

29 August 2003

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Productivity Commission  
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Dear Mr Hinton

### **Review of the Gas Access Regime**

Duke Energy International (DEI) welcomes the release of the Productivity Commission's Issues Paper for the Review of the Gas Access Regime.

Since its first investment in Australia in 1998, DEI has invested in excess of \$1.1 billion in existing, and more particularly, greenfield pipeline facilities in Australia. Given its substantial investments in pipelines throughout Australia, DEI has a significant interest in this review.

DEI believes that the current regulatory framework, and the manner in which it is being implemented, is having an adverse impact on incentives for future investment in natural gas transmission pipelines. DEI believes that reform of the following five key areas of the gas access regime will go a long way to improving the regulatory framework in Australia:

- Inclusion of an Objects Clause
- Strengthening the Coverage Criteria
- Framework for Unregulated Pipelines
- Return to Negotiate – Arbitrate Model
- Regulatory Free Periods

However, of these, the two most important reforms relate to amending the coverage criteria and a move back to the originally intended model of negotiate - arbitrate for those pipelines that satisfy the coverage criteria. Without a successful implementation of these two reforms, it is DEI's firm belief that Australia will simply not see the level of pipeline investment needed in Australia to enable it to realise its full potential.

I look forward to the release of the Productivity Commission's Draft Report and to providing further input into this Review as it progresses. Should you have any questions in response to this submission, please contact Stephen Livens (Senior Regulatory Analyst) on (03) 9685 1061.

Yours sincerely

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Encl.



**SUBMISSION TO THE  
PRODUCTIVITY COMMISSION'S  
REVIEW OF THE GAS ACCESS  
REGIME**

**29 August 2003**

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## 1 Overview of Duke Energy International

Duke Energy International (DEI) is a wholly owned subsidiary of Duke Energy, and is one of the world's leading international energy companies. DEI offers energy trading and marketing, risk management, and natural gas and power development expertise and operations services across Latin America, Europe and the Asia Pacific.

DEI's Asia Pacific energy portfolio includes 2,159km of natural gas, 1,100 gross megawatts of thermal generation, and energy trading and marketing located in Australia and New Zealand.

Duke Energy, a diversified multinational energy company, creates value for customers and shareholders through an integrated network of energy assets and expertise. Duke Energy manages a dynamic portfolio of natural gas and electric supply, delivery and trading businesses – generating revenues of more than US\$60bn in 2002. Headquartered in Charlotte, N.C., Duke Energy is a Fortune 500 company traded on the New York Stock Exchange.

## 2 DEI's Relevance to the Review

Since its first investment in Australia in 1998, DEI has invested approximately \$1.5 billion in the Australia energy market. This includes gas-fired and diesel-fuelled generation facilities, natural gas transmission pipelines and the provision of risk management services via trading and marketing positions in the electricity and natural gas energy markets. In terms of pipelines, DEI has invested in the following:

**Table 1 – Duke Energy International's Pipeline Assets in Australia**

Asset	Ownership	Year completed / purchased	Approximate Investment	Regulatory Status
Queensland Gas Pipeline	100%	1998 (existing)	Not Disclosed	Regulated
Eastern Gas Pipeline	100%	2000 (greenfield)	\$450 million	Unregulated
Tasmanian Gas Pipeline	100%	2003 (greenfield)	\$440 million	Unregulated
VicHub Facility	100%	2003 (greenfield)	Not Disclosed	Unregulated
Goldfields Gas Transmission P/line	11.8%	1998 (existing)	Not Disclosed	Regulated

As can be seen in Table 1, DEI has invested substantial sums (in excess of \$1.1 billion) in existing, and more particularly, greenfields pipeline facilities in Australia. Given its substantial investments in pipelines throughout Australia, DEI naturally has a significant interest in the Productivity Commission's (the Commission's) Review of the Gas Access Regime.

While DEI is not alone in investing substantial sums in the Australian natural gas transmission market over the last five years, it is in a unique position in that it has invested more than any other party in development of greenfield transmission pipelines in Australia. In particular, DEI has constructed, and is now operating, the Eastern Gas Pipeline and Tasmanian Gas Pipeline. Further, DEI is one of the few companies that operates very large transmission pipelines in an unregulated environment. Given this experience, DEI believes it is in a unique position to provide input on ways in which the Gas Access Regime can be improved.

DEI sees five key areas of the Gas Access Regime requiring reform:

- Inclusion of an Objects Clause
- Strengthening of Coverage Criteria
- Framework for Unregulated pipelines
- Return to Negotiate – Arbitrate Model
- Regulatory free periods

However, of these, the two most important reforms relate to amending the coverage criteria and a move back to the originally intended model of negotiate/arbitrate for those pipelines that satisfy the coverage criteria. Without a successful implementation of these two reforms, it is DEI's firm belief that Australia will simply not see the level of pipeline investment needed in Australia to enable it to realise its full potential.

This submission is structured around these five key reform areas. In addressing these recommended reforms, a number of the questions raised in the Commission's Issues Paper for this Review are specifically addresses.

### 3 Clarifying Some Misconceptions

While the major thrust of this submission focuses on providing workable solutions to the problems associated with the current regulatory framework, including its implementation, DEI considers it important to clarify some misconceptions that are often cited, or at least implied, in support of the current regime.

One regular misconception put to the market is that the National Third Party Access Code for Natural Gas Pipeline Systems (the Code) has in fact encouraged investment in natural gas pipelines. For example, in a recent speech, Mr Ed Willett, Commissioner of the Australian Competition and Consumer Commission (ACCC) made the following observation:

*“Australia’s gas transmission has grown from 14,093km in 1997/98 to 20,109km in 2001/02...These figures provide compelling evidence that the ACCC’s role in natural gas transmission regulation has not harmed investment. To the contrary, the inception of the Code has coincided with renewed growth in investment in this industry...”<sup>1</sup>*

The NCC has also made similar observations:

*“...while there has been criticism of the Code and associated administrative arrangements by transmission pipeline interests, this criticism has coincided with a sharp increase in interest in exploration and development of gas fields and in the construction of new transmission pipelines.*

*Duke Energy has recently completed a major new pipeline, linking gas processing facilities at Longford in Victoria and consumers in Sydney, Canberra and elsewhere in New South Wales and Victoria.*

*Duke Energy is also constructing a pipeline from Longford to Tasmania”.<sup>2</sup>*

While these comments do not explicitly state that the Code has encouraged investment, they do imply that the application of the Code has stimulated pipeline development.

