



The Australian Gas Association

Submission to the Productivity Commission

***Inquiry into Clause 6 of the Competition
Principles Agreement and Part IIIA of the
Trade Practices Act 1974***

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National Office

Level 3, 40 Blackall Street, Barton ACT 2600
GPO Box 323, Canberra ACT 2601
Telephone: +61 2 6272 1555 Facsimile: +61 2 6272 1566
Email: canberra@gas.asn.au Website: www.gas.asn.au

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EXECUTIVE SUMMARY

The Australian Gas Association (AGA) welcomes the Productivity Commission's inquiry into the adequacy of Part IIIA of the *Trade Practices Act* ('Part IIIA') and Clause 6 of the *Competition Principles Agreement* ('Clause 6'), as it enables the natural gas industry to highlight some key improvements that can be made to the architecture of competition policy as it relates to the infrastructure sector. The Productivity Commission inquiry also provides a wider policy context to debate the direction of access and pricing regulation. In recent years this debate has tended to be conducted between industry and regulators and only in the context of specific regulatory determinations.

The National Third Party Access Code for Natural Gas Pipeline Systems ('the Code') which governs the transmission and distribution sectors of the natural gas industry is an example of an industry-specific regime developed under Part IIIA as it currently stands. As such, AGA believes its operation contains important lessons for the future of access regulation in Australia.

The AGA would contend that the incorporation of clearer principles, particularly access pricing principles, into Part IIIA has the potential to improve the quality and consistency of regulatory outcomes. The development of principles which regulators may use as a guide may also assist regulators in arriving at appropriate decisions that will shape infrastructure development in the decades to come. The appropriate balance that must be struck between the equally legitimate interests of consumers and asset owners is one key area in which access pricing principles could be of assistance. The need to balance providing incentives for long-term investment and asset replacement, with providing competitive prices for end users is a related but equally important area.

Since the inception of the Code three years ago, and the introduction of Part IIIA which preceded it, the regulatory framework has in many instances led to outcomes that have:

- damaged investor certainty;
- delayed project start dates;
- discouraged enhancement of existing gas infrastructure;
- curtailed the potential benefits flowing to end consumers from having greater choice in energy provision; and
- imposed onerous regulatory costs

These deficiencies illustrate that regulatory frameworks applying to infrastructure assets need to remain flexible in order to deal with evolving market realities. This is especially relevant in the Australian context with a comparatively underdeveloped national gas market that is characterised by the need to encourage large-scale greenfields investments. The AGA considers that in the design and administration of the regulatory regime both policymakers and regulators have in many instances failed to recognise these circumstances.

The AGA believes the current regime should not be regarded as immutable and therefore welcomes the opportunity of the Productivity Commission inquiry as a necessary precursor to legislative and policy adjustments. The nature of these suggested adjustments are outlined below, as well as in the body of this submission. We request they are considered by the Commission alongside the views of other asset infrastructure owners whom also submit to the process.

AGA RECOMMENDATIONS

Part IIIA and Clause 6 of the Competition Principles Agreement should include principles to referring to the need to promote market development through ensuring adequate returns on investment for infrastructure owners.

Part IIIA should include access pricing principles that reflect that community benefits from the provision of infrastructure are maximised where access pricing recognises the need for ongoing investment in infrastructure assets.

Consideration of the future regulatory framework for infrastructure projects should include specific provisions recognising the need to encourage new developments.

Access regulation should not apply in circumstances where new infrastructure does not clearly meet “national significance” criteria.

Regulatory periods should be assessed on the basis of the need for assets to earn adequate returns over the life of the project

Access holidays to be considered as a potentially attractive means of encouraging new, nationally significant, infrastructure.

Part IIIA and Clause 6 should include principles recognising that the costs of information requirements on infrastructure operators need to be clearly justified by the need to prevent the exploitation of a natural monopoly position.

Future regulatory arrangements should be made with a view to reducing regulatory costs and delays for infrastructure operators.

Consideration to be given to adequate resourcing of regulatory bodies.

Principles for Part IIIA and Clause 6 of the Competition Principles Agreement should address the need for more flexible periods over which businesses and consumers can fairly benefit from efficiency improvements.

Enhanced treatment of decisions regarding maintenance and replacement of existing infrastructure, which should provide for regulatory certainty and an opportunity to make returns commensurate with risk.

Further consideration should be given to the optimum number of, and roles for, infrastructure regulators, in the context of improving the consistency and quality of regulatory outcomes.

Competing pipelines should not be covered under the Code. Specific guidelines need to be developed under Part IIIA to determine the level of competition in such circumstances.

All sectors of the gas supply chain should be subject to market pressures recognising that in the upstream sector the key driver of competition is creating the market and regulatory preconditions for greater interconnection of high pressure transmission pipelines.

1. BACKGROUND

1.1 Introduction – The Role of the Australian Gas Association

The Australian Gas Association (AGA) encompasses all sectors of Australia's natural gas industry – including gas network owners/operators, gas retailers, pipeliners, manufacturers of gas appliances and equipment, gas producers and exporters of liquefied natural gas (LNG).

Of these sectors our core membership are the owners of the gas distribution networks and high pressure pipelines which reticulate and transport gas to the cities, towns and regional areas of Australia. The AGA estimates the capital value of this infrastructure at approximately \$24 billion, with potential investment of another \$6 billion over the next 5 years. In compiling this submission it is the perspective of the distribution or network sector that has been reflected in the comments on the regulatory regime.

As has been well-documented gas distribution and transmission has undergone significant regulatory and ownership changes over the past five years. This process has seen a shift from a small number of mostly government owned entities transporting and distributing gas within unconnected state based markets. Today's picture is very different with the dominance of privately owned high pressure pipeline and distribution companies which in turn provide gas to an increasing array of 'ring fenced' gas an energy retailers.

Over the period the South Eastern Australian gas markets have moved towards greater interconnection leading to the prospect of basin on basin competition. The most notable developments include the interconnect between NSW and Victoria at Culcairn and the recently completed Eastern Gas Pipeline between Longford and Sydney. In the longer term, and provided both the economic and regulatory conditions allow, the major Eastern seaboard markets of Sydney, Melbourne and South East Queensland may have access to gas flowing south from the Timor Sea and/or Papua New Guinea.

