Australian Pipeline Industry Association

Supplementary Submission to the Productivity Commission Review of the Gas Access Regime

December 2003

This submission has been prepared by APIA's Membership in conjunction with Network Economics Consulting Group Pty Ltd.

Contents

List of Abbreviations

ABDP	Amadeus Basin to Darwin Pipeline
ACT	Australian Competition Tribunal
AGA	Australian Gas Association
AGLGN	AGL Gas Networks
APIA	Australian Pipeline Industry Association
APT	Australian Pipeline Trust
ACCC	Australian Competition and Consumer Commission
ABARE	Australian Bureau of Agriculture and Resource Economics
CAPM	Capital Asset Pricing Model
CGBP	City Gate to Berrimah Pipeline
CGP	Carpentaria Gas Pipeline
CoAG	Council of Australian Governments
CWP	Central West Pipeline
DEI	Duke Energy International
DBNGP	Dampier to Bunbury Natural Gas Pipeline
DORC	Depreciated Optimised Replacement Cost
EAPL	East Australian Pipeline Limited
EGP	Eastern Gas Pipeline
GGT	Goldfields Gas Transmission Pty Ltd
GGP	Goldfields Gas Pipeline
GJ	Giga Joule
GRTF	Gas Reform Task Force
IGA	Inter-Governmental Agreement
LNG	Liquid Natural Gas
MAPS	Moomba to Adelaide Pipeline System
MSP	Moomba to Sydney Pipeline
NCC	National Competition Council
NCP	National Competition Policy
NDAP	Non Discriminatory Access Policy
NPV	Net Present Value
NSW	New South Wales
ORC	Optimised Replacement Cost

PJ	Peta Joule
PWC	Power and Water Corporation
QGP	Queensland Gas Pipeline
RBP	Roma to Brisbane Pipeline
SA	South Australia
SWQP	South West Queensland Pipeline
WACC	Weighted Average Cost of Capital
TGP	Tasmanian Gas Pipeline
TJ	Tera Joule
TPA	Trade Practices Act 1974
WA	Western Australia

1 Introduction

In September, APIA made a submission to the Productivity Commission's Inquiry into the *Review of the Gas Access Regime*. In this submission, APIA wishes to respond to several of the issues that were raised both at the public hearings and in submissions by other stakeholders.

This submission is set out as follows:

- section 2 responds to the suggestions that the Gas Access Regime has provided a climate that has fostered significant investment in gas transmission infrastructure;
- section 3 considers the efficacy of proposals to create a two-tiered regulatory model;
- section 4 outlines the trends in regulation and rebuts the suggestion that regulation in the future is likely to become more streamlined;
- section 5 highlights the inconsistency in claims that the flexibility provided by the Gas Access Regime in relation to coverage is a desirable attribute;
- section 6 re-emphasises the importance of the separation of the roles of the NCC and the ACCC for the purposes of assessing coverage issues;
- section 7 responds to the criticisms of the negotiate arbitrate approach raised in submissions;
- section 8 expands upon APIA's initial submission in respect of the role of workable competition for the purposes of guiding regulatory decision making;
- section 9 responds to the suggestion that the truncation problem for new pipelines is overstated; and
- section 10 concludes this submission.

2 Investment

APIA is concerned that a misleading view has been expressed that the current gas access regime has in some way been responsible for encouraging the construction of new pipelines, a view most clearly expressed by the ACCC[1]:

> "Gas reform since the mid 1990s has supported a significant growth in the industry and should be regarded as a success story. Removal of restrictions on interstate sales of gas, coupled with the introduction of third party access to natural gas transmission and distribution pipelines has encouraged the construction of a number of new pipelines."

or, as BHP Billiton claimed, that the industry would have realised the likely impact of the gas access regime many years before its introduction:

> "… industry participants would have factored in to their decisions the likelihood of a mandated access regime as early as 1991, and considered such a regime a high probability by 1994, and then had substantial certainty about the final shape of the regime by mid 1996."[2]

APIA considers that neither of these assertions stands up to scrutiny of the facts.

2.1 Development of the Gas Access Regime – an industry perspective

Early discussion of the likely shape and aims of a gas access regime revolved around identifying the impediments to the free and fair trade in gas and are perhaps best characterised by the views expressed by ANZMEC in its 1993 report to CoAG which recommended that:

- CoAG adopt a "light handed regulatory regime characterised by market monitoring rather than price or rate of return setting … (with) formal price setting only as a final resort";

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1 For example, ACCC 15 September Submission, page vi.

2 BHP Billiton Submission, page 18.

- Governments refine legislative definitions to provide open access within and between jurisdictions;

- CoAG "supports *industry development* of a Code of Practice relating to third party access as a measure that will complement government action to ensure pipeline access for third parties";

- Governments review legislation applying to transmission pipelines and develop arrangements to ensure access subject to spare capacity.

As such, during the early 1990's, the industry believed that open access on a negotiate arbitrate basis as outlined in the Hilmer Report was the most likely outcome and was actively involved in developing a supporting industry Code of Practice which it presented to ANZMEC in July 1993. This approach was consistent with the advice provided by ANZMEC to CoAG in 1993 that CoAG should support industry development of a Code of Practice relating to third party access as a measure that would complement government action to ensure access to third parties.

It was also consistent with the "light handed" negotiate arbitrate models adopted by the Commonwealth in respect of sale of the MSP (March 1994) and the South Australian Access Regime (March 1995) as well as the February 1994 CoAG communiqué which included the Council's detailed decisions in relation to free and fair trade in natural gas as Attachment B. This attachment included a set of agreed principles for the cooperative development of legislation to provide free and fair trade in gas through third party access to pipelines as outlined in Box 1.

Box 1 CoAG's 1994 Gas Access Principles

In February 1994, CoAG established the following principles to underpin the cooperative development of the gas access regime (emphasis added):

- pipeline owners and/or operators provide access to spare pipeline capacity for all market participants on <u>individually negotiated non-discriminatory terms and conditions</u>;
- information on haulage charges, and underlying terms and conditions, to be available to all prospective market participants on demand;
- if negotiations for pipeline access fail, provision be made for <u>the owner/operator to participate in compulsory arbitration</u> with the arbitration based upon a clear and agreed set of principles;
- pipeline owners and/or operators maintain separate accounting and management control of transmission of gas;
- provision be made for access by a relevant authority to financial statements and other information necessary to monitor gas haulage charges; and
- access to pipelines would be provided by <u>either Commonwealth or State/Territory legislation based on these principles by 1 July 1996</u>.

2.1.1 Industry expectations of the Gas Access Regime

As such, the industry expected that a light-handed negotiate arbitrate model consistent with the recommendations of the Hilmer review would be introduced. Such an approach was also consistent with Part IIIA of the TPA that was then under development and was subsequently introduced in 1995. In the eyes of the industry such an approach promised to deliver significant benefits and support the development of a robust integrated gas pipeline system capable of playing a pivotal role in meeting Australia's future energy needs.

It was not until the July 1996 release by the Gas Reform Task Force (GRTF) of an exposure draft of the Gas Code that the industry became aware of the possibility that the proposed regulatory framework was to move away from a negotiate arbitrate regime and be replaced by a compulsory access arrangement approach. Indeed, in August 1996 the Australian Gas Association (AGA) noted that what was proposal was:

> "…in effect, the service provider is negotiating terms and conditions with the regulator who represents and balances the interests of all users, large and small…

> if the service provider and regulator fail to reach agreement, the regulator can impose terms and conditions…"

At this time the AGA noted that the exposure draft was so substantially different from previous drafts provided by the GRTF that it was virtually a new document.

2.1.2 Industry response to Exposure Draft

The industry considered that the proposed Gas Code was a radical departure from what had been previously proposed but found that the time frame for effective consultation had been truncated with CoAG setting a target date of 30 September for finalisation of the Gas Code and associated Inter-Governmental Agreement leaving only two months for stakeholder consultation with respect to a document which was to all intents and purposes completely new from the industry's perspective. As such, the industry was left with no choice but to assess the revised Gas Code and identify key issues that could be addressed in the time available. To this end, the industry noted that the exposure draft did not include allowance for merits review and it was decided that the reinstatement of merits review to the fullest extent possible should be industry's highest priority.

In addition, in discussions the GRTF argued that the Gas Access Regime would include a review mechanism so that if the industry were to accept the proposed arrangements it would be possible to address areas of particular concern via the Gas Access Regime's review process subsequent to its implementation. However, it is only now, some five years after introduction of the Gas Access Regime that there has been any real opportunity for the industry to seek to address what it sees as a flawed and intrusive regime.

2.2 Pipeline investment – due to or in spite of the Gas Access Regime?

The above timeframe meant that in practical terms it was not until late 1996 that the industry had any real appreciation of the actual detail of the proposed Gas Access Regime and that even then, industry was not in a position to truly understand the full ramifications of the Gas Access Regime until after the establishment of regulatory precedent.

As such, the argument that the increase in pipeline capital expenditure which occurred from 1996 could in any way be attributed to the current Gas Access Regime is clearly false especially given the extended lead time associated with approval processes and construction of major pipeline infrastructure. Even an expedited planning and construction process for a major pipeline is unlikely to be completed in under three or four years. For example, the DEI TGP grew out of a 1997 Tasmanian Government expression of interest process which led to a memorandum of understanding being signed between DEI and the Tasmanian Government in May 1998. Construction of the pipeline was completed in 2002 with the entire project having taken some five years to go from concept to completion. This is faster than many projects that remain just proposals for many years before all of the critical investment factors are aligned to allow the project to be progressed. An example of such a project would be the PNG pipeline which has been at the proposal stage for some eight years, although the proponents have undertaken major efforts aimed at moving it to the construction phase.

2.2.1 History of recent pipeline developments

In its original submission, the ACCC identified a significant increase in expenditure on gas pipelines since 1996 (Figure 1, page vi), an increase which it suggested was evidence of the success of the Gas Access Regime in encouraging investment. APIA believes that careful consideration of the major projects that have occurred since 1996 clearly indicates that this is not the case. Indeed, the evidence suggests that in most instances, in the absence of specific legislation quarantining new investments from the impact of the Gas Access Regime, those investments would never have proceeded. In support of this contention, APIA offers the following brief discussion of the main pipelines that have commenced operation since 1996.[3]

Goldfields Gas Pipeline (GGP)

The GGP grew out of a combined industry and Government desire to see a reliable source of consistently priced fuel provided to industry in central Western Australia and the Goldfields. In 1993 the Western Australian State Government called for expressions of interest for the construction of a natural gas pipeline from the Pilbara to the Goldfields. The GGT was

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[3] APIA also recognises that there have been expansions since the introduction of the Gas Access Regime. A good example is the RBP, which was expanded through a process of commercial negotiation with customers outside of the Gas Access Regime (see Case Study 9 of APIA's initial submission). Pipeline development in the past was actively sponsored by State Governments and provided for significant spare capacity to be developed in the original construction of the pipeline through pipeline sizing . Hence, expansion simply was not required through the 1980's and early 1990's as this spare capacity was utilised which in turn has meant that expansions could be deferred until the late 1990's. However, as a consequence of the regulatory risk that has been introduced with the Gas Access Regime, pipelines are increasingly built and expanded with no spare capacity. Examples of this include the Stage 3A expansion of the DBNGP in 1999 and 2000 and the Stage 2 expansion of the MAPS in 2000 and 2001.

selected as preferred proponent and a State Agreement was subsequently negotiated and signed in March 1994.