<sup>1</sup> IEA Workshop on Security of Gas Supply in Australia, 27 June 2003

<sup>2</sup> National Competition Council, Submission to the Energy Market Review, 2002

The Energy Users Association of Australia, however, went even further in its submission to the Commission's Review of the National Access Regime with the following observation:

*"Thus, the Eastern Gas Pipeline is a \$450 million project that has been directly facilitated by the Code."<sup>3</sup>*

DEI can advise that, certainly with respect to its \$900 million worth of greenfields investment, the Code did not represent a stimulant. In fact the opposite could be said. At a minimum, it is fair to say that DEI's investment in greenfields pipeline occurred in spite of, rather than because of, the Code.

To support this assertion it is useful to provide a time frame of decision making for these two pipelines:

- The Board approved construction of the Eastern Gas Pipeline (EGP) in late 1998. At that time, the Code was in its infancy and there was little in the way of guidance as to the approach regulators would take under the Code.

After failing to reach any agreement regarding regulatory arrangements with the ACCC prior to commercial flows, the decision was made to operate the EGP in a manner that would avoid the need for regulation under the Code. The behavioural based approach to operating the EGP was the genesis of DEI's Non-Discriminatory Access Policy (discussed in detail further in this submission).

- The Board approved construction of the Tasmanian Gas Pipeline (TGP) in October 2000. While consideration was initially given to the TGP being subject to the Code, at the time of Board approval, it was DEI's explicit intention that the TGP also be operated in a manner to avoid the need for regulation under the Code.

Given the above, it is clear that any assertions that the Code has encouraged DEI's investment in greenfields transmission pipelines need to be disregarded.

DEI also notes the following excerpt from the ACCC's submission to the Energy Market Review:

*"Between 1995-96 and 1999-00 capital expenditure in relation to transmission pipelines averaged \$330 million per year. During that time the following major investments were undertaken:*

- *Goldfields Gas Pipeline, WA (completed in 1996);*
- *Ballera to Mt Isa Pipeline (the Carpentaria Pipeline), Queensland (constructed during 1997-1998);*
- *Ballera to Wallumbilla Pipeline (the Southwest Queensland Pipeline) (constructed in 1996); and*
- *Southwest Pipeline, Victoria (completed in 1999).<sup>4</sup>*

Given the Code came into effect in 1997, of the above investments, the only one relevant for the purpose of assessing the Code's impact on investment in

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<sup>3</sup> Energy Users Association of Australia, Submission to the Productivity Commission's Review of the National Access Regime, p.25

<sup>4</sup> ACCC submission to the CoAG Energy Market Review, May 2002, pp 44-48

transmission pipelines is the Southwest Pipeline. Clearly, the above statement is misleading.

DEI also notes that there may be reference to the SEA Gas Pipeline as a further example of the Code encouraging investment. However, it is apparent the SEA Gas pipeline was designed purely to meet the demand of its foundation customers and thereby avoid the impact of regulation. Therefore, this is another example of a pipeline being built in spite of, rather than because of, the Code.

Perhaps even worse, however, is that building pipelines to size represents an inefficient, or socially undesirable, investment. This is because, even assuming only a modest demand growth for a pipeline, it is more efficient to invest in a larger diameter pipeline than it is to compress or loop an existing pipeline later on. DEI understands that the SEA Gas consortium are already (that is, even prior to completion of the initial pipeline) assessing augmentation options.

Unfortunately, it appears that the SEA Gas Pipeline is the first example of investors building pipelines, in an inefficient manner, purely to avoid the current approach to access regulation. An inevitable result of this outcome is that eventually, more expensive augmentation of the pipeline will occur, and ultimately, at the expense of customers.

## **4 Concerns with the Code**

### **4.1 Pricing Methodology**

The modern era of access regulation in Australia may be traced to the report of the Independent Committee on National Competition Policy in 1993 (the “Hilmer Report”).<sup>5</sup> DEI has significant concerns over the manner in which regulated access to nationally significant infrastructure has been implemented in Australia post Hilmer.

The Hilmer Report favoured a light-handed approach to regulation in the form of a “negotiate-arbitrate” model, in which commercial negotiations were preferred to more prescriptive regulation, whereby a regulator directly set terms and conditions of access. Indeed, the Hilmer Report indicated that:

*“it may be appropriate to allow the parties to come to their own arrangements, and only declare such a right if experience shows that access is being abused.”*

Part IIIA of the *Trade Practices Act 1974* implements this kind of arrangement. Under Part IIIA, access arrangements are intended to be negotiated privately, with the parties having recourse to binding arbitration by the ACCC only when they fail to reach agreement.

The Code was agreed upon following the delivery of the Hilmer Report, and was intended to facilitate the introduction of “free and fair trade” in gas in Australia. It was introduced largely due to a desire to achieve a greater level of certainty and consistency in the application of access regulation to gas transmission and distribution pipelines in Australia.

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<sup>5</sup> Independent Committee of Inquiry into Competition Policy in Australia (Chairman: Professor F. Hilmer) 1993, *National Competition Policy: Report by the Independent Committee of Inquiry into Competition Policy in Australia*, AGPS, Canberra.

Unlike Part IIIA, however, the finally agreed version of the Code establishes a far more prescriptive, “heavy-handed” form of regulation. Terms and conditions of access are not established by market negotiations, but by regulators who generally possess insufficient information about the commercial environment to perform this function without the risk of imposing substantial costs on the parties.