In the context of this major expansion of gas service infrastructure it is the view of the AGA that the associated regulated regime has struggled to remain relevant and in many circumstances adds to the investment uncertainty of very risk sensitive greenfields projects. This submission will develop our position and articulate specific improvements to the regulatory structure to enhance both the expansion of the industry and the benefits flowing to end consumers of gas.

1.2 Industry Overview and Outlook for Growth

Australia's natural gas industry is a large and diverse energy supply industry. The natural gas industry is a major contributor to both the domestic economy, through the efficient supply of clean and abundant energy to Australian businesses and households, as well as being a major foreign trade income earner through the export of LNG

Estimated recoverable reserves of natural gas (as at December 1998) stood at around 109,000 petajoules (PJ), equivalent to over 90 years of supply. In addition, Australia has huge reserves of coal seam methane gas which are only just starting to be utilised.

Production of natural gas in Australia is around 1200PJ annually from fields in the Gippsland Basin, the Bass Strait, the North West Shelf, Cooper Basin, Eromanga Basin and a number of other basins in central Queensland, and the Otway region.

Natural gas' share of primary energy consumed in Australia is around 18 percent compared with Oil (35%), Black Coal (28%), Brown Coal (13%) and renewables (6%). The major uses of natural gas are for industrial purposes (especially in chemicals and minerals processing), electricity generation, and residential and commercial water and space heating applications. More recently the transport sector has emerged as a potentially significant market for natural gas in the future.

Australia's natural gas transmission and distribution networks continue to expand throughout regional and urban Australia, reaching a total of 87,680 km in mid 1999. Both networks are likely to continue to grow as new projects currently in planning and development begin to be constructed.

The expanding transmission and distribution networks have allowed the natural gas industry to gain approximately 3.1 million customers throughout Australia, comprising over 3 million residences (approximately 6 million people) and around 90,000 businesses.

In late 1999 the AGA released the Gas Industry Development Strategy 2000-2005 which provided a detailed blueprint for the industry' expansion and nominated specific growth targets which are attainable by the gas sector. These projections were based on the work of the National Institute of Economic and Industry Research.

In summary they confirmed strong growth prospects for the industry with a potential annual growth rate in gas consumption of 4.1% up to 2014-15. At that time natural gas may have the second largest share of primary energy consumption within Australia at 26.4%. In volume terms this implied consumption growth of 854.8 PJ between the base year of 1996-97 and 2014-15.

In considering these projections which could lead to a doubling of the current market size the AGA declared several important caveats.

Achieving this level will only occur if a conjunction of policies which assist gas market growth are realised. These policies, relate to areas including the environment, regulatory issues, taxation and the regional development priorities of government.

Since 1999 the industry has developed more serious concerns regarding the manner in which regulatory oversight at both the Commonwealth and State level may have mitigated or delayed the building of both transmission and distribution infrastructure. This in turn has placed at some risk our earlier growth projections. In this regard the AGA is optimistic that the report of the Productivity Commission may be able to highlight the key concerns of industry in the context of the operation of both Part IIIA and its linkages to the Code.

2. GAS INDUSTRY REGULATION

2.1 Brief History of Gas Regulation

Australia's natural gas industry was until the 1990s dominated by state markets. Monopolies operated in the production, transmission, distribution and retailing sectors. The gas supply chain was highly integrated with legislative and regulatory barriers restricting the interconnection of the States' pipeline systems and thereby interstate trading in natural gas. This traditional structure perpetuated low levels of competition between different sources of natural gas

Throughout the 1990s there was a growing recognition that significant reform was needed in Australia's infrastructure sector. This need arose from a judgement that the sector was unresponsive to potential economic shocks. It was also considered that the infrastructure sector could make a better contribution to general economic performance if it was operated by the private sector, under an efficient regime that promoted competition (especially in the areas that had natural monopoly characteristics).

Privatisation was also driven by a desire on the part of States and Territories to refocus resources on core government functions (e.g. health and education) rather than expending public resources on the management and operation of utilities. Competition policy reform was seen as an essential to the emergence of a vibrant, competitive, private sector driven infrastructure sector.

In the context of gas market reform, reforms were designed to deliver the balanced outcome of free and fair trade in natural gas and encouraging the expansion of the gas supply industry. Commonwealth, State and Territory regulators and governments must recognize this context for gas market reforms, and where possible, reflect it in their decision making.

In February 1994 the Council of Australian Governments (CoAG) agreed to take steps aimed at stimulating competition and achieving 'free and fair trade in natural gas'. This commitment had the goals of:

- removing policy and regulatory impediments to competition in the natural gas sector;
- removing restrictions on interstate trade in natural gas; and
- developing a nationally integrated and competitive natural gas market by establishing a national regulatory scheme for third party access to natural gas pipelines and thereby facilitate investment in exploration and development, and the interconnection of gas pipelines

A combined industry/government forum, the Gas Reform Task Force, later renamed the Gas Reform Implementation Group (GRIG), was formed to developing a policy framework that achieved these aims. GRIG focussed on measures to enhance competition in the downstream sector of the gas supply chain, including gas

transmission, distribution and retailing. Following two years of work, GRIG developed a uniform national regulatory framework to govern third party access to natural gas pipeline systems for the consideration of governments.

The regulatory framework developed by the GRIG was endorsed by the Commonwealth and all State and Territory governments in the form of the *Natural Gas Pipelines Access Agreement*, signed by the Prime Minister, Premiers and Chief Ministers on 7 November 1997.

Upstream reform has been recognised as an essential component of long-term market reform in the natural gas industry. Work on upstream reform issues has taken a different path than the code based access regime that currently exists for the gas transmission and distribution sectors. This different approach is also illustrated by the specific exclusion of production facilities from coverage under the Part IIIA provisions of the *Trade Practices Act 1974*. In part, this different approach was due to an assessment that immediate benefits from market reform could most easily be captured by initially focussing on the gas transmission and distribution sectors. Thus, it was not until 1998 that the high-level Upstream Issues Working Group (UIWG) was formed to consider reform issues with representative from all jurisdictions, industry, the Australian Competition and Consumer Commission (ACCC) and the National Competition Council (NCC).

