the australian PIPELINE industry association Inc.

22 December 2000

The National Access Regime Inquiry
Productivity Commission
PO Box 80
Belconnen ACT 2616

Dear Sir

THE NATIONAL ACCESS REGIME INQUIRY

The Australian Pipeline Industry Association (APIA), as the peak national body representing Australia's natural gas transmission sector, welcomes the opportunity to make the attached submission to the Productivity Commission's inquiry into arrangements for access to significant infrastructure facilities provided for in Part IIIA of the *Trade Practices Act 1974* and Clause 6 of the Competition Principles Agreement.

It is generally recognised that Australia's natural gas transmission sector remains relatively underdeveloped by international standards. Accordingly, the nature and extent of economic regulation applied to the sector will have a crucial bearing on the level of private sector investment in support of pipeline operations in this country, including maintenance and extension/enhancement of existing pipelines and major new greenfield investment.

According to APEC Energy Ministers, demand for natural gas is expected to grow significantly over the next 20 years, driven by the need to promote economic development and growth, the need to increase energy security and the requirement to improve environmental outcomes. These fundamental requirements are especially relevant to Australia, reinforcing our need to develop world class pipeline infrastructure. According to the Asian Development Bank, as much as $70 billion in investment will be required for natural gas infrastructure in Asia over the next 15 years. In addition it is estimated that hundreds of billions of dollars in investment will be required for North America, South America and Russia over the same period. A considerable proportion of these total amounts will relate to transmission pipeline infrastructure. This, in turn, reinforces the need for Australia's economic regulatory arrangements to ensure a sensible balance between facilitating new development and ensuring that the legitimate needs of customers and potential customers are met.

Increasingly, Australia's regulatory arrangements, as evidenced by decisions taken by regulators for existing assets and the regulatory mindset being applied to new investment activity, is being viewed with considerable alarm by potential private sector pipeline developers and the investment community. It is clear to the pipeline industry that current regulatory attitudes and outcomes, unless addressed, will work to the detriment of private sector investment in support of national economic performance, regional development, jobs growth, security of supply and environmental outcomes.

The inquiry by the Productivity Commission represents an important opportunity to address the current imbalance between incentives (for existing operations and new investment) and perceptions of customer's needs. The submission sets out a number of recommendations which, if adopted, could improve investor confidence and enhance Australia's opportunities to meet its future "essential" infrastructure needs through private sector investment.

APIA would be pleased to elaborate on any of the points made in this Submission.

Yours faithfully

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Executive Director

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Response by the Australian Pipeline Industry Association (APIA) to the Issues Paper Released by the Productivity Commission in Relation to the Review of Part IIIA of the TPA and Chapter 6 of the CPA

Date: 22 December, 2000

1. The Need for Clear Objectives in the National Access Regime.

Under the Terms of Reference (5 (b) and (d)) of the Review, the Productivity Commission is to clarify the objectives of Clause 6 and Part IIIA and consider alternative means of achieving these objectives.

Part IIIA does not currently have specifically outlined objectives, yet it has formed the basis of access regulatory systems and pricing regulatory systems, including in the gas transmission sector. The National Third Party Access Code for Natural Gas Pipeline Systems states that an Access Arrangement under the Code is similar in many respects to an undertaking under Part IIIA of the Trade Practices Act and is designed to allow the owner or operator of the Covered Pipeline to develop its own tariffs and other terms and conditions under which access will be made available, subject to the requirements of the Code. The Pipeline Industry argues that the prescriptive nature of the Code (including the prescriptive nature of interpretation of the Code by economic regulatory bodies) has generated outcomes which extend well beyond the policy intent of Part IIIA which is primarily an "access" framework, ie the Code represents an inflexible mandated pricing regime imposed on Service Providers.

In setting Part IIIA objectives it should be recognised that currently Part IIIA is largely an "access only" regulatory system, yet third party access to natural monopoly infrastructure creates the need for pricing principles. This need has been addressed on an "ad-hoc" basis by the creation of industry-specific codes which focus on mandated price and conditions of access, with little regard for the need to create a framework which encourages new development and reinvestment activity.

The national access regime should therefore contain a single set of clear "access and pricing" principles that identifies, amongst other things, if or when price control applies and if or when price control should be the primary focus.

Given that Part IIIA does not currently have specifically outlined objectives regulators have applied considerable scope to exercise discretion under regulatory regimes based on Part IIIA. Understandably, given the primary role of regulators as "consumer advocates", they have applied this discretion with the primary objective of ensuring lower reference tariff prices for consumers, with little – if any - regard to the implications of their actions on the long term development needs for energy infrastructure such as gas transmission pipelines. This exercise of discretion creates risk and uncertainty for which infrastructure owners are not necessarily compensated.

Examples of risk and uncertainty arising from regulator discretion include:

- Victorian Electricity Industry: The Victorian electricity distribution industry has a regulatory regime that includes price control and a fair sharing of efficiency improvements between customers and service providers. Based on this regime service providers invested to grow the market and hence improve efficiency (via economies

of scale). In recent months the regulator has used its discretion and decided that, while customers and service providers should share the benefits of efficiency improvements arising from cost reductions, customers receive the total benefits of efficiency improvements arising from growth, including growth induced by service provider action. This has established a disincentive for service providers to benefit from their actions in growing markets.

