19 March 2004

Gas Access Regime Inquiry
Productivity Commission

Via email: gas@pc.gov.au

APIA SUBMISSION RESPONDING TO DRAFT REPORT ON REVIEW OF THE GAS ACCESS REGIME

The Australian Pipeline Industry Association (APIA) welcomes this opportunity to comment on the Productivity Commission's Draft Report on the Review of the Gas Access Regime.

APIA remains deeply concerned about the nature of the regulatory environment that has emerged in Australia and shares the Commission's observations regarding the adverse impact of regulation on investment and the long term community benefit. Over recent years the transmission sector has been distracted from the critical task of market development and creation of arrangements genuinely conducive of a national gas market.

Recent events in South Australia have highlighted the benefits that an interconnected pipeline system brings to the Australian economy. However, APIA is very concerned about the consequences - to customers and the community at large – of recent events in Western Australia which highlight the importance of regulatory policy settings and guidance that ensures timely expansion of transmission pipelines.

As noted by the Commission the market conditions facing the gas transmission sector has changed significantly since the Gas Access Regime was introduced. APIA agrees that a gas access regime of sorts is still warranted. However, our principal concern, particularly in light of the evolving nature of Australian gas markets, is to minimise regulatory distortions to investment and commercial uncertainty.

APIA's submission includes an analysis of recent decisions by the Australian Competition Tribunal which, despite the very high threshold for merits review under the Code as it stands, highlights the very serious nature of problems with the current regulatory environment. Rather than suggest that the Regime is undergoing a process of "clarification", the outcomes confirm:

- deeply embedded structural flaws in the application of the current regime; and
- increasing scope for regulatory error.

An important insight from the Tribunal's decision is that the regulator's role is to assess whether an Access Arrangement falls within a reasonable range before amending it. This is totally consistent with APIA's understanding of the "reference tariff" philosophy which was intended to underpin the Regime. In practice, however, a fundamentally different interpretation based on intrusive, cost-of-service has emerged.

APIA supports the overall thrust of the majority of the findings of the Draft Report and acknowledges the genuine attempt that has been made to develop workable solutions to clarify the intent and scope of the regime and to provide better guidance to regulators consistent with deficiencies identified in the report.

Our main concern is that implementing the Draft Report's recommendations could actually exacerbate the shortcomings of the current regime. The submission therefore examines the key recommendations in detail, outlines the plausible consequences of the current drafting and proposes alternative drafting to meet our understanding of the Commission's underlying intent.

The issue of legal drafting is a very important issue to resolve if the clarity sought by the Commission is to be achieved. In support of the importance the transmission sector attached to this issue, APIA refers the Commission to the covering letter of our submission of 12 September 2003 which stated:

"…providing clarity in the final recommendations (preferably in the form of legal drafting of proposed amendments to the regime) will be essential; otherwise the scope for reinterpretation at the policy implementation stage would add to, and not reduce, the current high level of investor uncertainty."

APIA looks forward to discussing our submission further at the Public Hearing on 26 March and, as required, would welcome the opportunity to elaborate on this submission.

Yours sincerely

Allen Beasley
Chief Executive Officer.

Australian Pipeline Industry Association - Submission

Response to Productivity Commission's draft report on the Gas Access Regime

THIS SUBMISSION HAS BEEN PREPARED BY APIA'S MEMBERSHIP IN CONJUNCTION WITH NETWORK ECONOMICS CONSULTING GROUP PTY LIMITED

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1 Introduction

APIA welcomes the opportunity to respond to the Commission's draft report on the Gas Access Regime (the draft report). APIA remains deeply concerned about the nature of the regulatory environment that has emerged in Australia.

In responding to the draft report, APIA's principal concern is to ensure that regulatory arrangements provide a sustainable basis in which regulatory distortions to investment and commercial activity are minimised. APIA believes that the current environment falls well short of such a requirement and in so doing imposes a substantial long term cost on the community.

The Commission will be aware that following the finalisation of the draft report, the Australian Competition Tribunal handed down two significant decisions. Despite the relatively narrow scope for merits based review that is provided under the Gas Access Regime, both appeals against the regulator's decisions were successful in varying the regulator's decisions.

APIA believes these decisions warrant close study – not only do they highlight the importance of the retention (and extension) of merits review but more fundamentally they confirm the structural flaws of the current regulatory regime and its application by regulators. The decisions provide important insights into the substantially enhanced scope for regulatory error under the intrusive model that currently applies under the Gas Access Regime.

In essence, whilst APIA accepts several of the Commission's draft findings and recommendations from its draft report, there remains a serious and significant gap between the Commission's proposals and what is required to transform the Gas Access Regime into a sustainable regulatory regime particularly given the proposed process by which the MCE has announced it will follow in implementing any changes to the Gas Access Regime. Indeed, APIA is concerned that implementing the draft report's recommendations could even exacerbate the iniquitous elements of the current regime.

APIA notes the enormous significance of the Commission's work in the MCE's policy formulation process and is concerned that the complexity of the issues can create scope for material shifts in positions as findings and recommendations are implemented. Accordingly, APIA urges the Commission to adopt clear definitions and guidelines in drafting its final report.

This submission outlines APIA's reasons for this view and its proposals for sustainable reform of the Gas Access Regime. The submission is structured as follows.

- section 2 summarises some important recent decisions of the Australian Competition Tribunal;
- section 3 considers the objects clause and the guidance provided to regulators under the Gas Access Regime;
- section 4 examines the threshold test for tier 1 regulation;
- section 5 reviews the approach that should be taken to monitoring;
- section 6 considers the threshold test to be applied to tier 2 regulation;
- section 7 reiterates APIA's views on the type of regulation to be applied to those pipelines that meet the tier 2 test;
- section 8 reviews the Commission's recommendations in relation to new investment;
- section 9 considers institutional and other matters; and
- section 10 concludes this submission.

2 Recent Australian Competition Tribunal decisions

2.1 Introduction

The price reductions that have been mandated under the Gas Access Regime have come at a high cost to the community.[1] These price reductions have arisen from regulators imposing the outcomes of desktop pricing exercises based on high level estimates on pipeline owners – a process which is particularly prone to regulatory error.

As recognised by the Commission,[2] lower prices in the short term translate into poor outcomes for consumers in the long term from:

- deferred investment decisions, and as a result a deferral of the benefits from basin on basin competition and from the diversity of energy supply new pipelines offer to the community; and
- distorted investment decisions – such as undersizing pipelines to minimise regulatory risk, an outcome that paradoxically denies the community the benefits of scale economies that provided the original rationale for regulatory intervention. Undersizing of gas transmission pipelines increases the cost of gas transmission in the long term.

Not only are gas consumers adversely affected, but so too is the community. For example, the current regulatory climate creates disincentives to entrepreneurial risk taking. This means that gas transmission initiatives which advance economic growth and regional development are not pursued.

An examination of the Australian Competition Tribunal's recent decisions on the Moomba Adelaide Pipeline System (MAPS)[3] and GasNet[4] transmission systems makes it clear that these reductions do not reflect a balanced assessment of all of the factors required to be considered in assessing an Access Arrangement for the provision of services. Indeed, in many instances these reductions were contrived by regulators making unreasonable judgements.

In APIA's view, these recent decisions cast serious reservations on the fundamental approach used to regulate gas transmission pipelines under the Gas Access Regime. This

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1 Draft Finding 4.2.

2 Draft Finding 4.3.

3 Australian Competition Tribunal, Application by Epic Energy South Australia Pty Ltd [2003] ACompT 5.

4 Australian Competition Tribunal, Application by GasNet Australia (Operations) Pty Ltd [2003] ACompT 6.

section reviews the Tribunal's decisions followed by a discussion of the key issues to emerge and the implications for the Commission's review of the Gas Access Regime.

2.2 Moomba to Adelaide Pipeline System

The Tribunal's decision on the MAPS is critical of the ACCC adopting the lowest possible parameter value. In particular, the Tribunal was critical of the ACCC's decision to determine the cost of line pipe based on the lowest internationally available price at a particular point in time. The Tribunal noted the uncertainty over the values to be adopted and the unreasonableness of the ACCC's approach:[5]

> For planning purposes, however, this price cannot be known with any certainty and a prudent operator would likely find it to be commercially unwise to plan a pipeline project based on the lowest known line pipe cost, or even the average line pipe cost of suppliers in the lowest-cost producing country. The risk here is highly asymmetric, all on the upside. Thus a prudent operator, in the absence of perfect information, would factor into its estimates the expected value of line pipe costs, based on its estimation of the range of likely future prices and the assessed probability of occurrence of each possible price.
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> In the absence of knowledge of such a probability distribution at the planning stage, an operator might therefore obtain some indicative estimates based on less-than full information being available, compared with a specific tender to job specifications, and take either a simple arithmetic average, a modified arithmetic average, or the median of these prices as the indicative planning parameter value. It would be a highly risky commercial action to take the lowest figure found in any such non-detailed price-seeking activity.

The Tribunal determined that a median or mean value for the cost of line pipe was an appropriate response to estimation uncertainty. In so doing, the Tribunal highlighted the asymmetric risk that the ACCC had created:[6]

> In taking the approach that it did, the ACCC exposed Epic to an asymmetric risk whereby the likelihood of underestimating the true actual line pipe cost was much greater than that of overestimating it. To take the lowest price from a source of supply, runs the risk of serious commercial understatement of the expected cost of line pipe.
>
> The Tribunal finds that the ACCC made a choice in selecting the Greek price for line pipe from the determination of the ORC that in all the relevant circumstances is unreasonable. It is not an exercise of discretion that a reasonable person would have made in all the circumstances. It falls beyond the boundaries of what a prudent

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5 Australian Competition Tribunal, Application by Epic Energy South Australia Pty Ltd [2003] ACompT 5, paragraphs 63-64.

6 Ibid, paragraphs 94-95.

> commercial operator would be expected to do in this forward-looking planning circumstances.

The Tribunal thus highlighted the extreme nature of regulatory practice as it has been applied in Australia, where the removal of perceived monopoly rent is the overwhelming focus of regulatory decision making. As was pointed out in APIA's earlier submissions, the inevitable consequence of such an approach is that the pipeline owner's legitimate business interests are overlooked with adverse long term consequences for the economy.

The Tribunal also found that the ACCC had acted unreasonably in relation to its decision that an expansion of the pipeline that was built after the access arrangement was lodged for approval but before the regulator handed down its decision (Pelican Point Power Station expansion) should be part of the covered pipeline. That expansion was fully contracted for firm (FT) service and had limited scope for interruptible (IT) services. The Tribunal found that:[7]

> In the Tribunal's view, it is not reasonable to argue that the Pelican Point FT service expansion of 25 TJ per day should be now be regulated because of the potential market power associated with any IT service that Epic might be able to exercise…
>
> .. The effect of including the Pelican Point expansion will almost certainly be lower tariffs for all contracted users when the contracts expire, even though the capacity was fully paid for by Pelican Point which has a contract for the FT service capacity until 2019.
>
> The Tribunal finds that there were no factual circumstances which would have entitled the ACCC to reasonably conclude that Epic would be able to exercise any market power of a significant nature in the market for IT service. The ACCC did not provide any cogent explanation of what the mechanism was, through which Epic could systematically act to exercise any market power, nor did it provide any evidence as to what the effects would be, or who would be affected, and for how long the effects would last. The ACCC could do no more than say that in the absence of proof that the Pelican Point expansion *`was fully contracted in every sense of the word'* then it was correct for it to conclude that Epic could potentially exercise market power in the supply of IT service. That, in the view of the Tribunal, was not a sufficient basis upon which to conclude that the Pelican Point expansion of capacity ought to be covered and included in the SPC of the Pipeline System available for the provision of a FT service being the Reference Service in the AA Epic lodged on 1 April 1999. Nor was it open to the ACCC to come to the decision which it did without due consideration of the legitimate business interests of Epic which the ACCC failed to consider.
>
> In the view of the Tribunal, the decision of the ACCC to include the Pelican Point expansion capacity in the SPC of the pipeline system was in error, and unreasonable in all the circumstances, and ought to be set aside.

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[7] Ibid, paragraph 108 and paragraphs 119-121.

In essence, the Tribunal found that the Pelican Point extension provided Epic with no market power in the market and was not expected to yield any additional revenue over the regulatory period. Yet, despite this, and without a cogent basis, the regulator *assumed* that the pipeline possessed market power in the relevant market and further attributed revenue to the sale of interruptible capacity without any reasonable basis for doing so. Again, this finding highlights the propensity of the regulator (and the regulatory process) to yield unreasonable results. The Tribunal made similar findings on the regulator's decision in GasNet.

2.3 GasNet

In its decision on GasNet, the Australian Competition Tribunal was highly critical of key features of the regulator's approach to the overall assessment process, in particular, the weighted average cost of capital (WACC).