Pipeline construction commenced in 1995 with commissioning undertaken progressively along the pipeline between June and October 1996. At the time of commissioning, the GGP is estimated to have had a construction cost in excess of $450 million.

The key factor ensuring that the GGP project went ahead was the presence of the State Agreement that provided for, amongst other things, non-discriminatory access and tariffs under a light handed regulatory framework with a commitment that the joint venturers would suffer no material adverse effect on their legitimate business interests with the future introduction of the Gas Access Regime. The Agreement is substantially less prescriptive than the Gas Access Regime and gives the Pipeline owner far greater flexibility and freedom in terms of the level and structure of charges. This allowed an entrepreneurial project to be progressed despite the uncertainty associated with the development of the Gas Access Regime.

South West Queensland Pipeline (SWQP)

In 1994 the Queensland Government commenced a competitive tender process for the construction of the SWQP. Selection of the successful proponent included an assessment of tariffs proposed by the developers. Tenneco Gas Australia (now Epic Energy) was the successful proponent and construction began in 1994 and was completed in 1996 with access to pipeline services provided under the terms and conditions proposed in the original competitive tender. The pricing aspects of these terms and conditions were the subject of a derogation when the Gas Access Regime was introduced. The effect of the derogation is that the tariff for the full forward haul service will not be reviewed until the end of 2016 with other tariffs not reviewable under the Code until 30 December 2004. Therefore, the only elements of the Gas Access Regime that apply are the non-price elements.

Clearly, the development of the SWQP predated the formal introduction of the Gas Access Regime while the development arrangements agreed between the developer and the Queensland Government ensured that to all intents and purposes, the proposed Gas Access Regime would not impact on the financial arrangements governing access to the pipeline.

Carpentaria Gas Pipeline (CGP)

The CGP was developed via a Queensland Government competitive tendering process which commenced in 1994/95.

The successful proponents (APT and SWQ Producers), agreed to access principles with the Queensland Government that underpinned project financial close in May 1995. Construction commenced in late 1996 and was completed in May 1998.

Tariffs were agreed as part of the competitive tendering process and were in turn the subject of derogations when the Gas Access Regime was introduced. As such, while the CGP is covered under the Gas Access Regime, the ACCC has no power to set reference tariffs before 2023. That is, as is the case with the SWQP, the only elements of the Gas Access Regime that apply are the non-price elements.

Thus the CGP developers were assured that the proposed Gas Access Regime would not impact on the financial arrangements governing access to the pipeline.

Central West Pipeline (CWP)

Development of the Central West Pipeline was assisted by the Federal Government's Regional Development Program. This program required that a tender process be established to select the preferred proponent for development of the pipeline which occurred around mid-1996.

The AGL group of companies were selected as preferred proponents and financial close was reached in early 1997. It is a $30 million project. Construction commenced in late 1997 and was completed in two stages in April and August 1998.

As the CWP was included in Schedule A of the Gas Access Regime, it was automatically covered on completion and as such is a regulated pipeline. Therefore, AGL proposed an access arrangement in December 1998 with the ACCC delivering its final approval in October 2000.

Construction of the CWP largely predated the formal introduction of the Gas Access Regime and certainly predated any industry understanding as to practical impact that the Gas Access Regime would have. As such, APIA believes that the CWP was constructed in spite of the Gas Access Regime and before regulatory precedent had been established.

Eastern Gas Pipeline (EGP)

The EGP project was originally proposed by Westcoast Energy and BHP in the mid 1990's with the project development rights being subsequently purchased by DEI.

Project financial close occurred in November 1998 with project construction costs estimated at around $450 million. Construction commenced in August 1999 and was completed in August 2000.

In developing this project, DEI always intended that it would be operated on a non-discriminatory, open access basis. In support of this, DEI submitted a voluntary access undertaking under Part IIIA. However, the ACCC indicated its intention to assess an undertaking under Part IIIA as if it were an access arrangement under the Gas Access

Regime. That is, including binding reference tariffs. As such, DEI withdrew its undertaking and decided to operate the EGP as an unregulated pipeline.

Nevertheless, a coverage application was made on the EGP in January 2000 with the Minister's Decision to cover the EGP being overturned by the ACT in May 2001. The ACT decision therefore vindicated DEI's position underpinning its investment that the Gas Access Regime would not apply to the pipeline. The EGP is now operated under DEI's non-discriminatory access policy (NDAP).

Tasmanian Gas Pipeline (TGP)

The TGP project was originally proposed by the Tasmanian Government. In 1997, it sought expressions of interest in the development of a natural gas supply to Tasmania. In May 1998 DEI signed a MOU with the Government undertaking to assess the feasibility of the project.

Project financial close occurred in October 2000. The TGP is a $440 million project. Construction of the main undersea pipeline commenced in December 2001 and was completed in September 2002.

The TGP is currently an unregulated pipeline operated under DEI's Non-Discriminatory Access Policy with prices set via negotiation. In light of its success with the EGP non-coverage case, and given the formal introduction of its NDAP, DEI considered that the TGP would not satisfy the coverage criteria and was therefore willing to proceed with the project notwithstanding the perception of substantial regulatory risk should a successful coverage application be made.

SEAGas

The SEAGas project is the result of a SA Government sponsored initiative in late 2000. Originally, SEAGas and DEI both proposed projects and competed to capture the customer base necessary to ensure the viability of the project. DEI subsequently withdrew its proposal.

SEAGas reached project financial close in September 2002, a little over a year after the ACT decision to overturn the Minister's recommendation to cover the EGP. It is a $500 million project. Construction commenced in October 2002 and with commercial operation scheduled to commence in January 2004.

SEAGas propose to operate the pipeline on an unregulated open access basis with prices set via negotiation. The SEAGas project was developed subsequent to the ACT EGP decision and SEAGas considered that the project would not satisfy the coverage criteria (due to it competing with the MAPS) and as such, had a relatively low risk of regulation. Even if coverage is imposed, it is considered unlikely to have a significant impact on the pipeline as the majority of the initially installed capacity is already committed and expansions are likely to occur as a result of commercial negotiation (a situation which is similar to that which applies to the Roma to Brisbane pipeline[4]).

2.3 Conclusion

Investment in new transmission pipelines of well over $2 billion accounts for the vast majority of pipeline investment since 1996. Of the seven pipelines completed since 1996, only the $30 million CWP (a relatively minor pipeline that proceeded on the basis of direct Government financial assistance) is regulated under the Gas Access Regime. That is, less than 2% by value of new investment in transmission pipelines since the introduction of the Gas Access Regime is actually regulated under the Gas Access Regime, and arguably the investment decision in relation to the covered pipeline was affected by Government assistance. Moreover, where investment faced the threat of regulation (as with the Goldfields pipeline), measures were taken to insure the pipeline owners against potential detriments. APIA believes that this clearly indicates the reality that the investment that has occurred over the last eight years has occurred in spite of the Gas Access Regime rather than because of it. As was elaborated upon in APIA's original submission, it is also further evidence that future development of capacity will occur on inefficient basis.

In this regard, APIA reiterates the comments of DEI's Managing Director at the Commission's hearings:[5]

> Duke Energy International will not invest in any further pipeline developments in Australia until regulatory certainty is achieved.

Similarly, at the hearing, Mr Ian MacGillivray, Epic Energy's General Manager Commercial and Project Development and a Director of the Epic Energy Group of Companies stated that:[6]

> 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

4 APIA Submission to Productivity Commission Review of Gas Access Regime, Case Study 9, pg 36.

5 Productivity Commission, Inquiry into the Gas Access Regime, Transcript Of Proceedings At Sydney On Friday, 19 September 2003, page 380.

6 Ibid, page 382.

pipeline for one jot more capacity than the market acquires [requires] at that immediate time.

3 Two-tiered regulatory models

3.1 Introduction

An issue raised by the Commission both in its Issues Paper and during public hearings is the possibility of introducing a more light-handed form of regulation as part of a two-tiered approach to the regulation of gas pipelines. In the Commission's Issues Paper, this was raised in the context of a more light-handed approach being applied to all gas pipelines or possibly, being limited to circumstances where coverage decisions were marginal.

APIA expressed a clear preference in its initial submission for a negotiate arbitrate model for those pipelines that meet a strengthened coverage test. APIA sees this regulatory framework being supported by a voluntary industry Code of Conduct applicable to all pipelines setting pro-competitive behavioural standards for the industry. APIA acknowledges that, in a sense, this scheme represents a two-tiered model, with voluntary adoption of an industry Code of Conduct being the first tier and the negotiate-arbitrate framework for covered pipelines representing the second tier.

However, the key differences between the models relate to their levels of regulatory intervention and their susceptibility to regulatory creep. APIA believes that its preferred model will minimise regulatory intervention, and with it, the risk of regulatory creep, whilst ensuring the public interest is protected in cases where pipelines possess significant market power. In contrast, APIA considers that the formal two-tiered regulatory approach the Commission has floated would be particularly prone to unnecessary regulatory intrusion and regulatory creep.

In explaining why this is the case, the following sections:

- reiterate APIA's views on the current coverage test;
- outline why regulatory gradations would be difficult in practice apart from a universal coverage application in the first tier;
- highlight the efficacy of the APIA model relative to the formal two-tiered approach.

3.2 APIA's views on the current coverage test

APIA's initial submission noted the Commission's remarks in previous reviews concerning the potential need to tighten coverage tests, and to this end, APIA recommended that a national significance test be incorporated as part of the test together with paragraphs (a) and (b) of the threshold test being tightened. The following briefly reviews these proposed amendments in light of recent developments and then considers the strengths of this regulatory framework.

3.2.1 Proposed amendment to paragraph (a)

In APIA's initial submission, it was recommended that paragraph (a) of the threshold test for coverage be amended as follows:

> *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*

In respect of this proposed change, APIA notes that the ACCC has recently argued – for example in the proceedings involving the possible purchase by AGL of a stake in Loy Yang – that "likely" does not mean "more likely than not" but merely means "possible." As a result, APIA believes that if the threshold test is to be given real meaning, it must set a degree of likelihood which prevents coverage from proceeding in instances where the alleged effects are not probable but only possible.

More generally, 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 development only serves to highlight the need for reform of this criterion.

3.2.2 Proposed amendment to paragraph (b)

In APIA's initial submission, it was recommended that paragraph (b) of the threshold test for coverage 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*

APIA notes that the Ministerial decision on the MSP highlighted shortcomings of the existing interpretation of this limb of the test:[7]

> 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.

3.2.3 Advantages of current coverage framework

Whilst the determination of coverage under the Gas Access Regime will often be clear-cut, APIA recognises that there may be cases where there is a degree of uncertainty associated with whether a particular pipeline should be subject to coverage, especially in light of the significant impact that access regulation has on property rights and the associated concerns as to its impact on investment incentives. APIA believes that this uncertainty is at least in part due to the nature of the coverage test and that the modifications APIA has proposed will reduce the likelihood of marginal cases arising on this point.