- Queensland Gas Pipelines: Price regulation for access to Queensland gas pipelines has been derogated for a period of time from current regulatory arrangements due to pre-existing access price regulation under pre-existing legislation (relatively recent infrastructure such as the Carpentaria Gas Pipeline and the Ballera-Wallumbilla Gas Transmission Pipeline was developed based on these derogated access pricing arrangements). Recently regulators have used their discretion and retrospectively assessed pre-existing Queensland access price regulations. Not surprisingly, it was concluded by the ACCC that the derogations did not meet the current requirements of the Code. At no stage in this process to date has the regulator given any consideration to the sovereign risk implications of their deliberations and the implications this would have for future investment. At the time of this submission, the NCC has yet to make a recommendation to the relevant Minister on the effectiveness of the Queensland Gas Regime and this is an aspect APIA would be pleased to address in a supplementary submission to the Productivity Commission at the appropriate time.

The Productivity Commission should consider appropriate limits to regulator discretion in order to facilitate regulatory certainty, while ensuring sufficient flexibility exists to allow special cases to be addressed. Regulator discretion may be limited by:

- A clear set of pricing and access principles;
- A regulator's code or regulator's guidelines; and
- Strengthening the appeal rights allowed to infrastructure owners in the TPA[1]. In particular 44X should be strengthened so that in making an access dispute determination the regulator must to consider the public interest with respect to current and potential infrastructure investment and maintenance as well as competition.

Recommendation: Part IIIA should contain a single set of clear "access and pricing" principles. Regulator discretion should be directed by these principles, there should be a strengthening of appeals provisions and, preferably, a regulator's code or guidelines should be developed in conjunction with representatives of regulated industries. Any such guidelines to regulators should strengthen the current lack of focus on the desirability of new infrastructure development activity, including in the gas transmission sector.

2. Effectiveness of Regulation in Producing Efficient Outcomes:

In considering the objectives of any access regime and associated pricing regime economic efficiency should be one of the prime considerations.

[1] eg the appeal and review rights in 44K, 44L, 44O, 44X, 44ZP and 44ZR, the restrictions in 44W and criteria in 44X of the Trade Practices Act

Effective regimes should result in economically efficient replacement investment and greenfields investment, economically efficient infrastructure maintenance and efficient price regulation.

2.1 Economically efficient greenfields investment
The current regulatory regime (eg gas and electricity codes) has focussed on establishing the minimum prices for access to existing infrastructure, not on whether appropriate incentives are in place for future infrastructure development.

Future infrastructure investment brings the benefits of infrastructure service to a larger number of citizens (particularly regional Australia), enhances competition between substitutes (eg gas pipelines increase inter-fuel competition) and enhances competition in upstream and downstream markets.

Efficient investment in future infrastructure requires regulatory certainty. Most infrastructure investment projects are marginal. Investors may refuse to invest in regulated marginal projects due to either:

- Uncertainty[2]: Regulatory certainty is required to ensure that best possible information is available, and consequently regulatory risk is minimised; or
- Regulated returns that, although known with some certainty, are insufficient for investment to proceed.

Under previous regulatory regimes (or in unregulated markets) high-risk marginal projects had a long life over which the infrastructure owner could recover costs and make a project return. Typically these returns would be low in the early years of the project and high in the later years of the project with the effect that over the life of the project the investment would make an economic return.

Under the current regulatory regime (eg gas and electricity codes) regulator-determined returns generally take a five year perspective rather than a project life (typically around 20 years for a transmission pipeline) perspective. This acts against greenfields investment for long-lived infrastructure which requires longer-term certainty in setting the tariff path than generally considerable desirable by regulators.

Over recent years, the attitudes taken by regulators in determining appropriate Reference tariffs for gas transmission pipelines have led pipeline developers and investors to seriously question whether the potential rewards are outweighed by the risks involved. Accordingly, the gas transmission industry has indicated that, before it will commit to new investment in the form of significant capital (eg ordering of higt cost items such as steel pipe), it must know in advance the regulatory arrangements, particularly the tariff path, that will apply to the development. This will enable the developer to make an informed decision on whether:

- To proceed with the development as envisaged

[2] In an unregulated market uncertainty is usually addressed via the possibility of increased returns

- To scale the project down to proceed at a scale of operations to meet the requirements of foundation customers only (thus avoiding the regulatory risks inherent with creating spare capacity for future use by third party users which could endanger negotiated foundation contract arrangements)
- To abandon or defer the project.

Current projects in this category include the $380 million Tasmanian Gas Project (Duke Energy International) and the $1.0 –1.5 billion Darwin to Moomba Project (Epic Energy). An additional issue that has emerged in respect of these projects is whether regulatory approvals (as evidenced by recent history where access arrangements have taken 18 - 24 months to finalise) can be gained in time for the necessary project decision making.

Overall, APIA contends that the current state of regulatory affairs in this country, where regulatory risk is seen as a more significant issue than the normal business risks associated with long term infrastructure development like gas transmission pipelines, reflects very poorly on the level of policy advice being given to regulators by government.