The Tribunal disagreed with the ACCC's position that it needed to determine the appropriate return. The Tribunal stated that the requirement of the regulator under the Code is to only propose an alternative Access Arrangement when that proposed by the Applicant (in this case GasNet) does not comply with the Code. The Tribunal noted:[8]

> Contrary to the submission of the ACCC, it is not the task of the Relevant Regulator under s 8.30 and s 8.31 of the Code to determine a '*return which is commensurate with prevailing conditions in the market for funds and the risk involved in delivering the Reference Service'*. The task of the ACCC is to determine whether the proposed AA in its treatment of Rate of Return is consistent with the provisions of s 8.30 and s 8.31 and that the rate determined falls within the range of rates commensurate with the prevailing market conditions and the relevant risk.

This is a key finding as it accepts there is considerable uncertainty over the WACC, and highlights that if the Code is applied properly, a business, in proposing an Access Arrangement, should be provided with the opportunity to choose from a range of plausible outcomes and models for the WACC that are consistent with the Code rather than have the regulator determine a WACC that it considers most appropriate for them. The Tribunal noted:[9]

> Where the Reference Tariff Principles produce tension, the Relevant Regulator has an overriding discretion to resolve the tensions in a way, which best reflects the statutory objectives of the Law. However, where there are no conflicts or tensions in the application of the Reference Tariff Principles, and where the AA proposed by the

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8 Australian Competition Tribunal, Application by GasNet Australia (Operations) Pty Ltd [2003] ACompT 6, paragraph 42.

9 Ibid.

> Service Provider falls within the range of choice reasonably open and consistent with Reference Tariff Principles, it is beyond the power of the Relevant Regulator not to approve the proposed AA simply because it prefers a different AA which it believes would better achieve the Relevant Regulator's understanding of the statutory objectives of the Law.

In the Tribunal's opinion, GasNet had applied the CAPM model consistent with the Code requirements, and therefore, this should have been accepted by the ACCC.

At a specific level, the Tribunal concluded that the ACCC's approach to determining the bond maturity in the risk free rate was inconsistent with the mathematical logic underlying the CAPM formula. As such the ACCC was not even applying the CAPM as required under the Code. It stated: [10]

> The ACCC erred in concluding that it was open to it to apply the CAPM in other than the conventional way to produce an outcome which it believed better achieved the objectives of s 8.1. In truth and reality, the use of different values for a risk free rate in the working out of a Rate of Return by the CAPM formula is neither true to the formula nor a conventional use of the CAPM. It is the use of another model based on the CAPM with adjustments made on a pragmatic basis to achieve an outcome which reflects an attempt to modify the model to one which operates by reference to the regulatory period of five years. The CAPM is not a model, which is intended to operate in this way. The timescales are dictated by the relevant underlying facts in each case and for present purposes those include the life of the assets and the term of the investment.

The Tribunal also found that the ACCC erred in not providing GasNet with the full costs of raising debt finance and accordingly determined that an allowance of 25 basis points should be included in the cost of debt for the cost of debt issuance.

In addition, during the course of the GasNet proceedings, the ACCC conceded several other aspects of its Final Decision should be changed. These concessions included that it was appropriate for GasNet to be provided with an allowance to self-insure against uplift liability risk, key person risk and employment practices risk, and that any costs associated with counterparty default and terrorism should be treated as a pass through item. Given that the ACCC's Final Decision on this matter had already been issued, it is clear that the only reason that these concessions were made is the fact that merits review was available to GasNet.

[10] Ibid, paragraph 47.

2.4 Implications of the decisions

It is important to recognise that the Gas Access Regime establishes a very high threshold for the merits review of regulator's decisions made under it. For example, the Tribunal in the MAPS decision explained the constraint upon merits review as follows:[11]

> Obviously, different observers may hold different views as to what is unreasonable, having regard to all of the relevant circumstances. However, before it will intervene in and substitute its own view, the Tribunal must be satisfied the applicant has established the decision under review is wrong for the reasons particularised in that ground of review. The Tribunal may then intervene to correct the error.

The fact that the Tribunal has felt compelled to substitute its own view for that of the regulator on each ground that was appealed in spite of this high threshold, highlights the seriousness of the problems with the current environment. APIA considers the circumstances of this intervention serve to highlight the fundamental limitations and dangers of any system of regulation that confers upon a regulator the type of heavy-handed powers that are conferred under the Gas Access Regime. This is especially important given the Commission's recommendation to retain a heavy handed form of regulation under the Gas Access Regime.

Indeed, it appears to APIA that in reality, the Tribunal was disputing more than merely the regulator's decisions in each case. Instead, and more fundamentally, the Tribunal was disputing the very culture that led to such extreme decisions being made in the first place. The essence of the approach adopted by the regulator in each case was to *unreasonably* adopt a value that was contrary to commercial practice and antagonistic to the pipeline owner's legitimate business interests.

The fact that these decisions were made in an environment where the asymmetric implications of regulatory error were well known to the regulator only serves to underscore the very high costs that have accompanied the form of heavy-handed regulation provided for by the Gas Access Regime.

An important insight from the Tribunal's decisions is that the regulator's role is to assess whether an Access Arrangement falls within a reasonable range before amending it. This is a fundamentally different approach from that which has been adopted by regulators to date, where the regulator has felt empowered to substitute its view for that of the service provider, irrespective of whether or not the service provider's position fell within a reasonable range.

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[11] Australian Competition Tribunal, Application by Epic Energy South Australia Pty Ltd [2003] ACompT 5, paragraph 15.

APIA sees considerable merit in the Tribunal's approach and submits that explicitly confining the changes a regulator could require to an Access Arrangement under the Gas Access Regime to those circumstances where the regulator is able to demonstrate that the service provider's position fell outside a reasonable range would be a significant improvement to the current regime. APIA believes that imposing such an obligation on a regulator, in an environment where merits review was not restricted to its current scope, would materially alleviate regulatory risk.

APIA considers that a clarification to the Gas Access Regime is especially important due to a likely (but unintended) impact of the Tribunal's decisions being that regulators will respond by adopting more narrow interpretations of the Gas Access Regime. This could result in regulators focusing more on highlighting tensions between proposed Access Arrangements and the objectives of the Gas Access Regime in regulatory decisions so as to reduce the scope for review of their decisions.

Finally, whilst APIA supports several (but not all) of the Commission's recommendations on reforms to the merits review provisions (refer section 9.1), APIA remains concerned that reliance upon merits review is not a panacea. Amongst other things, there is a positive externality associated with service providers prosecuting merits review appeals because they incur substantial cost (and risk) in engaging in these actions whilst the beneficiaries will often be other service providers. The combination of the limited scope of appeal rights, together with this positive externality, highlights the importance of structuring the Gas Access Regime so as to minimise the need for merits review appeals to be pursued in the first place.

Recommendation

APIA recommends that the changes a regulator could require to an Access Arrangement under the Gas Access Regime be confined to those circumstances where the regulator is able to demonstrate that the service provider's position fell outside a reasonable range.

3 Objectives and objects clause

Chapter 5 of the Commission's draft report covers the issues of the objects clause and the guidance to regulators for the assessment of access arrangements. APIA addresses the issues to emerge from the Commission's recommendations on these issues in turn.

3.1 Proposed objects clause

In general, APIA sees merit in focusing the objectives of the Gas Access Regime by inserting an overarching objectives clause in the Gas Access Regime legislation. The objectives currently contained in the Gas Access Regime have been shown to be ineffective in influencing regulatory decisions. APIA strongly endorses the recommendation that the objects clause have binding status under the regime.

APIA believes that the inclusion of multiple and conflicting objectives can only serve to undermine the very purpose of elucidating those objectives in the first place. This is because multiple objectives enables virtually any decision can be reconciled with at least some of the objectives.

In general therefore, APIA is strongly supportive of inserting an overarching objective that reflects that recommended in the draft report:[12]

> To promote the economically efficient use of, and investment in, the services of transmission pipelines and distribution networks, thereby promoting competition in upstream and downstream markets.

APIA acknowledges the precedent that this phraseology has in the context of the Commission's previous reports. However, APIA believes that the meaning of the provision should be clarified either through changes to the proposed definition or through explanatory materials.

In essence, the proposed objects clause encapsulates three concepts:

- the promotion of efficient use of the services of gas transmission pipelines;
- the promotion of investment in the services of gas transmission pipelines; and
- the promotion of competition in upstream and downstream markets.

There are three sets of issues that emerge from these objectives:

- the meaning of efficient;

[12] Draft Recommendation 5.1.

- the potential for conflict between the use of and investment in the services of transmission pipelines; and
- the promotion of competition in upstream and downstream markets being an end in itself rather than a means to an end.

3.1.1 The meaning of "efficient"

APIA wishes to clarify its perception of the meaning of "efficient" in the current context. APIA notes that the concept of "efficient cost" that has inspired much of the regulatory activity is anything but efficient in the long run in the way it has been applied. In APIA's view, the concept of "efficient" must be considered in the long run to incorporate dynamic aspects and fundamentally involves ensuring that the regulatory system does not distort investment incentives.[13] Given the uncertainty and scope for confusion over this term, APIA believes that the Commission should provide clear guidance as to its interpretation of this term.

3.1.2 Conflict between the use of and investment in infrastructure

APIA considers that the efficient use of transmission pipelines should be subordinate to the second objective of achieving efficient investment in infrastructure.

Failure to clarify the relative importance of these considerations could result in conflicts arising between the concepts. For example, it is possible that a short term focus could be applied which could legitimise an outcome where a regulator could require that spare capacity be priced at marginal cost in the short run (assuming it were an efficient use of infrastructure) – an outcome which would discourage investment in transmission pipelines in the long run.

The importance of this clarification is highlighted by the fact that the Commission has referred to the objects clause as the vehicle to resolve tension between pipeline owners and users:[14]

> In the Commission's view, it is difficult to see why ss2.24 (a) and (f) should be retained as explicit objectives. The overarching objects clause encapsulates the possible tension between the interests of service providers and users and seeks to resolve it in an efficiency context. In addition, the guidance for access arrangements discussed in chapter 7, particularly in relation to reference tariffs, would seem to cover these issues.

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[13] APIA refers to section 4 of its Initial Submission that discusses economic efficiency in the context of regulation.

[14] Page 152.

APIA does not accept that the objects clause alone (as proposed) satisfactorily addresses this tension in the current environment (see section 3.2 below). Moreover, APIA's view is that the only way in which the two concepts can be read consistently (and hence for this conflict to be resolved) is for the efficient use of infrastructure to be, in effect, subject to the efficient investment in infrastructure and submits that the clause should be clarified accordingly.

This is particularly so if, as has been widely recognised, the gas market is immature and for it to be an effective participant in the energy market, more infrastructure is required. This importance is further underscored by the fact that the private sector is now responsible for the development of gas pipeline infrastructure – there must be no disincentives to investment. Moreover, once an investment has been made in pipeline infrastructure, there is a strong *commercial* imperative to ensure that the pipeline's capacity is utilised in an efficient manner.

Finally, the reference to investment in the services of gas transmission pipelines is itself unclear. APIA assumes that what is sought to be promoted is the investment in this infrastructure in a way that is consistent with economic efficiency – this means pipeline infrastructure investment that is efficient – both in terms of timing and scale (as opposed to being delayed and then being "built to market" to minimise the risk and impact of regulatory intrusion). To remove doubt, APIA suggests that the word "efficient" be inserted before "investment" in the objects clause.

3.1.3 Promotion of competition a means to an end

In general, APIA supports the concept that the statement of the fundamental objective of the Gas Access Regime should include reference to promoting competition in upstream and downstream markets. However, APIA is concerned that the current reference to competition in upstream and downstream markets could be read as being an end in itself rather than a means to an end – being the promotion of economic efficiency.

APIA believes it is appropriate to address this concern simply by clarifying that the object is to promote competition in upstream and downstream markets where it is consistent with economic efficiency.

3.2 Guidance for access arrangements

APIA has two concerns with the proposed amendments to clause 2.24 of the Gas Access Regime. The first concern is that the changes could result in the Gas Access Regime ceasing to comply with clause 6 of the Competition Principles Agreement – as the matters

considered by a regulator in setting reference tariffs bind an arbitrator, the removal of the clause 2.24 factors could render the regime ineffective.

APIA is also concerned about the Commission's removal of the guidance provided to regulators that:[15]

> (a) the Service Provider's legitimate business interests and investment in the Covered Pipeline.

APIA recognises the Commission's argument that this matter becomes superfluous given the proposed amendments to the objects clause. However, it is submitted that this approach pays insufficient account to two critical factors:

- the reality that regulatory decision making in Australia has made the removal of assumed monopoly profit the focus of decision making; and
- the asymmetric consequences of regulatory error.

Reality of regulatory decision making

In 2002, the Western Australian Supreme Court overruled the decision of the Western Australian gas regulator on the grounds that the regulator's decision was wrong in law as it did not properly recognise the owner's legitimate business interests.[16] Moreover, Section 2 of this submission detailed the findings of two recent decisions of the Australian Competition Tribunal. APIA submits that a reasonable person carefully reading these decisions would be alarmed at the extreme views that were imposed by the relevant regulator in each case, views that which were overturned on appeal.