APIA believes that its proposed amendments to the coverage test also recognise that pipeline coverage is a means to an end rather than an end in itself, and in this respect endorses the Minister's statement that:[8]

> The purpose of the Code is to regulate gas transmission pipelines that may otherwise be capable of exerting market power, not to establish an immutable regulatory framework for gas access in its own right… A fundamental policy objective of Australian governments has been to encourage a competitive national market for natural gas, including encouraging investment in the transportation of natural gas.

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7 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.

8 ibid, para 152.

One benefit of the Gas Access Regime is that the current coverage test, while in need of tightening, is relatively straightforward - either a pipeline satisfies the test and is subject to the Gas Access Regime or it does not (whilst remaining subject to the risk of future coverage). This is also consistent with the declaration test under Part IIIA. It is with this in mind that APIA addresses issues arising from two-tiered coverage approach.

3.3 APIA's concerns with two tiered coverage

APIA acknowledges that the intention underlying a two-tiered approach is to create an environment that is less invasive than at present. However, APIA considers that the adoption of such a scheme will result in the regulatory environment becoming more rather than less invasive as it is likely to involve:

- a lowering of the threshold for the application of regulatory intervention; and
- an increased risk of entrenching heavy handed regulation.

In putting this view, APIA notes that its preferred model of a negotiate arbitrate regime is materially more invasive and confers upon access seekers materially stronger rights than the light handed forms of regulation that may be introduced for first tier regulation.

3.3.1 Lowering of the regulatory threshold

To the extent that a threshold test is applied for the first tier of more "light-handed" regulation, APIA is concerned that it is likely to lead to the situation where regulators decide that more pipelines (or all pipelines) should be covered on the basis that they would become subject to a lighter-handed form of regulation.

Applying a lower threshold test for the first tier (if one is applied at all) creates a substantial risk of significant Type I error.[9] APIA also notes that such an approach would be inconsistent with the Commission's previous observations on the effect of declaration:[10]

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[9] 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 such market failure exists.

> even though declaration confers an obligation only to negotiate, with ensuing arbitration criteria defining (or conditioning) the terms of access for declared services, it is still a significant intrusion on the property rights of service providers which weakens their bargaining position relative to that of access seekers.

This in turn will create the identical problems that beset the Gas Access Regime where regulation was applied where it was subsequently found to be unnecessary, a point recently re-emphasised by the Minister in his decision on the MSP that:[11]

> 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.

3.3.2 Increased risk of entrenching heavy handed regulation

APIA is also concerned that the threshold test for the second tier is difficult to visualise to the extent that it departs materially from the existing test (assuming it is modified in accordance with APIA's suggestions). Options for strengthening the test include imposing an additional limb to the current test such as a net benefit test or a behavioural threshold. The difficulty with both characterisations is that in practice they are likely to result in an immaterial increase in the threshold and merely facilitate an entrenchment of heavy handed regulation.

Moreover, APIA is concerned that the light-handed regulation provided by the first tier would become more heavy handed over time – especially where it has been determined that the pipeline has met a regulatory threshold. Indeed, one 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. 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.

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10 Productivity Commission 2001, *Review of the National Access Regime*, Report no. 17, AusInfo, Canberra, page 159.

11 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.

3.4 Why APIA's preferred solution is superior

3.4.1 APIA's preferred solution

It is for these reasons that APIA considers that the preferable approach is to rely upon:

- a tightened coverage test (as discussed above);
- the voluntary adoption of an industry Code of Conduct as a vehicle through which pipeline owners can minimise the risk of regulatory intervention;[12] and
- the availability of coverage and with it, a transparent arbitration mechanism for those who are unable to negotiate access to pipeline services.

APIA believes that this framework is more likely to lead to an environment that aligns the interests of pipeline owners and access with the public interest in a less invasive and more efficacious manner than either the Gas Access Regime or a two-tiered framework. In so doing, APIA believes that its model is more likely to be conducive to commercial negotiation and is unlikely to adversely affect investment whilst protecting against the misuse of market power by some pipelines. This is because APIA's preferred model provides for:

- an improved alignment of incentives;
- an enhanced role for the threat of coverage;
- a reduced scope for gaming of the regulatory environment; and
- reliance upon alternative mechanisms that already exist to address misuse of market power concerns.

3.4.2 Improved alignment of incentives

APIA believes that its proposed regulatory model provides for an improved alignment of incentives as:

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12 APIA's proposed Industry Code of Conduct was extensively discussed in section 7 of its initial submission to the Commission.

- the Industry Code of Conduct[13] will be voluntary and industry driven – which creates an environment that will not be considered invasive by the pipeline owners themselves and provides a protection against regulatory creep; and

- the Industry Code of Conduct provides a key element for a pipeline in any future defence to a coverage application. This provides a substantial discipline to both the content of the voluntary Code of Conduct as well as the levels of compliance by those who adopt it. This is because:

  - if the Code of Conduct is perceived to be too weak and hence is not credible, then service providers will gain little from adopting it in that it will provide a weak defence to coverage claims in which case there will be a high probability of the negotiate arbitrate model being applied except in the clearest cases of the service provider operating in a competitive environment;

  - failure by a service provider to adhere to the Code of Conduct is likely to provide a very strong signal that coverage ought to be applied except in the clearest cases of that service provider operating in a competitive environment. This is because it will be far easier for an access seeker to demonstrate that coverage will promote competition in respect of a pipeline where the owner of that pipeline has failed to adhere to a behavioural constraint. The impact of the threat of coverage in such circumstances was recognised in the EGP Decision, where it was stated that (emphasis added):[14]

    > With respect to the future, there are two aspects of the Duke standard terms and conditions for access which make monopoly pricing unlikely. Firstly, the advertised intention to increase prices by 75 per cent of the CPI, and secondly, the non-discrimination clause which has the potential to ensure that any benefits due to competition between pipelines (eg in Sydney and Canberra) flow through to all customers including those in the regional markets. In addition, there is the fact that these are new markets for gas which

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[13] APIA's proposals for an Industry Code of Conduct were outlined in its initial submission to the Commission (pages 64-69).

[14] Australian Competition Tribunal, Duke Eastern Gas Pipeline [2001] ACompT at para 132.

> EGP is attempting to develop, in competition with the currently available forms of energy. In these circumstances the prices that EGP can charge for transport will be constrained if market development is to be successful. *And there is the threat of regulation, with its associated costs, if prices are increased.*

- in the event that a pipeline becomes covered under the regulatory framework, a negotiate arbitrate model would be applied to ensure that access to the services provided by the pipeline would be available. APIA notes that arbitration is a far stronger sanction against pipeline owners than alternative "light-handed" regulatory models such as price monitoring.

- the Code of Conduct (when coupled with the threat of coverage) will encourage pipeline owners to be innovative in the services they offer to prospective users, rather than being reactive to users and prospective users who demand the establishment of a "vanilla" service under the current access arrangement approval process. This is a far superior means of achieving the objective of promoting the development of a competitive market for natural gas.

A related issue concerns the efficacy of the threat of coverage to which we now turn.

3.4.3 Impact of the threat of coverage

Under APIA's preferred model, the threat of coverage provides strong incentives for pipeline owners to behave in a socially desirable way due to:

- the probability of detection of transgressions by pipeline owners being very high by virtue of the transparent environment in which access seekers will have available to them mechanisms for redress where an access seeker is unable to reach agreement for the provision of access to a pipeline; and

- the cost of successful detection – under the proposed negotiate arbitrate framework, the costs of successful detection of abuses of market power by a pipeline owner are high given that it will become subject to an arbitrated outcome. Moreover, the outcomes of that review will include a published decision (making it clear where a regulated pipeline has acted unreasonably) and the risk that the pipeline owner will become liable for not only the costs of the arbitration but also the assessed costs of the access seeker. In practice, this threat represents a substantial motivation for pipeline owners to negotiate in good faith.

To the extent that there are legitimate concerns over the adoption of a negotiate arbitrate model, APIA believes that these can be addressed by the commitment to a further review five years after the introduction of a revised negotiate arbitrate gas access regime for transmission pipelines. At this time, it would be possible to assess the actual performance of such an approach in terms of the level of disputes and arbitrations and the cost of these arrangements.

In contrast, all other things being the same, the more heavy handed the default regulatory outcome, the less the incentive for access seekers to enter into bona fide negotiations with pipeline owners. This is because access seekers will perceive it in their commercial interest to actively seek the intervention of the regulatory agency. The most obvious example of this can be seen in the regulatory approval process for the DBNGP access arrangement. This in turn raises the issue of gaming by market participants.

3.4.4 Gaming

APIA endorses the proposition that price monitoring can provide an effective means of controlling market power. However, APIA is concerned that when price 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 the 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 prospects 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. Indeed, depending upon a regulatory body's incentives, it is possible that unless the agency responsible for price monitoring is separate to the body responsible for the second tier regulatory framework, the regulatory body itself may have incentives to press for a more invasive regulatory framework.

3.4.5 Availability of alternative mechanisms to address misuse of market power

One concern expressed in relation to the negotiate arbitrate framework relates to its comparative inability to address the misuse of market power by an incumbent pipeline owner seeking to protect its downstream interests. However, alternative mechanisms already exist to a heavy handed regulatory environment. For example, APIA's voluntary Code of Conduct contains provisions to protect against preferential self-dealing. Moreover, to the extent that candidates for coverage (who by definition are likely to enjoy substantial market power) engage in conduct that takes advantage of that market power for the purposes of:

- eliminating or substantially damaging a competitor;
- preventing the entry of a person into a market; or
- deterring or preventing a person from engaging in competitive conduct,

the relevant conduct is highly likely to breach the misuse of market power provisions of the Trade Practices Act. APIA submits the general competition provisions provide the most appropriate vehicle for addressing abuses of market power rather than a more invasive regulatory framework.

3.5 Conclusion

In essence, APIA considers that the most desirable regulatory model will align market participant's incentives to act in a way that minimises the need for further regulatory intervention. In essence, APIA believes that the negotiate arbitrate framework supported by a strengthened coverage test provides such a framework. In contrast, adoption of a two tiered scheme risks outcomes where the regulatory environment becomes more rather than less invasive, and service providers are restricted in their ability to be proactive and innovative, thus threatening the ability to realise a more competitive market for natural gas in Australia.

4 Trends in Regulation

APIA notes that a view has been expressed that access regulation is likely to become less contentious and less invasive in the future. For example, the ACCC submission asserted that:[15]

> The ongoing costs of the Code should continue to decline over time. The first round of access arrangements was always going to be more contentious and time consuming than subsequent rounds. This is significantly due to the once-off requirement to establish an initial capital base for regulatory purposes and it is also due to the lack of precedents or jurisprudence in this field within Australia.

In APIA's view, there no factual basis for this assertion. Indeed, APIA sees the regulatory environment increasing in complexity over time and with this increased complexity becoming more contentious. This section addresses the ACCC's suggestion that finalising access arrangements is likely to get easier over time, followed by a discussion of the industry's concern over increasing involvement by regulators between major reviews.

4.1 Contentiousness of the regulatory process

The ACCC has indicated that the regulatory framework would be more settled after the completion of the first round of access arrangements so that subsequent reviews would proceed more smoothly[16]:

> …the ACCC envisages that subsequent assessments will be increasingly less intensive especially as key issues such as the initial capital base are resolved in the first access arrangement.