The UIWG subsequently delivered a report on the implications of current approaches to upstream competition on competition downstream, and identifying options, costs and benefits associated with these issues to the Prime Minister and ANZMEC Ministers. The report identified three main issues for upstream reform, joint versus separate marketing arrangements, acreage management policies and third party access to upstream facilities (including gas processing plants and gathering lines) in the light of Part IIIA of the *Trade Practices Act 1974*. The report made a number of recommendations. The most significant of these was that a set of best practice principles should be developed to be brought to Ministers for endorsement so as to aid the process of determining third party access to upstream facilities on reasonable terms and conditions. The effectiveness of these best practice principles will then be reviewed in two years (in 2001).

2.2 Guide to Legislative and Regulatory Frameworks in the Gas Industry

Regulation of the gas transmission and distribution sectors of the natural gas industry largely flows from the elements of the *Natural Gas Pipeline Access Agreement*. These elements include:

- a political agreement and commitments to implementation;
- **Gas Pipelines Access Act (SA) 1997**: South Australia's lead legislation, containing the Code;
- **Gas Pipeline Access Act (Cth) 1998**: Applying the terms of the Code to the Sydney to Moomba pipeline and in offshore waters under Commonwealth jurisdiction

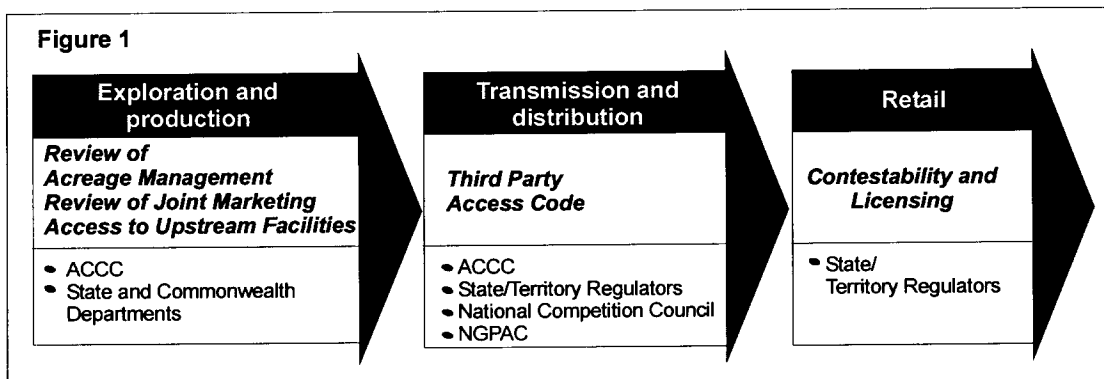
- Timetables for the phasing in of ‘contestability’ for designated customer classes
- Schedule identifying Code bodies to perform responsibilities under the access regime in each State and Territory

The third party access regime for natural gas pipelines is given legal effect by South Australia acting as the lead legislator and all other States and Territories applying the lead legislation. The Commonwealth’s legislation ensures the access regime applies to offshore waters and interstate pipelines.

This approach is designed to maintain the uniformity and integrity of the national access regime across all States and Territories. When the lead legislation is changed, the intention is that the *Gas Pipeline Access Law* (which includes the Code) will automatically change in all States and Territories.

Roles of Regulatory Bodies for the Natural Gas Industry

The Commonwealth’s gas access legislation defines the roles of the ACCC and NCC under the access regime. Figure 1 is an illustration of the regulatory bodies and their coverage of the gas supply chain.



The NCC is responsible for assessing States and Territories access regimes and for making recommendations on effectiveness of these regimes to the Minister under Part IIIA of the *Trade Practices Act 1974*. The NCC is also responsible for advising Ministers on whether a pipeline should be subject to the Code.

The ACCC is the national regulator for transmission pipelines in all States and Territories, except in Western Australia, which has its own State-based regulator. State and Territory based independent regulators regulate all distribution networks (except in the Northern Territory where the regulator is the ACCC). These distribution regulators are responsible for assessing and approving arrangements for access to pipelines and networks in accordance with the Code.

The National Gas Pipeline Advisory Committee (NGPAC) is established under *the Natural Gas Pipelines Access Agreement* to:

- Monitor and review the operation of the Code
- Advise Ministers on interpretation and administration of the Code;

- Prepare information on the Code for general publication; and
- Make recommendations on Code changes to Ministers who ultimately decide whether changes are made to the Code

NGPAC comprises of an independent Chair and the Code Registrar, and representatives from industry, the Commonwealth and State and Territory governments. NGPAC is the only entity that can make recommendations to Ministers on proposed changes to the Code to improve its operation.

The National Access Code

The major objective of the third party access regime is to establish a uniform national framework for third party access to natural gas pipeline systems. The Code aims to provide flexibility for the negotiation of third party access to pipeline systems, while also providing sufficient guidance to reduce the need for arbitration.

The key features of the Code are:

- Rules for coverage of pipeline systems;
- Reliance on an upfront Access Arrangement outlining Services and Reference Tariffs applicable to a Covered Pipeline;
- Pricing principles;
- Ring-fencing arrangements (where a service provider is also a gas retailer);
- Information disclosure requirements;
- Dispute resolution mechanisms; and
- Specific timelines for all processes

Under the Code the owner or operator of a pipeline that is covered is required to lodge an Access Arrangement with the relevant State, Territory or Commonwealth regulator. The Access Arrangement is modeled on an undertaking under Part IIIA and is designed to allow the owner/operator to develop their own tariffs and other terms and conditions under which third party access will be made available. The relevant regulator then seeks comments on the Access Arrangement and then may either accept or reject it and specify amendments it requires to be made to the Access Arrangement. If rejected the Access Arrangement must be amended and resubmitted.

2.3 Relationship between Part IIIA and the Code: Principles in Practice

There is a close connection between Part IIIA and wider gas industry regulation which makes the regulatory experience of the gas industry relevant in the context of examining the effectiveness of Part IIIA and Clause 6 of the *Competition Principles Agreement 1995*.