For example, the ACCC has recently moved to represent returns on a post tax nominal return basis. This results in nullifying, for regulated entities, any benefits of incentives such as accelerated depreciation, which apply across a range of industries. In this case, the approach adopted unilaterally by the ACCC is at odds with wider government policies applying to other infrastructure industries.

The Productivity Commission should address the fact that current regulatory approaches work against greenfields infrastructure investment projects as a matter of urgency.

A balanced regulatory regime is needed to ensure appropriate economic decisions regarding marginal infrastructure projects. Such a system would provide regulatory certainty and an opportunity to make returns commensurate with risk over the life of a project.

Efficient future infrastructure investment may be encouraged by:

- limits on regulated access to greenfields infrastructure that does not meet "national significance" criteria. The imposition of regulatory access and pricing systems on marginal infrastructure serving regional Australia is of little benefit if the existence of these systems discourages future investment;
- limits on regulated access to nationally significant greenfields infrastructure for a set period of time for marginal projects (ie an access holiday) as discussed in the Productivity Commission's Issues Paper (pages 34-35)

Recommendation: Infrastructure investment brings economic benefit and should not be discouraged (as it is under the current regulatory regime). A system is needed to ensure appropriate regulatory decisions regarding future infrastructure projects. Such a system

should provide regulatory certainty and an opportunity to make returns commensurate with risk over the life of a project. Proposals to:

- *limit regulated access to infrastructure that does not meet "national significance" criteria; and*
- *provide "access holidays" for marginal projects*

have merit in this regard.

2.2 Economically efficient infrastructure maintenance and replacement investment

Economic efficiency is served by a regulatory regime that provides certainty and ensures maintenance and replacement of capital at a level that maintains quality of supply while not resulting in asset owners receiving abnormal benefit from any allowance for maintenance cost or replacement capital cost.

Under the current regulatory regime (eg gas and electricity codes) appropriate levels of maintenance and replacement are discouraged by the inappropriate use of benchmarks by regulators designed to drive down allowed maintenance costs and replacement capital costs without specific consideration of the particular circumstances faced by the asset in question.

Under-investment must be avoided as it results in premature asset decay – and hence additional investment that could have been avoided if maintenance and replacement investment had been adequate.

In some circumstances the issue of appropriate levels of maintenance and replacement capital costs may be addressed through competitive arrangements, eg by contracting to third parties for these functions.

Recommendation: Infrastructure maintenance and replacement brings economic benefit and should not be discouraged (as it is under the current regulatory regime). A system is needed to ensure appropriate decisions regarding maintenance and replacement. Such a system should provide regulatory certainty and an opportunity to make returns commensurate with risk.

2.3 Efficient price regulation

Price regulation should act to ensure allocative efficiency. In considering allocative efficiency there is a practical trade-off between precise cost reflective pricing and undue complexity - this trade-off point may already have been passed in some energy infrastructure pricing where the complexity, detail and level of "regulator intervention" already tests the skills of industry experts in the area.

A key question when considering efficient pricing is "what should be the balance between pricing existing capacity efficiently and encouraging investment and are the two necessarily at odds?"

These two objectives are not necessarily opposed, but have been made so by current regulatory practice which has generally taken the strictest interpretation of "efficiency"

consistent with minimum returns to facility owners. The resulting returns are unattractive from the viewpoints of owners who are faced with the choice of accepting inadequate returns (consistent with risk) from existing or new facility investment under current regulation, or seeking better returns elsewhere.

Thus prices generated by current regulatory processes do not necessarily guarantee efficient or competitive price and market outcomes in the long term. Clearly, customers value both price and service (particularly reliability), but their perspective is guided by the former, at least until the latter actually becomes an issue at which stage the damage to the integrity of the asset has already been done.

In considering price regulation it should be noted that it is in the interests of the ring-fenced owner of a non-congested asset to provide access at a reasonable price in order to encourage utilisation of the asset. Thus there is no reason to believe that mutually acceptable prices cannot emerge from less intrusive regulatory systems.

Under such an approach the general provisions of the TPA can operate to punish abuses of market power (monopoly or otherwise) if or when they occur, whereas current regulation assumes that any such power will be abused and mandates a set of pricing outcomes. Thus, the regulatory process itself acts against an objective view of the longer-term needs of infrastructure owners and developers.

Recommendation: Current regulatory regimes minimise prices to an extent where insufficient returns are made, jeopardising future investment. Such a prescriptive pricing approach is not necessary as it is in the interests of a ring-fenced owner of non-congested infrastructure to provide access at a reasonable price in order to encourage infrastructure utilisation. Given this, the general provisions of the TPA, rather than prescriptive regulatory regimes, should operate to punish any abuse of market power.

3. Access Regulation, Price Regulation and Competition Issues

Access is more certain in industries that have ring fencing (eg gas pipelines) or a structure where owners and users of assets are separate (ie no vertical integration). In these industries it is not in the asset owners interests to impede access. The issues are efficient price regulation (as outlined above), the possibility of competition between infrastructure and market power and bottlenecks created by other participants.

3.1 Competition between infrastructure and the regulatory response to such competition.
Competition between infrastructure can take various forms.

