep this in mind when considering the following comments. The Association will review its position in light of the balance in the final package of recommendations made by the Commission to Government.

Proposal 5.1 (Inclusion of objects clause)

The proposal to include an objects clause that acts as a statement of purpose for the National Access Regime is strongly supported. There are a variety of views among those that operate within the Regime about its purpose. This variety of views, combined with the multiple industry specific regimes, can lead to that purpose being lost.

The objects clause proposed by the Commission is also strongly supported. It reflects the nature of essential infrastructure and the benefits it provides to the community. These benefits are maximised when efficient investment is promoted and available on an efficient basis.

Under point (b), APIA welcomes the proposal to link the Part IIIA objects clause with industry specific regimes. This could best be done by incorporating the Part IIIA objects clause into those regimes.

Proposal 5.2 (Vertically and non-vertically integrated services)

APIA acknowledges that the scope of Part IIIA needs to cover both vertically integrated and non-vertically integrated services. Transmission pipelines are generally not vertically integrated. However, the nature of the declaration and coverage tests should give explicit recognition to the degree of structural separation as a factor in determining whether declaration or coverage is necessary. In addition, the extent to which the facility is a true "bottleneck" should be taken into account, entailing examination of the nature of any upstream or downstream interests which a facility owner may have.

Proposal 5.3 (Inclusion of pricing principles in Part IIIA)

This proposal is strongly supported. The current lack of pricing principles in Part IIIA has created a key element of uncertainty (and therefore risk) for investors in pipeline infrastructure. The establishment of principles, which are consistently applied through to industry-specific regimes such as the Code, is essential to significantly reduce that uncertainty. The principles themselves (covered under Proposal 8.1) will need to be sufficiently high level to permit appropriate realignment of industry specific pricing principles, but will also have to be sufficiently detailed to remove the current

high level of regulatory discretion which has led to uncertainty for pipeline investment.

Proposal 6.1 (Modification of Part IIIA declaration criteria)

APIA supports an immediate strengthening of criteria for the applicability of the tests for declaration and coverage such as those proposed by the Commission. Whilst noting that there may be alternative formulations of the criteria other than those set out in Proposal 6.1, APIA nevertheless wholeheartedly endorses the concept of strengthening the declaration criteria based on the guiding principle that there must be clear evidence of market failure before any affirmative decision on declaration is made.

Proposal 6.2 (Criteria for declaration)

APIA supports the proposal for further declaration criteria and recommends that it be viewed as a Tier I issue, and not Tier 2 as outlined in the Position Paper.

Adoption of this proposal, and its application to the Code, would provide immediate benefits by advancing "greenfield" pipeline projects of a "marginal" nature – that is where the project risks do not balance the prospective returns.

The criteria proposed for Part IIIA must have as their overriding objective the demonstration of the net benefits of regulation and Proposal 6.2 is clearly moving in this direction.

With regard to proposed criterion (c) in relation to competition in downstream markets, APIA notes that the role of energy substitutes has been substantially underestimated by regulatory decision makers in their development of concepts for assessing potential market power in relation to new pipeline development in Australia.

Proposal 6.3 (Requirements to give sufficient information)

APIA agrees with this recommendation. It is essential for a balanced negotiation between an infrastructure service provider and an access seeker that there be sufficient information available to the access seeker. However, APIA questions whether in many cases the real effect of information provision is to facilitate the parties to "engage in effective negotiation". The proposal appears to assume that information asymmetry is the norm, whereas there are groups of market participants who have access to a formidable amount of technical and market information relevant to pipelines. Such groups include for example major gas producers who also act as significant gas wholesalers. These groups are major owners and developers of pipelines in their own right and are more than adequately informed about the markets into which they are selling and gas transportation costs. APIA questions whether it can be seriously contended that such participants lack relevant information. Indeed, buyers of pipeline services may have more market power than the pipeline company. Thus, while information requirements specified under Part IIIA may appear significant, they may be marginal depending on the specifics of the market concerned.