Part IIIA was initially developed in response to growing uncertainty over the ongoing operation of the common law doctrine of essential facilities, and is the legislative expression of the Commonwealth's agreement to implement the more general principles in Clause 6. The Part IIIA declaration process continues to have an important role in regulating access in situations where an effective access regime or other arrangements are not in operation.

However, the overwhelming importance of Part IIIA lies not in these *ad hoc* cases, but in the fact that Part IIIA and the State and Territory access regimes that have been certified or the undertakings that have been given under it are now the primary vehicle for regulating access to infrastructure assets valued well in excess of \$49 billion.

The Third Party Access Code was intended to mirror the undertaking process contained within Section 44ZZA of Part IIIA of the *Trade Practices Act 1974*. It shares many similarities, an example being the criterion upon which the regulator may accept an undertaking (under Section 44ZZA of Part IIIA) or an Access Arrangement (under Section 2.24 of the Code). Each section deals with the need to ensure the legitimate business interests of the provider of the service are protected, and that the public interest (including in having competition in markets) and the interests of potential users of the service are considered. There are also equivalent sections in each document dealing with existing contracts and other matters.

These connections mean the current regulatory environment that the natural gas industry faces can be seen as a practical outcome, a working model, of the principles that the Productivity Commission is examining in the present inquiry. In particular, the development of the principles of the undertaking route under Part IIIA into a detailed access regime, operating as the Code, provides an insight into how important it is to establish flexible and balanced base principles for industry regulation. The gas industry therefore believes it has much practical knowledge to bring to a process of reexamining the value, operation, and underlying principles of Part IIIA and Clause 6.

3. KEY ISSUES WITH CURRENT REGULATION

The National Third Party Access Code for Natural Gas Pipeline Systems, which provides the legislative underpinning for pipeline/distribution regulation, was originally intended to be:

- balanced for all parties;
- light handed in practice;
- flexible in application;
- consistent across jurisdiction; and
- incentive based in design.

Since the Code's implementation in November 1997, a number of significant concerns have been expressed by industry about its practical operation.

The challenge for the regulators and governments is to ensure:

- a better balance between the interests of the infrastructure asset owners and those of third party users and customers;
- a greater streamlining of the regulatory process — with a focus on outcomes, not on inputs and processes;
- asset owners earn adequate returns so they will continue to expand gas supply networks; and
- regulatory framework provide real financial incentives for network operators to improve performance.

These broad challenges that face the system of gas industry regulation are dealt with in more detail below, beginning with the key issue of concern, underpinning pricing principles (or lack thereof), that guide the current regulatory model.

3.1 Providing Appropriate Pricing Principles

Avoiding Under Investment

Gas industry third party access regulation in Australia has been consistently framed with two aims – first, to regulate monopoly assets in a way that is fair to asset owners and consumers, and secondly, to allow market development to bring the benefits of natural gas to a wider market. These twin aims, greater competition and creating a climate for market development were explicitly recognised by Heads of Government when the Code was agreed to in 1997. The link between gas industry specific regulation and Part IIIA has been drawn earlier in this submission.

Part IIIA mechanisms are designed to prevent anti-competitive refusals to provide access to facilities. High access pricing can have the same practical effect as a refusal to provide access. This is why regulation has tended to focus on the issue of minimising access prices.

However, equally important is ensuring that access prices provide facility owners with an adequate revenue stream to prevent under investment in assets. The important role of ensuring incentives for ongoing efficient investment is easily overlooked when the regulator's focus is on the short-term objective of removing the potential for monopoly rent. However, it is pertinent to emphasise that facilities fall under Part IIIA because they are essential and have a nationally significant character. Given the essential nature of these assets, ensuring the ongoing investment and the access revenue required to support them is crucial.

The ideal for access pricing of natural monopoly assets is to replicate a contestable market price. This would be low enough to protect access seekers and end customers from the exercise of monopoly power, but also high enough to ensure that appropriate investments are made to deliver the essential services at an adequate level of quality and quantity.

In reality, determining efficient costs with any degree of certainty is very difficult, especially given the substantial uncertainties that characterise regulated industries as to asset valuations, operating costs and the nature of efficient new and replacement investment. As a consequence, access price estimates are often the result of a series of subjective decisions about parameter values made by a regulator. The problem is not one of inadequate regulatory behaviour, but rather one of limited information. A regulator cannot be expected to exhibit perfect foresight about all future investment needs.

There are strong economic reasons in many regulated industries to place particular emphasis on ensuring the incentives for efficient investment are maintained. In exercising their discretion, regulators effectively face a choice between erring on the side of lower access prices and seeking to ensure they remove any potential for monopoly rents and the consequent allocative inefficiencies from the system; or allowing higher access prices in order to ensure that sufficient incentives for efficient investment are retained with the consequent productive and dynamic efficiencies such investment engenders.

Short-term above-cost pricing may result in an appropriation of part of consumer surplus by the asset owners, i.e. a transfer of wealth, without any further long-term inefficiencies. Below-cost pricing, which results in chronic under investment in an essential asset, on the other hand, may result in a short-term gain in consumer surplus, followed by a far greater reduction in total net welfare as under investment in the asset constricts its availability to current and future consumers.

Unfortunately, Part IIIA, as currently drafted, fails to provide any significant guidance on how regulators are to exercise the discretion they are given. To ensure that regulated firms continue to face incentives to undertake these investments efficiently, AGA submits that greater guidance needs to be provided to regulators, stressing the

greater importance of longer-term factors such as ensuring that access prices provide the right incentives for efficient investment.

Matching Returns with Risk Profiles

To deliver on the objective of consistent market development, gas regulation must deliver asset owners adequate economic returns. Several early regulatory decisions brought about significant devaluations of the market capitalisations of listed gas utilities. These early decisions by various regulators consistently set the weighted average cost of capital (WACC) at around 7.75 per cent. This WACC rate (which with the calculation of an initial capital base contributes to the final rate of return achievable by the regulated business) did not seem to vary, as it logically should have, according to the particular risk profile of the regulated assets, or interest rates at the time.