Yet these extreme views have been adopted in an environment where specific guidance has been given to regulators about the need to "protect the legitimate business interests of service providers" (admittedly amongst other objectives). In both of the recent Tribunal decisions, the Tribunal paid particular regard to the legitimate business interests of pipeline owners in arriving at its finding.

APIA submits that the approach of Australian regulators is far from the regulatory capture that has been described in the academic literature. Instead, as was described in APIA's initial submission, the reality of regulatory decision making in Australia has been that the removal of assumed monopoly profit has been the sole focus of regulatory decision making for at least some economic regulators.

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[15] Draft Recommendation 5.4.

[16] Re Dr Ken Michael AM; ex parte Epic Energy (WA) Nominees Pty Ltd & Anor [2002] WASCA 231.

In such an environment, APIA submits that it is imperative that the legitimate business interests of owners be recognised if economic efficiency is to be achieved in the implementation of regulation, especially as the Commission has recommended the retention of an intrusive price setting role under the Gas Access Regime. This is all the more the case when regard is had to the asymmetric consequences of regulatory error.

Asymmetric consequences of regulatory error

APIA fully endorses the sentiments expressed by the Commission in its Position Paper on the asymmetric consequences of regulatory error: [17]

> The possible disincentives for investment in essential infrastructure services are the main concern. In essence, third party access over the longer term is only possible if there is investment to make these services available on a continuing basis. Such investment may be threatened if inappropriate provision of access, or regulated terms and conditions of access, lead to insufficient returns for facility owners.
>
> While the denial or monopoly pricing of access also impose costs on the community (see above), they do not threaten the continued availability of the essential services concerned. Thus, over the longer term, the costs of inappropriate intervention in this area are likely to be greater than the costs of not intervening when action is warranted. The substantial information and other difficulties that confront regulators in establishing access terms and conditions, make this asymmetry in the benefits and costs of access regulation even more important in a policy context.

In this context, APIA submits that it is efficient and socially desirable that regulatory bodies are specifically directed to have regard to the legitimate business interests of service providers – even if the interests of other parties are considered in the wider context of the pursuit of the efficient use of and investment in pipeline infrastructure. The importance of this issue is implicitly recognised by the Commission its findings on the standing of parties to seek merits review of regulatory decisions.

APIA submits that directing regulators to have regard to the legitimate business interests of service providers will in itself protect the interests of users of the facility in the long run. Failure to have sufficient regard to the interests of service providers will result in the long run cost of providing services to users increasing for two reasons:

- the costs imposed on society from the investment distortions induced by regulatory decisions; and
- the increase in the capital cost of providing infrastructure to compensate investors for regulatory risk.

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[17] Productivity Commission, "Review of the National Access Regime Position Paper", March 2001, pp xviii-xix.

The Commission acknowledged in the draft report that the application of the Gas Access Regime has caused distortions in pipeline investment.[18] These distortions manifest themselves in delayed and distorted investments creating congestion and allocative efficiency losses.

This has led to the paradoxical situation where the implementation of the Gas Access Regime has meant that those seeking access to pipelines have at times confronted capacity constraints - not as a result of a refusal to provide access to spare capacity (of which APIA is not aware of any such instances either before or after the Gas Access Regime came into force), but from a hold-up to capacity augmentation created by the regulatory regime. In APIA's view, these costs are likely to have outweighed the *economic* benefits from the introduction of the regime.

Moreover, when investments are undertaken, there is an increasing tendency for them to be sized for short term demand so that the scale economies that could be secured to minimise the long run average cost of the provision of gas transmission services are foregone. Similarly, regulatory risk has imposed an additional capital cost that must be recovered in order for pipeline investments to be undertaken. The costs created by regulatory uncertainty are simply a deadweight cost on the community.

A parsimonious means of alleviating these adverse impacts is to specifically direct regulators and appellate bodies to consider the legitimate business interests of service providers. Whilst APIA does not consider that this is a complete answer to the issue of regulatory design and regulatory risk, APIA believes that the retention of the guidance provided by clause 2.24(a) will send a strong signal to market participants and regulators on the importance of encouraging efficient investment in infrastructure. Accordingly, APIA submits that clause 2.24(a) of the Code should be retained.

Recommendation

APIA recommends that:

- the meaning of efficient be clarified in respect of it being a long run concept;
- the potential for conflict between the use of and investment in the services of transmission pipelines be removed by making the former subordinate to the latter concept;
- the word "efficient" be inserted before "investment" in the objects clause;
- the promotion of competition in upstream and downstream markets be subject to an efficiency enhancing criterion;
- clause 2.24 objectives be retained to maintain compliance with the Competition Principles Agreement, and that, in any event, clause 2.24(a) be retained.

[18] Draft Finding 4.3.

4 Tier 1 coverage test

APIA's principal concern with the form of regulation that has applied under the Gas Access Regime is that the coverage criteria have in practice created a low threshold to the application of invasive regulation. The fact that a less intrusive form of regulation is being contemplated under the tier 1 regulatory model in no way reduces the importance of ensuring that coverage is rejected where it does not advance economic efficiency significantly. Accordingly, APIA strongly endorses the Commission's draft recommendation that the coverage criteria include a new limb — namely, that coverage of the pipeline is likely to improve economic efficiency significantly.[19]

This is especially the case given that APIA's concerns that the light-handed regulation provided by the first tier could easily become more heavy handed over time due to the similarity of the threshold tests. APIA can envisage a scenario where regulators are pressured to use the regulatory instruments at their disposal under the first tier (eg information gathering under price monitoring) to press for the application of the more invasive regulatory approach of the second tier. Indeed, APIA suggests this may have already occurred in the case of price monitoring of aeronautical services in Australia. Moreover, as set out in APIA's initial submission, the history of the Gas Access Regime highlights the risk that regulatory environments become increasingly invasive over time.

It is with this in mind that APIA wishes to set out its serious reservations with many of the Commission's other findings and recommendations on the coverage criteria, including:

- the retention of the "likely" threshold in the competition test;
- the failure to address the limitations of the interpretation of the "uneconomic to duplicate another pipeline" test;
- the failure to retain a safety threshold, which consigns such issues to be addressed . under the public interest, with a reversal of the onus;
- the failure to incorporate a national significance test; and
- the status of covered pipelines under the new regime.

These issues are addressed in turn in the following sections.

[19] Draft Recommendation 6.4.

4.1 Promotion of competition

Whilst APIA supports the Commission's proposed lifting of the threshold from a promotion of competition test, it remains concerned that this attempt to strengthen this test is substantially undermined by the retention of the "likely" threshold. In addition, APIA supports the inclusion of examples of factors that may be considered under it, and wishes to take this opportunity to augment those proposals.

4.1.1 Likely

APIA agrees with the Commission's draft finding 6.4 that:

> The test 'would be likely to have the effect of increasing competition in a market to a substantial degree' would set a higher threshold than 'promotes competition'.

However, APIA is concerned that this finding overlooks the critical consideration of the test – namely the threshold that applies for the decision maker to be satisfied of the increase in competition. Since a mere possibility of a substantial increase in competition could meet the "likely" threshold, APIA considers that the Commission's proposed change could have virtually no impact on the practical application of the test. The recent decision of French J in the AGL litigation confirms that "likely" means a 'real chance' of having the effect.[20]

APIA's concern regarding the phrasing of paragraph (a) of the threshold test has only been confirmed by the NCC's recommendations in relation to the GGP, where it was interpreted as a de facto monopoly pricing test – despite pricing considerations explicitly not forming part of the threshold test. The NCC has, in other words, asserted that it is sufficient that absent coverage, prices would not be "optimal" for coverage to be recommended. This highlights the need for there to be a probability rather than a mere likelihood that coverage would increase competition in an upstream or downstream market. APIA considers that in an environment where property rights are fundamentally affected by decisions, affirmative satisfaction of the threshold requirements should be required as a minimum.

It is for this reason that APIA's initial submission recommended that paragraph (a) of the threshold test for coverage be amended to provide that coverage would only apply where (emphasis added):

> that access (or increased access) to Services provided by means of the Pipeline would ***be more likely than not*** to achieve a substantial increase in competition in at least one market (whether or not in Australia), other than the market for the Services provided by means of the Pipeline

[20] See *AGL v ACCC* (No 3) [2003] FCA 1525; French J at pages 108, 109 and 110.

This criterion set a materially lower threshold than was suggested in the Hilmer Report which stated (emphasis added):

> .. access to the facility in question is ***essential to permit*** effective competition

Similarly clause 6(3)(b) of the Competition Principles Agreement provides that (emphasis added):

> access to the service is ***necessary in order to permit*** effective competition in a downstream or upstream market

It is clear that each of these tests place a strong obligation on a person seeking declaration or coverage to demonstrate the necessity or the essentiality of access to enable upstream and downstream competition. There is simply no mention of a threshold as low as "likely".

Accordingly, APIA submits that the intention of raising the bar to coverage applications in respect of criterion (a) is fundamentally undermined by the inclusion of a test that merely requires that there is a "likely" increase in competition. Consequently, APIA considers that the change will make little difference to the application of the current threshold test, and ,may even lower it in practice. Moreover, APIA submits that the meaning of the term "substantial" should be clarified to mean "large, weighty or big". Those terms in the definition have their own meaning in the context of jurisprudence and no further definitions are needed. APIA also submits that the reference to "likely" should be amended to state "more likely than not".

4.1.2 Examples of matters to consider in assessing the promotion of competition

APIA endorses the Commission's recommendation that the Gas Access Regime be amended to provide guidance on the following matters being considered in the context of whether or not coverage would be likely to increase competition to a substantial degree:

> (a) the nature of demand for the commodities and services of end users of gas
>
> (b) the actual and potential level of competition from substitutes such as gas from other sources delivered through other pipelines, and other forms of energy such as electricity
>
> (c) the nature and extent of any barriers to entry in the market
>
> (d) the degree of countervailing power in the market

However, APIA contends that the following paragraph should be omitted:

> (e) the likelihood that rejection of coverage would lead to significant and sustainable increases in prices or profit margins.

APIA submits that increases in prices or profit margins do not represent undesirable outcomes in and of themselves especially when it is remembered that any view of prices or profit margins must be considered over the lifetime of the pipeline. This will only be the

case where prices or profit margins are above economic levels. APIA does not understand the relevance of such a provision in a test designed to determine whether coverage will promote competition in upstream or downstream markets – that is a market other than the market for the service that is the subject of the coverage enquiry. The inclusion of this provision will create a climate in which coverage decisions will reduce to a de facto regulatory pricing test as to whether or not prices are 'optimal'.

In addition, APIA suggests that the following examples also be included:

> (f) the actual and potential level of competition from substitutes such as gas from other storage facilities and from the ability of upstream and downstream interests to engage in trade
>
> (g) the nature and impact of self imposed behavioural constraints that are adopted and applied
>
> (h) the contestability of the market for the services provided by means of the pipeline
>
> (i) the dynamic characteristics of the market, including growth and innovation
>
> (j) the nature and intensity of competition in upstream and downstream markets;
>
> (k) the revenue loss that a pipeline owner would suffer if it failed to supply gas to a customer or ceased to supply gas to a customer.

4.2 Uneconomic to duplicate another pipeline

APIA notes that the Commission did not recommend any change to the uneconomic to duplicate test on the basis that criterion (a) provided an adequate vehicle for substitution possibilities to inform coverage decisions. In coming to this recommendation, the Commission noted that:[21]

> Given that criterion (b) is a screen for natural monopoly and consistent with the CPA and Part IIIA, the Commission considers that this criterion should be retained with no change.

However, APIA submits that the Commission's reasoning on this ground has limitations. To understand these limitations, it is important to recognise that this logic simply concedes that the provision has virtually no purpose whatsoever. Indeed, on the Commission's interpretation, the role for criterion (b) would be limited to a situation where parallel pipelines compete (and presumably one in which there could be no issue as to whether or not coverage would promote competition or increase economic efficiency). However, if that is the intention, one must ask why it forms a fundamental component of the coverage test – not only for the Gas Access Regime but also Part IIIA of the Trade Practices Act.

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[21] Productivity Commission, "Review of the Gas Access Regime", Draft Report, December 2003, p 180.

APIA submits that a more realistic and economically defensible interpretation would be to consider the role of criterion (b) with respect to the criterion (a). In APIA's view, there are sound reasons for the two limbs to examine functionally distinct layers of the delivery chain.

APIA believes that the purpose of criterion (b) is to look to the "essentiality" of the service provided by the facility. It does this by considering the extent of market power possessed by a pipeline in the relevant *transport* market. It is only by being satisfied that a pipeline does in fact possess a level of market power in the transport market commensurate with that of a natural monopoly that criterion (b) is satisfied and criterion (a) becomes relevant. In essence therefore, criterion (b) is a preparatory step to criterion (a).