The injection of the regulator into the price setting process hinders the ability of the service provider and access seeker to reach a commercially agreed solution. Under regulation, the decision making process changes so that many important decisions are made through bilateral agreement between the service provider and the regulator. The regulator’s effectiveness as an agent for the buyer depends on its incentive structure and the quality of the information base upon which decisions are made, as well as the methods through which such decisions are implemented.

The regulator, as with any public sector body, has an incentive structure compromised by a complex set of accountability relationships. These relationships are intended to service a wider set of objectives rather than being focused toward serving the direct interest of access seekers.

This has produced a tendency to establish access prices that do not provide pipeline investors with sufficient protection against both market and regulatory risk and, in doing so, distorts incentives and commercial decision-making.

Currently under the Code, tariffs are set according to broad reference tariff objectives outlined in section 8.1 of the Code. Although a service provider has some discretion as to the form of regulation (eg. Cost of Service, IRR, NPV), in practice, whichever option is adopted, the price control methodology will ultimately be based on a building block model. What this means is that reference tariffs are set on the basis of a detailed dissection of the service provider’s costs.

The individual components of the building blocks include return on capital, depreciation (return of capital) and operating and maintenance expenses. This approach involves extensive input costs analysis by the regulator. Usual practice is to use the weighted average cost of capital (WACC) to derive the regulated rate of return. The equity beta, used in the return on equity calculation, is set by the Capital Asset Pricing Model (CAPM).

There are a number of shortcomings to using this approach:

- debate over the value of key parameters use in the WACC calculation;
- debate over the treatment of asymmetric diversifiable risk;
- for pipelines in existence before the introduction of the Code in 1997, the determination of the DORC methodology to establish the initial capital base;
- assumptions and subjectivity in making demand forecasts used to determine average prices;
- regulatory discretion over the prudence of capital expenditure;
- regulatory discretion in determining efficient levels of operating and maintenance expenditure;
- extensive information requirements;
- high cost of compliance, consultancy expenditure and development costs associated with an Access Arrangement; and
- information asymmetry as the regulator has less knowledge about the business and its associated risks than the service provider.

Further, such an approach bears no resemblance to commercially orientated outcomes.

#### **4.2 Effect on Investment Incentives**

One of the more unfortunate outcomes of the current Code and its subsequent application by regulators has been its adverse impact on investment incentives. This has been well-documented in various reports, including the recent Parer Report and the Commission's Review of the National Access Regime. Various media releases and discussions with industry also suggest that Governments have not overlooked this point.

In formulating a decision as to whether to proceed with a new business development, investors need to be cognisant of a myriad of risks. According to standard capital market theory, these risks are classified as either diversifiable (or systematic) or non-diversifiable (non-systematic). Non-diversifiable risks are those risks that are related to wider market or economic conditions, and as they are commonly shared among all businesses, they cannot be mitigated through diversification. Diversifiable risks are those risks that are specific to the business itself, irrespective of wider market issues. For a pipeline development, such risks could include construction costs risk, the risk of bypass, demand uncertainty, or other uninsurable risks such as acts of terrorism.

In Australia, regulators have, under the standard building blocks approach, universally adopted the Capital Asset Pricing Model (CAPM) to calculate the return on equity used to determine the Weighted Average Cost of Capital (WACC). By definition, the CAPM methodology only takes into account the level of non-systematic or non-diversifiable risk, as it is assumed that across a diversified portfolio of investments, an investor can eliminate the diversifiable risks. This occurs in theory because the poor returns associated with sub-optimally performing projects will be offset by higher returns on other projects.

However, once regulation is injected into the equation, business are not offered the ability to earn higher rates of return on some projects due to the tendency of regulators to cap rates of return at the economically efficient level, as determined by the regulator. This gives rise to regulatory truncation at the efficient rate of return. Regulators have not adopted suitable measures to allow service providers to share sufficiently in the upside risk of successful projects in order to compensate for the downside losses.

Although regulators have introduced revenue sharing mechanisms in recent determinations, service providers are still deprived of the necessary returns required to fully mitigate the losses associated with early stage project developments. This issue stems from the common perception that all profits above the economically-efficiently level must be monopolistic profits. Pure monopolistic profits should be separated from the "blue sky" returns associated with a successful investment. In this regard, the concept of workable competition, as opposed to economically efficient prices under pure competition, has been endorsed by the court in the recent Epic high court decision.<sup>6</sup>

Therefore, the inability to secure the upside from a successful investment in a regulated environment will tend to stifle investment and cause projects to be delayed or deferred altogether. In this way, short-term regulatory focus on lower prices for

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<sup>6</sup> Re: Dr Ken Michael AM; Ex parte Epic Energy (WA) Nominees Pty Ltd & Anor [2002] WASCA 231

consumers will have more detrimental effects due to the lack of adequate investment in the future.

There are also the disincentives to invest associated with regulatory risk. Regulatory risk includes, among other things, the risk that regulators will restrict profits, change positions, make errors, redistribute wealth among market participants and contribute to the delay of projects. Regulatory risk is asymmetric in nature, as there can be no counterparty to offset the risk. Therefore, because regulatory risk is asymmetric and unavoidable, it cannot be diversified away by service providers.

The regulatory risk associated with pipeline development has become an increasing concern for investors since the inception of the Code in 1997. In DEI's case, the Board of Directors are now inclined to give much higher weighting to regulatory risk than at the time of the inception of the Code. Concerns regarding regulatory risks have come to light as the interpretation of the current Code by regulators has emerged in subsequent Access Arrangement determinations. These concerns have been further fuelled by a number of recent court cases (eg. Epic, DEI EGP) that have highlighted the potential losses that can result from an adverse regulatory decision, and the significant amount of time and resources that may be required for service providers to challenge these determinations.