APIA believes that this is highly unlikely as the only significant issue that will not be contentious in subsequent reviews is the initial capital base which is not subject to review. This is because there remains a large number of critical issues that are, and are likely to continue to be, highly contentious and, in turn, may well lead to litigation in future reviews.

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15 ACCC Submission to the Productivity Commission Review of the Gas Access Regime 15 September 2003, page 11.

16 ACCC Submission to the Productivity Commission Review of the Gas Access Regime 15 September 2003, page 48.

These issues include the form and magnitude of asset depreciation, operating efficiency targets (including but not limited to Key Performance Indicators), demand forecasts and the cost of capital. In respect of the cost of capital, it is by no means clear that *any* parameter value is settled. For instance:

- the term of the risk free rate remains highly contentious. The ACCC is the only regulator in Australia that consistently applies the term of the regulatory period as the horizon for the assessment of the risk free rate. All other regulators use the 10 year Commonwealth bond rate which is the longest deeply traded bond in Australia, and trades at a premium in the order 25 to 35 basis points above the 5 year bond. The ACCC approach relies on strong assumptions which are not met in practice;

- the market risk premium remains contentious. Regulators have at various times suggested that the market risk premium typically allowed of 6 % is excessive. Yet the collective wisdom of over 100 years of market experience is that a 6 % market risk premium is at the bottom of a reasonable range;

- equity and asset betas, as well as the approach to determining the debt beta, are still subject to debate. This is evidenced in the ACCC's recent Discussion Paper for the regulation of electricity transmission infrastructure entitled *Review of the Statement of Principles for the Regulation of Transmission Revenues*. The approaches outlined in that document, including confidence intervals for beta estimates, highlight the fact that this very contentious area is anything but settled;

- the valuation of imputation credits. There is a high degree of foreign ownership of gas pipelines in Australia. This would suggest that the marginal investor in a major Australian pipeline is an international investor. Such an investor will experience extreme difficulty accessing or unlocking the value of imputation credits, in turn suggesting a value of zero may be appropriate for larger pipeline companies. Whilst the attribution of a value of 0.5 for imputation credits may represent a reasonable compromise at this point in time, at least for pipeline companies owned by domestically domiciled shareholders, it is a value that is increasingly dated and relies upon questionable logic; and

- asymmetric risk – regulated businesses are increasingly seeking to robustly quantify asymmetric risks as part of the assessment of their commercial environment. It can be expected that regulated businesses will continue to improve the sophistication and credibility of their estimation techniques.

It is also noteworthy that the ACCC has recognised additional costs since the first round of regulatory reviews began. One example relates to the allowance for equity raising costs as forming a legitimate component of a regulated businesses' cost structure for regulatory purposes. Whilst the approach to the treatment of such costs is not settled, the fact that the ACCC has recognised additional cost allowances highlights that the regulatory environment continues to evolve and there is every reason to believe this will continue in the future.

Accordingly, all of the critical parameters in the assessment of the cost of capital are still highly uncertain and will continue to be contentious, and potentially litigious. This merely serves to confirm that there is no legitimate basis from which one could conclude that regulatory processes in future will be any less contentious than they have been in the past. Indeed, there is a real possibility of increasingly polarised views on the part of both regulators and service providers leading to a more controversial environment.

This fact is borne out when we consider the only current example of a major pipeline having completed a second access arrangement, which is GasNet. While the administrative process of developing the access arrangement was completed in a relatively timely manner, the ACCC found it necessary to draft and approve its own access arrangement after failing to gain agreement with GasNet. This has resulted in GasNet appealing the ACCC's decision before the ACT. This appeal is currently in progress. Clearly, this is evidence of second round reviews being no less contentious than first round reviews.

The likelihood of future reviews being no less contentious than previous reviews is also consistent with the "political economy" of the situation. Access seekers have become habituated to regulatory reviews delivering them significant reductions in tariffs. However, if pipelines ever earned any monopoly profit that could be transferred to other market participants, that is no longer the case. As a result, access seekers' efforts at gaining further tariff reductions from regulatory processes will face increased, rather than reduced, difficulties. This is highlighted in submissions already received by the Commission, such as from the Hunter User Group:[17]

> As part of the national energy reform agenda, the HUG saw the introduction of the national gas code as a mechanism to reduce the market power of the gas suppliers in the gas supply chain, and to generate a lower pricing regime by preventing the abuse of monopoly power. By doing so this would in part counter the impact of the reduction of import tariffs. Thus the energy reform was to balance the increased competition Australian industry faced by its tariff reduction program. **So far the**

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17 Hunter Gas Users Group: Submission To The Productivity Commission's Review Of The National Gas Access Regime, August 2003, page 3.

> **<u>HUG members have not seen many cash benefits promised by the gas reform process</u>**.
>
> In general, the HUG considers that the National Gas Access Regime has worked in providing conditions for more effective and competitive gas transportation tariffs, but **<u>much more needs to be achieved to provide gas users with the competitive pricing promised under the Regime</u>**. In this regard, the HUG is concerned with any moves to roll-back the provisions of the Regime under the guise of assertions about "regulatory uncertainty and intrusion", "inadequate rates of return" and "investment deterrence.

If the current regime remains in place, the stresses it creates and the conflicts it gives rise to will become ever more acute as they so fundamentally turn on what are now zero-sum games. The efforts of access seekers will only intensify over time, creating even greater pressure on the regulatory process, and adding to what is already a contentious environment.

APIA therefore submits that the overwhelming evidence is that regulatory processes are becoming no less contentious, and as a consequence, continue to be drawn out. APIA considers that there will be numerous issues that emerge in each regulatory review and that the suggestion that things will settle down in the future is a promise which bears a striking and worrying resemblance to the statements that were made when the Gas Access Regime first came into operation (that is, that the regime would be light-handed in nature).

4.2 Invasiveness of the regulatory process

In APIA's view, a key element of a successful incentive regulation framework must be a commitment by the regulator to reduce its involvement after a regulatory reset and allow the service provider to operate its business. Indeed, it is the essence of incentive regulation that regulated businesses operate relatively independently of the regulator during the periods between regulatory resets. Anything else can only undermine the credibility of the regulator's commitment to the principles that form the cornerstone of incentive regulation.

Unfortunately, APIA believes that the nature of the current Gas Access Regime encourages regulators to take an increasingly intrusive role between regulatory reviews. One example of the desire of regulators to take on a greater role is the 1999 proposal put to NGPAC by regulators seeking to increase their information collection powers. The industry strongly opposed this increase in powers as it considered that there was no evidence that existing information collection powers had in any way limited the ability of regulators to complete their job.

NGPAC was not convinced of the need to expand the information powers of the Gas Access Regime and, in light of the proposed review of the Gas Access Regime deferred further consideration of this issue. Nevertheless, APIA believes that the argument developed by the regulators in support of the increase in powers was indicative of the underlying mentality that “the more we know, the more we need to know”.

Underpinning this view might be the sense that the collection of information is costless or relatively inexpensive for regulated businesses. However, information collection impositions can involve very considerable costs due to the unintended consequences of those requirements. These costs include:

- the costs of the regulatory body in establishing the information gathering framework, including the costs of interested parties participating in relevant processes. Then, once implemented, there are also the costs associated with the regulator analysing this information;

- the costs incurred by regulated businesses in re-orientating information and accounting systems. This is especially the case where regulated businesses find it necessary to develop specific arrangements to comply with regulatory requests;

- the managerial time in ensuring compliance over time. For example, it is not uncommon for directors of international companies to be obliged to sign off on the information required by regulatory bodies – securing these signatures can involve considerable management input to explain to the directors the regulatory requirements and the organisation’s responses. Moreover, the management time that is consumed is often at very senior levels within the affected organisations; and

- there is the cost that arises from a loss of incentive for the regulated business – there remains the understandable concern that the principal reason for the collection of information is to instigate mid term reviews of regulatory decisions or to otherwise act in a way that is contrary to the service provider’s interests.

The absence of formal requirement for regulators to consider the costs and the benefits of their use of information gathering powers means that regulators are essentially unaccountable for their decisions. APIA, for example, questions the need for detailed gathering of information between regulatory periods. Such an approach is seen in OffGAR requiring the provision of detailed quarterly information from the GGT on an ongoing basis.

This is symptomatic of APIA’s concern that specialised regulators will have an incentive to ‘make work’ between regulatory reviews in order to ensure that staffing levels and therefore organisational skills are maintained at a constant level. APIA concerns are only increased by the fact that regulated businesses are increasingly becoming directly responsible for the payment of regulator's costs (a situation that currently applies in Western Australia, where arguably the most invasive regulatory information requirements have been imposed).

APIA considers that a comprehensive solution to this problem is to adopt APIA's preferred option of a negotiate arbitrate model supported by an industry code of conduct which guarantees disclosure of key service offering information. Under this model the regulator does not have an initial obligation (or incentive) to become involved in the service provider's business.

5 The virtues of coverage flexibility

A view appears to be emerging that the current gas access regime is sufficiently flexible to accommodate the concerns of the pipeline industry. For example the ACCC suggests[18]:

> …the Code in its present form has the capacity to support greenfields investment so that the interests of all parties are balanced.

In a similar vein, BHP Billiton suggested[19]:

> The criticisms of the Regime — and its administration by regulators — with respect to greenfields projects ignores the flexibility already contained in the Regime to deal with these projects, and the substantial efforts that regulators have made to demonstrate how the Regime can accommodate — and even promote — these projects.

and:

> The fact that many of the major pipelines built recently are not covered by the Code clearly demonstrates the fact that the Regime is not acting to inhibit investment levels in the industry. It is our view that the construction of major new pipelines from outside the Code provides further evidence that the regulatory regime as it currently stands is effective.

The chief examples of this suggested flexibility are the non-coverage of new pipelines such as DEI's EGP, and the novel arrangements agreed to for the Central West Pipeline (CWP) in NSW. APIA does not accept that these examples highlight where the current regime is as efficacious as suggested in these submissions or as raised in questions by the Commissioners during the public hearings.[20]

In responding to these submissions, APIA:

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18 ACCC Submission to the Productivity Commission Review of the Gas Access Regime 15 September 2003, page 49.

19 BHP Billiton Submission to the Productivity Commission, pages 68 and 76.

20 Productivity Commission, Inquiry into the Gas Access Regime, Transcript of Public Hearings 19 September, 2003, pp 382-4.

- reiterates the circumstances in which coverage has been revoked; and
- submits that the arguments that have been put forward concerning the virtues of non-coverage overlook the key consideration – namely how the regulatory regime has affected the *choices* that have been exercised by those potentially subject to it.

5.1 Revocation no excuse for incorrect coverage

At the Gas Access Regime's inception virtually all major pipelines were covered automatically. Since that time 17 pipelines have succeeded in achieving revocation. APIA strongly supports the revocation machinery as forming a critical component of the regulatory framework but considers that the more fundamental issue as to why these pipelines were ever covered.

The owners of these 17 pipelines consumed considerable resources over many years restoring a status they should never have lost in the first place. A single example makes the point. The owners of the NT Gas City Gate to Berrimah Pipeline spent an amount equal to 23% of that pipeline's annual revenue in order to achieve revocation. The experience of those owners is by no means unusual.