Proposals 6.4 to 7.2

APIA notes that these proposals do not impact directly on the gas transmission sector.

Proposal 7.3 (Effectiveness principles should be in Part IIIA)

The incorporation of effectiveness principles into Part IIIA is recommended as a Tier 2 issue; however, APIA would question both the terms of the recommendation itself and its Tier 2 status.

It is proposed that the effectiveness principles will be "used to assess the effectiveness of existing access regimes". However, what APIA seeks is effective *amendment* of those regimes to accord with the recommended changes to Part IIIA. For the Commission's recommendation to work properly, it is imperative that a clear path exists to amend all existing regimes in accordance with the revised Part IIIA principles. In addition, the revised Part IIIA will set the principles for assessing any new access regimes. APIA agrees with the Commission's comments on page 174-5 of the Position Paper:

"The inclusion of the criteria for all access routes within one document would increase the standing of Part IIIA as an access framework and foster greater congruence in outcomes under the various access routes. Such alignment would also make assessments of effectiveness less dependent on the regulator's discretion."

Thus APIA agrees with the Commission's intent to align the criteria used for assessing existing and new regimes with any revised Part IIIA criteria, particularly as a very significant proportion of existing access regimes are being implemented by State and Territory regulators. Because of its wide-reaching implications, Proposal 7.3 should be Tier 1.

If it is accepted – as APIA urges – that there must be potentially significant changes to existing State and Territory regimes, then these changes must be implemented through meaningful revisions to the overarching Part IIIA access regime. While it is noted that the Terms of Reference for the Inquiry state that there is no intention to revisit past certifications, it is essential that the industry-specific regimes be reviewed to ensure they meet what is proposed for future certification of regimes. In October 2000, the Treasurer and the Minister for Industry, Science and Resources signalled their support for a review of the Code following the Commission's review of the National Access Regime. APIA is of the view that this is the appropriate mechanism for making the Code consistent with the findings of the current review along with any consequent changes to Part IIIA itself, and urges a strong recommendation from the Commission in this regard.

Proposal 7.4 (Criteria for effectiveness)

APIA views Proposal 7.4 as an important issue which should be Tier 1, not Tier 2 (consistent with other comments made above) if this review of Part IIIA is to have a significant impact on the framework for access to essential infrastructure across Australia. For Part IIIA to be fully effective the certification criteria included in Part IIIA should be designed to embody all the principles to be applied to infrastructure that becomes regulated directly under Part IIIA. As a result the proposed criteria may not be sufficient. In order for the criteria to be consistent with the other terms of Part IIIA, each of them must be matched to those relating to the other elements of Part IIIA. That is, the objects clause for certification of an access regime should be consistent with the objects clause in Part IIIA. Similarly, the coverage criteria for an access regime should be consistent with the declaration criteria. The same approach to consistency should be applied to each of the other criteria proposed.

Finding 7.1 (Owners of infrastructure potentially covered by industry specific regime should be able to retain ability to lodge Part IIIA undertaking)

APIA considers that this finding should be elevated to a Tier 1 recommendation, recognising the need to remove the potential "double jeopardy" of infrastructure coverage under both Part IIIA and an industry-specific regime. Recent gas industry experience has highlighted this risk. It is possible that a pipeline may be covered under Part IIIA through a voluntary Access Undertaking and subsequently become covered under the Code (resulting in a risk that arrangements agreed in the undertaking could be over-ridden as a result of Code processes relating to the setting of reference tariffs etc). In an attempt to remove this "double jeopardy" APIA sought a Code amendment which would mean that if an Access Undertaking under Part IIIA was agreed, it could not be overridden if the pipeline were to become covered under the Code. However, as referred to elsewhere in this submission, this rational outcome was not agreed because of the view of NGPAC that approval of an undertaking should result in automatic coverage under the Code. APIA did not agree this position in view of the importance we attach to the coverage test as a mechanism to avoid regulatory creep. We understand that NGPAC's recommended Code change to Ministers will be withdrawn, but our overarching issue of "double jeopardy" remains a primary concern to potential investors which has not been addressed.