Two subsequent decisions have arrived at rates of return on equity that seem to be somewhat more in line with returns in businesses not faced with such tight regulatory environments. For example in Victoria, the ACCC argues that its determination of a return on equity of 13.2 per cent was appropriate, and in the case of the Central West Pipeline that a return on equity of 15.4 recognised the particular risk profile of the investment. The gas industry has ongoing concerns with the adequacy of returns flowing from economic regulators. These particular decisions, however, indicate the possibility that there may be an increasing awareness on the part of regulators that specific pipeline assets within a broad asset class have different risk profiles, and that therefore returns should vary to appropriately reward risk.

However, returns on equity are an incomplete measure of regulatory outcomes in the case of gas pipelines, where the regulators play a large part in determining how assets should be valued and at what rate they may be depreciated. The determination of the initial capital base, for example, has a direct connection with the 'headline' rate of return that is available to asset owners. This point is referred to in the exchange of letters in **Attachment A** of this submission. Amongst other positive effects, the inclusion of clear pricing principles in Part IIIA would lead to debates such as those at the attachment being carried out from common reference points. This attachment illustrates industry concerns in relation to the valuation of the Initial Capital Base, where the outcome is seen to be largely within the discretion of regulators. The Initial Capital Base is as important as the return on equity in assessing investment in pipelines, and because of this regulatory discretion should be transparent and consistent with the access pricing principles referred to above.

Recommendation:

Part IIIA and Clause 6 of the Competition Principles Agreement should include principles promoting market development through ensuring adequate returns on investment for infrastructure owners.

Part IIIA should include access pricing principles that reflect that community benefits from the provision of infrastructure are maximised where access pricing recognises the need for ongoing investment in infrastructure assets.

3.2 Regulatory Regime Fails to Encourage New Investment

A major concern for gas infrastructure owners is that the regulatory 'architecture' acts as a disincentive to new investment. In particular the operation of Part IIIA and the Code are better suited to dealing with existing assets rather than providing the required certainty to help underpin the economic viability of higher risk greenfield projects.

The key difficulty for project developers is the need to establish up-front regulatory certainty as this is a necessary precondition for the long-term commitment of capital from investors and lenders.

Regulatory Determination Periods Need to be Longer

Prior to the current regulatory model a project had a much longer time frame and opportunity to recover costs and achieve a return for investors, this period could extend anywhere up to twenty years. This contrasts with today's position where a regulator determined return under an access arrangement mostly only provides for a five-year period before a required reset. Clearly in this instance the regulatory instruments are acting as a disincentive to newer, longer-lived and more marginal projects.

Exemptions from Access Arrangements

Under the operation of the Code there have been several instances of pipeline and distribution developments of a small scale which have been subject to access and pricing systems well beyond what is reasonable given their size. The industry considers that access regulation should not apply in circumstances where the new infrastructure does not meet the "national significance" criteria. Regional Australia would be a substantial beneficiary from this relaxation as it would offer the potential for greater investment in infrastructure serving smaller communities.

Access Holidays

Market development risk intertwined with regulatory uncertainty is the biggest challenge facing the development of new gas infrastructure projects. This hurdle has slowed the interconnectivity of the pipeline grid and further extensions to the distribution system. As a result gas consumption is well below its potential and the benefits of competitively priced energy choices is not always widely available.

With reference to the Issues Paper's discussion of the concept of access holidays, AGA considers there is merit in providing access holidays to foster more marginal yet nationally significant projects. Ideally the holiday period should be uniformly available to projects which are deemed marginal by an agreed set of criteria, furthermore for consistency the holiday period should not differ between projects.

Recommendation:

Consideration of the future regulatory framework for infrastructure projects should include specific provisions recognising the need to encourage new developments.

Access regulation should not apply in circumstances where new infrastructure does not clearly meet “national significance” criteria.

Regulatory periods should be assessed on the basis of the need for assets to earn adequate returns over the life of the project

Access holidays to be considered as a potentially attractive means of encouraging new, nationally significant, infrastructure.

3.3 Regulatory Intrusion

The natural gas industry has significant concerns about a trend towards regulatory intrusion. Regulation of the gas transmission and distribution sectors was originally designed to be ‘light-handed’ in application.

The trend towards regulatory intrusion has emerged following the privatisation of State-owned utilities, and has been most noticeable in the proliferation of information-sharing requirements. Whilst overcoming information barriers is part of regulating natural monopoly assets, it is the view of network operators in particular that current information requirements go beyond that which is required for that purpose, and constitute regulatory intrusion. The proprietary nature of much of the data requested by regulators under the Code, has also fostered considerable concern amongst AGA members about ensuring confidentiality of the data.

It is a result of what appears to be a gradual moving towards cost-based regulation that information requirements massively increase. There is a growing recognition that cost-based (sometimes referred to as ‘cost plus’) regulation, particularly where it seeks to predict future costs, is an information and resource intensive regulatory model. It can require regulators to essentially duplicate the functions and deliberations of the management of regulated businesses. It should be noted as well that the efficiency and welfare costs of regulators arriving at incorrect conclusions about future investments are very much higher than if an individual regulated business should do so.

Regulators and jurisdictions, however, need to recognise that the large-scale privatisation of the energy infrastructure brings with it a reduction in the volume of information that can reasonably be required of asset owners. Some recent proposals from the Independent Pricing and Regulatory Tribunal illustrate that regulators still have some way to go on this issue. Contained within *Ring-Fencing of New South Wales Electricity Distribution Network Service Providers: Discussion Paper and Ring Fencing Guidelines* is a proposal to require network service providers to engage and fund a compliance officer, selected by and responsible to IPART, to monitor and report on the compliance of the network service provider.

Recent examples of heavy-handed information requirements, together with the suggestion of such impractical concepts as company-funded compliance officers by regulators, have only increased concerns in the gas industry about future extent and impact of regulatory intrusion.

Recommendation:

Part IIIA and Clause 6 should include principles recognising that the costs of information requirements on infrastructure operators need to be clearly justified by the need to prevent the exploitation of a natural monopoly position.

3.4 Compliance Costs

High compliance costs are a key concern of AGA members who operate within the third party access regime.