This approach contrasts to the approach which has been adopted (and supported by the Commission) where criterion (b) is all but automatically satisfied leaving the entirety of the competition issues to be resolved under criterion (a). Yet, as was pointed out in APIA's initial submission, participants in monopolistically competitive markets potentially exhibit the very characteristics which could authorise coverage.[22]

APIA speculates that the recognition of the potential for inappropriate coverage has contributed to the Commission's desire to focus on criterion (a) in lifting the threshold test for coverage. APIA accepts the need (particularly under the current approach to considering coverage questions) to increase the threshold for criterion (a). However, APIA is concerned that in looking to reform criterion (a), the flaw in criterion (b) will remain.

APIA believes that the proper interpretation of (b) is that the criterion looks to the essentiality of the pipeline and the absence of substitutes to the service it provides. This interpretation confers on criterion (b) a substantive role in the assessment of the market power possessed by a pipeline. In turn, this enables a more realistic and less pivotal role for criterion (a) in the legislative scheme.

APIA submits that apart from providing an interpretation which gives a balanced role for each limb of the test, this approach has the additional benefit of reducing the reliance on a limb (namely criterion (a)) that is relatively difficult to apply in practice. After all, it is inherently difficult for any decision maker to assess the likely impact of coverage on a pipeline on competition in upstream and downstream markets over the next 15 years. A far clearer test, which is more easily applied, is to look to the market power possessed by the pipeline in question.

APIA therefore submits that the criterion needs to be redrafted so as to be clarified and perform a proper role in coverage deliberations. This requires that:

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[22] At least in respect of a Paretian relevant range of output.

- the term "pipeline" be replaced with the term "facility", to recognise the rich array of substitution possibilities that present in practice, including electricity, swap contracts and storage facilities;
- correcting the point to point misnomer so that substitution possibilities are correctly allowed to inform the decision as to whether or not a pipeline is a natural monopoly. This thinking is echoed in the Ministerial decision on the MSP which stated:[23]

> It is therefore no longer appropriate to think in terms of gas transportation as being from a single well-head or processing plant along a single transmission pipeline to a single off-take point… It would be unduly restrictive to conclude that a single transmission pipeline must provide the same point to point service as the MSP Mainline to be considered relevant to Criterion B.

APIA submits that paragraph (b) of the threshold test for coverage should be amended as follows:

> that there does not exist and it would be uneconomic for anyone to develop another facility to provide the service or a close substitute for the service in the same market as that in which the service is provided by means of the Pipeline.

4.3 Retention of undue risk to health and safety

In its Draft Report, the Commission has recommended removal of criteria 1.9(c) requiring that access be provided without undue risk to health or safety.[24] This recommendation is inconsistent with both the Commission's recommendations contained in the Review of the National Access Regime and the provisions of the Competition Principles Agreement. APIA also notes that the Commission relied in part on maintaining consistency with the Competition Principles Agreement to justify retaining criterion (b) in its current form.

In the review of the National Access Regime, the Commission did not see the need to recommend removal of criteria (c) which requires that "access to the service can be provided without undue risk to human health or safety".

The Competition Principles Agreement requires access regimes to contain a requirement that access only be allowed where "the safe use of the facility by the person seeking access can be ensured at an economically feasible cost and, if there is a safety requirement,

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[23] The Hon Ian Macfarlane, Applications for Revocation of Coverage on certain portions of the Moomba to Sydney Gas Pipeline System, 19 November 2003, para 24. Nevertheless. APIA does not endorse the Minister's comments (paragraphs 52 and 53) in relation to the need for there to be at least three independent gas transmission systems in order for there to be effective competition.

[24] Draft Recommendation 6.3.

appropriate regulatory arrangements exist."[25] This requirement is arguably stronger than that included in either the Gas Access Regime or Part IIIA of the Trade Practices Act.

Furthermore, APIA notes that whilst health and safety issues will generally not be significant, on the occasions when they arise it is most likely to be the case that they will be germane to the provision of access to the services provided by the facility. Accordingly, where these issues arise, it is appropriate that they are addressed at the coverage stage rather than in subsequent regulatory proceedings.

The public interest criterion requires the NCC and the Minister be satisfied that access would not be contrary to the public interest. Criterion (d) therefore reverses the onus that applies under the other limbs of the test which require positive satisfaction of the requirement in each case (so that a neutral position would only satisfy the public interest limb of the test). The importance of ensuring that access can be provided to a pipeline in a safe manner is such that the service provider should not be subject to such a reversal of the onus. This is also inconsistent with the Commission's recommendation that reference to safety related considerations be retained in clause 2.24. Accordingly, APIA submits that criterion (c) of the threshold test ought to be retained.

4.4 National significance

In its initial submission to the Commission, APIA argued that a national significance test should be incorporated into the coverage criteria. However, the Commission's draft report stated:[26]

> The coverage criteria currently do not have any threshold test for the significance of a gas pipeline, so a small pipeline could be covered, even if the net benefits of its coverage (from a communitywide perspective) are insignificant once the costs of regulation are taken into account. In contrast, such a pipeline is unlikely to meet the 'national significance test' in the part IIIA declaration criteria. In that sense, the efficiency criterion might be considered to perform a similar function (with a different mechanism) to that of the national significance test in part IIIA.

Whilst APIA strongly endorses the inclusion of an economic efficiency criterion, APIA submits that the Commission's approach on this issue misses the point. It is precisely because the national significance test provides an efficient first pass filter that its inclusion in the coverage criteria is desirable.

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[25] Clause 6.(1)(d).

[26] Productivity Commission, "Review of the Gas Access Regime", Draft Report, December 2003, page 183.

APIA's membership has already incurred substantial cost that could easily have been avoided had such a simple test been included in the coverage criteria in the first place. An economic efficiency test, whilst welcome, cannot perform this function.

Moreover, APIA notes that in its Final Report on the Review of the National Access Regime, the Commission recommended that changes to the current declaration criteria be limited to the revision of criteria (a) and that if changes were required to the declaration threshold, that there remained the need to retain the national significance limb of the test:[27]

> *A screening test:* to ensure that the service (rather than the facility) is of significance to the national economy and that it stems from a natural monopoly technology."

Accordingly, APIA recommends that a national significance test be explicitly incorporated into the threshold test for the Gas Access Regime.

4.5 Revocation

As was highlighted in the Commission's Review of the National Access Regime, a policy of granting access too liberally is equivalent to a Type I error, because it means that the regulator has wrongly identified a case of market failure requiring intervention where there is in fact no market failure (or the costs of that failure are less than the costs of attempting to correct it). Conversely, a policy of not granting access where it should have been granted is equivalent to a Type II error, because it means that the regulator has failed to correct market failure where it exists.

This suggests that a cautious approach is warranted to declaration, even in respect of tier 1 monitoring. There remains a substantial risk of significant Type I error under any approach to regulation, including monitoring. APIA considers therefore that the onus for coverage should remain on the party seeking coverage.

However, in APIA's view, the more significant issue in practice is the approach to be taken to the revocation of existing pipelines covered under the Gas Access Regime. As was highlighted in APIA's initial submission, already the coverage of 17 pipelines has been revoked. The original coverage of these pipelines occurred without a threshold test ever being applied.

To the extent that any recommendation increases the threshold, it automatically follows that the merits of coverage for every covered pipeline must be called into question, especially since the Commission explicitly indicated that the current regulatory arrangements should only apply in extreme circumstances. APIA therefore believes that a

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[27] Productivity Commission, "Review of the National Access Regime", Inquiry Report, September 2001, page 192.

failure to explicitly incorporate revocation provisions as part of the reform of the Gas Access Regime will create the identical problems that beset the regime where regulation was initially applied and was subsequently found to be unnecessary. This point was also made by the Minister in his decision on the MSP:[28]

> What is needed is to reverse the onus of proof for meeting the requirements for access regulation. Coverage should apply to those pipelines which are being managed contrary to competitive market principles. There should not be a presumption of access regulation.

Accordingly, APIA recommends that the existing covered status of existing pipelines be revoked. APIA accepts tier 1 regulation being applied as the default for those pipelines that are currently covered under the Gas Access Regime, subject to the right of each pipeline to challenge that coverage status.

APIA's view is that the risk of adverse social outcomes from this approach is low. APIA notes that each pipeline has been subject to a price review in recent years so there is a regulator endorsed base line from which each pipeline operates. This regulated price path means that monitoring will be a more efficient mechanism than it otherwise would be, and that the risks to society of moving to such a regime will be correspondingly lower.

APIA therefore submits that existing pipelines should be covered under tier 1 regulation unless the criterion is met for more heavy handed forms of regulation to be applied.

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[28] The Hon Ian Macfarlane, Applications for Revocation of Coverage on certain portions of the Moomba to Sydney Gas Pipeline System, 19 November 2003, para 226.

Recommendation

APIA recommends that:

- criteria (a) be amended to provide that:

  that access (or increased access) to Services provided by means of the Pipeline would *be more likely than not* to achieve a substantial increase in competition in at least one market (whether or not in Australia), other than the market for the Services provided by means of the Pipeline

- examples of promotion of competition be amended as follows
  - deletion of the proposed example (e)
  - insertion of the following examples:

    (f) the actual and potential level of competition from substitutes such as gas from other storage facilities and from the ability of upstream and downstream interests to engage in trade

    (g) the nature and impact of self imposed behavioural constraints that are adopted and applied

    (h) the contestability of the market for the services provided by means of the pipeline

    (i) the dynamic characteristics of the market, including growth and innovation

    (j) the nature and intensity of competition in upstream and downstream markets;

    (k) the revenue loss that a pipeline owner would suffer if it failed to supply gas to a customer or ceased to supply gas to a customer.

- criteria (b) be amended to provide that:

  that there does not exist and it would be uneconomic for anyone to develop another facility to provide the service or a close substitute for the service in the same market as that in which the service is provided by means of the Pipeline

- criteria (c) be retained;
- a national significance test be included;
- all pipelines that are currently covered be subject to tier 1 regulation unless and until a successful tier 2 coverage application is made.

5 Outline of monitoring arrangements

5.1 Background

APIA supports the Commission's recommendation that:[29]

> The Gas Access Regime should be amended to provide for a lighter handed form of regulation whereby the application of the alternative regulation involving an access arrangement with reference tariffs would only occur in the more extreme circumstances. The lighter handed alternative should be a monitoring regime. It is important that the monitoring regime not develop into an intrusive and costly form of regulation.

Nevertheless, APIA shares the Commission's concern over the potential for an initially light handed monitoring regime to turn into an intrusive, information intensive arrangement not dissimilar to that currently prevailing with respect to Access Arrangement Information under the Code.

The Commission went on to make the following further Draft Recommendations with respect to the recommended form that monitoring might take:[30]

> The monitoring form of regulation to be implemented under the Gas Access Regime should have the following features:
>
> - a third party access policy formulated by the service provider
> - separation of pipeline operations from associated businesses in upstream and downstream markets
> - public disclosure of information by the service provider (which would be well short of the 'access arrangement information' currently required under the Gas Code)
> - scope for the service provider to adopt, at its discretion, additional pro-competitive features, such as a code of conduct.
>
> In making a coverage decision to apply the monitoring regime, the National Competition Council should specify what information the service provider is required to disclose to the relevant regulator. Implementation of the information disclosure requirements would involve:
>
> - the regulator focusing more on trend performance, including in relation to profitability
> - reporting and monitoring after the event, without any need for prior endorsement by the regulator

[29] Draft Recommendation 8.1.

[30] Draft Recommendations 8.2-8.4.

- the regulator particularly monitoring cases where access negotiations have been unsuccessful.

The relevant regulator should collate and publish annually the information disclosed by a pipeline under the monitoring regime. Any commentary made by the regulator should be of a factual nature only.

APIA considers that while these recommendations go some way towards minimising the risk associated with introducing a new level of regulation there remain a number of critical issues to be resolved. In particular, there are important lessons to be learned from the application of price monitoring to the provision of aeronautical services.

APIA's Initial and Supplementary Submissions to the Commission outlined the parallels that exist between airports and gas transmission pipelines, and highlighted that gas transmission pipelines will generally have far less market power than airports. In addition, the industry has demonstrated the effectiveness of commercial negotiation to underpin new investment in the industry. Indeed, the detailed history of investment in gas transmission infrastructure under the Gas Access Regime outlined in APIA's Supplementary Submission highlighted that it is only the recourse to commercial negotiation that has enabled the vast majority of investment in the industry to proceed.

In light of this experience, APIA is concerned that the implementation of price monitoring in the provision of aeronautical services has been highly intrusive. The information requested from providers of aeronautical services is at least as detailed as applies to information currently required of gas transmission businesses under the Gas Access Regime. APIA submits that this highlights the need for the Gas Access Regime itself to prescribe the reporting framework for gas transmission pipelines and APIA submits that the Commission's final report should provide definitive guidance on this issue.

5.2 Monitoring of gas transmission pipelines

In developing a monitoring framework for gas transmission pipelines APIA considers that a materially lighter handed approach is justified in the case of gas transmission pipelines than applies to aeronautical services.

First, it must be remembered that the focus of the monitoring regime should be to provide information on the interaction between the provision of access to a gas transmission pipeline and competition in upstream or downstream markets. APIA submits that the information that is most relevant to this enquiry relates to the access policy that is adopted by the service provider and the actual history of negotiations for access to the pipeline. Indeed, APIA submits that the nature of the service provider's access policy and the history of concluding access negotiations will provide the most relevant information to

assess the impact on competition in upstream and downstream markets, rather than detailed cost related information.