The existence of duplicated infrastructure of sufficient size with provisions for third party access provides prima facie evidence of competition. In these circumstances the infrastructure should not be subject to price regulation unless it can be demonstrated that collusion or some other form of non-competitive behaviour has occurred.

The current case of the Eastern Gas Pipeline (EGP), which has been recommended for coverage under the Code following an adverse recommendation from the NCC, serves to highlight that, given a sufficiently narrow definition of market, virtually any asset can be viewed as a natural monopoly. However, in the case of the EGP there are a number of competing suppliers of the service and other suppliers have reacted to the threat of competition by reducing their haulage prices. APIA's arguments on the reasons for not covering the EGP are at Attachment A to this submission. The Minister's decision on coverage of the EGP is currently the subject of appeal through the Australian Competition Tribunal.

In order to assist assessment of infrastructure-on-infrastructure competition, there needs to be clearer guidelines on assessing the existence of competition in Part IIIA of the Trade Practices Act.

Recommendation: Duplicated infrastructure provides evidence of competition. In these circumstances the infrastructure should not be subject to price regulation.

Guidelines to assist assessment of infrastructure-on-infrastructure competition should be incorporated into Part IIIA.

3.2 Market power and bottlenecks created by other participants

The aim of competition policy should be to maximise the total benefit of competition to society – competition should not be an end in itself.

If any monopoly rents released by access and price regimes are appropriated by participants in non-competitive upstream or downstream markets, then the regulatory regime does not benefit the broader community or meet public interest criteria. Thus upstream and downstream markets should be competitive to ensure that the aims of competition policy are realised.

For example in the natural gas market there is the potential for extensive downstream competition, but with limited supply sources (particularly on the east coast), the full benefits of that competition will not be attained as benefits are appropriated by participants in non-competitive upstream markets. This has been previously recognised by the Industry Commission[3] who have stated:

> *the dominant position afforded to Australian producer joint ventures in their exploration and production licences may hinder the emergence of greater competition in the Australian gas market*

Since these words were written there has been large-scale change to gas infrastructure markets and regulation but the non-competitive nature of upstream markets has not altered.

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[3] Industry Commission (1995) Australian Gas Industry and Markets Study March 1995 pxviii

Access to certain upstream facilities – notably gas processing plants – could encourage greater competition in these non-competitive (east coast) upstream markets.

Some might argue that natural gas production is a "production process" for the purpose of Part IIIA and thus cannot be covered by access. If so, this indicates a fault in the structure of the access model, which looks only at "bottlenecks" in the middle of the supply chain and not the market as a whole.

Although there have been actions by some Australian governments aimed at encouraging greater upstream competition (most notably through revised exploration lease retentions) these actions could only affect competition in the long term. If the intention is to promote competitive outcomes now, firmer action on access to upstream facilities is needed, particularly in mature petroleum provinces where new field discoveries are likely to be smaller.

The issue of upstream competition has received considerable attention in recent years from the investigations of the Upstream Issues Working Group (UIWG) under the auspices of CoAG. In December 1998, UIWG reported to jurisdictions. The report identified three areas where governments could possibly implement a more pro-competitive framework:

- The allocation and management of prospective acreage for exploration and production;
- Third party access to upstream gas facilities;
- A requirement for joint venture suppliers to market individually rather than collectively.

With respect to acreage management, UIWG suggested a number of measures to promote the goals of increasing the contestability of exploration acreage and enhancing the diversity of gas supply. With regard to joint marketing, UIWG noted that this practice may have value in immature markets, but the policy objective should be to encourage separate marketing whenever feasible.

While UIWG's recommendations directionally promote greater upstream competition, they do so only in the long term. Major changes in acreage ownership and the abandonment of joint marketing may be decades away.

On the issue of access to facilities, UIWG observed that any perception by third parties that it was difficult or impossible to negotiate access to existing upstream facilities on reasonable terms and conditions might deter entry into the industry. While UIWG believed that there was no need to mandate an access regime at this time, it saw a strong case for developing a set of "best practice principles" for access that would have the commitment of all stakeholders. The upstream industry went on to develop a set of principles by mid-1999 which, unfortunately, did not satisfy all stakeholders. Deficiencies were seen in the lack of any specified timelines for negotiations; the lack of

any tariff setting principles; the absence of formal provision for dispute resolution; and in other matters.

UIWG noted that it would be open to jurisdictions to take the principles further if they so wished; for example, by legislating for a basic right of third party access and binding dispute resolution. In view of the somewhat neutral outcome of UIWG's recommendation on access to upstream facilities, it is timely that the matter be reconsidered in the context of the Part IIIA review and some firm access principles be proposed with the aim of encouraging greater upstream competition in the near term.

Recommendation: Non-competitive upstream or downstream markets, may act contrary to the aims of the regulatory regime. For example in the natural gas market there are limited upstream supply sources – there is potential for the benefits of competition to be appropriated by participants in these non-competitive upstream markets. Access to certain upstream facilities – notably gas processing plants – could encourage greater competition in these non-competitive upstream markets. To this end Part IIIA should be amended to make it clear that gas production activities can fall within the framework of access to essential facilities.