Proposal 8.1 (Pricing Principles)

APIA acknowledges and agrees with the intent behind the specific pricing principles as put forward by the Commission in Proposal 8.1, particularly the focus on investment returns commensurate with risks. Nevertheless, APIA believes the principles will need to be extended further to adequately address the whole issue of investment risk and regulatory uncertainty, which remains the point of major concern for investors in pipelines and other infrastructure.

With regard to the proposal in 8.1 that revenues must at least cover "efficient long run costs", APIA notes that the NECG submission (in section 4.2) raises a number of concerns with this formulation. NECG notes, among other points, that the term "efficient long run costs" is ambiguous and could mean either forecast costs or even bear no relation at all to actual costs. As an example of the latter, APIA notes that it is possible that the regulatory process may simply "deem" certain costs to be "efficient" which could then invite a regulator to cap costs unnecessarily in the long run.

This industry's primary concern rests with the practical problems and disincentives to investment contained in the details of the price control system imposed under the Code.

Proposal 9.1 (Remove decision making role of Ministers)

APIA views this proposal as a major concern. Ministers have an important role in providing an independent check on the regulator's recommendations. This is recognised as desirable to avoid "regulatory creep". If designated regulatory bodies were to be given this role, the removal of Ministerial involvement would have to be accompanied by full merit appeal rights. Further, the removal of Ministerial involvement would have significant implications for industry specific regimes such as the Code which were designed with the specific objective of ensuring Ministerial consideration of recommendations brought forward by an advisory committee

(NGPAC) which includes regulatory representatives. The removal of Ministerial involvement would increase the influence of regulators in the Code change process and this is undesirable. It is also essential that Ministers continue to be key decision-makers on changes to access regimes such as the Code to avoid de-facto changes to the law by non-elected government officials.

Proposal 9.2 (ACCC given role of regulating all aspects of Part IIIA)

This is an important issue which is critical to the overall regulatory environment. APIA strongly disagrees with the proposal. APIA notes the response by NECG in section 6.2 of their submission, which argues for retention of the current system of checks and balances contained in Part IIIA through separation of the policy and regulatory functions required under the National Access Regime. In order to protect the integrity of access regulation, it is important that the roles of determining:

(a) if access is regulated; and

(b) the terms and conditions of that access

be in the hands of completely separate bodies who also operate independently from each other.

Proposal 9.3 (Time limit on Ministerial decisions on declarations)

APIA supports the proposal to maintain effective timelines on Ministerial decisions. The timeliness of decisions is an important part of effective government and is often a critical element in investment decisions. It is not unreasonable that Ministers with the support available from their departments and advisers maintain the disciplines of timelines in the same way that the organisations which regulate organisations are required to.

Proposal 9.4 (Full merit review on undertakings)

APIA strongly agrees with the proposal for full merit review by the Australian Competition Tribunal of decisions on undertaking applications.

The role of appeals is a fundamental requirement for infrastructure owners. The possibility of appeal of a regulator's decision is a key element in ensuring the reasonableness of regulatory decisions. Appeals are an important element of judicial and administrative decision making that is integral to Australian public administration. There are a number of reasons why merit reviews should be part of the Access Regime, and not only in relation to undertaking decisions:

- The matters being decided by regulators are important and have a significant impact on investors as well as access seekers;

- It is Australian practice that judicial decisions may be reviewed on a wide range of matters. Similarly for many types of administrative decisions review is available at least on their merits, and often on other matters as well. It is therefore appropriate that regulatory decisions can be reviewed on their merits as well as for other matters such as correct process;

- Significant decisions by the ACCC under the Trade Practice Act are subject to review;

- There is always the possibility of poor decisions and these should be capable of correction through review (eg as in the case of the NCC recommendation adopted by the Minister on coverage of the EGP); and

- The Competition Principles Agreement provides for review of the decisions of a tariff.