Second, the very application of monitoring will only be applied in the context of there being a pipeline specific finding that more heavy handed regulatory options are not appropriate for that pipeline. That is, monitoring is only applied where it is deemed that more invasive regulatory approaches cannot be justified for the particular pipeline. This is a materially different environment to that prevailing in aeronautical services where there is no immediate capacity to differentially apply the regime to different airports.

Third, gas transmission pipelines have already and recently experienced a heavy handed price review involving a thorough examination of costs. Whilst APIA retains its reservations about the illusion of rigour in much of this analysis, the fact that it was undertaken and is publicly available casts serious doubt on the benefit on continuing detailed cost disclosure under a price monitoring regime.

Fourth, APIA notes that users of pipeline infrastructure are highly concentrated and possess countervailing market power. APIA's customers normally have substantial choice as to location and fuel source when pipeline capacity is sold. APIA's Initial Submission demonstrated that the gas transmission pipelines possess less market power than airports due to gas pipelines typically exhibiting lower barriers to entry and facing more elastic demand.

Finally, the monitoring arrangements can (and no doubt will) be reviewed in the future. Given the recent regulatory decisions and cost based information available in respect of these pipelines, it is submitted that high level monitoring is justified on the basis of more detailed options can be applied in the future if necessary.

We now turn to a consideration of the nature of the monitoring regime.

5.2.1 Basis of monitoring

APIA agrees with the Commission that the regulator should not be responsible for the development of reporting guidelines. However, APIA believes that in order to exclude any possibility of regulatory creep, reporting guidelines should be explicitly established and incorporated within the revised Gas Access Regime.

Further, APIA considers that the best metrics to be reported against remain the most simple, for example, real change in unit transport prices for a specific service quality offering. Such simple measures do not extend to assessment of firm profitability as the measurement of economic profitability raises issues of very considerable complexity, as does the appropriate interpretation of changes in that measure over time.

At least initially, the fact that all substantial pipelines will have undergone a detailed cost of service review provides a more than adequate basis against which to track movements in prices over time. That is, rather than being cost or profit based, measures should be focused on price changes and the provision of qualitative information about the business and service offerings.

5.2.2 Scope of price monitoring

APIA considers that monitoring should be applied to core service offerings in much the same way that airport monitoring is limited to aeronautical services.[31] These should be limited to include:

- firm transmission. Where a range of firm services is provided to the market, it may be appropriate for the service provider to disclose the movements as a basket of the service offerings with the weighting of the basket being transparent and based on past history of the revenue earned from these services; and
- (where relevant) interruptible transmission.

APIA further submits that non-core service offerings should not be subject to price monitoring. Non-core services would include, for example, gas park and lend and backhaul services, the uptake of which is to a significant extent discretionary given the presence of core transport services.[32] Park and lend is a market driven risk management service provided by a gas transmission pipeline. Backhaul services are a peripheral service that can effectively be replicated through contracting by market participants. Therefore these services are value added services relative to the standard or core service offering for which substitutes exist (eg through various contracting options). As such

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[31] The Direction issued to the ACCC (Direction No 27 provided pursuant to section 27A of the Prices Surveillance Act 1983) to undertake "formal monitoring of the prices, costs and profits related to the supply of aeronautical services and aeronautical related services". The services detailed in Direction No 27 were "aeronautical services" such as aircraft movement facilities and activities and passenger processing facilities and activities, together with "aeronautical related services" such as vehicle access to terminals, public staff and taxi parking or holding areas, check-in counters and aircraft maintenance sites.

[32] Direction No. 27 excludes (by default) monitoring of other commercial services such as retail shopping facilities, restaurants and bars (which are not fundamental requirements to provision of aeronautical services). In addition, services such as commercial lounge space were also excluded, even though these services may be characterised as closely linked to the provision of aeronautical services.

APIA believes that an analogy can be drawn between these service offerings and the non-aeronautical operations of airports (provision of retail space for shopping facilities etc) which are not subject to price monitoring. Accordingly, APIA does not consider it is necessary or appropriate for price monitoring to be applied to such service offerings.

In addition, foundation contracts should not be subject to the price monitoring framework. Again, an analogy can be drawn with the exclusion of services for which a contract existed at the date the airport lease was granted.[33] It is also critical that commercial in confidence information is protected under the regime. Additionally, these foundation contracts are entered into at a time when the pipeline cannot have market power. As a result, there can be no justification for subjecting them to regulation, even if that form of regulation is 'light handed.'

5.2.3 Quantitative reporting requirements

Nature of price monitoring

APIA believes that a critical distinction between the monitoring that should apply under the Gas Access Regime and the price monitoring regime that applies to airports relates to the existence of detailed regulatory reviews which are now in place for each covered pipeline. APIA considers that this history justifies a materially more light handed approach applying to gas transmission pipelines. Accordingly, APIA believes that the regime should require service providers to set out for each identified service category identified above:

- the percentage changes in yield over the previous year; and
- the volumes or units of throughput over the previous year.

APIA acknowledges that a consequence of this approach is that detailed cost reporting would not be required under such a regime. Extensive analysis of each gas transmission pipeline's costs has already been undertaken as part of the regulatory reviews. APIA therefore submits that there is no immediate need for cost or profit reporting for gas transmission pipelines. Under APIA's proposed approach, the detailed cost allocation arrangements, which involve significant compliance costs in modifications to service provider's accounting systems, can be avoided.

5.2.4 Qualitative reporting requirements

As such, APIA proposes the following suite of reporting measures:[34]

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[33] Direction No 27 specifically excludes those services for which a contract (under the seal of the FAC) existed at the date the airport lease was granted.

[34] Ring fencing issues are addressed in section 9.2.

- a description of the service provider's third party access policy;
- details of any access disputes or instances where access negotiations have failed; and
- CEO sign off of reporting measures.

Description of the service provider's third party access policy

APIA believes that the simplest solution to mandating the provision of details of the service provider's access policy would be to ensure that the monitoring regime requires reporting on the industry's proposed Voluntary Code of Conduct as detailed in Section 7 of APIA's Initial Submission. The Draft Voluntary Code of Conduct was based on eight core principles, namely:

1. developing market-responsive pipeline services;
2. the use of non-discriminatory tariffs;
3. public disclosure of dealings with affiliates;
4. public disclosure of key contract details;
5. protection of confidential information;
6. facilitate capacity trading;
7. performing independent external audits of compliance with the principles; and
8. binding independent dispute resolution process.

Industry's reporting requirement would then be to provide details of how it was satisfying the Code of Conduct and to provide the result of the independent audit of compliance with the principles.

This Code of Conduct in and of itself goes a significant distance towards addressing the Commission's Draft Recommendation 8.3, particularly with respect to ensuring public disclosure of information relevant to access seekers and protection of confidential information.

Details of access negotiations

In an environment where the key consideration is the promotion of competition in upstream and downstream markets, APIA submits that the most important consideration for the monitoring regime should be the details of the success or otherwise of access negotiations.

APIA therefore believes that providing details of the nature of any access dispute occurring during the reporting period together with basic information on where negotiations have failed will provide useful qualitative information as to the nature of a service provider's relationship with access seekers. As such, APIA proposes that service

providers subject to monitoring should, as part of their annual reporting requirement, record:

- the number of negotiations commenced within the year;
- the number of negotiations completed resulting in an access agreement being negotiated;
- the number of access negotiations withdrawn from by the access seeker;
- the number of negotiations in dispute;
- the number of dispute resolution processes commenced; and
- the number of dispute resolution processes completed.

There may be elements of the information provided that would be commercially sensitive and as such should not be disclosed in the regulator's public report.

CEO sign-off

APIA believes that in order to underpin the accuracy and credibility of the information provided in any monitoring report, that the service provider should ensure that the CEO signs off on the report

5.2.5 Caveat - use of price monitoring to assess monopoly pricing

APIA is concerned that there remain significant issues with the use of any point in time assessment of financial returns as a guide to the presence of monopoly pricing – especially given the broad acknowledgement that a simple annual building block analysis of pipeline returns (based on accounting information) will inevitably result in finding a progressive increase in profits as pipeline throughput increases and fixed capital costs decrease with accounting depreciation of the asset base. Thus it is important to recognise that increasing profitability is not prima facie evidence of misuse of market power. The critical issue is whole of life returns in NPV terms, a measure that it is beyond the scope of annual price monitoring to assess. Further, it has also been broadly accepted that some individual pipeline project returns will need to exceed the notional efficient cost of capital if projects on average are to meet their target returns.

What is more, pipeline profitability will generally increase even in the presence of real reductions in unit transport tariffs. That is, increasing demand for the service coupled with decreasing fixed (accounting) costs will potentially deliver significant increases in accounting profit even with a declining price path.

Taken together, this means that extreme care needs to be taken in assessing the implications of any increase in profitability identified via the price monitoring process and that the use of a simple unit price metric may in fact be more appropriate.

Recommendation

APIA recommends that:

- The PC provide definitive guidance on arrnegments, with scope of monitoring be limited to:
  - the percentage changes in yield over the previous year; and
  - the volumes or units of throughput over the previous year,
  - and exclude all foundation contracts.

  The offerings subject to monitoring should be limited to:
  - firm transmission. Where a range of firm service offerings is provided to the market, it may be appropriate for the service provider to disclose the movements as a basket of the services with the weighting of the basket being transparent and based on past history of the revenue earned from these services; and
  - (where relevant) interruptible transmission;
- the scope of other monitoring be limited to:
  - a description of the service provider's third party access policy;
  - details of any access disputes or instances where access negotiations have failed; and
  - CEO sign off of reporting measures.

6 Tier 2 coverage test

6.1 The risk of regulatory creep

APIA believes that monitoring can provide an effective means of controlling market power. However, APIA is concerned that when monitoring forms part of a wider regulatory framework, that it will be vulnerable to gaming by the market participants. For example, APIA is concerned that the creation of a two-tier test will encourage access seekers (and potentially regulators) to ensure that the second tier of the regulatory framework is invoked.

This will create the perverse effect on access seekers - instead of seeking to enter into commercial negotiation, access seekers' incentives will be to ensure that they are able to secure recourse to a regulator, a process that will significantly undermine their commitment to the negotiation process.

Indeed, there is likely to be a moral hazard problem that emerges in such an environment – access seeker's incentives in relation to contractual options will be affected by the prospect that, at the end of the contract, they will gain from recourse to the regulator (or arbitrator). This may cause access seekers not to seek the protections they might otherwise pursue through commercial negotiation.

Moreover, APIA reiterates that such an environment is also prone to regulators being pressured to use the regulatory instruments at their disposal to argue for an expansion of power. Certainly, the information gathering for airport price monitoring is at least as detailed as applies to information required of covered pipelines under the Gas Access Regime. Because this information is published on an annual basis, there is no capacity to consider profitability in the context of the life of the asset as a whole. This is a major limitation of any price setting or monitoring regime, and in the current context could generate unwarranted calls for tier two regulation.

Indeed, it is entirely possible that the regulatory body itself may have incentives to press for a more invasive regulatory framework, especially where the agency responsible for monitoring is the same body who would become responsible for the application of the second tier regulatory framework.

APIA is therefore concerned that the light-handed regulation provided by the first tier would become more heavy handed over time. As set out in APIA's initial submission, the history of the Gas Access Regime highlights the risk that regulatory environments become increasingly invasive over time. This is illustrated by the recent decision of the Tribunal in the MAPS. Here, the Tribunal's decision highlighted the regulator's propensity to

assume market power existed in respect of a pipeline extension despite there being no factual circumstances which would have entitled the regulator to reasonably conclude that Epic would be able to exercise any market power of a significant nature in the relevant market.

With this in mind, APIA turns to a consideration of the second tier threshold test proposed by the Commission. This is followed by a discussion of the limitations of the regulatory approach that is being considered in such cases.

6.2 Assessment of the tier test

APIA has serious reservations with the proposed amendments to the coverage test:

- there is no real distinction between the first and second tier threshold tests so that dramatic consequences turn on the decision-maker's interpretation of "shades of grey"; and
- the threshold test is too low.

6.2.1 The correspondence between the tests

APIA acknowledges that the economic efficiency merits of alternative regulatory regimes will vary. However, APIA notes that the key difference in the threshold test for the first and second tiers is the substitution for "substantial" for "material". APIA's legal advice suggests that there is no meaningful distinction between these tests either as a matter of law, and, more importantly, in practical implementation.

APIA's legal advice confirms that the meaning of the terms "material" and "substantial" is synonymous for all practical purposes - there is little if any difference between the concepts. In the absence of specific guidance as to its meaning, a change can be "substantial" even if it merely occasions a non-trivial or non-inconsequential effect. Similarly, the meaning of material reflects a low threshold. In the context of a material matter or a material particular, the concept relates to any matter that an informed decision maker would regard as relevant to the subject matter being considered.