4. Other Issues

4.1 Cost of Regulation

The Issues Paper (page 18) identifies costs of regulation including administration costs, uncertainty, reduced flexibility, reduced incentives to invest and the creation of "gaming" activity by participants. It is agreed that these costs are considerable.

There is also a cost arising from the adversarial nature of the regulatory system. Under the current system the focus is often on "point-scoring" against perceived opponents rather than on the provision of appropriate incentives to ensure efficient and effective outcomes and appropriate returns.

The effect and level of these costs should be considered for all participants not just users, infrastructure owners or regulators. These costs should be quantified if possible to assess if they are greater than benefits in some instances.

In any instance where the costs are greater than the benefits the basic rationale supporting third party access and access pricing should be re-considered.

4.2 Relationship between Part IIIA and industry specific codes and the relationship between regulators.

The Productivity Commission is to examine the role of, and relationships between, regulatory bodies (including consistency between regulatory regimes, efficient regulatory administration and regulatory duplication).

The role of regulatory bodies is an important issue. There are possible conflicts of interest in the multiple roles of regulators, and in particular the nature of the regulator as an active

player in the process (eg as a consumer advocate). For example 44V of the TPA allows the determination of an access dispute by the ACCC to include matters that were not the basis for the notification of the dispute. This provides the opportunity for the ACCC to use the access dispute to force its own agenda as an active player, rather than as a disinterested judge.

In the industry's view the identity of the regulator is a secondary issue. The primary issue is the attainment of effective and efficient economic and regulatory outcomes as outlined in this paper.

Recommendation: In order to ensure effective and efficient economic and regulatory outcomes a regulator with clearly defined and non-conflicting roles is required. The identity of the regulator is a secondary issue.

4.3 Avoiding Regulatory Overlap

Consistency of regulation is an important issue, in particular there should be clarification of the relationship between the less prescriptive voluntary undertakings under Part IIIA and the more prescriptive arrangements under industry specific regimes (eg the Gas Code).

Greenfields investments or competitive infrastructure should be able to use the less prescriptive approach.

Epic Energy has indicated its intention to use the Part IIIA undertaking approach, primarily because of deficiencies it has identified in the operation of the Code as it applies to major new greenfield pipeline development projects.

However, for this to occur with certainty, there will need to be amendment to the Code to avoid regulatory overlap. These issues are currently being progressed through the National Gas Pipelines Advisory Committee.

Recommendation: There should be clarification of the relationship between voluntary undertakings under Part IIIA and arrangements under industry specific regimes, with greenfields and competitive infrastructure being given the continuing opportunity to make use of the former approach (recognising that this will require amendments to the Code).

4.4 Timing Uncertainties

In the report *"Recommendations Concerning Accelerating Investment in Natural Gas Supplies, Infrastructure and Trading Networks in the APEC Region"* (9 October 1998) APEC Energy Ministers concluded that the absence of "facilitating and predictable" legal, regulatory and trade frameworks represented a barrier to private investment in natural gas infrastructure. One of the manifestations of frameworks with such barriers

was "cumbersome regulatory processes that lengthen the time required for government officials and investors to make decisions."

Who may or may not be at fault (ie regulators or proponents) in such arrangements is not at issue; the fact that Australian economic regulatory approvals are routinely taking 18 months to 2 years to achieve is indicative of a regulatory system that is inconsistent with that envisaged by APEC Energy Ministers. The Gas Access Code envisaged that regulatory approvals should be achievable within a six-month time frame, but nothing like this has been achieved in regulatory practice.

This, in turn, places Australia's climate for investment at a disadvantage compared to arrangements that should apply in our region in order to facilitate a certain investment climate.

Recommendation: That the Productivity Commission give consideration to the arrangements needed to ensure a considerable reduction in the time currently being taken to achieve decisions on economic regulatory arrangements for existing and proposed pipelines.

Attachment A.

the australian PIPELINE industry association Inc.

6 June 2000

Mr Luke Berry
Policy Manager
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Melbourne Vic 3001

6 June 2000

Dear Luke

NCC Draft Recommendation – Application for Coverage of the Eastern Gas Pipeline (EGP)

This submission is made by the Australian Pipeline Industry Association (APIA), whose pipeline members own and operate the majority of high-pressure natural gas transmission pipelines in Australia.

The NCC's deliberations are taking place in an environment where the Access Code cannot be viewed as a vehicle that creates regulatory certainty and promotes pipeline investment. The Code has very little operational basis and regulators have experienced major delays in reaching draft and final decisions. Notwithstanding recent statements by NCC Chairman Graeme Samuel on the "facilitative" nature of the Code, the fact remains that the small number of transmission pipeline Access Arrangements that have been commented on or approved by ACCC do not demonstrate that regulators have much understanding of the commercial drivers and economic issues that confront pipeline owners and proponents of new pipelines. They simply do not have the necessary experience to form judgements on the fine balances to be achieved – including the need to provide genuine "facilitation" to new pipeline development and enhancement of existing systems. APIA reiterates the risks in using North American and European models as the bases for their education – markets in these countries are very different to Australia's and their infrastructure is much more mature.