The Gas Access Regime's revocation provisions are a necessary safeguard, but they do not resolve all the problems with a 'regulate first and ask questions later' philosophy, any more than health insurance removes the risks in hang-gliding. The fact is that the onus of proof should never have been reversed in this way and that the revocation safeguard is extremely costly to invoke.

In covering pipelines without first applying a threshold test, the Gas Access Regime makes it clear that it in the minds of those who developed it, the risk of covering too many pipelines (sometimes known as a Type I error) is less than the risk of not covering pipelines that possess substantial market power (sometimes known as a Type II error). APIA remains concerned that the approach to blanket coverage under the Gas Access Regime evinces insufficient regard to the critical consideration that market failure is a necessary but not sufficient condition for government intervention.

Moreover, APIA considers its desire for reform of the coverage criteria has recently been endorsed by the Minister in his decision in respect of the MSP. Here, the Minister expressed reservations with the way in which the NCC applied the criteria (for example, in respect of criterion B) as well as criteria themselves. APIA considers this highlights the need for reform in this important test.[21]

5.2 Regulation of prospective vs existing investment[22]

In relation to the Gas Access Regime's application to new pipelines, stakeholders have argued that the fact that new pipelines have been excluded from coverage confirms the flexibility inherent in the Gas Access Regime. For example, the BHP Billiton submission states:[23]

> However the ability of the Regime to *exclude* pipelines from coverage under the Code where it is not deemed necessary is also an important indicator of the overall efficacy and appropriateness of the current regulatory framework

APIA disputes that this is the case. Leaving aside issues with the characterisation of the coverage test (addressed in APIA's initial submission and in section 3 of this submission), the proposition does not make sense as:

- the most important consideration is how the regulatory regime has affected the *choices* that have been exercised by those potentially subject to it – the fact that almost universally new investments have been made on the basis that the Gas Access Regime would not apply suggests that the application of the Gas Access Regime to existing investment is anything but compatible with providing incentives to invest; and

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21 Para 81, 230 and 232.

22 A related issue concerns the regulatory arrangements for greenfields pipelines. APIA's views on regulatory holidays were contained in its initial submission. APIA notes the ACCC's Greenfields Guidelines represent an attempt to acknowledge some of the issues that arise in the context of the regulation of risky assets. However, the Guidelines are extremely vague and in practice amount to no more than a (completely untested) statement of good intentions. Under the Guidelines, the ACCC continues to enjoy a very considerable range of discretion in respect of the key regulatory parameters, including in future resets. Consequently, in APIA's initial submission, it was argued that greater legislative clarity is needed to prevent regulatory opportunism and to ensure regulatory frameworks do not discourage new investment.

23 Page 74.

- application of fundamentally different rules to sunk investments and new investments does not suggest that the flexibility in the Gas Access Regime is a desirable attribute – indeed it only serves the confirm the incompatibility of the regulatory environment with investment incentives.

5.2.1 The impact of the Gas Access Regime

APIA agrees that the non-coverage of the EGP provides an important precedent that has unquestionably facilitated other pipeline developments in Australia, notwithstanding the considerable expense, difficulties and regulatory risk DEI overcame in securing the non-coverage status that required a merits appeal to the Australian Competition Tribunal (ACT) following the coverage recommendation by the NCC and the decision by the Minister.

Indeed, less than 2% of the $2bn of pipeline investment since the development of the Gas Access Regime has been directed to pipelines that are expected to be covered under the Gas Access Regime – one wonders if any of this investment would have proceeded if it was to be covered under the Gas Access Regime.[24] Accordingly, whilst APIA acknowledges that the flexibility not to apply the Gas Access Regime to a new pipeline that does not meet the coverage criteria is desirable, in that it has reduced a regulatory impediment to pipeline developments, it far from legitimises the application of the Gas Access Regime to existing infrastructure, to which we now turn.

5.2.2 Regulation of existing investment at time of the investment

The overwhelming evidence of the *choices* that pipeline owners are making is to invest in infrastructure that will not be covered under the Gas Access Regime. This means that the regime has only in general applied to pipelines that are sunk – that is to pipelines where the owners had *no choice* as to the nature of the regime that would be applied (including the extent to which that environment departed from the regulation that prevailed at the time the investment was undertaken).

Accordingly, in order to assess the compatibility of the Gas Access Regime with that investment, it is necessary to contrast the regime with the regulatory environments that

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24 APIA acknowledges that the ACCC in its assessment of the CWP sought to include mechanisms to ameliorate the greenfields risk of the pipeline. It remains an open question as to whether sufficient account was taken of the truncation factor in the setting of the cost of capital.

prevailed *when the relevant investments were committed*. With the exception of the CWP, the regulatory regimes applying to covered transmission pipelines bore little or no resemblance to that which has since prevailed under the Gas Access Regime.

Buchanan draws the critical distinction between rational decisions undertaken at a point in time (which even they would act differently due to subsequent unavoidably change) and how those changes subsequently affect expectations:[25]

> If a commitment is made and things happen, such happenings affect the individual's utility—quite independently of the fact that they cannot be avoided. The individual suffers utility loss as a consequence of a prior decision even if, on balance, the decision was itself fully rational . . . Since choice has been made, this cost is irrelevant *excepting insofar as the experience may modify anticipations about choice alternatives in the future*.

With this in mind, it is relevant to note the history of recent investment that was catalogued in section 2 of this submission. Underpinning the vast majority of investment in gas transmission pipelines developed since the Gas Access Regime began to take shape were specific regulatory arrangements developed to *minimise* the impact of the Gas Access Regime. This is hardly a ringing endorsement about the investment compatibility of the Gas Access Regime as it only serves to confirm the *incompatibility* between the flexibility for new investment and the treatment of sunk investment.

APIA therefore submits that whilst the Gas Access Regime has resulted in new pipelines not being covered - this fact only serves to raise questions over the invasiveness of the framework for existing pipelines when it is clear it has been so consistently avoided in respect of new pipeline developments. The fact that the regulatory environment inherent in the Gas Access Regime is so unappealing to new investment only highlights that it represents a form of regulation that is too invasive for the investment to which it currently applies that was sunk at the time the regime became operative.

5.3 Conclusion

APIA believes the Gas Access Regime as it is currently structured is poorly placed to address concerns about its deadening impact on investment. Practically speaking, the only assets

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[25] Buchanan, James (1969) Cost and Choice: An Inquiry Into Economic Theory, Markham, Chicago (italics added).

captured by the Gas Access Regime are sunk assets – and those assets are now covered by a regime that is far more invasive than applied at the time that these investments were made. In such an environment, the flexibility not to apply the regime to new pipelines is hardly a virtue for those that remain subject to it. One impact from this "flexibility" in the treatment of "old" (presumed covered unless revoked) versus "new" pipelines under the Gas Access Regime is to distort investment from the expansion of existing pipelines into the creation of new pipelines. This only serves to highlight the incorrectness of the claims concerning the virtue of the flexibility the Gas Access Regime is said to provide.

6 Institutional arrangements

APIA notes that issues raised in submissions concerns the independence of the gatekeeper role and the importance of merits review of regulatory decisions being retained. These issues are addressed in turn.

6.1 Independence of gatekeeper role

APIA is concerned that consideration may be being given to the possibility of amalgamating the coverage test role currently undertaken by the NCC with the role of regulator as currently undertaken by the ACCC. APIA believes that these two roles must remain independent of each other.

As a matter of principle, APIA considers it is critical to separate these roles on account of the fact that a single regulator is unlikely to be best placed to determine both coverage and ongoing regulatory issues. A regulator responsible for ongoing regulatory matters, for example, is likely to be poorly placed to independently assess the limitations of that process, and hence the desirability of coverage, especially where that regulator's focus is on the removal of perceived monopoly profit.

Moreover, APIA believes that combining these two functions will result in the perception that coverage decisions will be tainted by the potential desire of the regulator to either increase the scope of its activities (that is, to recommend coverage when it may in fact not be justified) or to protect the current activities it is performing (that is, to fail to recommend revocation of coverage when it may in fact be justified).

Accordingly, whilst APIA maintains its very strong reservations about the stance the NCC has taken on coverage issues, APIA supports the original intention of the Hilmer Report in establishing the an independent body with a range of responsibilities including declaration and revocation recommendations. The key characteristics of such a body originally identified in the Hilmer Report are equally as relevant today as they were in 1993 (see Box 2). In particular, the need to have a body independent of Government and capable of taking a pragmatic, business like approach is still crucial.

Box 2 Hilmer Report views on NCC

The Hilmer Report proposed the NCC as an independent body created jointly by the Commonwealth, State and Territory Governments and identified six key characteristics[26], namely:

- its functions would be purely advisory (although the recommendation of the NCC would be required in cases of proposed unilateral action by a Commonwealth Minister);
- it would be independent of government;
- it would take an integrated, economy-wide view of competition policy matters, and could draw on industry-specific expertise when required;
- it would take a pragmatic, business-like approach, focusing on specific practical reforms, and would consider transitional issues arising from its recommendations;
- it would operate through open processes, with input from all affected parties; and
- it would not duplicate the skills or resources of other agencies, and could contract analytical work to specialist agencies such as the Industry Commission.

In addition, APIA supports continuation of the current arrangement whereby the NCC's role is purely advisory and coverage decisions are in the end the responsibility of the relevant Minister. APIA believes that this ensures that these very important decisions that have such a major impact on property rights are not made by unelected bureaucrats but rather, are the responsibility of our elected representatives. Doing so preserves a very real degree of accountability for coverage decisions. APIA also regards the continuation of merits review rights as being of fundamental importance to the efficacy of the regime.

26 Hilmer, F., M. Rayner and G. Taperell (1993), National Competition Policy: Report by the Independent Committee of Inquiry, AGPS, Canberra pg 319

6.2 Importance of Merits Review

In its initial submission APIA argued that there were strong reasons for retention of merits review. The key reasons were summarised as[27]:

- providing a vehicle to correct errors in determinations;
- promoting accuracy in adjudication;
- reducing regulatory risk;
- promoting confidence in the regime; and
- providing consistency in Australian competition policy.

APIA has noted that not all submissions were equally supportive of the retention of merits review. For example, in its initial submission the ACCC suggested that there were reasonable grounds to justify the exclusion of merits review[28]:

> …in relation to the relevant regulator's consideration of an access arrangement or revisions to an access arrangement.

This was justified on the basis that assessment of an access arrangement involved wide ranging investigation and consultation and that undertaking a full merits review of such a decision would be both excessively time consuming and costly. The ACCC's discussion on this issue relied heavily on the Australian Review Council (ARC) guideline "*What Decisions should be Subject to Merit Review?*", in particular, paras 4.53 to 4.57.

APIA notes that the comments on merits review in submissions pertained mainly to access reviews of access arrangements. However, APIA believes that merits review plays such a fundamental role in the Gas Access Regime that the comments here are made in relation to the importance of merits review for coverage as well as for reviews of decisions made in respect of access arrangements.

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27 APIA Submission to the Productivity Commission Review of the Gas Access Regime, page 66.