Costs related to the production of Access Arrangements (i.e. the Code equivalent to Part IIIA undertakings) are particularly high. These costs include demands on in-house senior management resources and the provision of external specialist legal/economic advice. In addition to these resources, many gas industry network businesses employ over 5 in-house specialists in the area of regulatory affairs. Estimates of the total costs of developing and negotiating Access Arrangements for small extensions to gas distribution networks range from \$200 000-\$250 000. In cases where a small number of customers are involved, the cost per customer of a developing an Access Arrangement can be extremely high. Costs for development of Access Arrangements for transmission pipelines are even greater. So far, these Arrangements have been estimated to cost \$10 million, with associated annual costs of \$1-2 million. These high costs call into question whether the Code reflects the essential principle that the benefits of regulation must outweigh the costs.

An accompanying concern that has greatly added to costs and uncertainty are the frequent and lengthy delays in the approval of Access Arrangements. **Attachment B** sets out the periods between lodgment, draft decisions, and final approval of Access Arrangements for gas pipelines. AGA views the delays and lengthy approval processes that the table sets out as unacceptable from the viewpoint of both regulatory efficacy and the costs to the regulated businesses involved.

Recommendation:

Future regulatory arrangements should be made with a view to reducing regulatory costs and delays for infrastructure operators.

Consideration to be given to adequate resourcing of regulatory bodies.

3.5 The Need for Incentive-Based Regulation

Cross Period Incentive Mechanisms

An essential feature of any model of monopoly regulation is providing incentives for efficient service provision. Sections 8.44-6 of the Code contain provisions for the use of 'incentive mechanisms', at the discretion of the regulator, in setting the reference tariff policies for a service provider.

There is a conflict, however, in the practical operation of incentive mechanisms and the current approach taken to regulatory periods. The majority of Access Arrangements are subject to 'regulatory resets' each five year period that mitigate against the fullest advantage being made by service providers under the Code of opportunities to improve efficiency and lower costs. For example, in the period immediately leading up to a review of an Access Arrangement, a Service Provider has a perverse (in terms of efficiency outcomes) incentive to delay the introduction of an efficiency until the beginning of the next period of the Access Arrangement. This is because the delay would allow the Service Provider to retain at least part of the efficiency gain through increased profits over the next period of the Access Arrangement.

Recognition that regulatory approaches need to maximise the attractiveness of incentive based improvements in efficiency is required. The Code does not clearly provide for this at present. A part of any new principles for Part IIIA and/or Clause 6 of the Competition Principles Agreement should address this need for more flexible periods over which businesses and consumers can fairly benefit from efficiency improvements. A model that can provide for a greater incentive for regulated businesses to improve efficiency is a glide path approach that extends beyond a single regulatory period, where benefits to asset owners can be maintained for a longer period of time without a loss of consumer benefit.

Incentives for Repair and Maintenance of Existing Assets

Long-term economic efficiency is best provided by a regulatory environment which provides incentives for the maintenance and replacement of capital at a level that maintains quality of supply while not leading to asset owners receiving abnormal benefits from any allowance for maintenance cost or replacement capital cost.

Under the current regulatory framework (e.g. the Code) appropriate levels of maintenance and replacement are discouraged by an inappropriate use of benchmarks by regulators to drive down allowed maintenance costs and replacement capital costs.

Under-investment in asset replacement and maintenance should be avoided as it eventually leads to premature asset decay – and hence additional investment that may have been prudently avoided if maintenance and replacement investment had been rewarded appropriately.

Recommendation:

Principles for Part IIIA and Clause 6 of the Competition Principles Agreement should address the need for more flexible periods over which businesses and consumers can fairly benefit from efficiency improvements.

Enhanced treatment of decisions regarding maintenance and replacement of existing infrastructure, which should provide for regulatory certainty and an opportunity to make returns commensurate with risk.

3.6 Regulatory Performance and Overlap

Regulatory performance, and avoiding inefficient regulatory overlap, is a key industry concern.

Clearly, the multiple economic and technical regulators across jurisdictions have the potential to impose significant costs on market participants. This is particularly apparent where separate network assets are owned by a single company across multiple jurisdictions. This situation can require the company to expend resources on coming to grips with and working within several different jurisdictional systems, where the underlying business, i.e. owning and operating gas infrastructure, is the same. With national energy companies expected to play an increasing role in Australia's energy markets, such complexity may become even more costly in the future.

Recent public statements from the Chairman of the ACCC, Professor Allan Fels, indicate that regulatory overlap is an issue being considered by regulators as well as by industry, and that regulators are particularly aware of the costs of dealing with multiple regulators. The gas industry recognises that through such mechanisms as meeting regularly in a regulator's forum, regulators of gas transmission and distribution networks are attempting to lower the risk of inconsistency across jurisdictions.

The number and identities of gas infrastructure regulators is a valid issue for future consideration, and views on the best approach may vary. What is of overriding importance is the achievement of effective and efficient regulatory outcomes that encourage market growth in addition to free and fair trade in natural gas.

Recommendation:

Further consideration should be given to the optimum number of, and roles for, infrastructure regulators, in the context of improving the consistency and quality of regulatory outcomes.

3.7 Competing Pipelines

A central role for Part IIIA and the Code is to provide a framework whereby competitive outcomes can be achieved where otherwise there exists a monopoly asset.

This raises the question of what is the most appropriate form and level of regulatory oversight where competition exists between infrastructure assets such as two gas pipelines serving the same market. Duplicated infrastructure of sufficient size with provision for third party access provides a reasonable indication of a competitive market.

In such circumstances we see no need for the relevant competing pipelines to be specifically covered under the Code and the provisions relating to price regulation. The market behaviour of the owners would however be subject to the general competition provisions of the *Trade Practices Act*.

Recommendation:

Competing pipelines should not be covered under the Code. Specific guidelines need to be developed under Part IIIA to determine the level of competition in such circumstances.

3.8 Fostering Competition throughout the Supply Chain

As this submission has indicated gas market regulatory reform is well (although not necessarily efficiently) advanced in the transmission and distribution sectors. Within the retail sector the State and Territory jurisdictions are developing the mechanisms for the adoption of full retail competition over the next two years.