Governments have given strong support for the need to develop an integrated, national energy market which will provide for the needs of a growing population and support a shift towards less greenhouse intensive fuels, including natural gas. However, these objectives are in direct contrast to the direction of recent regulatory decisions, which have worked to increase investor uncertainty. The regulatory and/or sovereign risks that have been highlighted in recent decisions may result in a project being shelved or not proceeding. However, it should be noted that in terms of quantifying this effect, many projects will be scrapped at the early stages, well before a construction cost figure has been established which can be used to show the extent of investment that has not proceeded.

In addition to projects that may not proceed, the threat of regulation may cause the service provider to "undersize" the pipeline so there is only sufficient capacity to meet obligations for the foundation customers that underwrote the development of the pipeline. The SEA Gas pipeline is a good example of a pipeline being built to size to avoid regulatory intervention. Such an outcome is inefficient, and not conducive to the development of Australia's emerging gas market.

Regulatory risk in the current environment in Australia is heightened by a perception that regulatory decisions will inevitably favour end user customers, as opposed to the theoretical established objective of regulation which is to strike a workable balance between the interests of service providers and consumers. These concerns are further reinforced by the fact that the principal pipeline regulator in Australia is also charged with responsibility for consumer protection.

A further, less considered, dilemma associated with the building blocks model is the impact such an approach has on incentives to invest in competing pipelines. This dilemma arises where a new pipeline is constructed to compete with a regulated pipeline established prior to the inception of the Code. This situation will eventuate if the Government upholds the NCC's coverage recommendation for EAPL's Moomba to Sydney Pipeline (MSP) which directly competes with DEI's EGP.

It is DEI's view that this situation should not arise as the competition between the EGP and MSP should mean that the MSP would not satisfy the coverage test.

However, to the extent that the coverage test fails to address this issue and the MSP remains covered, the practical effect of such regulation needs to be examined.

In this event, applying the current pricing methodology under the Code, the tariff for the MSP would most likely be established using the Depreciated Optimised Replacement Cost (DORC) methodology to derive the initial capital base. As the MSP was completed in 1976, the accumulated depreciation is likely to result in a tariff below the marked-based tariff that would prevail under a competitive situation.

The regulator-determined tariff would set the ceiling price DEI could charge on the EGP, which is a newer, unregulated pipeline. Therefore, despite successfully challenging a coverage application, the EGP would be subject to “defacto” regulation. Moreover, the resulting tariff would, in reality, be lower than that which would exist if the EGP itself had been subject to regulation.

Therefore, in situations where a new unregulated pipeline competes with an existing regulated pipeline, the cost of service approach is likely to artificially distort the economics of new pipeline developments and potentially undermine their commercial viability. This situation hampers investment in new transmission pipelines and the further development of a competitive natural gas market. The veracity of this is borne out by the evidence. The only truly greenfields pipelines, of any size, built since inception of the Code are the EGP, TGP and SEA Gas Pipeline.

In the case of the EGP, DEI simply did not expect the regulatory framework to be implemented in the manner that it has. As DEI has previously observed, had DEI known then (in terms of the regulatory framework), what it knows now, the EGP would not have been built. In the case of the TGP, approval to construct was agreed on DEI’s Board’s expectation that it would be operated in such a manner that it would not be subject to regulation.

In terms of the SEA Gas Pipeline, it has been built with no spare capacity, and therefore is not impacted by the regulatory framework. Clearly, however, the SEA Gas situation raises disturbing efficiency concerns (as discussed later in this submission), as does the fact that no other greenfield pipelines have been built.

This situation is a direct and unavoidable consequence of applying a building block approach to a regulated pipeline which competes with an unregulated pipeline (it should be noted that this scenario also clearly has implications for the Access Holiday concept).

DEI believes that the impact of regulatory risk on investment incentives could be mitigated to a certain degree by the specification of clearer objectives, a strengthened coverage test, a more light handed form of price regulation, and separate treatment for new greenfields investments.

## **5 The Need for an Objects Clause**

The cornerstone of any regulatory regime should be a clearly defined set of objectives. The need for a clear set of objectives is paramount to the gas access regime, particularly when viewed in the context of the divergent interests of the involved parties. In the absence of an objects clause, there is the very real threat that regulators may, when interpreting and applying the framework to regulated entities, misconstrue the original intention of that framework.

Undoubtably, one of the factors contributing to the uncertainty and litigation arising from the current Code has been the lack of a clear direction on the primary objectives of the Code. The conflicting sources of objectives under the gas access regime have resulted in considerable uncertainty for service providers and users of pipeline infrastructure. In addition, it has resulted in a blurring of regulator accountability.

The addition of an objects clause to the Code would have the following advantages:

- replace inconsistent and contradictory guidance in the existing regime;
- ensure regulatory authorities adequately considered the medium term interests of existing and potential gas users in ongoing investment in new and existing networks when making access pricing decisions;
- facilitate efficient commercial negotiation on terms and conditions of access by giving greater guidance and certainty to asset owners, access seekers and other interested parties; and
- reduce the risk of regulatory error or inappropriate intervention, and increase regulatory accountability.

Currently, in applying the national gas access regime, regulators must consider the following when making decisions on covered pipelines:

- section 2.1 of the 1997 Natural Gas Pipelines Access Agreement (which is reproduced in the non-binding preamble of the Gas Pipelines Access Law).
- recent court rulings;
- the non-binding introduction section of the Code;
- section 2.24 of the Code; and
- general reference tariff principles outlined in section 8.1 of the national Code.

However, the Code itself contains no formal objects clause that succinctly guides the overall objective of regulation under the Code. This is in spite of the divergent and sometimes conflicting nature of the three main sections in the Code itself that provide high level guidance – the introduction, section 2.24 and section 8.1.