At the outset, APIA was extremely concerned about the indecisiveness of the NCC's Draft Recommendation in relation to coverage of the EGP. The NCC's pipeline coverage test should provide clear guidance on the Council's views on whether the EGP should be subjected to the onerous provisions of the National Gas Code.

In its Draft Recommendation, the NCC has failed to express a clear view on the fundamental question of whether the entire pipeline should be "covered" or "not covered" by simply putting forward both alternatives, but with the implication that the Council was in favour of coverage. The Draft Recommendation is not framed in a form that could be considered a recommendation to the relevant Minister.

Private sector pipeline developers have every right to expect clear and unambiguous draft decisions from government agencies on major regulatory issues affecting pipelines. This is particularly important for the transmission sector given the large capital investment involved and the fact that the Code gives explicit recognition that a decision to cover a pipeline can have major commercial implications for pipeline companies.

The NCC has been given an important role under the *1997 Natural Gas Pipelines Access Agreement*. The ambiguous nature of NCC's response in the first major coverage assessment assigned to it sends a deplorable signal to the pipeline industry, runs counter to the goal of effective administrative decision making, and has created additional uncertainty in relation to a key aspect of the *1997 Natural Gas Pipelines Access Agreement*.

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Turning to the Draft Recommendation, APIA notes that the overall presumption in the NCC's assessment is that transmission pipeline owners will be "rent seekers". The NCC's assessment ignores or downplays a number of key factors relevant to transmission pipeline operations and the specific circumstances faced by the EGP and its competitors. These factors are:

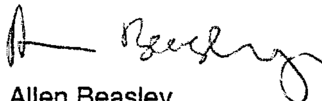
- Transmission haulage is a "wholesale" activity characterised by a relatively small number of informed buyers
- Transmission charges are a small component of the total delivered price of gas in the Sydney market
- The Code was designed for "natural monopoly" pipelines and did not contemplate "competing" transmission pipeline activities
- Firm haulage rates for the competing Moomba-Sydney pipeline have fallen
- Excess transmission pipeline capacity into the NSW market is expected to be long term in nature given projections of gas demand growth in NSW
- The NCC has failed to assess the consequences of a coverage (or partial coverage) decision in terms of costs, the possibility of regulatory error and the prospect of regulatory intervention acting as an impediment in the evolution of new services
- The NCC has failed to substantiate its assertion that the construction of the EGP will render further development of the Interconnect and associated pipelines uneconomic
- The NCC's views on competing energy sources and convergence are contrary to current industry thinking which views convergence of gas and electricity as important factors.

APIA takes the view that it would be inappropriate to make a decision to cover the EGP in the absence of compelling evidence that this intrusive regulatory avenue represents the only available means to "replicate the outcome of a competitive market." The NCC's recommendation will be viewed in a relatively wide context, including future business decisions relevant to greenfields, high risk transmission pipelines. It will also provide damaging market signals to pipeline users in NSW, many of whom have substantial market power in their own right resulting from three competing pipelines and three supply basins. Against this broader background, therefore, any recommendation for coverage (or part coverage) of the EGP would send a clear signal that the NCC's desired approach is to decrease the influence of markets and increase the level of regulatory uncertainty.

In conclusion, the dominant principle to be adopted by the NCC in its final decision must be to create the best environment in which to promote competitive outcomes wherever possible. In the case of the EGP the only appropriate decision is to recommend against coverage, including part-coverage of the pipeline.

The NCC should adopt a "wait and see" approach to regulation of the EGP under the Code. This will minimise the risk of error, allowing the Council to monitor the behaviour of pipeline owners serving the NSW/ACT markets and obtain information about market operation and shippers' reactions. APIA recommends that a period of three to five years will allow market participants to develop responses to pipeline-on-pipeline and basin-on-basin competition in the market. Access Code based regulation will only impede the development of the vigorous market conditions that are now beginning to emerge.

Yours sincerely



Allen Beasley
Executive Director

Encl.

DRAFT RECOMMENDATION BY NATIONAL COMPETITION COUNCIL ON APPLICATION FOR COVERAGE OF THE EASTERN GAS PIPELINE

SUBMISSSION BY THE AUSTRALIAN PIPELINE INDUSTRY ASSOCIATION

Introduction

The role of the National Competition Council (NCC) in relation to pipeline coverage is described in the *1997 Natural Gas Pipelines Access Agreement* agreed by the Council of Australian Governments.

The Code outlines in Schedule A those pipelines which are to be covered from the date of commencement of the Code. The Code also sets out three approaches to coverage of new pipelines under the Code, viz.:

- A case by case approach under which the NCC would use criteria specified in the Code
- The ability of service providers to request Coverage by submission of an Access Arrangement
- Use of a competitive tender arrangement, resulting in coverage from the time the Regulator approves the outcome of the competitive tender.

In addition, parties have the ability to avail themselves of provisions of Division 6 of Part IIIA of the Trade Practices Act through submission of an Undertaking to the ACCC.

The Code also includes a process to revoke the coverage of pipelines, including those listed in Schedule A and any other pipelines that may become covered under the Code.

The Code gives explicit recognition that a decision to Cover a Pipeline or to Revoke Coverage can have major commercial implications for service providers and prospective users; hence a mechanism was provided for review of the decision by the relevant appeals body.