Proposal 9.5 (Abolish appeals against decisions to declare services)

As detailed elsewhere in this submission, APIA strongly disagrees with the proposal to abolish provision for appeals against declaration decisions. The discussion in relation to Proposal 9.4 strengthens the arguments in support of the importance of appeal rights in the National Access Regime. The major ground for opposition to appeal rights on grounds of delay is not valid (eg the time taken for the EGP coverage appeal was not unreasonable) and, even if delays were an issue, this should not override considerations of due process.

Proposal 9.6 (Public comment on applications for declaration and certification)

APIA agrees with this proposal and suggests that it would also be appropriate for draft decisions on certification recommendations to be circulated for public comment.

Proposals 9.7 – 10.1

While agreeing with these proposals, APIA has no specific comments to make.

5. *Requests for additional information*

(a) Costs of administration

The actual cost of regulation is significant, with the direct cost to industry of developing Access Arrangements to date amounting to well over $10 million. The cost of regulation per event increases dramatically when appeals are triggered, although there is scope for appeal bodies such as the Tribunal to award costs.

For major, mature pipeline systems the amount, expressed in cents/GJ gas hauled (as regulators invariably do), does not appear to be excessive. It must be emphasised, however, that the cost of ongoing regulation is also significant, particularly given the tendency of regulators seeking to become involved in the day-to-day business activities of transmission pipeline operators.

The perception by the Productivity Commission that much of the cost would be otherwise expended in the course of negotiation is not necessarily the case. Often, industry is faced with regulatory scrutiny of negotiated outcomes and therefore pays additional costs for regulation. It would be of benefit to industry if the regulator were to adopt an approach where negotiated outcomes were simply accepted as having met a particular threshold. This is a further reflection of the view that regulation should only occur in circumstances of demonstrated market failure.

The cost in developing and implementing Access Arrangements for small transmission systems is considerable and in many cases are likely to represent a disproportionate cost because of small customer numbers and/or small throughput

volumes; in the case of the Cental West Pipeline the Access Arrangement development cost amounted to around $300,000 (representing a disproportionate impost given the exceedingly small volumes of gas currently hauled).

More fundamentally, the real cost will only be felt in the longer term as the industry begins to make decisions not to invest or re-invest because of regulatory uncertainty (eg resulting from the current inability to gain binding rulings ahead of investment) and/or inability to meet unacceptably low hurdle rates imposed by regulators purporting to act on behalf of the market.

WA Issues of Cost

In Western Australia, gas pipeline owners pay all standing and service charges for the gas access regulator, which although it regulates a specific industry regime, is still part of the national access regime. Whilst the benefit of this arrangement is that there is minimal impact on state funds, as Western Australia has opted to have its own regulator (OffGAR) rather than the ACCC, gas consumers pay a "stealth tax" in the form of higher charges for delivered gas.

The way that OffGAR is funded has been of serious concern to many in the gas pipeline industry since its inception. While pipeliners fund all activities of the regulator, they have no influence on the efficient timing of regulatory decisions, nor the reasonableness of methodology and costs associated with the decision making process. Whilst it is proper for the regulator to remain independent, it is not right that the regulator should have no accountability for the way in which costs are accrued. The question of who might pay costs associated with litigation is also unresolved. Recently Epic Energy was advised of costs incurred by a consultant to consider the decision for the DBNGP, owing to unavailability of OffGAR core staff. However, the decision has been further delayed as that staff member is now released from other obligations and requires time to review the DBNGP decision, further adding to time, cost and process inefficiency. There is a pipeline industry view that proper transparent public funding of the regulator will lead to greater accountability and more efficient use of resources than the current method.

(b) Specific impacts of access regulation on investment

The current debate within the industry is driven by assertion and counter-assertion about whether the Code has acted as a disincentive to pipeline investment.

Regulators, major customers (eg producers) and a number of policy makers in government assert that the considerable number of competing pipeline proposals now under development provides evidence that the industry is willing to invest under the environment created by the Code. The pipeline industry, on the other hand, has pointed out that no transmission pipelines have actually been constructed under the Code and the majority of development proposals are contingent on the regulatory arrangements that will apply.