The introduction to the Code states the following:

*“The objective of this Code is to establish a framework for third party access to gas pipelines that:*

- (a) facilitates the development and operation of a national market for natural gas; and*
- (b) prevents abuse of monopoly power; and*
- (c) promotes a competitive market for natural gas in which customers may choose suppliers, including producers, retailers and traders; and*
- (d) provides rights of access to natural gas pipelines on conditions that are fair and reasonable for both Service Providers and Users; and*
- (e) provides for resolution of disputes.”*

While the introduction provides a useful overview of the Code, it is not binding and does not provide the necessary guidance to regulators to ensure all competing interests are adequately balanced.

Section 2.24 of the Code specifies a list of factors a regulator must consider in assessing a proposed access arrangement. Section 8.1 includes a list of general principles that must be considered when assessing an access arrangement.

While there are certain similarities between these three high-level directional clauses, there are also some rather significant differences. In particular, section 2.24 is the only one of the three sections to specify the need to consider the services provider's legitimate business interests.

Where such differences exist, this raises the dilemma of which section should be given primacy. This issue was at the heart of the Epic challenge in the Supreme Court of Western Australia. The Court subsequently ruled that section 2.24 had precedence over the introduction and section 8.1. The Court's ruling sends a strong message that there is now a greater need to resolve contentious and conflicting sections that convey high level guidance on the intent of regulation under the Code.

The need for a general objects clause in part IIIA of the Trade Practices Act was acknowledged previously by the Commission in its Review of the National Access Regime.

Support for the inclusion of an objects clause in part IIIA was also highlighted in the Government's response to the Commission's report. The Government's response proposed the following objects clause, which essentially mirrors the Commission's recommendation except for the additional wording including after the comma in clause (a):

*"The object of this part is to:*

- (a) promote economically efficient use of, and investment in, essential infrastructure services, thereby promoting effective competition in upstream and downstream markets; and*
- (b) provide a framework and guiding principles to discourage unwarranted divergence in industry-specific access regimes."*

DEI has no concerns with the Government's amended proposal.

The introduction of an objects clause in industry-specific access regimes such as the Code should have regard to any objects clause contained in Part IIIA, as Part IIIA provides the overarching basis for all access regulation. DEI notes that clause (b) above will not be relevant for industry specific access regimes. However, DEI believes that there is significant merit in including principle (a) (as amended by the Government) as the guiding objects clause for the Code.

## **5.1 Recommendations**

### **Recommendation 5.1**

**DEI recommends that the following objects clause should be included at the beginning of the Code and should be considered binding.**

***'The objective of the Code is to:***

- (a) promote economically efficient use of, and investment in, essential infrastructure services, thereby promoting effective competition in upstream and downstream markets.***

## 6 The Coverage Test

It is well accepted that access regulation imposes significant costs on owners of regulated infrastructure, regulators, and ultimately consumers. DEI does not dispute that there are circumstances under which it is necessary to regulate bottleneck facilities that have both the ability and incentive to misuse market power. However, given the associated costs, it is important that essential infrastructure is only subject to regulation where there is a demonstrable need for such regulation. DEI does not believe that the Code, as it is currently worded, provides the requisite test to ensure that regulation is limited to only those justifiable situations.

DEI believes that there are four areas where the coverage criteria requires refinement:

- “Denial of access” before coverage application can be lodged
- Refinement to criterion (a) to ensure its relevance
- Inclusion of the word “substantial” in criterion (b)
- Inclusion of a national significance test

### 6.1 Denial of Access

DEI is firmly of the view that a coverage application should only be able to be lodged on a pipeline where it can be demonstrated that the facility owner has unreasonably denied access to an access seeker. At present, coverage can be sought even when an attempt to negotiate access has not been made. Although section 1.4 of the Code enables vexatious or trivial coverage applications to be dismissed outright, the potential still exists for access seekers attempting to gain a competitive advantage to submit an application on purely strategic grounds. This results in significant time and costs for not only the asset owner, but the regulator and other industry participants.

Unfortunately, DEI has direct experience with such an outcome. In the case of the EGP, a party that had not tried to seek access to the pipeline lodged a coverage application. The result, while ultimately in the favour of DEI, cost in excess of \$2 million. Such a situation should not be allowed to re-occur.

In addition, the current ability for the relevant regulator to make an application for coverage is clearly inappropriate as it would imply an automatic assumption of guilt, without first allowing access negotiations a chance to secure an agreed outcome.

As such, DEI believes the coverage test should be amended so that a coverage application can only be made by a bona fide user who has first tried to seek access and is able to demonstrate that access has been unreasonably denied. It is not envisaged that such a test would be an overly onerous one, but at least sufficiently robust to require the access seeker to demonstrate “denial of access” by the pipeline owner.

### 6.2 Criterion (a) – Promote Competition Test

The purpose of the promote competition test is to ensure that a right of access exists where access is essential for competition. As noted by the Commission in its Review of the National Access Regime:

*“The genesis of the criterion [a] can be traced to the Hilmer Committee which considered that a right to access should be created only where ‘access to the facility in question [was] essential to permit effective competition in a downstream or upstream activity’. Subsequently, Clause 6(1) of the Competition Principles Agreement specified that the Commonwealth would put forward legislation to*

*establish a regime in which 'access to the service is necessary in order to permit effective competition'. Clearly, criterion (a), which refers only to promoting competition, sets a lower standard than envisaged initially."*<sup>7</sup>

In its Review of the Access Regime the Commission went on to conclude:

*"If a as result of mandated access there were only a minor improvement in competition, declaration [coverage] would be of little practical benefit and, given the potential costs of intervention, could be damaging for the economy."*<sup>8</sup>

DEI concurs with this view. To address this matter, it is necessary for the coverage test, and in particular criterion (a), to be strengthened to incorporate the requirement for 'a *substantial* increase in competition'.

While DEI has always been of this view, recent events provide further support for the inclusion of the term 'substantial' in criterion (a). In particular, reference is made to the NCC's Final Recommendation in November 2002 on the East Australian Pipeline Limited's application for revocation of coverage of parts of the Moomba to Sydney Pipeline (MSP).