28 ACCC Submission to the Productivity Commission Review of the Gas Access Regime page 90.

APIA appreciates that administrative bodies would prefer that there be less rather than more scope to potentially overturn decisions. However, APIA considers that the ACCC's arguments do not present a balanced view on this important issue and responds as follows:

- the merits review process under the Gas Access Regime is already restricted in respect of reviews of access arrangements;
- it is not clear in the long run that merits review causes delay or is costly;
- the ACCC considered only the costs of merits review and ignored the important benefits the process provides;
- judicial review is not an effective substitute for merits review;

6.2.1 Merits review under the Gas Access Regime is already restricted

APIA considers that the restrictions that already apply to merit review of the regulators' decisions largely address the areas identified by the ARC as grounds for excluding such review. Specifically, APIA notes that the Gas Access Regime already imposes significant limitations on merits reviews, in terms of restricting the grounds upon which an application for review may be made, imposing very tight timelines on responses, preventing the applicant from raising new matters and limiting the factors that the appeal body may consider.

The impact of these limitations is to ensure that a merit appeal cannot effectively reopen the access arrangement process but is strictly limited to assessing already provided information and reviewing the regulator's decision given the facts on hand.

In this sense, the scope for review is substantially more limited than that which applies in respect of (for example) authorisation decisions under the Trade Practices Act. These decisions too involve wide-ranging investigation and a substantial degree of consultation. Despite that, they are subject to full merits review – and there can be little argument with the proposition that the full merits review process has made a crucial contribution to the development of the relevant law in Australia.

Moreover, APIA considers that the time restrictions imposed as part of the response to the Final Decision and of the merits review process involve unnecessarily strict time frames. APIA notes that regulatory decision making is not constrained under the Gas Access Regime, yet a 2 week period is imposed on pipeline owners to respond to a Final Decision - that is, to submit a revised Access Arrangement and any associated submission which would support revisions which do not conform to the Final Decision. A similar restricted time frame is imposed with respect to a Further Final Decision for the purposes of instigating merits review processes.

APIA submits that this is an unreasonably short period of time when one considers the detailed nature of regulatory decisions and the need for senior management involvement in resolving these issues, which are of profound importance to regulated businesses. Longer periods to respond are clearly indicated if service providers are to have sufficient time to understand regulator's decisions (which are usually extensive) and formulate considered responses.

6.2.2 Costs of merits review

APIA does not accept that the objectives of establishing merits review processes would be equally served by having "better" decisions at first instance (for example, by providing regulators with more resources to enable them to make more accurate decisions). As Shavell has argued, appeals processes are actually less costly for society than improving the quality of the initial decision:[29]

> . . . if litigants possess information about the occurrence of error and appeals courts can frequently verify it, litigants may be led to bring appeals when errors are likely to have been made but not otherwise . . . Under these circumstances, not only may the appeals process result in error correction, it may also do so cheaply, for the legal system will be burdened with reconsidering only the subset of cases in which errors were more probably made. This may render society's investment in the appeals process economical by comparison to its improving the accuracy of the trial process – an approach that, by its nature, would require extra expenditure in every case. The appeals process, in other words, may allow society to harness information that litigants have about erroneous decisions and thereby to reduce the incidence of mistake at low cost.

Furthermore, review of regulatory decision-making processes need not be time consuming. There are two possible reasons why merits review may be costly or time consuming - the inherent importance of the subject matter to the parties (which is a factor that clearly supports the provision of merits review) or inefficiency in the merits review process.

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[29] Shavell, Steven (1995) "The Appeals Process as a Means of Error Correction", *Journal of Legal Studies*, vol.24, June, pp.379-426, at pp. 381-2.

Where inefficiency is the cause for delay, it cannot be a credible argument against merits review as the more thorough the decision-making processes that are the subject of the appeal, the more the field of issues in dispute and requiring resolution on review will be narrowed. As a result, the review process may potentially be brief and inexpensive.

In any event, arguments against review based on costs confuse private costs with social costs. From a public policy perspective, consideration of the appropriate role of review of regulatory decisions should turn not on private resource costs but on social opportunity costs. This makes it especially important to give due weight to the benefits that can come from subjecting regulatory decisions to independent, authoritative scrutiny.

6.2.3 Merits review has important benefits

In focusing exclusively on the costs of merits review, APIA considers that the ACCC has ignored the benefits the machinery provides to the integrity and credibility of the regulatory process. Indeed, the ACCC appears to have selectively interpreted the ARC guidelines for example, para 4.57 of the guideline reads (emphasis added):

> … merits review of a decision not to waive a filing fee of, say, $150 may be difficult to justify on an economic basis. That said, <u>the cost of review must be accounted for not only by comparison with the extent of the interests of any individual that may be affected, but also by comparison with the broader and beneficial effects that merits review is intended to have</u> on the overall quality of government decision-making.

APIA therefore submits that the ACCC has presented a distorted analysis of this issue. As noted in APIA's initial submission, the benefits of merits review are significant and extend to factors such as:

- increasing the accuracy of regulatory decision making and allied with this, promoting public confidence in regulatory decision making;
- promoting merits review provides investors with the confidence that they will have recourse should there be any form of regulatory taking;
- increasing the accountability of regulators who have very significant power over the property rights of regulated businesses;
- reducing regulatory risk associated with merits review promises to reduce the cost of raising funds and to facilitate increased investment over time.

APIA believes that these benefits are very significant and more than compensate for the limited costs and delays inherent in the occasional merits review, especially as it is to be expected that the number of merits reviews would decline as the incentive for more accurate decision making progressively improves the standard of such decisions.

After all, in the context of the EGP, the absence of merits review rights would almost certainly mean that the pipeline would still be covered. The criticality of the availability of merits review from coverage decisions in particular has only increased with what APIA believes is an increasingly narrow interpretation of the coverage criteria by the NCC.

Under the Gas Access Regime, regulators are conferred considerable discretion. A good example of this discretion arises in respect of asset valuation under the Gas Access Regime – where the regulator is normally confined to assessing an asset value between the wide range of DORC and DAC, but is able to determine an asset valuation that falls outside of this band.

The significance of the impact of this discretion was recently evidenced in the ACCC's Final Decision on the MSP – here the ACCC decided to derive an asset value by applying straight line depreciation to the optimised replacement cost valuation assuming a 50 year asset life to 2000 and 80 year life thereafter. The impact of this "kink" in the depreciation schedule was to reduce the Initial Capital Base for the MSP by over $150 million – equivalent to 20% of the ACCC's normal method of calculating DORC.

APIA considers that a fundamental component of prudent regulatory design is to match discretion and accountability. In other words, APIA believes that the greater the discretion conferred on regulators under regulatory instruments such as the Gas Access Regime, the greater the need for:

- regulators to be accountable for their decisions; and
- those who are potentially adversely affected by the exercise of that discretion to have recourse to rights of review.

APIA therefore submits that the discretion that remains part of regulatory decision making must be balanced with the accountability for the way in which that discretion is exercised. Given the materiality of decisions under the Gas Access Regime for regulated pipelines, APIA submits that extensive merits review processes must form a fundamental element of an efficacious access regime.

Furthermore, consideration must be given to the role that a regulator is to play in any merits review. The role of a regulator in an access arrangement approval process is that of a "defacto arbitrator". To have the regulator involved in any merits review as an effective contradictor and taking an adversarial position against the applicant is fundamentally at odds with the proper role of an arbitrator. The Gas Access Regime envisages that the merits review body can call on the assistance of the regulator in any merits review. However, the recent experience of APIA in all merits reviews commenced in relation to decisions of regulators to draft and approve their own access arrangements is that the regulator takes an adversarial position in the proceedings.

However, it should be noted that under the proposed negotiate/arbitrate model proposed by APIA, the need for merits review is significantly diminished as a decision of an arbitrator should be binding on all parties to the arbitration.

6.2.4 Judicial review is not a substitute for merits review

Removing merit appeal rights as suggested by the ACCC and leaving only judicial review would further limit service provider's rights and fails to recognise the very real differences provided by these alternative appeal processes as noted by the ARC[30]:

> 5.30. The Council does not consider that a decision is inappropriate for merits review merely because that decision may also be the subject of judicial review.
>
> 5.31. The Council's view follows from the fact that the judicial review powers vested in the Federal Court are complementary to, but distinct from, merits review powers. Judicial review involves the exercise of the Commonwealth's judicial power and results in findings in law. Merits review involves the exercise of administrative powers and results in a correct and preferable decision. The different realms of operation of the two forms of review mean that they can, and often do, co-exist.

Furthermore, real issues of perceived bias will arise were judicial review to be the only option. If a regulator were to participate actively in any judicial review proceedings, and the Court were to find that the Regulator's decision was affected by fundamental errors of law, having that same Regulator reassess an access arrangement will give rise to perceived bias.

This issue is exacerbated by the fact that many of the critical decisions of regulator's are made with the significant support of consultants who, not being responsible for these decisions, will use the reassessment process to seek to protect their position and protect their professional reputation.

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30 Administrative Review Council, What Decisions should be Subject to Merit Review (paras 5.30 & 5.31)

6.2.5 Conclusions on merits review

APIA notes that the Commission regarded *extending* merits review to undertakings as being relatively uncontentious in its *Review of the National Access Regime* and that the proposal received "widespread support".[31] APIA considers that the overwhelming benefit of merits review processes has already been demonstrated under the Gas Access Regime and therefore submits that there is no case to confine the rights in any way from those that already exist. Indeed, it is by no means clear to APIA that there is net benefit in confining the scope of merits review from decisions on access arrangements, should such processes continue under the Gas Access Regime.

Ultimately, merits review subjects regulators to a discipline that is not dissimilar to that of potential competition. It removes the monopoly they would otherwise hold on regulatory decision-making and forces them to accept constraints that they would otherwise not face. As with any other monopolist, regulators would rather not be exposed to competitive disciplines; but the potential social costs of regulation are, in APIA's view, so high that making regulators effectively accountable should and must be a priority.

However, the Commission should give serious consideration to the role that the regulator is to play in any merits review.

[31] Productivity Commission 2001, *Review of the National Access Regime*, Report no. 17, AusInfo, Canberra, Page 390.

7 The efficacy of the negotiate – arbitrate model

APIA wishes to respond to a number of claims made in respect of the efficacy of the negotiate arbitrate model it has recommended be adopted for the regulation of access to gas transmission services. In its submission, the ACCC indicates that the negotiate arbitrate model is unlikely to be effective on account of:

- pipeline owners are likely to adopt a “take it or leave it” attitude in access negotiations;
- the slowness of the negotiate arbitrate process;
- the high transaction costs associated with the arbitration process;
- the current regime will be more effective in promoting commercial negotiation.

APIA wishes to respond to these comments in turn.

7.1 Take it or leave it approach to negotiation

APIA simply does not accept that pipeline owners have an incentive to adopt a ‘take it or leave it’ under a negotiate arbitrate model. APIA submits that there is no history of a ‘take it or leave it’ approach being adopted during the period in which pipelines were either unregulated or regulated under negotiate arbitrate regimes. Indeed, this period is characterised by a marked absence of disputation between access seekers and pipeline owners. This is merely consistent with APIA’s view that the industry has always been responsive in relation to the sale of pipeline capacity and that there is no reason to suggest that this responsible approach will not continue into the future. After all, the pipeline industry has always relied on commercial negotiation to deliver new projects through the negotiation of foundation contracts.