In practice, the absence of the difference between the tests is exacerbated by the practical reality that both tests are applied in an essentially abstract environment with a threshold of "likely". In a coverage application, the NCC and then the Minister (and ultimately the Tribunal) would be asked to consider the difference between two virtually indistinguishable tests in a hypothetical case – namely, the likely impact of alternative regulatory structures on promoting competition and economic efficiency over a long term horizon. The likely result would be a focus on word games associated with giving meaning to subtle differences in language, rather than on the economic substance of the decision.

This is in stark contract to the Commission's recommendation that "alternative regulation involving an access arrangement with reference tariffs would only occur in the more extreme circumstances".[35]

APIA believes that there should a correspondence between the difference in the tests and the consequences of meeting those thresholds. Here, we have a dramatic difference in the consequences of meeting two indistinguishable tests. The seriousness of the consequences of applying tier 2 regulation is confirmed by the Commission's own assessment of the conduct of the cost of service type regulation undertaken under the Gas Access Regime to date is that:[36]

> The Gas Access Regime is a form of price regulation based on a cost-of-service model. It is, therefore, at the more intrusive end of regulation.
>
> The Gas Access Regime deters and distorts investment, possibly altering the nature and timing of pipeline projects. Pipeline construction might be delayed, for example, or pipelines might be built 'fit for purpose'. Such alterations can delay the emergence of competition in upstream and downstream markets.
>
> There is high potential for regulatory error when approving reference tariffs. The Gas Access Regime requires regulators to make decisions about future market circumstances that are uncertain. This has led regulators to use many debatable assumptions. There is a consequential tendency for regulators to seek additional information from service providers and further studies by consultants. This is unlikely to reduce uncertainty significantly.
>
> The current regulatory approach of having access arrangements with reference tariffs is costly, especially in relation to the market impact. Therefore, while some refinements to the existing regulatory approach are needed, there is a sound basis for an alternative less costly approach.

Moreover, because the tier 1 and tier 2 tests are so similar, APIA is concerned that any pipeline that meets the tier 1 threshold will also meet the tier 2 threshold. This would mean that monitoring, proposed as the conventional regulatory threshold to be applied in the absence of extreme circumstances, might be applied only rarely in practice.

6.2.2 The tier 2 threshold is too low

A corollary of the similarity of the tier 1 and tier 2 tests is that the tier 2 test has been proposed to be set at a level which is too low. APIA's legal advice clearly indicates that the proposed changes to the competition limb of the threshold test will do little to raise that threshold. This is especially the case given the ease with which an access seeker can

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[35] Draft Recommendation 8.1.

[36] Draft Findings 3.1, 4.3, 7.6 and 7.6.

establish a *possibility* or a real chance of a substantial increase in competition (on account of the retention of the "likely" threshold).[37] APIA submits that such a test is in reality consistent with that which has already been applied by the Tribunal in the Eastern Gas Pipeline case.[38]

However, APIA believes that the consequences of meeting the tier 2 threshold will be even more severe than under the current framework. This is because a finding that the tier 2 threshold has been met provides an even greater legitimacy than is currently the case for regulators to indulge in the very types of extreme and unreasonable decision making that has been highlighted in the recent Tribunal decisions outlined in section 2 of this submission. APIA is also concerned that heavy handed regulatory outcomes are likely to be entrenched under such a framework and become the default regulatory model.

APIA welcomes the specific incorporation of a long term economic efficiency criterion as part of the threshold test. However, APIA remains concerned that this is the only meaningful change that has been proposed in respect of the coverage threshold. APIA turns to its proposed threshold test for tier 2 in the following section.

6.3 APIA's preferred test for tier 2 regulation

In APIA's view, the challenge is to establish a threshold test for tier 2 regulation that is consistent with the consequences it attracts – namely the heavy handed form of regulation that would be then applied. This demands a high threshold be set. APIA is concerned that applications for coverage under the tier 2 model will focus on the minimisation of Type II errors (which relate to the costs of not regulating when in fact it is socially desirable to do so) at the expense of not commensurately considering the likelihood or impact of Type I errors (which relate to the costs imposed on regulating when it was not socially desirable to do so).

APIA considers that the best approach is to make the instrument (in this instance, the threshold test) as closely as possible reflect the objective to be satisfied (namely, the avoidance of situations where access to pipelines is denied or is only provided on terms and conditions that are inconsistent with the Code). Accordingly, APIA recommends that the following tier 2 test be adopted:

> Tier 2 regulation can only be applied to a pipeline where the decision maker is affirmatively satisfied that:
>
> - access to a pipeline has been unreasonably denied; and

[37] Refer section 4.1.1 of this submission.

[38] Duke Eastern Gas Pipeline [2001] ACompT 2 (4 May 2001).

- the absence of tier 2 coverage has prevented competition from developing in a dependent market.

In implementing this test, the decision maker cannot conclude that access has been unreasonably denied unless the terms and conditions on which access has been provided are inconsistent with the Code.

The essence of this test is that tier 2 regulation would only be applied in circumstances where it is necessary to do so in order to prevent access being denied in a way that is inconsistent with the objectives of the Code. This is superior to the test currently being proposed by the Commission as it focuses on the justification for tier 2 regulation being applied.

APIA considers that the demonstrated existence of an unreasonable denial of access is fundamental to the demonstration that tier 2 regulation is warranted. APIA believes that an access seeker must show that a service provider not only possesses the substantial market power which would enable it to unreasonably deny access, but also that the service provider has in fact misused that market power in denying access.

Similarly, the second limb of the test focuses on avoiding the prevention of competition emerging in dependent markets as opposed to the promotion of competition. Again, this limb is stronger than the current test and is directed at ensuring that access is only regulated where it is essential for competition to emerge in upstream or downstream markets.

Finally, the limb that requires that access is not otherwise available on terms consistent with the Code is also crucial. This limb prevents intrusive regulation from being imposed where it would only serve to allow the regulator to put in place an interpretation of the Code that it prefers to that in any event embodied in the pipeline's voluntary access arrangement. This limb therefore formalises and gives clear and unambiguous standing to the Tribunal's finding that a regulator should not be able to displace one valid interpretation of the Code's criteria with an interpretation that it prefers for whatever reason. In so doing, it helps limit the extent to which the scope for interpretation that is inevitably built into instruments such as the Code translates into regulatory risk.

In other words, tier 2 regulation would only be applied where it is necessary to do so – that is in extreme circumstances. As such, this approach reduces Type II error associated with declarations.

6.4 Standing

APIA endorses the Commission's draft finding that there would be merit in requiring access seekers to demonstrate they have undertaken "best endeavours" in commercial negotiations and that these have failed.

This requires that access seekers demonstrate before making a coverage application that:

- access to a pipeline has been made by a genuine applicant;
- negotiations between the access seeker and service provider having failed;
- the access seeker engaged in the negotiations on a best endeavours basis;
- the application is not frivolous or vexatious; and
- the applicant exhausted the process for gaining access under the tier 1 regime.

Recommendation

APIA recommends that:

Tier 2 regulation can only be applied to a pipeline where the decision maker is affirmatively satisfied that:

- access to a pipeline has been unreasonably denied; and
- the absence of tier 2 coverage has prevented competition from developing in a dependent market.

In implementing this test, the decision maker cannot conclude that access has been unreasonably denied unless the terms and conditions on which access has been provided are inconsistent with the Code.

- For standing to make a tier 2 coverage application access seekers demonstrate that:
  - access request has been made by a genuine applicant;
  - negotiations between the access seeker and service provider have failed;
  - the access seeker engaged in the negotiations on a best endeavours basis;
  - the application is not frivolous or vexatious; and
  - the applicant exhausted the process for gaining access under the tier 1 regime.

7 Tier 2 regulatory arrangements

As set out in APIA's Initial and Supplementary Submissions, APIA believes that the negotiate-arbitrate model (supported by a voluntary industry code of conduct) provides a more efficient vehicle for addressing market power concerns associated with natural gas pipeline infrastructure than the continuation of the cost of service model proposed by the Commission. APIA maintains this view if monitoring is to be adopted as an alternative regulatory approach.

The efficiency of the proposed negotiate arbitrate model which would be supported by an industry code of conduct (as least in its application to natural gas transmission pipelines) arises on account of:

- an improved alignment of incentives. APIA proposes that the adoption of a voluntary code of conduct would provide a strong basis to resist tier 2 coverage applications in particular. However, too weak a Code would increase the risk of coverage as would failure by a service provider to adopt or adhere to it;
- an enhanced role for the threat of coverage. This threat is particularly effective in relation to gas pipeline transmission infrastructure on account of the high probability and high cost of successful detection of breaches of the code. APIA recognises that under its proposed model the minimum term of 5 years for tier 1 regulation could be relaxed where a service provider failed to adhere to the code of conduct (or if the code of conduct changed in a way that undermined its effectiveness as a behavioural regulation instrument);
- a reduced scope for gaming of the regulatory environment. The environment will enhance the incentives of parties to resolve issues commercially rather than seek the recourse of the regulator; and
- reliance upon alternative mechanisms that already exist to address misuse of market power.

APIA refers the Commission to its Initial and Supplementary submissions for the detailed reasoning in support of this proposition. Moreover, to the extent that the current system of regulation is retained for tier 2 coverage, APIA notes that there are numerous defects in design and operation of the regime. APIA refers the Commission to the submissions of its members as well as the other submissions that have addressed this issue.[39]

[39] See, for example, Australian Gas Association, Submission to the Productivity Commission Review of the Gas Access Regime, 29 August 2003.

Recommendation

APIA recommends that the form of regulation applied to tier 2 pipelines be consistent with the negotiate arbitrate model.

8 Issues for new investment

8.1 General observations on investment and regulation

APIA notes that the Commission's report addresses several issues associated with new investment. However, APIA has reservations about the approach adopted by the Commission.

Fundamentally, APIA believes that new investment proposals are contestable in nature. This contestability was highlighted in APIA's initial submission which reviewed the competitive dynamic between SEAGas and Duke in connection with the now operational SEAGas pipeline.

In light of this reality, APIA believes the key issue when considering the regulation of new investment, whether that investment is in the form of a greenfields pipeline or an expansion or extension of existing pipelines, is how the regulatory environment will distort that investment. APIA considers that any regulation of new pipeline infrastructure is likely to delay or distort investment. The flaws in the suggested coverage tests outlined in sections 4 and 6 only serve to highlight these concerns.

APIA notes the Commission's discussion of the risks confronting new investment focuses on the impact of regulation on undiversifiable risk and how this interacts with the regulatory environment. However, APIA submits that the analysis omits crucial information about the nature of the interaction between diversifiable and undiversifiable risk. For example, as the Commission recognises, a regulatory environment can reduce undiversifiable risk that a pipeline exhibits simply by reducing reference tariffs – as doing so is likely to reduce the correlation of the free cash flows produced by the asset with economic activity. However, such action is likely to have the effect of increasing the diversifiable risk of the pipeline on account of increasing the market's perception of regulatory risk associated with the pipeline.

For any new investment, it will be the diversifiable risk profile of the investment as well as the undiversifiable risk profile that will govern its financial robustness. However, regulators are exceptionally poorly placed to assess the nature and extent of these diversifiable risks. This, in turn, only serves to increase the regulatory risk associated with a new pipeline – if only because a regulator will have a poor appreciation of the bad states of the world that could have prevailed in the event that the investment does turn out to be successful (and hence being regulated). It is the very difficulty in assessing such a risk profile that drives the fundamental incompatibility between the prospect of invasive regulatory intervention and investment in new pipelines. One of the benefits of the access holidays suggested by the Parer Report is that it provides a mechanism to address the

diversifiable risk issues in a way that is less likely to distort investment decisions that available alternatives.

8.2 The importance of access holidays

APIA is concerned that the Commission's recommendations diminish the role for access holidays suggested in the Parer Report which found that:[40]

> Second, it is proposed that project developers be given a choice, to be exercised before financial closure. For all new pipelines, project developers could approach the regulator to seek a longer term binding ruling on the regulatory conditions that will apply. Alternatively, for new transmission pipelines, project developers could opt for a 15 year economic regulation free period. The 15 year economic regulation free 'holiday' would be automatic if the developer opted for this route. Clearly, the availability of the 15 year economic regulation free 'holiday' will put pressure on the regulator for appropriate binding rulings. The 'holiday' will only be available to pipelines with sufficient vertical separation of control so that the pipeline owners do not have an incentive to reduce competition in upstream or downstream markets.
>
> There is considerable logic behind the 15 year economic regulation free 'holiday' for new transmission pipelines. When transmission pipelines are built they are on the basis of agreements between upstream and downstream 'consenting adults'. There is no issue of pipeline market power because without both the supplier and the user the pipeline will not be built. Fifteen years balances the need for certainty with the need eventually to give potential new pipeline users some rights of regulatory assistance in gaining later access.

APIA wishes to reiterate the view it expressed in its Initial Submission – access holidays will not of themselves correct the deficiencies in the current regime. However, access holidays form an important component of a regulatory regime that has the objective of encouraging investment in pipeline infrastructure.