In its Final Recommendation, the NCC found that criterion (a) is satisfied on the basis that a continuation of coverage of the MSP:

*"...would promote competition in upstream and downstream markets as a consequence of the ability and incentive of the pipelines to charge monopoly prices for transport services."*<sup>9</sup>

However, a thorough reading of the NCC's Final Recommendation reveals that rather than finding that coverage of the MSP *would* promote competition, it found that it is *likely* that it would. The NCC came to this finding despite the fact that it relied on misunderstandings of fact and/or law, and unsubstantiated assertions. It also relied heavily on conclusions of Ordover and Lehr despite their statement:

*"Based on the limited data we have seen, we tentatively conclude that the case for removing coverage of the MSP is not compelling. Plainly, MSP meets criterion (b). There is evidence, albeit much less compelling, that the MSP possibly meets criterion (a)."*<sup>10</sup>

The NCC's approach assumes the case for revoking coverage bears the burden of proof. This is not correct. The statutory test does not require the case for revocation to be compelling. On the contrary, it is the case for retention of coverage that requires a compelling case to be established that all of the criteria are met. If Ordover and Lehr find that the MSP "*possibly*" meets criterion (a), and the evidence for that is "*much less compelling*" it is not possible for the NCC to be affirmatively satisfied that criterion (a) is satisfied. However, that is exactly what the NCC has found.

The fact that the NCC recommended that the MSP remain covered when it was only able to find that is *likely* continued coverage would promote competition is not only

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<sup>7</sup> Productivity Commission 2001, Review of the National Access Regime, p. 163

<sup>8</sup> Productivity Commission 2001, Review of the National Access Regime, p. 171

<sup>9</sup> National Competition Council, Moomba to Sydney Pipeline System – Revocation Application Under the National Code, p.253

<sup>10</sup> Ordover and Lehr 2001 – Should Coverage of the Moomba – Sydney Pipeline be revoked?

inconsistent with a correct interpretation of the Code, but also inconsistent with the NCC's stated interpretation of the Code:

*"...the test in Part IIIA requires that declaration will promote competition – it is not a test of likelihood but rather one that requires a degree of certainty..."<sup>11</sup>*

The NCC's approach in its MSP revocation recommendation is typical of its presumption to regulate when in doubt. Given the potential substantial costs, and associated damage to the economy in the long term, such a presumption could be very harmful. DEI is of the view that amending criterion (a) to include the term substantial would remove the ability of the NCC to err on the side of regulation.

DEI also notes that a move to a substantial increase in competition is consistent with Part IV of the Trade Practices Act (TPA). The Restrictive Trade Practices provisions of the TPA are aimed at procuring and maintaining competition in trade and commerce. The concept of substantial competition is a cornerstone of this Part and is well established and supported by precedent in case law. As such, the move to the term substantial in criterion (a) could not be considered to introducing an unknown, but rather, a concept that is well understood. It would also ensure consistency between Part IIIA and Part IV.

In the Commonwealth Government's response to the Commission's Review of the Access Regime, it proposed that, rather than the inclusion of the word 'substantial', criterion (a) should be amended to include the term 'material'. The basis for its position was its concern that the term 'substantial' may exclude situations where a smaller supplier is prevented from gaining access to significant infrastructure.

However, while on the surface this may appear to have some merit, it needs to be borne in mind that there are very significant costs associated with being subject to regulation. As noted above, these are costs not just borne by the regulated infrastructure, but by regulators and ultimately consumers, not to mention the potential damaging impact to the economy overall. It is doubtful that, should access to a small customer not represent substantial increase in competition in a relevant market, then the costs associated with allowing regulation for just that one customer would be far outweighed by the benefits.

DEI also notes that the inclusion of the term 'material' would be introducing a concept that is not well established and supported by precedent. It is introducing somewhat of an unknown. It would also represent a continued divergence from the cornerstone of the TPA, which as noted above, is founded in the term 'substantial'.

As such, DEI does not support the Commonwealth's proposed approach, but rather, believes criterion (a) should be amended to include the term 'substantial'.

### **6.3 Criterion (b) - The Monopoly Test**

DEI notes that the Australian Competition Tribunal interpretation in the Eastern Gas Pipeline case on criterion (b) has made it clear that the criterion will only fail in the most extreme or narrowest of circumstances. In order to satisfy this criteria, it would only be necessary to establish that it would be "uneconomic" for anyone else to develop another pipeline to provide the same service of transmission of gas from Longford in Victoria, up the east coast of Australia, then ending at Horsley Park in NSW (that is, the precise service offered by the EGP).

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<sup>11</sup> National Competition Council, Submission to the Review of the Access Regime, p.37

DEI notes that this issue is one that the Productivity Commission considered at some length in its Report on the National Access Regime. In effect, it is now clear that the “uneconomic to develop” criterion, as it is currently drafted under the Code, precludes consideration of whether it would be economic to develop alternative (closely substitutable) services for the precise service offered by the pipeline in question. This means it would be necessary to rule out consideration of the feasibility of developing pipelines from other potential sources of natural gas, as well as the economics of developing close substitutes in the supply of natural gas (for example, electricity). Yet frequently, the competitive threat posed by these potential sources of energy is a compelling reason not to impose regulation on certain pipelines.

In its Review of the Access Regime the Commission expressed concern with the implications of the ACT’s interpretation of criterion (b) but ultimately concluded that the current wording is adequate, so long as substitution possibilities are considered elsewhere. In forming this opinion, the Commission noted that since the EGP case, there have been no further Tribunal hearings. As such, the Commission relied, to some extent, on the latest (at that time) NCC Issues Paper on the MSP Revocation Application to obtain guidance on how the NCC was intending to interpret the EGP case.

Unfortunately, while one interpretation of the Issues Paper could suggest that the NCC would consider matters consistent with the findings in the EGP case, the NCC’s Final Recommendation ultimately reveals that its approach is not entirely consistent with those findings. Therefore, DEI submits that, to the extent the Commission relied on its understanding at the time of the approach the NCC was to take going forward, and to the extent the NCC actual approach has differed from this understanding, then the Commission should review its finding in this regard.