In considering this issue due weight must be given to the views of the investment community who will have the final say on financing for many of the projects now under development. In this context Hastings Funds Management has stated categorically that the gas pipeline sector is currently unattractive (for investment) due to sovereign and regulatory risk (Mike Fitzpatrick, Managing Director, Hastings Funds Management Ltd, APIA Pipeline Development Forum, 27 July 2000). Other investors have expressed the same sentiment publicly.

APIA is not aware of any specific major gas transmission pipelines that have been abandoned as a direct result of the Code - yet. APIA emphasises that the lead-time for commercial developments is typically several years and that it is too early to make definitive statements about outcomes from the current regime. However, the current situation cannot be taken to be evidence that the Code is operating to the benefit of new development and we are not aware of any major developments actually constructed under the Code.

The evidence to date relates to deferrals (eg the Central West Pipeline where regulatory uncertainty was certainly a factor), the incremental nature of system augmentation to minimise regulatory risk which would result from uncommitted new capacity (eg recent looping of the Moomba - Adelaide pipeline) and the unacceptable situation faced by pipeline developers in taking new development proposals to Boards (which on current indications on the operation of the Code will lead to pipelines sized to accommodate foundation contracts negotiated with customers, rather than creation of the "spare" capacity needed to meet longer term growth).

In relation to the Tasmanian Gas Project due to commence construction towards the end of this year, it is worth noting that the pipeline is not covered under the Code; Duke Energy International has asserted that management of regulatory risk on this pipeline will be one of its overriding concerns as the project proceeds.

(c) Methodologies for valuing assets

Regulatory outcomes in Australia have emphasised the return on equity because they believe in the "causal link" between the weighted average cost of capital (WACC) and the value of the company. The problem is that there is no such causal link.

The fact is that WACC is no more and no less than the name implies – it is the weighted average costs of funds on an enterprise and there is no causal relationship between the value of a project and its proponent's WACC or of a developer and its WACC. Nor is WACC, by any economic decree, an appropriate hurdle rate for new investment. Indeed, most company directors would admit that if they set the hurdle rate for new investment at the WACC they would be in serious trouble, because the average returns earned by companies on their project investment portfolios seldom equals or exceeds the average of the returns which were forecast at the time those investments were submitted for board approval.

The problem is that pipeline regulation, which set out to ensure that anti-competitive behaviour did not constrain economic growth, has become little more than price regulation. The spectre of anti-competitive behaviour no longer comes from the industry, but from regulatory structures and attitudes which are both rigid and market insensitive.

If, as evidenced in current trends, regulation forces a pipeline company to equate its hurdle rate for new investments and its WACC, it will force the pipeline company to change its approach to evaluating projects and project risk.

There is a real risk that pipeline companies will be forced to sharply differentiate their decision to invest in pipeline projects from their decision to invest in other (eg non-regulated) assets. This represents the most plausible outcome if, as at present:

- Pipeline companies are forced to change the way they assess investments in regulated assets relative to their assessment of other investments; and

- At the same time, the ACCC, continues to do all that it can under the discretions available to it under the Code to confiscate any equity created by pipeline companies, but which is not measured as part of the replacement cost of the company's assets.

6. Conclusions

In conclusion, this submission supports the overall conclusion that regulation of Australia's infrastructure industries, including gas transmission pipelines, must be modified to enhance its benefits, reduce potential costs and create a framework that encourages new investment.

APIA believes that more effort needs to be expended to ensure that the Part IIIA review process delivers the desired outcomes for new development activity and effective regulatory outcomes.

Whilst many of the recommendations of the Position Paper are supported by APIA, others are not. APIA's commentary on the package of recommendations and the specifics of the gas transmission industry are designed to assist the deliberations of the Commission in reaching an appropriate balance in the final recommendations to Government.

In practice, implementation of reform proposals to Part IIIA of the Trade Practices Act must also address the need to realign industry specific regimes such as the gas pipeline access Code. This process must be independent of government and existing regulatory agencies and needs to be progressed in parallel with implementation of changes to Part IIIA itself.