Moreover, APIA notes that pipeline owners themselves experience substantial losses through any delays to signing up customers or from delays to the sale of pipeline capacity. In this regard, APIA reiterates its initial submission,[32] which highlighted the economic characteristics of the industry – since pipelines exhibit very high levels of operational leverage, there is a very strong linkage between throughput and pipeline profitability. This

[32] Page 13.

creates very strong incentives for pipelines companies *not* to adopt a 'take it or leave it' approach.

APIA acknowledges that the economic circumstances of the telecommunications industry interconnection disputes may present a different incentive environment to that faced by gas transmission pipelines – however, the ACCC has not examined these underlying factors when making its assertion.[33]

The ACCC also assert that pipeline users have no countervailing power:[34]

> The 'take or leave it' approach also demonstrates an absence of countervailing market power on behalf of an access seeker. This is due to the absence of a comparable alternative to a bottleneck transmission facility that would provide a similar service and similar price.

The ACCC does not provide any evidence to support its assertion that there is an absence of countervailing market power for gas transmission pipeline users. In this respect, APIA again draws the Commission's attention to its initial submission,[35] where it demonstrated that the top 3 customers of each pipeline constitute about 88% of pipeline capacity in Australia (with the top 5 accounting for approximately 94% of pipeline capacity).

The concentrated relationships between buyers and sellers suggest that there is extremely strong countervailing market power enjoyed by access seekers in access negotiations. Moreover, different pipelines will often have the same major customers which means that these customers tend to be significant and experienced users of pipeline services.

7.2 Timeliness

The ACCC assert that the prolonged process of securing access under a negotiate arbitrate model will provide a substantial disincentive for parties to instigate those processes and as a consequence entrench pipeline owner's market power. APIA acknowledges that the process

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33 APIA further understands that much of the delay that was experienced through the telecommunications access regime in conducting negotiations arose on account of the delays associated with the ACCC's publication of pricing principles.

34 Ibid, p26

35 Page 13.

of securing coverage and in undertaking an arbitration could take some time. However, APIA also submits that the assertions that this would be a prolonged process are incorrect and do not have regard to the adverse consequences of alternative arrangements.

For example, much of the delay that has been attributed to the negotiate arbitrate model arises in the context of the coverage process itself. Of course, one can remove any delay associated with securing coverage simply by deeming all pipelines to be covered. APIA has already commented extensively on the adverse consequences of adopting such an approach.

Whilst APIA has expressed serious reservations with several aspects of the coverage process, the importance of an inquiry into the merits of coverage is only increasing over time – to the point where the Minister charged with the task of deciding pipeline coverage has suggested *reversing* the onus of proof on coverage issues.[36] Moreover, the availability of merits review, has been fundamental to the correction of error that would otherwise have been made in the process – in the absence of merits review, the EGP would still be covered today.

Simply put, if processes are to fundamentally reconfigure property rights, it is important that those rights not be removed capriciously or arbitrarily and that accordingly the observance of proper coverage processes is fundamental to providing a climate in which investors will have confidence to invest in the industry.

Moreover, APIA does not accept that timeliness need be a critical issue for access negotiations. For example, it is quite open for the parties to enter into a contract recognising that particular aspects of that arrangement may be subject to a review occurring at some future time. It is even possible through contractual negotiation to agree to provide that the outcomes of those price review processes be backdated to certain points in time. Accordingly, there is no reason to believe that the necessary delays associated with establishing a negotiate arbitrate model provide legitimate criticism of the arrangements.

Finally, in respect of timeliness, APIA wishes to reiterate the comments it made in its initial submission,[37] noting that the average time taken for the assessment of an access arrangement has been in the order of 2 years. To illustrate these delays, APIA reproduces below table 1 from its initial submission to the Commission.

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36 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.

37 Pages 24 and 25.

Table 1 Length of regulatory processes[38]

Pipeline	Duration of Regulatory Process	Current Status of Process
DBNGP	3 Years 9 Months	Final decision May 2003 with revised access arrangement lodged August 2003
MAPS	4 Years 5 Months	Appeal to Australian Competition Tribunal[39]
MSP	4 Years 5 Months	Final Decision
GGP	3 Years 9 Months	Awaiting Amended Draft Decision

7.3 High transaction costs

The ACCC assert that the negotiate arbitrate model is not well specified for industries where we see a large number of small users. However, again the ACCC provided no evidence to support its contention that there exists large numbers of small users of gas pipelines. Indeed, a review of the evidence suggests precisely the opposite, that the industry is characterised by a *small* number of *large* users (the top 3 customers of each pipeline constitute about 88% of pipeline capacity in Australia and the top 5 customers account for approximately 94% of pipeline capacity).

Quite apart from the protections offered through the proposed Industry Code of Conduct, APIA notes that markets provide very efficient mechanisms to address transaction cost issues – for example, transaction cost issues are unlikely to be a concern since smaller users are able to share in the benefits of aggregation through competitive retail markets.

The relatively high transactions costs associated with undertaking arbitration can be substantially ameliorated by conferring upon the arbitrator the capacity to award both the costs of the arbitration but also the costs of the parties as part of its final arbitration decision.

Furthermore, these arguments overlook the very substantial *deadweight* cost arising from the regulatory process. APIA reiterates the estimate contained in its initial submission that the

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38 Delays in finalising access arrangements are not necessarily the fault of any one party but rather, are indicative of the failings of the current regulatory framework.

39 The MAPS Access Arrangement is effective notwithstanding the appeal.

costs of the first round of regulatory reviews are likely to have cost between $35 and $45 million.[40]

APIA notes that the ACCC's view is that a higher level of prescription is warranted on account of:[41]

> A higher level of prescription is also warranted in circumstances where the intermediate price is a modest proportion of the final price since access seekers would be unwilling to undertake a costly process in order to eliminate monopoly pricing.

APIA does not understand this proposition. APIA believes that the decision as to whether or not to "undertake a costly process in order to eliminate monopoly pricing" will simply be governed by the expected return from doing so. APIA considers the issue does not turn on whether or not the intermediate price represents a modest proportion of the final price – the single consideration relates to whether the benefits from taking action outweigh the costs. In this regard, APIA reiterates that the inclusion of cost orders as part of the arbitration framework would substantially address this concern.

Moreover, this quote highlights a key consideration of the economic characteristics of access regulation for gas transmission pipelines. Simply put, it suggests that the social costs of Type II errors are extremely low due to the fact that failure to regulate more intensively is highly unlikely to produce resource allocation distortions in the economy. The asserted unwillingness of a party to undertake a costly process to eliminate monopoly pricing due to the modest proportion of the final price simply confirms this position. In contrast however, as outlined in APIA's initial submission and section 2 of this submission, the Type I errors involved in access regulation of gas transmission pipelines are extremely high due to the asymmetric consequences of regulatory error.

Finally, in contrast to the ACCC's Greenfields Guidelines, APIA submits that the ACCC submission could be taken as inferring substantial similarities exist between pipelines that mean the current regulatory approach provides an efficient means of addressing access issues. However, APIA submits that all pipelines are not the same and in fact present materially different risk profiles and commercial drivers. Again, this suggests that the one size fits all approach that permeates the Gas Access Regime represents an undesirable

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40 Page 26.

41 Ibid, p27

approach to access regulation. APIA also submits that the variety of commercial circumstances confronting the pipeline owners provides further support for the negotiate arbitrate model.

7.4 Facilitation of commercial negotiation

Finally, the ACCC assert that the Gas Access Regime facilitates commercial negotiation. APIA points out that the overwhelming evidence is precisely the opposite. It is difficult to see how an environment characterised by interposing a regulator between commercial parties can enhance those negotiations. APIA's initial submission highlighted this point in relation to:

- the commercial negotiation that has occurred under the Gas Access Regime has occurred in spite of the regulatory arrangements (eg RBP, Case Study 9);
- the existence of reference tariffs and reference services result in a gravitation towards this offering – in contrast the EGP provides a much richer variety of service offerings (Case Study 12);
- the long history of the industry negotiating foundation contracts.

7.5 Conclusion

APIA submits that instead of providing a robust criticism of the negotiate arbitrate model, the ACCC's submission in fact suggests that the most likely outcome of such a model will be an efficacious regime. This is because the criticisms of the model simply do not stand up to close scrutiny.

APIA also reiterates that the negotiate arbitrate in fact provides a considerably more robust framework for access seekers than alternative models, such as price monitoring, recently considered by the Commission in other inquiries.[42] APIA believes that this highlights the alignment of incentives inherent in the sale of pipeline transmission capacity and the industry's confidence that the responsible approach to the provision of access its members have demonstrated in the past will continue.

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42 For example, Productivity Commission (January 2002) Inquiry Report Price Regulation of Airport Services.

8 Workable Competition

Included in the ACCC's submission as Attachment A was a paper by Dr Darryl Biggar discussing issues related to workable competition flowing from the WA Supreme Court's Epic Decision. In APIA's initial submission, the point was emphasised that the focus of regulatory bodies on the removal of perceived monopoly profit was incompatible with the reality of the environment in which investment in transmission pipelines occurs.

Biggar goes on to note at paras 38 and 39 that:

> The concept that regulators should replicate the outcomes of competitive markets seems to be widely accepted. It is not so widely understood that this principle is ambiguous in many respects. There are many different competitive markets with quite different properties. The competitive markets principle does not assist the regulator to determine which outcomes of which markets it should emulate.
>
> Overall, the Court in the Epic decision seems primarily concerned to exclude a narrow concept of competitive market. In particular, the Court excludes the narrow theoretical concept of "perfect competition" to embrace a broader concept of workable competition. Workable competition, like its cousin "effective competition", is not a precise concept or a term of art but simply denotes that state of competition which yields broadly acceptable outcomes. However a very wide range of markets yield broadly acceptable outcomes. This conclusion alone provides virtually no guidance for the regulator.

Dr Biggar acknowledges that the key question that arises from the recognition of the role of workable competition in respect of regulation relates to:

> what are the outcomes of a competitive market which are to be emulated?

APIA submits that whilst Dr Biggar raises many of the issues that arise from a consideration of workably competitive markets, the analysis overlooks some of the critical distinctions between the approach that has underpinned regulator's assessment of access charges for gas transmission pipelines and the approach that would be taken if it were workably competitive markets that were sought to be replicated. Australian regulatory practice to date has been to focus on replicating the outcomes of a *perfectly competitive (or contestable) market* rather than a workably competitive market.

In a perfectly competitive market, there is no differentiation between products. This means that there is no value in brand, and, as a consequence, no incentive for any market participant to invest in its brand (such as obtaining a reputation for better satisfying customers than competitors). Yet this is the essence of rivalry in a workably competitive market.

In a perfectly competitive market, firms are price takers and price represents the *sole* dimension of competitive rivalry. No firm is able to raise price without instantaneously losing all of its market share. This means that price is always reflective of an efficient service provider's marginal cost.

Hence the approach that regulatory authorities have adopted under the Gas Access Regime reflects the objective to replicate the outcomes of a perfectly competitive (or contestable) market. Here, we have a single price (reference tariff) for a single product (reference service) and considerations of efficient cost represent the overriding determinant of pricing outcomes.