It is certainly DEI’s view that while some comfort may have arisen from the NCC’s Issues Paper, the NCC’s ultimate recommendation demonstrates that it is not safe to rely on criterion (a) to consider substitutability options.

DEI also notes the Commission’s conclusion in its Report on the Access Regime with respect to this matter:

*“...the current state of case law has not established that there is a significant risk that facility services with natural monopoly characteristics but little market power, on the existence of substitutable services, will be declared.”<sup>12</sup>*

DEI submits that subsequent to the release of the Commission’s report, the NCC has, via its Final recommendation on the MSP revocation application, demonstrated that there is a significant risk that services with monopoly characteristics but little market power (due to the existence of substitutes), will be recommended to be covered. As such, DEI submits that subsequent events have transpired which are contrary to the understanding on which the Commission based its findings at the time.

In addition, DEI is concerned that, given case law is still evolving in this area, and the potential substantial costs associated with inappropriately subjecting a pipeline to coverage, it would be prudent to take this opportunity address the deficiency of the current criterion (b).

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<sup>12</sup> Productivity Commission, Review of the National Access Regime, September 2001, p191

That there is a deficiency is further supported by the fact that the current drafting requires significant (if not excessive) reliance on criterion (a). As noted by the Commission in its Review of the Access Regime:<sup>13</sup>

*“...the relative ease with which a gas pipeline could meet criterion (b) indicates that criterion (a) needs to do a lot of work...”*

DEI therefore believes that criterion (b) requires rewording to ensure that competitive alternative sources of energy be considered in the context of determining the uneconomic to develop test. An appropriate reworded criterion has been proposed by NECG:<sup>14</sup>

*(b) that it would be uneconomical for anyone to develop another facility to provide the service or a substitute for the service in the same market as that in which the service is provided.*

Such an amendment would enable consideration of the relevant market and thereby achieves two outcomes:

- It focuses an assessment onto any facility (as opposed to only pipelines) that can provide the service or substitutable service
- It enables consideration of alternative or substitutable services

DEI believes criterion (b) should be reworded as proposed above.

#### **6.4 National Significance Test**

The Declaration criteria in Part IIIA of the TPA includes a test to ensure that only facilities with a significant role in the Australian economy are potentially subject to regulation. However, DEI notes that the Code's coverage test does not include a similar national significance test.

The genesis for the exclusion of this test from the Coverage test is not clear to DEI. While the Commission briefly explored the issue of the national significance test in its broader Review of the Access Regime, it appears that it did not come to any landing on the merits for its inclusion (or otherwise) in the Code.

It is DEI's view that, as a threshold issue, and particularly given the substantial costs of regulation, it needs to be demonstrated that the infrastructure is of national significance. This seems to be intuitively obvious.

DEI also notes that there have been a number of perverse outcomes in other countries arising from the absence of a national significance test. Given the potential for this to occur in Australia, it would seem only prudent to amend the Code to prevent any such perverse outcomes eventuating.

DEI also considers that, for the sake of consistency between Part IIIA and industry specific regimes, it is appropriate that a national significance test should be a part of the coverage criteria.

As such DEI recommends that a national significance test, consistent with the in Part IIIA if the TPA is included into the Cas Code's coverage test.

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<sup>13</sup> Productivity Commission, Review of the National Access Regime, September 2001, p. 175

<sup>14</sup> Productivity Commission, Review of the National Access Regime, September 2001, 185

## **6.5 Recommendations**

### Recommendation 6.1

The Code be amended such that a coverage application can only be submitted by a bona fide user, subsequent to an attempt to gain access to the pipeline that has been unreasonably denied by the service provider.

### Recommendation 6.2

Consistent with the Commission's Recommendation 7.1 in its Review of the National Access Regime, the promotion of competition test in section 1.9(a) of the Code should be amended as follows:

***“that access (or increased access) to Services provided by means of the pipeline would promote 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.”***

### Recommendation 6.3

The uneconomic to duplicate test contained in section 1.9(b) of the Code should be amended as follows:

***“that it would be uneconomical for anyone to develop another facility to provide the service or a substitute for the service in the same market as that in which the service is provided.”***

### Recommendation 6.4

Section 1.9 of the Code should include a national significant test as an additional criterion. Such a test should be along similar lines to section 1.44G(2)(c) of Part IIIA of the Trade Practices Act.

## **7 Framework for Unregulated Pipelines – Code of Conduct**

DEI notes the concerns expressed in the Energy Market Review about a lack of market supporting mechanisms for non-covered pipelines.<sup>15</sup> To address these concerns, the Review recommended that industry develop a Code of Conduct providing enforceable minimum requirements.

DEI agrees that unregulated pipelines should be obliged to comply with certain minimum requirements. These should include a commitment to open access, protection of confidential information (essentially ring fencing without the accounting obligations) and disclosure of details regarding deals with affiliates. The Australian Pipeline Industry Association (APIA), in conjunction with its members, is currently developing a code of conduct that addresses these issues, and more. The intention being that pipeliners can voluntarily comply with the Code of Conduct. However, should pipeliners not comply, the threat of not doing so is the risk of a successful coverage application.

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<sup>15</sup> Towards a Truly National and Efficient Energy Market, December 2002, 194

In the case of DEI, it is already committed to operating its two unregulated transmission pipelines on a non-discriminatory access basis. The approach DEI has adopted is to operate within behavioural bounds that are designed to achieve pro-competition outcomes. This behavioural policy is based around eight core principles, which taken together, represent DEI's Non-Discriminatory Access Policy (NDAP).

DEI believes that these principles will ensure the long term sustainable operation of pipeline assets within a market based environment, as well as providing all of the benefits associated with economic access regulation, without the significant associated costs. These eight key principles are the commitment to:

- Developing market-responsive pipeline services;
- The use of non-discriminatory tariffs;
- Public disclosure of dealings with affiliates;
- Public disclosure of key contract details;
- Protection of confidential information;
- Facilitating capacity trading;
- Performing independent external audits of compliance with the principles; and
- Binding independent dispute resolution process.