The overlying attractiveness to customers of coverage under the Code is that it is expected to "replicate the outcome of a competitive market" and lead to lower prices.

A key concern of the Code to service providers is its prescriptive nature, the regulatory risk inherent in the role given to the regulator, the cost of service approach implied in the pricing principles (and borne out in practice in Access Arrangements) and the disincentive/regulatory impediments to innovative pricing and rewards for the development of new services in a rapidly changing energy market environment.

The challenge for the NCC, therefore, is to consider and make the most appropriate and informed recommendation to the Minister on the finely balanced interests of the service provider and customers/potential customers. The recommendation must also be viewed in a much wider

context - it will provide signals to the pipeline industry which will influence business decisions on investment in greenfields, high risk transmission pipelines. It will also provide signals to pipeline users in NSW, many of whom have recognised that they have market power where three pipelines (EAPL, EGP and the Interconnect) and three supply basins (Cooper, Gippsland and Otway) are competing. A recommendation for coverage of EGP will signal that the Governments of Australia (through the agency of the NCC) wish to decrease the influence of markets and increase uncertainty.

However, the dominant principle must be to create the best environment in which to promote competitive outcomes whenever possible (as outlined in the NCC's mission statement). If NCC chooses to recommend coverage under the Code as the only available means to "replicate the outcome of a competitive market" it has not properly assessed the facts of this case.

Background to Code

The entire National Gas Pipelines Agreement is based on the assumption that transmission represents a natural monopoly and that there is no scope for competition in "natural monopoly" parts of the gas market serviced by the Code, ie transmission and distribution.

More generally, the Code approach assumes that transmission operators will be "rent seekers" by virtue of their natural monopoly position.

In this respect, the NCC's overall analysis on coverage ignores an important difference between distribution and transmission activities. Transmission haulage is a "wholesale" activity characterised by a relatively small number of large customers (retailers and major users); distribution on the other hand has a very large number of customers large and small (industrial, commercial and residential). Transmission owners deal with a small number of informed buyers who are in an excellent position to negotiate price of haulage services (particularly given that they have a number of competing supply routes and haulage options to meet their anticipated needs).

The Code is based on the assumption that the same conditions of "market power" and "natural monopoly" apply to both transmission and distribution in all circumstances. Neither the Code nor the Agreement accommodates the possibility of "competing" transmission pipelines and the means by which this should be treated under the regulatory framework. Had such issues been considered it would be reasonable to assume that the Code include appropriate guidance (eg as currently applies to coverage of pipelines under tender arrangements). Further evidence that such issues were not considered is provided by the fact that government policy makers are only now turning their attention to issues surrounding competing pipelines under the activities of the National Gas Pipelines Advisory Committee (the body set up by governments to advise on the Code and its implementation).

The Market

In its draft recommendation the NCC has adopted a very narrow interpretation of its role under the Code. The apparent intention of the NCC appears to be to develop an argument for coverage under the Code, rather than conduct an objective assessment on whether coverage is justified on the facts of the matter.

There is some evidence that the NCC may view its role as one of securing lower prices for customers. As recently as 31 May 2000 the Minister for Financial Services and Regulation, the Hon Joe Hockey, issued a press release (including an officer from the NCC as a contact person) under the heading "West Australians to Get Cheaper Gas". (The Media Release makes a direct link between the NCC's approval of WA's Third Party Access Regime as an effective regime and the expectation of lower gas prices flowing from the decision). It is evident that the NCC does not consider the wider context of the development of Australia through a regulatory regime that allows companies to manage risk and add value to the community by encouraging growth.

History confirms that governments have at best a very ordinary record at picking winners, so new infrastructure developments are best left to companies who have the risk management skills. Companies have to operate under the threat of retaliation by shareholders if they fail in their management of risk. Governments also have a role in that they can provide the threat of heavy regulation if the behaviour of companies is inappropriate.

In these circumstances, the NCC can make a very "safe" decision by recommending no coverage and observe the way in which the market participants behave. If there is clear evidence of the exercise of market power, the first to complain will be disaffected users, who will seek a review of the coverage decision in the light of new information. This is "behaviour regulation" followed by the threat of onerous regulation. The effectiveness of the Trade Practices Act gives strong support to this approach.

The NCC Draft Recommendation

APIA has previously expressed its concerns about the nature of the NCC's so called draft recommendation on coverage of the EGP. It simply does not reach any substantive draft recommendation in relation to coverage of the pipeline that could be put to the Minister.

Against the background of perceptions that are being created in the minds of the general public about the NCC's role, APIA is therefore very concerned that the Council's assessment has either ignored or discounted outcomes emerging in the NSW energy and gas markets, including those resulting directly from EGP's prospective entry into the Sydney region:

- *Firm haulage rates for the Moomba-Sydney Pipeline have fallen*

Other pipelines competing into the NSW market (MSP, Interconnect) have signaled their intention to compete with EGP in the provision of transmission pipeline haulage services.

The NCC's assessment of the state of competition in NSW does not even refer to this outcome and the implications this may have for coverage (or non-coverage) of the pipelines in question under criterion (a).