There are a number of issues regarding retail market inconsistencies in contestability timetables, metering, and customer transfer requirements between States and Territories and electricity and gas which create concerns for AGA. These issues may not be directly relevant to the present inquiry. However, AGA is able to provide further detailed comments on these issues should the Commission seek them.

Turning to upstream regulatory issues the three areas of reform previously identified by the AGA and wider industry include: joint versus separate marketing arrangements; acreage management policies; and third party access to upstream facilities. It is expected the Commission will examine these issues in the context of this inquiry. Moreover, in order to ensure the full benefit of competition reform accrues to the end users of gas the AGA considers that no part of the supply chain can be quarantined from competitive pressures.

The AGA recognises the benefits of competition in the sector. The most effective means, however, of promoting basin on basin competition is to create the market and regulatory preconditions for long term investment in interstate pipelines to link various basins around Australia with key markets. This remains the foundation stone to deliver supply diversity and competition between producers.

Recommendation:

All sectors of the gas supply chain should be subject to market pressures recognising that in the upstream sector the key driver of competition is creating the market and regulatory preconditions for greater interconnection of high pressure transmission pipelines.

4. CONCLUSION

The Third Party Access Code is an example of an industry specific access regime developed and operated under Part IIIA and Clause 6 as they currently stand. If Part IIIA is to continue to be the overarching legislative framework for regulation of infrastructure assets in Australia, Part IIIA in particular has to be structured in a way that gives regulators of these nationally significant assets guidance on several key issues.

One key issue is how to balance the short-term interests of end users in lower access prices with the long-term benefits to the general community of adequate ongoing investment in existing pipeline networks and the development of new pipelines. Explicit guidance on balancing the interests of end-users and asset owners in regulatory decisions, a balance that lies at the heart of the Code, is equally essential.

These issues can most effectively be addressed by the incorporation of clear access pricing principles into Part IIIA of the *Trade Practices Act*. These access pricing principles could assist regulators in making decisions which will have important economic, environmental and social effects in the decades to come. AGA is keen to provide the Commission with any further assistance it can offer in the development of its final recommendations.

Pipeline confusion throws shadow over ACCC's role (AFR 28 November 2000)

On "A connected gas system in the pipeline" by Ian Howarth (AFR, November 17) you quote ACCC chairman Professor Allan Fels on the profitability of natural gas transmission pipelines in Australia. He asserts that pipeline returns on equity compare favourably with those offered with those offered by the Australian sharemarket and superannuation funds.

However, the comparison is very misleading. The rates of return on equity for pipelines derived by the ACCC are based on theoretical economic modelling results which cannot, on any objective basis, be compared to actual market results from other investment activities.

The results quoted by Professor Fels represent an "allowed" return on equity derived from a highly complex regulatory model – not a guaranteed return. Given other considerations, including the ability of the ACCC to set the Initial Capital Base for existing pipelines, regulatory intervention on allowed operating costs and some of the uncertainties built into the regulatory model (e.g. the details of the tax modelling approach used in the model), one has to be sceptical as to whether these returns on equity will ever be achieved in practice.

More generally, Professor Fels' comments highlight the emerging conflict between the role of the ACCC as a "consumer advocate" and its specialised role as a pipeline regulatory body, under which it is required to balance fairly the needs of pipeline companies and customers.

If, as pipeline and major investment companies argue, the ACCC continues to get this balance wrong, major gas transmission pipeline developments now under active assessment will not occur, to the detriment of regional, State and national economic development and jobs growth in this country.

Allen Beasley

Executive Director

Australian Pipeline Industry Association

ACCC pipeline returns above average (AFR 1 December 2000)

Mr Allen Beasley, the executive director of the Australian Pipeline Industry Association, makes much of the fact that the ACCC's approach to setting prices of natural gas transmission pipelines does not represent a "guaranteed return" ("Pipeline confusion throws shadow over ACCC's role", AFR, November 28).

The closest thing to a guaranteed return is a government bond which is currently offering around 6 per cent.

The numbers of the rates of return which have been used in recent ACCC decisions do not seem ungenerous. They are above the average return on shareholder funds for Australian business and at the high end of international regulatory benchmarks. Pipeline operators nevertheless have the opportunity to demonstrate that investment may be deterred and the ACCC will take this into consideration.

For example, in Australia the return on equity for gas transmission for Victorian gas was determined by the ACCC in October 1998 at 13.2 per cent. Other

ACCC determinations were Central West Pipeline 15.4 (June 2000) and Moomba-Adelaide 13.0 (August 2000).

This compares favourably with the Australian superannuation funds pooled three year average return of 10.4 per cent or the Australian Stock Exchange's return on equity over ten years of 11.3 per cent. Further recent international energy decisions compare favourably. In the United States, gas and electricity returns in California were 10.6 per cent and 11.6 per cent (1998, 2000) and in the United Kingdom, Ofgem struck a rate of 6.0 and 6.5 per cent for electricity transmission and distribution in 1998 and 2000.

Moreover, the ACCC values assets on a replacement cost basis, again an approach not likely to deter investment.

Finally, Mr Beasley is right in saying that the returns above are not guaranteed. However, he conveniently fails to mention that, in practice, returns may well prove to be higher than the projection suggest because "incentive price mechanisms" are used.

Under "incentive pricing" a price is set for a number of years ahead based on projected costs and volumes as well as an allowed rate of return. If operators exceed the forecasts they will receive higher returns than the model suggests. Gas pipeline operators generally support "incentive pricing" mechanisms for this very reason rather than traditional approaches under which prices are determined annually or so by the regulator to guarantee a rate of return.

The simple facts are that Mr Beasley and his members will complain about regulators' decisions no matter how high the prices are set. This is because being monopolies they have the capacity, unlike most businesses, to set prices even higher than the regulators determine, at the expense of downstream users and downstream investment.

The commission will continue to play its statutory role of setting prices that encourage investment and yet setting some limit thereby avoiding monopoly exploitation of business users and consumers.

Allan Fels

Chairman

Australian Competition and Consumer Commission

Fels wrong to oversimplify pipeline regulation issues. (AFR 6 December 2000)

I read with some concern the response from Allan Fels regarding the regulatory environment confronting owners and developers of gas pipeline assets in Australia ("ACCC pipeline returns above average", AFR Letters, December 1). The issue is not as simple as has been portrayed.