To APIA, the key issue relates to the contestability of the market for new investment and the implications of that contestability for new investment. Given the intention that the Gas Access Regime is to minimise distortions to the efficient investment in pipeline capacity, APIA considers that the approaches that are adopted to the regulation of new investment will be a critical consideration to new investors.

Fundamentally, APIA is of the view that new investments in pipeline capacity are contestable. The relevant dimension of competitive rivalry is in competition for the

[40] Council of Australian Governments Energy Market Review, (2002), Towards a Truly National and Efficient Energy Market, page 37.

market as much as it is competition in the market. Consequently, any regulation of this investment is both unnecessary and harmful.

This is particularly the case given the circumstances confronting any new pipeline development in Australia. Simply put, every major energy load centre is served by an existing gas transmission pipeline.

New pipeline infrastructure serving a major load centre will therefore by definition compete with an existing pipeline. Not only must any new gas transmission pipeline compete with an entrenched alternative fuel source, but it must also compete with an incumbent pipeline servicing the load centre. Suggesting that regulation would be appropriate in such a situation is plainly incorrect – the new pipeline simply will not possess the market power to justify such action. If we take the analogy of domestic aviation, it is equivalent to suggesting that Virgin's airfares should have been regulated when it entered the market.

There are also concerns that new pipelines serving an existing load centre from a new basin will be in a position to capture upstream rents. However, the reason why this might be the case is unclear. First, the market for the development of gas transmission infrastructure is contestable – there is therefore no reason why a new pipeline would be able to capture these rents. Second, in the unlikely event that this were not the case, and to the extent that there are upstream rents available, then in the absence of those rents being extracted by the gas transmission provider, they would simply be retained by the upstream producer. As such the welfare effects of the regulation of gas transmission pipelines in such an environment are ambiguous once these second best issues are considered.

Clearly, other pipeline developments (which will generally be driven by a specific customer need) will also be highly contestable in nature. This is a very different situation to one in which load centres are vulnerable to the market power of a greenfields pipeline developer.

Yet, APIA believes that an almost inevitable result of the approach the Commission has recommended is that new pipelines will become subject to monitoring for a 5 year period followed by the prospect of heavy handed regulation being applied after this time. This was all but acknowledged in the Commission's deliberations:[41]

> However, the NCC might find it difficult to make binding rulings that preclude coverage for as long as 15 years. As noted above, the NCC (sub. 57, p. 69) expressed concerns about whether it would be in a position to judge the difficult issues involved in a coverage application for a proposed pipeline. In addition, the asymmetry of observed

[41] Productivity Commission, "Review of the Gas Access Regime", Draft Report, December 2003, ibid page 286.

> outcomes might cause any organisation assigned the task of making binding coverage rulings to err on the side of caution. That is, the coverage decision might be influenced by the possibility that failing to cover a pipeline with market power is easier to observe than a wrong decision to cover a pipeline with no market power.

APIA considers that, in contrast to the Commission's phraseology, "a cautious approach" would be one in which the caution is manifested in a reluctance to regulate (ie preparedness to accept some Type I error) rather than the opposite as suggested in this passage. Nevertheless, APIA acknowledges the Commission's concern. APIA submits that it merely represents a microcosm of a more fundamental risk in the relationship between economic regulation and the advancement of the public interest. Wherever there is a choice as to whether or not to apply regulation to a new pipeline, the response is likely to be to apply regulation – even though this has created an environment in which regulation has stifled investment, as recognised in Draft Finding 4.3:[42]

> The Gas Access Regime deters and distorts investment, possibly altering the nature and timing of pipeline projects. Pipeline construction might be delayed, for example, or pipelines might be built 'fit for purpose'. Such alterations can delay the emergence of competition in upstream and downstream markets.

Moreover, APIA submits that the application of lighter handed forms of regulation does not provide sufficient confidence for transmission pipeline owners to overcome the distortions of the current regulatory regime. Indeed, all that has really been offered in the Commission's draft report is the likelihood that a monitoring regime would apply in the first 5 years of the life of the pipeline – a period during which the pipeline will only be building volume. Indeed, somewhat perversely, the only circumstances in which this will not be the case might arise would be where a pipeline was either built to market (and hence fully contracted) or where development of the pipeline had been delayed relative to the socially desirable time for the investment to occur (on account of, for example, regulatory risk).

Finally, APIA submits that a 20 year holiday period is superior to a 15 year holiday period on account of the following factors:

- in modelling pipeline economics (that is the basis upon which project revenue requirements are determined, as distinct from project financing which might conceivably be based on the assumption of a 20 year loan life with subsequent re-financing anticipated after this), periods well in excess of 20 years (rather than 15 years) are routinely utilised. The duration of the mechanism must also pay particular regard to addressing (at least in part) the truncation issue which generally emerges only towards the end of the economic life of a pipeline; and

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[42] Ibid, page XXXVI.

- too short a holiday period runs the risk of access holidays only operating during the loss-making period – when demand for access is low in any case – with regulation being potentially introduced when the investment is proven at which point access seekers will want to share in the blue sky;
- for taxation purposes, 20 years was the period agreed for depreciation of pipelines. The 20 year period ultimately determined for transmission tax depreciation purposes reflected the outcome of an intense debate on the appropriate balance – recognising the need for a simple and effective solution - and the same values and principles should be reflected as the "floor" for the economic regulation free period.

Accordingly, APIA submits that in an environment where there is a low objective likelihood that new gas transmission pipelines will possess substantial market power, the most appropriate regulatory response is to provide a regulatory holiday to new investment as a default. APIA adheres to its view that a 20 year holiday period is likely to be superior to the 15 year period recommended by the Commission. In addition, for the concept of an access holiday to be credible, APIA considers that any regulation of the pipeline occurring after the end of the period should only be considered on a prospective basis and then only after satisfaction of the relevant threshold test.

APIA accepts that monitoring issues may arise during the regulation free period. In this respect, APIA acknowledges that the tier 1 test for monitoring could be applied to these pipelines. APIA also accepts the specific constraints on access holidays identified by the Commission are appropriate.

Subject to these caveats, APIA therefore recommends that new pipelines be conferred an automatic 20 year regulatory free period.

8.3 Fixed truncation premium

In principle, APIA agrees that the application of a fixed truncation premium potentially provides a vehicle that could ameliorate regulatory risk and avoid distortions to investment.

APIA notes that the very need for a fixed premium principle to be specified highlights the dangers of leaving the setting of such a parameter in the hands of regulators. If the regulatory processes undertaken to date effectively incorporated the risks facing new investments, there would be no need for such recommendations to be made.

Consequently, APIA does not have any confidence that the current regulatory system would be able to deliver a sufficient premium absent any legislated or mandated provision quantifying its extent.

8.4 Competitive tendering

APIA agrees with the Commission's recommendation that the competitive tendering provisions of the Code should be simplified. In order to provide some guidance with respect to such simplification, APIA suggests that greater recognition should be placed on the competitive nature of the process as recognised by the Commission, namely that:[43]

> …competition *for* the market is a good proxy for competition *in* the market.

As such, APIA considers that the results of any reasonably open tender process should be considered as a-priori evidence of market tariffs. This belief is founded on the fact that new pipeline projects are, by their nature, contestable at the project stage and therefore, are marginal projects.

Once it is accepted that new projects are fundamentally marginal in nature and therefore are unlikely to possess substantial no market power, the job of the relevant regulator is simplified to ensuring that the tendering process is conducted at arms length, is not unduly restricted in terms of project specifications and is open to all interested parties. APIA believes that this role could be performed by a probity auditor.

Moreover, APIA does not consider that the lowest cost solution is necessarily the most desirable approach to take. Instead, APIA submits that the relevant test should be that investment which maximises the social surplus from the investment.

8.5 Expansions

APIA refers the Commission to its Supplementary Submission which catalogued the significant pipeline investments that have occurred in Australia since the implementation of the Code. Without exception, these expansions have been underpinned by commercial negotiation rather than by regulation. In other words, it has been the fact that regulation has not applied to these investments that has enabled them to proceed.

APIA is therefore concerned that the Commission's recommendation that has effectively recommended a reversal of the onus on pipeline coverage in respect of expansions. Such a reversal will create serious distortions to the incentives for pipeline expansion.

First, APIA submits that the approach will create a bias in favour of new pipelines instead of expansions to existing pipelines on account of the former being exposed to less regulatory risk. APIA accepts that there is a case for a different treatment of greenfields pipelines to expansions to existing pipelines on account of the increased regulatory and

[43] Ibid, page 237.

commercial risk exposures of greenfields pipelines. However, this does not justify creating an effective presumption that such expansions should be covered.

Moreover, it is submitted that such an approach runs contrary to the Tribunal's decision in the MAPS, where the regulator was criticised for assuming market power existed in respect of a pipeline extension despite there being no factual circumstances which would have entitled the regulator to reasonably conclude that Epic would be able to exercise any market power of a significant nature in the relevant market.

In addition, this recommendation, if implemented, will entrench the current approach to pipeline expansion where pipeline owners are reluctant to expand in the absence of an expansion being completely underwritten by a contract from a customer. APIA refers in this respect to the comments made by one of Epic Energy's directors at the Commission's earlier hearings in this review:[44]

> At no stage now do we look to build in any additional capacity in any particular project for fear that particular capacity will become captive to the regulatory process and most-favoured nation clauses in the foundation contracts would drive down the overall investment. So both in terms of new investment, new greenfields investments and expansions, certainly Epic Energy would not now build a new pipeline or expand an existing pipeline for one jot more capacity than the market requires at that immediate time.

Accordingly, APIA submits that the appropriate approach to expansions and extensions to existing transmission pipelines is to apply the coverage test to such expansions or extensions before any form of regulatory oversight is applied.

Recommendation

APIA recommends that:

- new pipelines be conferred an automatic 20 year regulatory free period.
- any regulation of the pipeline occurring after the end of the period should only be considered on a prospective basis and then only after satisfaction of the relevant threshold test;
- in relation to competitive tendering, the role of the regulator be limited to ensuring that the tendering process is conducted at arms length, is not unduly restricted in terms of project specifications and is open to all interested parties. This role should be able to be performed by a probity auditor;
- the appropriate approach to expansions and extensions to existing transmission pipelines

[44] Mr Ian MacGillivray, Epic Energy's General Manager Commercial and Project Development and a Director of the Epic Energy Group of Companies. Productivity Commission, Inquiry into the Gas Access Regime, Transcript Of Proceedings At Sydney On Friday, 19 September 2003, page 382.

is to apply the coverage test to such expansions or extensions before any form of regulatory oversight is applied.

9 Institutional arrangements and other matters

APIA's comments on institutional arrangements and other matters relate to:

- merits review;
- ringfencing requirements and associate contract approvals;
- Ministerial decisions on coverage applications;
- Code change processes; and
- the incompatibility of capacity trading arrangements with price discrimination.

9.1 Merits review

APIA's initial submission focused on the need to ensure continued availability of merits review of coverage decisions. APIA did not address the need for the expansion of the availability of existing merits review rights from regulator's decisions on the basis that the other reforms of the regulatory system APIA was recommending would substantially dispense with the need for merits review from regulatory decisions. APIA remains of the view that the negotiate arbitrate model is superior for tier 2 regulation but offers these comments in light of the Commission's draft recommendations on the form of tier 2 regulation.

However, given the prospect of the continued application of heavy handed regulation, APIA considers that the arguments that apply to coverage decisions apply with even more force in respect of the accountability of the decisions of the regulator. In this respect, APIA strongly endorses the Commission's recommendations for the current limitations on merits review to be removed.

Indeed, APIA notes that since the Commission completed its draft report, the Tribunal has handed down two judgements that have resulted in imposed access arrangements being modified (refer to section 2 of this submission). The impact of these decisions in APIA's view will continue the tradition of the Tribunal providing important guidance on

competition related matters to Australian regulatory bodies. For example, APIA reiterates the Tribunal's statement in the GasNet decision: [45]

> Contrary to the submission of the ACCC, it is not the task of the Relevant Regulator under s 8.30 and s 8.31 of the Code to determine a '*return which is commensurate with prevailing conditions in the market for funds and the risk involved in delivering the Reference Service'*. The task of the ACCC is to determine whether the proposed AA in its treatment of Rate of Return is consistent with the provisions of s 8.30 and s 8.31 and that the rate determined falls within the range of rates commensurate with the prevailing market conditions and the relevant risk.

The key point is that the regulator should be required to demonstrate the areas where a service provider's arrangements are unreasonable, rather than the converse which currently prevails. Formalising such a change in the onus of proof would help address the regulatory risk that distorted investment decisions and increased the long run cost of providing gas transmission services to the community.

APIA disagrees that the scope of the review should be confined to the documents that were before the regulator. APIA notes that a service provider has no incentive to withhold relevant information from a regulatory process – indeed, the opposite is the case. It is clearly in a service provider's interests to minimise the risk that an appeal from a regulator's decision becomes necessary to protect its commercial interests.