This is an important factor which must be addressed by the NCC in its "promotion of competition test" under which "the Council compares the market conditions which would prevail if the pipeline were not covered under the National Code with those that would prevail if it were covered under the National Code."

- *With the entry of the EGP, and on current demand projections in NSW, the NSW market will have excess pipeline capacity until beyond 2010. The Moomba-Sydney pipeline, when fully compressed and operating at 100 percent load factor, has sufficient capacity to serve the entire NSW market beyond 2020. With the addition of the EGP, demand as a proportion of capacity may reach only 61 percent by 2020*

Against this background the NCC reaches the absurd conclusion that the EGP is likely to have market power in the gas sales market and that it is likely to be able to use that market power by restricting throughput in the pipeline and, as a consequence, charging higher prices than would otherwise be the case. The NCC also concludes that the market power, and the possibility of profitable exploitation, is likely to increase as surplus gas transmission capacity is dissipated by market growth.

However, the NCC has failed to conduct any objective assessment to substantiate any evidence it may have to support the arguments it presents in relation to "market power". Rather it simply raises the possibility "...the prospect that the Eastern Gas Pipeline will behave in a competitive

manner ....especially in the short to medium term", and fails to reach any draft recommendation on the issue of coverage or non-coverage of the entire pipeline.

- *The NCC asserts that transport costs normally represent a significant proportion of total delivered costs, but fails to provide any analysis of the situation as it relates to transmission in NSW*

According to the most recent published information on gas prices to customers (AGA, Gas Industry Statistics 1999), the transmission component of haulage (derived from Port Jackson's report for the BCA "Australia's Energy Reform: An Incomplete Journey" and before the prospect of the EGP and opportunities for pipeline-on-pipeline competition) represents less than 6 percent of the total price paid by residential customers and less than 15 percent of the price paid by commercial/industrial customers. The NCC assertion is flawed because it fails to present the fact that, for pipelines in the south east of Australia, the transmission tariff is a very small component of the total delivered price of gas.

- *The NCC has failed to assess the consequences of a coverage decision in terms of costs, the possibility of regulatory error and the prospect of regulatory intervention acting as an impediment in the dynamic evolution of new services.*

The NCC concludes that access (or increased access) - under the Code - to the services provided by means of the pipeline would not be contrary to the public interest (criterion (d)). However, assessment under this criterion is dependent on the Council's ultimate approach to partial or full coverage of the pipeline.

If a recommendation were made in support of coverage only to the Canberra offtake, the NCC should be required to include in its recommendation a full assessment of the costs and expected benefits and alternative approaches to achieve equivalent customer protection (recognising that only a very small number of customers would be involved, gas volumes to the markets in question are small and the pipeline owner has indicated that pricing policies for the regional markets will be referenced to the major Sydney market).

The most appropriate means of addressing this issue is to require the NCC to issue a Regulatory Impact Statement (including costs and benefits) in relation to criterion (d) as an attachment to its recommendation to the Minister.

- *The NCC concludes that "with the construction of the Eastern Gas Pipeline, it would not be economic to further develop the Interconnect and associated pipelines to provide the services of the Eastern Gas Pipeline."*

This is a remarkable conclusion given the current state of evolution of gas and electricity markets in southeast Australia. It suggests that the NCC has a thorough understanding of the nature of competitive forces in both the gas and electricity sectors, the location of possible future natural gas discoveries, the markets they may serve and a comprehensive understanding of the issues that will impact on the future development of the interconnect once the EGP is operational.

The NCC must either provide detailed substantiation in support of its arguments (which appear to be based on elementary, general assertions regarding surplus/developable capacity in the EGP and perceptions of capacity constraints either side of the interconnect), or withdraw the statement and revise its assessment under criterion (b).

- *The NCC states that "While energy sources, such as electricity, provide some competitive discipline on the sale of natural gas, the field of rivalry between these energy products is not so close as to integrate the markets."*

Given the moves towards convergence of electricity and gas in Australia (and overseas) the NCC should detail its reasoning in reaching this conclusion, since it is in conflict with the experience of the North American and European energy markets. Australia is rapidly moving along a path towards convergence. Already electricity generators and gas producers are using inputs from both sectors to determine pricing and development opportunities

The NCC's view is contrary to current industry thinking which views convergence of gas and electricity as an important factor (and one that is recognised as such by jurisdictions).

Power generation is expected to be a major source of increased demand for gas. Given the development of the National Electricity Market, including separate transmission arrangements, it will be open for generators to locate in one state and sell energy in another. Generators will have a range of options in siting their plants, based on an integrated assessment of market demand projects, electricity transmission charges and haulage charges along gas transmission pipelines. In effect, gas pipeline haulage is in direct competition with electricity transmission charges, a factor that the NCC does not appear to have considered in its assessment of the market under criterion (a).

Conclusion

APIA and its constituency are very concerned about the absence of full analysis of the facts of this case and strongly recommend that the NCC engage the industry and large users to carry out a proper economic and commercial analysis of the situation. This analysis would need to take into account all the aspects of the development of energy markets. APIA believes that the NCC must substantiate fully its assertions to support its case for the implementation of heavy-handed regulation which, based on the industry's and users' analyses, will not be in the public interest.