As a pipeline owner and operator, Duke Energy makes determinations about investments in pipeline infrastructure around the world. In Australia, the company has just invested \$450 million in a new pipeline and is looking at the possibility of a further \$400 million investment in a Tasmanian pipeline project. In taking on such initiatives, the company accepts significant market, construction and operations risks. The ability to manage such risks is a core competency and we are willing to take them head-on, providing there is the ability to earn a reasonable return.

Professor Fels' letter suggests that the current regulatory environment is somehow suitable, based on a simplistic comparison of relative rates of return. As

Professor Fels is aware, and as the Australian Pipeline Industry Association outlined in a recent letter, the issue is not simply the rate of return approved by the regulator. Equally important is the capital base to which that rate of return is applied. For example, a 15 per cent return applied to 50 per cent of the capital base is in fact only a 7.5 per cent return. To draw broad conclusions regarding the acceptability of returns for pipeline investors without recognising the complexity of the issue is unfortunate. Pipeline investments are highly capital-intensive and deliver significant benefits to the community through the delivery of clean and efficient energy options. The natural gas sector of the energy industry is neither one-dimensional nor lacking in competitive forces.

Indeed, in the case of many gas pipeline assets that have been responsibly designed with extra capacity to stimulate growth in gas consumption, the pipeline operator must respond to intense competition in the wider energy marketplace to stimulate growth in the natural gas sector. To state that natural gas pipelines are all monopolies reflects a fundamental misunderstanding of the competitive marketplace in the energy industry and betrays a bias in approach that is destructive to responsible investment in the industry.

Competitive and reliable energy supply is a fundamental of economic growth and is at the core of Australia's future growth and prosperity. Visionary pipeline projects embrace this challenge but need to be supported by appropriate approvals processes and regulatory environments.

Michael MacDanold
Managing Director
Duke Energy International

Pipelines able to gush profits (AFR 13 December 2000)

Michael MacDanold's recent complaint about the regulatory regime for gas pipelines ("Fels wrong to oversimplify pipeline regulation issues", AFR Letters, December 6) smacks of special pleading but without much substance. From the point of view of major energy users, the returns and the treatment of the capital base of gas pipelines being allowed by the ACCC and State regulators are more than adequate to justify investment in gas pipelines, given the relatively low risk they face compared to many, if not most, businesses in the private sector.

It would be a very lax owner indeed who could not readily achieve the levels of return and implied profitability allowed by the ACCC, since he is able to adjust his prices to suit conditions so long as he remains within the price cap derived from the ACCC rulings. It is virtually a risk-free game up to that level of return, with the possibility of even further gains, as Professor Fels pointed out ("ACCC pipeline returns above average", AFR Letters, December 1).

Energy users have observed repeatedly the very handsome levels of profitability regularly reported by both gas and electricity facility owners operating under the very regulatory regime that Mr MacDanold so objects to. Their levels of profitability exceed by far those able to be achieved by the major listed companies in Australia.

Part of the problem has undoubtedly been the inflated treatment of both returns and asset valuations put into place by the State governments to "fatten up" their utilities for privatisation and/or the extraction of high levels of dividend. The

ACCC has the unenviable task of reducing those inflated expectations to more reasonable and proper levels. The energy users of Australia, while not in agreement with everything the ACCC does by any means, is with them on this one.

Alan Reichel
Executive Director
Australian Gas Users Group

Gas Statistics Australia 2000 - Gas Transmission Access Arrangements — Duration of Approval Process – Correct as at August 2000

Access Arrangement (AA)	AA Lodged	Draft Decision	Final Decision	Final Approval	Duration to Draft Decision	Duration to Final Decision	Duration to Final Approval
Transmission Pipelines Australia (Victoria)	3.11.97	28.5.98	6.10.98	16.12.98	7 months	11 months	13.5 month
Multinet, Stratus and Westar	3.11.97	3.6.98	6.10.98	17.12.98	7 months	11 months	13.5 months
Mildura Natural Gas Distribution System (Envestra Limited)	17.6.98	7.10.98	3.6.99		4 months	12 months	
AGL Gas Networks	11.1.99	28.10.99	30.6.00 ^a	21.7.00	10 months	18 months	19 months
Central West Pipeline	31.12.98	10.9.99	30.6.00		8 months	18 months	
SA Gas Distribution System (Envestra Limited)	22.2.99	13.4.00			14 months		
Moomba–Adelaide Pipeline System (Epic Energy)	1.3.00	Aug 00					
Moomba–Sydney Pipeline System (East Australian Pipeline Limited)	5.5.99	Dec 00	7.9.00 ^a				
Parmelia Pipeline	7.5.99	27.10.99			6 months		
Amadeus Basin — Darwin Pipeline (NT Gas)	28.6.99				na		
Mid-West and South-West Gas Distribution Systems (AlintaGas)	30.6.99	14.3.00	30.6.00	13.7.00	8.5 months	12 months	12.5 months
Great Southern Energy Gas Networks Pty Limited (Wagga Wagga, NSW)	Mar 98	29.9.98	8.3.99	Sept 99	6 months	11.5 months	18 months
Tubridgi Pipeline System	21.10.99	21.8.00 ^a			8 months ^a		
Riverland Pipeline System SA	22.11.99				na		
DBNGP (Dampier to Bunbury Natural Gas Pipeline)	15.12.99	Oct 00 ^b					
GGT (Goldfields Gas Transmission)	15.12.99	Sept 00 ^b					
City Gate to Berrimah Pipeline (NT Gas)	12.2.01 ^b						
Palm Valley–Alice Springs (NT Gas)	30.6.00 ^a				na		
Centre Gas Systems, NT Distribution Systems (Centre Gas)	30.6.00 ^b				na		
Mildura Pipeline	11.11.99				na		
Kalgoorlie to Kambalda	Dec 00 ^b				na		
Albury Gas Company	30.06.98		31.12.99	Feb 00	na	18 months	20 months

^a Extended to

^b Expected in (Sources: ACCC and State Regulators).