APIA's concern is that the effect of this limitation causes the regulatory process itself to become less efficient. The fundamental problem with this approach is that the service provider is unaware of the way in which the regulator will react to the issues raised by the service provider during the review. Consequently, limiting the material that can be subsequently reviewed forces the service provider to undertake far more extensive preparation than would otherwise be the case. In effect, the service provider needs to prepare for every issue considered in the regulatory review as if it were being appealed.

In addition, a limitation to review on the documents gives the regulator the 'last word.' This is because it allows the regulator to raise considerations in the final stage prior to review that had not been raised earlier or had not been given weight earlier. The effect is to place the service provider in a position where it has not had an effective opportunity to reply prior to the appeal stage. The need to cover off this risk will further increase the incentives the service provider has to ensure that it canvasses all issues in the material it submits.

Therefore, from a service provider's perspective, interacting with the regulator becomes a more expensive and less efficient exercise, due to the fact that review of the correctness of the regulator's decision is confined to the material that was presented before the regulator.

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[45] Australian Competition Tribunal, Application by GasNet Australia (Operations) Pty Ltd [2003] ACompT 6, paragraph 42.

APIA submits that removing this restriction would enhance both the efficiency and the accountability of the regulatory process. Indeed, one of the desirable aspects of merits review processes is that it potentially increases the efficiency of the process overall. This is because it facilitates more extensive research and review of the matters that prove to be most contentious.

In addition, limiting the materials in this way prevents service providers raising legitimate issues that arise after the closure of the regulatory process. The regulatory environment is clearly evolving and will further change over time. APIA believes that if the key concern (which it accepts) over the conferral of a right of merits review is to protect the service provider's property rights, then the service provider should not be prevented from pursuing issues on merits review that were not known during the course of the regulatory process.

Finally, APIA submits that the need for consultation on every issue before an appellate body is overstated. As the Commission stated in the draft report, there is no requirement for the merits appeal body to undertake time consuming and costly public consultation. APIA submits that removing the constraints on the matters that may be considered on appeal does not change this requirement.

Accordingly, APIA submits that the current limitation on the matters that may be considered on appeal should be removed and rejects draft recommendation 11.6.

9.2 Ring fencing and associate contracts

In its initial submission APIA acknowledged the legitimate role that ring fencing plays in providing assurance to access seekers that their commercial position will not be undermined[46]. However, APIA believes that the current approach to ring fencing may benefit from revision in light of the Commission's suggested change to the Gas Access Regime to provide for tier 1 and tier 2 coverage arrangements. Adoption of such a framework will see three effective classes of gas pipelines:

- uncovered pipelines;
- tier 1 covered pipelines; and
- tier 2 covered pipelines.

Uncovered pipelines

APIA believes that uncovered pipelines should not be subject to any form of ring fencing or affiliate contract approval processes. APIA notes however, that pipelines that do not

[46] APIA Submission to the Review of the Gas Access Regime, September 2003, page 81.

establish credible alternative arrangements will do so at their peril as they will be materially more exposed to coverage applications.

APIA believes that its proposed Industry Code of Conduct provides a credible alternative arrangement as discussed in Section 7 of its Initial Submission. APIA believes that this commitment to non-discriminatory tariffs, the disclosure of key contract details, the protection of confidential information and independent external audit of compliance will ensure, in a transparent manner, similar outcomes to that sought by the current ring fencing commitments of the Gas Access Regime.

Tier 1 pipelines

APIA believes that the Industry Code also provides a basis for modifying the ring fencing requirements to be applied to Tier 1 service providers subject to monitoring. APIA proposes that Tier 1 covered pipelines continue to be covered by the existing ring fencing provisions of the Gas Code with the exception of requirements 4.1(c) and 4.1(e) dealing with the requirement to maintain separate accounts and to allocate shared costs as these requirements are cost based and inappropriate for a monitoring framework. Further, for gas transmission pipelines, operating costs (which are the subject of cost allocation rules) are likely to be limited to between 10% and 20% of total costs reflecting the highly capital intensive nature of gas pipeline services.

APIA is of the view that tier 1 pipelines should not be subject to the requirement for regulator approval of affiliate contracts where those pipelines establish alternative mechanisms to address preferential self-dealing concerns. APIA submits that the principal alternative mechanism will be compliance with the Industry Code of Conduct which the Commission has acknowledged would overcome this problem.[47]

APIA believes that such an arrangement will address the Commission's concerns over the potential efficiency impacts of a mandatory non-discriminatory tariff arrangement as outlined in Chapter 8 of the draft report, namely:[48]

> …it might be efficient for service providers to offer volume discounts to increase the throughput of under utilised pipelines.

The optional nature of the proposed arrangement allows the service provider to select the approach that it considers will result in the most efficient outcome (ie self imposed non-discriminatory access or the seeking of regulator approval for associated contracts). Thus,

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[47] Productivity Commission, "Review of the Gas Access Regime", Draft Report, December 2003, page 320.

[48] Ibid, page 266.

should the firm consider that self imposed mechanisms to address preferential self dealing (such as commitments to non-discriminatory pricing) might not be beneficial, it can choose the alternative, namely to seek regulator approval of any affiliate contract.

Tier 2 pipelines

While APIA remains convinced that the most appropriate approach for covered pipelines is the introduction of a regulatory framework based on a negotiate arbitrate model, should this approach be rejected by the Commission and the current framework maintained for the setting of reference tariffs for tier 2 covered pipelines, APIA considers that the current ring fencing arrangements are largely appropriate. The principal areas for improvement remain as identified in APIA's original submission, that is:

- simplify cost allocation and information reporting requirements; and
- reducing the need for regulator approval of affiliate deals.

APIA supports any move to standardise and simplify reporting requirements under the Gas Code. In APIA's original submission it was argued that:[49]

> …it is inappropriate for ring fencing to be used to prescribe cost allocation methodologies applicable to the regulated business. In other words, APIA believes that cost allocation for ring fencing should be confined to the allocation of cost between regulated and unregulated affiliated businesses, rather than internal cost allocations by an access provider (that is, within the regulated business alone).

APIA continues to believe that limiting cost allocation requirements under the Gas Code to the issue of cost allocation between the regulated and unregulated business would be a significant step in limiting the impact of regulator imposed information requirements on the day to day operations of the service provider.

APIA believes that a requirement for transparent and non-discriminatory pricing with respect to affiliate transactions offers a viable and socially desirable alternative to the current requirement for such contracts to be referred to the regulator for approval and APIA believes that such an option could be extended to tier 2 covered pipelines.

Notwithstanding such a change, APIA supports the Commission's suggestion (Draft Recommendation 10.1) that the Gas Code be amended:

> …such that a service provider entering an associate contract for the supply of services at the reference tariff must notify the relevant regulator, but is not required to seek authorisation.

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[49] APIA Submission to the Review of the Gas Access Regime, September 2003, page 82.

9.3 Ministerial decisions on coverage applications

APIA notes that the Commission recommended that draft recommendation 11.2 provides that the Minister would be deemed to have agreed to the NCC's recommendation for coverage in the absence of a Ministerial objection within 21 days. APIA rejects this suggestion. Whilst APIA's members have at times been concerned about the time taken for Ministerial decisions, they have certainly been comforted by the fact that the Minister has independently considered the NCC's recommendation. The Ministerial decision making process is a fundamental step in the coverage process yet the Commission's proposal could render the Ministerial decision making process a "rubber stamp". APIA therefore rejects recommendation 11.2.

9.4 Code change processes

APIA concurs with the Commission's conclusion that the National Gas Pipelines Advisory Committee is not working effectively and that changes are essential.

APIA notes that the Ministerial Council on Energy (MCE) announced on 11 December 2003 that the Australian Energy Market Commission (AEMC) would be established by 1 July 2004 and that its core functions would include code change functions currently undertaken by the National Gas Pipelines Advisory Committee (NGPAC).

The MCE intends to establish a more structured and transparent code change process to be followed by the AEMC in which market participants, end users, the Australian Energy Regulator and the ACCC will be involved. Energy Ministers envisage that the AEMC will take on responsibility for the National Gas Code following MCE consideration of the current review of the National Gas Access Regime.

APIA maintains that there must be effective separation of the Gas Code change and regulatory functions and that there should not be direct regulator participation or involvement in the Code change process. The Draft Report suggests that an advisory committee making recommendations to governments should comprise government officials only. APIA does not concur with this approach. Whilst APIA accepts that responsibility for initiating changes to the Gas Pipelines Access Law should rest with government officials, both governments and market participants (through their industry associations) should be represented on the Code Change Advisory Group. Under the current NGPAC arrangements, market participants are represented (producers, transmission, distribution and customers) and this model should be maintained. It should be noted that under the current NGPAC arrangements the market participants are given the opportunity to state their positions and participate actively in the policy debate, but have no voting rights on the Committee. APIA believes that this is the most effective means of

ensuring effective consultation with market participants. It is noted that the chairman of NGPAC referred to the importance of this representational structure in his submission prior to the release of the Commission's draft report.

Under the model outlined above APIA envisages that responsibility for formally initiating changes to the Gas Access Code would lie with governments and market participants (through their industry associations), but not with regulators. Efficiency would be enhanced by requiring that a minimum number of service providers or current users be required to initiate a code change proposal. There should be open consultation according to a statutory process in the Gas Pipeline Access Law and proposed changes should be assessed against the objectives of the Code to establish the level of net benefit a change would deliver to the gas transport market, markets upstream and downstream of that market and through them the wider economy.

This should involve a robust quantification of the benefits of the proposed change showing how the proposed change will further the object of the Gas Access Regime (clarified in accordance with this submission). Moreover, the onus should be on the party seeking the change to demonstrate that it will lead to net benefit and that that party should be required to demonstrate that benefit on a balance of probability standard.

In order to ensure an open and transparent process, the AEMC should be required to address issues raised by submissions and to publish reasons demonstrating the validity of its findings against the objectives of the Code. APIA recommends that the Ministerial Council for Energy should be the decision maker on code changes.

The issue of funding arrangements is a matter which is being progressed by the MCE and stakeholder consultation on proposed arrangements is due to commence shortly.

9.5 Capacity trading and price discrimination

APIA considers that the Commission's draft report could be interpreted in a way that produces an important inconsistency. Whilst APIA in general supports the pricing principles proposed by the Commission, the adoption of those pricing principles (which specifically endorse multi-part tariffs and price discrimination where it aids efficiency),[50] is potentially inconsistent with the Draft Finding that "Service providers could facilitate capacity trading by posting information on their websites regarding unutilised capacity that shippers want to trade".[51]

[50] Draft Recommendation 7.1

[51] Draft Finding 7.4.

APIA notes that service providers have adopted different approaches to the issue of facilitating trading or engaging in price discrimination. Some have sought to retain the capacity to price discriminate, whilst others have formed the view that pipeline throughput will be maximised where non-discriminatory terms and conditions are applied across the market.

APIA submits that service providers have legitimate commercial decisions to take in this regard. APIA further submits that economic efficiency is likely to be enhanced where access regulation respects and supports the commercial judgements that are made on the tradeoffs between capacity trading and price discrimination.

Accordingly, APIA requests that the Commission clarify that the circumstances in which capacity trading is to be facilitated does not apply in those instances where price discrimination is being applied.

Recommendation

APIA recommends that:

- there be no limits on merits appeals;
- there be no presumption of the Minister's acceptance of a coverage recommendation;
- that market participants, but not the regulator, be represented on the Code Change Advisory Group;
- in relation to ring fencing:
  - uncovered pipelines be required to adhere to self regulatory principles and be subject to coverage applications for transgressions;
  - Tier 1 covered pipelines continue to be covered by the existing ring fencing provisions of the Gas Code with the exception of requirements 4.1(c) and 4.1(e). Tier 1 pipelines should not be subject to the requirement for regulator approval of affiliate contracts where those pipelines establish alternative mechanisms to address preferential self-dealing concerns;
  - Tier 2 – continue with current arrangements except cost allocation processes should be limited to cost allocation between regulated and unregulated businesses and approvals of associate contracts at reference tariffs not be required;
- the Ministerial Council for Energy should be the decision maker on code changes; and
- the Commission clarify that the circumstances in which capacity trading is to be facilitated does not apply in those instances where price discrimination is being applied.

10 Concluding comment

APIA recognises and shares the Commission's concerns with the adverse impact of regulation on investment and the long term community benefit. APIA believes it is important to reiterate the industry's view that the natural response of pipeline companies to an unacceptable framework has been to modify its approach to investment in order to minimise exposure to that framework.

The recent events in South Australia have highlighted the benefits that an interconnected pipeline system brings to the Australian economy. The timely commissioning of the SEAGas pipeline has alleviated impacts in South Australia. The impacts on New South Wales have been mitigated considerably by the spare capacity that was built into the Eastern Gas Pipeline.

APIA considers that the commercial environment that now presents is fundamentally different to that which prevailed when the Gas Access Regime was developed. Perhaps at that time it was appropriate to adopt a relatively detailed regulatory scheme. However, APIA believes that the increasing interconnectedness of the gas market means that the balance of risk associated with regulation has fundamentally shifted. The time has come to let the market work.