However, a workably competitive market recognises the practical realities of the market in which price and efficient cost remains *but one* of the dimensions of competitive rivalry. Success in a workably competitive market depends upon identifying and satisfying customer demand better than one's rivals. Hence, determining prices on a theoretical "best" practice basis through an invasive or aggressive form of price regulation is likely to be inconsistent with the notion of workable competition. Yet that is precisely the approach that regulatory bodies in Australia have adopted to date.

Moreover, in a workably competitive market, subtle price/service/quality differentiations are vital to competitive success. However, regulatory processes to date have all but ignored this dimension of competitive rivalry. Indeed, as APIA's initial submission highlighted, we are seeing the richest range of service offerings from the uncovered EGP pipeline.

In the long run, dynamic efficiency is the most important dimension of efficiency for the advancement of consumer welfare – a point that was recognised in the WA Supreme Court's decision in Epic. Whilst the WA Supreme Court did not set out the precise implications of replicating the outcomes of workably competitive markets, it did present a position that challenges the approach that Australian regulators have adopted to date.

In essence, APIA believes that the negotiate arbitrate approach is likely to lead to outcomes that more closely resemble workably competitive markets that the current regulatory processes. Whilst Dr Biggar criticises this lack of precision, APIA submits that it provides very significant guidance for regulatory and policy settings.

For example, commercial negotiation between concentrated buyers and sellers itself is likely to produce outcomes that resemble workably competitive markets. In this respect, APIA draws the Commission's attention to the Nash Bargaining Solution – an outcome where the surplus that arises from a contract is shared between the parties. To a regulator, this sharing of the gains represents a monopoly profit – yet it is an outcome that APIA submits is totally compatible with a workably competitive market.

Similarly, in setting a principle that foundation contracts establish a floor for future arbitrations, APIA notes that such a provision recognises that the these contracts would have been negotiated in a fundamentally contestable environment (ie before the pipeline was built). Yet, APIA is not aware of a single regulatory process that has considered the relevance of such contracts for price setting purposes.

Finally, what is clear is that reliance upon the cost of service model – that focuses on the removal of monopoly profit to the exclusion of all other considerations for price setting purposes - is not consistent with the outcomes of a workably competitive market.

APIA therefore submits that Dr Biggar has underestimated the contribution that a consideration of workably competitive markets provides to regulatory analysis. Whilst applying consideration of the outcomes of workably competitive markets increases the complexity of regulatory decision making – principally because it requires a move away from the removal of monopoly profit as the overriding objective – APIA submits that the negotiate arbitrate approach is the most likely approach to deliver such outcomes for the gas pipeline transmission industry.

APIA does not wish to re-interpret the Epic decision. However, APIA notes that the most important dimension of efficiency in the long run is dynamic efficiency. In the context of pipeline development, the achievement of dynamic efficiency requires risk taking on the part of the pipeline developers.

One of APIA's major concerns with the current environment is that the principal focus of regulatory decision making is the removal of perceived monopoly profit. APIA has already demonstrated the dramatic impact of this regulation on pipeline development – pipeline developers are taking low risk options, including sizing pipelines to meet foundation contracts, partly as a response to the failure of regulators to properly appreciate and price risk in regulatory decisions.

APIA believes that when one moves away from the narrow constraints of the perfectly competitive model for tariff setting purposes, regulators may gain a greater appreciation for the inherent limitations of the price setting process as it has been applied to date by regulatory bodies. This is particularly the case with the appreciation and pricing of risk. In this regard, APIA endorses the Commission's findings in its review of the National Access Regime that:[43]

> regulators should not be too ambitious in their approach, and that governments should not place too great a level of expectations upon them. A sensible goal is to improve significantly on unregulated outcomes, while recognising that precision is not possible.

APIA draws the Commission's attention to the changes to pipeline investment that have occurred since the introduction of the Gas Access Regime as clear evidence of the failure of regulatory bodies to appreciate the risks inherent in pipeline development. It is with this in mind that APIA now turns to the assertion that has been raised in submissions regarding the overstatement of the so-called truncation problem.

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43 Productivity Commission 2001, *Review of the National Access Regime*, Report no. 17, AusInfo, Canberra, page 340

9 The truncation problem

APIA remains concerned that there appears to be a continued misunderstanding with respect to the impact of regulation on investment. This is perhaps most clearly expressed in the ACG paper that formed Part 2 of the initial BHP Billiton Submission.

The crux of the ACG argument appears to be that while regulatory truncation of returns has the potential to significantly undermine investment, this will only be the case where the *expected* variance of returns is large and that where this condition is not satisfied, there is unlikely to be any significant impact on investment. ACG go on to indicate that, in their view, the expected variance of returns on transmission pipeline investments is likely to be quite low (both on the downside and the upside):

> …most of the transmission pipelines that are regulated have much of their capacity tied up under long term, fixed commitment contracts, some of which may have been signed prior to the investment taking place. In both of these cases, the *ex ante* demand risk facing the pipeline owner/investor — and the potential for 'blue sky' — is low. (pg 19)

ACG support this argument with a simple numerical example from King and Gans[44] showing outcomes under a high variance of returns (where regulation results in an expected loss and therefore results in the project not proceeding) and also under a low variance of returns, where the impact on expected returns is insufficient to stop the project from proceeding. Of course, one wonders what sensible role there would be for regulation for pipelines which have "much of their capacity [is] tied up under long term, fixed commitment contracts".

The essential point to emerge from the ACG analysis is that in circumstances where upside and downside returns are symmetrical, the lower the variation of those returns, the lower the impact of truncation of the upside will have on the mean return that may be expected from an investment.

However, this is of questionable relevance to gas transmission pipelines for several reasons:

- the contestable nature of new investment;
- the risk profile is not symmetrical;

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44 King, S, J. Gans, 2003, 'Access Holidays or Network Infrastructure', *Agenda*, Vol 10, No.2, pp.163-178.

- it ignores the distortions regulation induces in pipeline investment.

The ACG example involves an investment with an expected economic rent of $9 million being based on the proposed project's ex-ante expected gross return of $60 million on a $51 million investment. This outcome is sensitive to the assumptions - if the cost of the project was actually $59.5 million (rather than the $51 million in the King and Gans example), making it a marginally NPV positive project absent regulation, then the impact of regulation using the remaining ACG assumptions would be to make the expected returns negative (that is, a $58.5 million return compared to a cost of $59.5 million or a loss of $1 million).

APIA has previously argued that transmission pipeline projects tend to be contestable investments. The recent history of competition between DEI and the successful proponent of the SEAGas pipeline simply highlights this fact. The key characteristic of such investments is that expected returns will be competed back to a level consistent with the WACC, allowing for factors such as asymmetric risk. This means that such projects will be marginal with expected returns (in NPV terms) close to zero. The critical point that APIA wishes to make is that any truncation of expected returns associated with regulation must have a negative impact on marginal investment.

APIA takes issue with the suggestion that gas transmission infrastructure exhibits a low variation in expected free cash flows. APIA notes that the assessment of such risk for price setting purposes should be determined on the basis of the conditions that prevailed at the time of financial close of the project. The range of risks to which a new pipeline will be exposed to include:

- the risk of construction costs being greater than forecast, whether because of delay or cost overrun;
- uncertain demand - the risk that demand is insufficient to justify the investment – either on account of the throughput volumes that are achieved or the prices that are paid on that throughput;
- the risk of competing pipelines;
- reserve risk as well as the risk of supply interruption (whether due to upstream or downstream events);
- uncertain regulatory outcomes and sovereign risk;
- uncertain operating costs;
- uninsurable risks.

When one considers these risks, it is clear that they will not usually be symmetrically distributed. This is especially the case on account of that fact that pipeline investments are sunk. This means that the probability distribution of expected free cash flows generated by gas transmission pipelines will normally be heavily skewed to the left. Consequently, the example contained in the ACG submission is seriously misleading in the context of gas transmission pipeline infrastructure.

APIA considers that the ACG analysis highlights the impact of regulation on new investment. APIA does not believe that regulation in the form of the Gas Access Regime will exert a significant impact on “low risk” investments (if such a thing exists in the gas transmission industry). Clearly, to the extent that regulation influences investment decisions, it is likely to most dramatically affect those projects that are relatively high risk in nature. As such, the impact of regulation will be to distort investment away from higher risk entrepreneurial investments into lower risk investments where, for example, there is a high degree of foundation contract coverage. APIA addresses some of the implications of this development in its concluding comments to this submission.

10 Concluding comments

APIA believes it is important to realise that it is probably only now, some five years after the introduction of the Gas Access Regime, that its impact on investment is likely to become apparent. The first sign of that impact is likely to be the increasingly vocal concerns expressed by individual pipeline companies over the perception of increased regulatory risk under the Gas Access Regime. APIA believes that such comments are not made lightly as pipeline companies are only too aware of the critical part that confidence plays in attracting investment and as such, are unlikely to needlessly concern potential investors.

APIA believes it is important to reiterate the industry's view that the natural response of pipeline companies to a framework that they had significant misgivings with, misgivings subsequent regulatory decisions were to reinforce, has been to modify its approach to investment in order to minimise exposure to an unacceptable regulatory framework. As noted in APIA's previous submission, inappropriate regulation is likely to:

- destroy the incentive to invest – where regulatory risk causes an otherwise commercial investment to no longer be viable, society foregoes the entirety of the surplus that would be generated from the investment;

- delay investment – the increased risk associated with regulation means that investment can be delayed until, for example, greater throughput can be achieved (or a target level of throughput becomes more certain) making the investment less risky and thus commercial. For example, delays could arise because foundation contracts are pursued over a higher proportion of initial capacity than would otherwise be the case. Similarly, expansions and extensions of existing pipelines are only likely to occur where access seekers are willing to make a contractual commitment sufficient to underpin the expansion or extension. This imposes a cost on society to the extent that the benefits from the investment are foregone for the duration of the delay; and

- distort investment – regulatory risk will tend to result in smaller pipelines being built as a means of insulating investors against regulatory risk. Limiting pipeline size is especially attractive if there is a risk that regulators will strand any excess capacity without allowing an offsetting premium to be earned when at-risk capacity experiences high demand. Reducing pipeline size imposes cost on the community on account of foregone scale economy benefits and increased likelihood of capacity constraints.

In APIA's experience the most likely impact of an unsuitable regulatory framework will not be a capital strike as, by their nature, pipeline development companies will be aggressive in looking for new investment opportunities. Nevertheless, APIA considers that the regulatory regime imposes high social cost on the community due to the impact of pipeline owners minimising their exposure to regulatory risk.

Consequently, the unintended consequence from the application of regulation is that not only are scale economies afforded by pipeline expansions foregone but that a serious impediment is created for those seeking small increments of additional capacity. In contrast, in an environment of lower regulatory risk, pipeline owners are likely to see the expansion of their pipeline as a significant commercial opportunity (just as is the case with any provider of a service in a competitive market).

This highlights the point raised in APIA's original submission that the single minded pursuit of removal of monopoly rent, which, if it exists at all (a point that is by no means clear given the contestability of new investment), is highly unlikely to result in changes in output, comes at a very significant social cost as regulation distorts investment decisions.