DEI's NDAP applies to all DEI's uncovered transmission pipelines from the commencement of commercial gas flows. These NDAP Principles are discussed briefly in Box 1.

One of the most appealing aspects of DEI's NDAP is the degree of transparency associated with it. DEI publishes on its website all service offerings that are currently available, all contracts entered into with its affiliates<sup>16</sup>, available capacity, standard terms and conditions, as well as facilitating a customer to trade any excess capacity that it may have at any point in time. All of these are managed on DEI's external web page so that all market participants are aware of developments in the EGP and TGP markets. It is a much more transparent approach than that under the Code.

It has also proven to be very successful. Since commencement of commercial flows on the EGP, DEI has entered into approximately 15 different contracts for services. These include a range of different firm forward haul, backhaul, park and lend, and even measurement services. The wide range of service offerings that have been made available to EGP customers reflect the flexibility DEI's NDAP provides to pipeliners so that it can be innovative and meet the needs of the market. This compares to the approach under the Code where the services offered under the Access Arrangements are basically a one size fits all, take it or leave it. DEI's NDAP is far more suited to greenfield and competing pipelines where the service provider is competing and striving to gain market share.

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<sup>16</sup> DEI offers to all customers the same terms and conditions as that provided to its affiliates.

## Box 1

### DEI's Non-Discriminatory Access Policy – NDAP

#### ❑ **Market Responsive Pipeline Services**

One of the key aims of DEI's alternative to prescriptive regulation is to be able to better respond to market signals. Key aspects include establishing appropriate maximum time frames within which responses to requests for the provision of a service will be provided and ensuring information is freely available as to available pipeline capacity and service offerings.

#### ❑ **Non-Discriminatory Tariffs**

Under this principle, all customers have equal access to the tariff for a given service offering. There is no tariff differentiation on the basis of type of customer, volume of gas or type of gas. Rather, alternative service offerings would be differentiated on the basis of factors such as transportation path, service priority, contract period or presence of a price link. DEI will also ensure that specific service offerings remain available for reasonable time frames with notice being provided to the market of the intention to withdraw a service offering. This principle is important to establishing confidence and credibility in the integrity of the arrangements.

#### ❑ **Affiliate Deal Disclosure**

One of the most important components of the principles concerns the protections that ensure DEI will not be in a position to provide a competitive advantage to a related company. Accordingly, this principle requires that key characteristics of all contracts with related entities be made public and that these terms are available to any other interested party.

#### ❑ **Disclosure of Contract Details**

The public disclosure of key contract details is important to assure all market participants of the non-discriminatory nature of service offerings to the market. Accordingly, all of the defining characteristics of a service are to be publicly disclosed. This means that sufficient information will be available to enable interested parties to enter into a similar service offering. This commitment is important to providing confidence in the efficacy of the non-discriminatory commitment.

#### ❑ **Protection of Confidential Information**

This principle commits DEI to only use confidential information for the purpose for which it was provided. Detailed procedures are required to ensure compliance with this principle (the auditing arrangements are discussed separately below). Again, the principle is critical to providing confidence to users or potential users that related parties of DEI will not gain access to confidential information about users of the pipeline.

#### ❑ **Facilitate Capacity Trading**

This principle provides the right for customers to use and freely trade pipeline services (ie pipeline capacity). DEI commits to facilitating the trade in pipeline capacity and to the development of supporting systems. This principle reduces the risks associated with customers signing long-term contracts for pipeline capacity through assisting in the development of a liquid secondary market for pipeline services.

#### ❑ **Independent External Compliance Audit**

The application of independent external audits of the extent of compliance with the principles and associated procedures is critical to the integrity and credibility of the arrangements. Accordingly, audit outcomes will be publicly released by DEI to demonstrate its commitment to transparency in its conformance to the principles.

#### ❑ **Binding Independent Dispute Resolution**

All customers and prospective customers will have access to independent and binding dispute resolution processes where there is a grievance with the NDAP that cannot be satisfactorily solved through negotiation.

DEI's Non-Discriminatory Access Principles are supported by a comprehensive suite of supporting procedures which form DEI's Non-Discriminatory Access Management System (NDAMS). These procedures specify required actions and key accountabilities and form the basis on which an annual audit is conducted.

DEI's NDAP more than satisfies those minimum market supporting mechanisms identified by the Parer Review. Furthermore, DEI's approach is far more pro-competitive, and certainly more flexible than Gas Access Regime.

DEI also makes the observation that not only does its NDAP provide the necessary market supporting mechanisms, it also provides a system which removes the ability of a pipeline to misuse its market power in the event such power is ever realised. This protection comes about through the commitment to Non-Discriminatory Tariffs.

One of the most powerful aspects of this principle is the commitment not to differentiate services on the basis of the volume of gas transported. DEI explicitly commits to this aspect of the principle (that is, the no volume discount) for the singular purpose of satisfying the market that it is not possible for it to misuse any market power that it may have, now, or in the future.

This principle achieves this end essentially as a function of the transmission market. On every transmission pipeline there is always (at least) two or three very large users who, simply by their size, have countervailing market power. They are very large users; without their custom, the pipeline would not be viable. Therefore, any tariff negotiated between these large users and the pipeline owner is, by virtue of the countervailing market power of the counter-parties, a market based tariff.

In accordance with the principle that DEI will not discriminate on volume, any other access seeker, regardless of the size of their custom, has access to the same terms and conditions as those provided to the very largest. Those smaller customers can therefore be confident of accessing the very best available terms and conditions.

It is worth noting that some would argue that it is inefficient not to offer volume discounts. However, the reality is, within the gas transmission market, there is no economic justification for the concept of volume discounts. This is because volume discounts are generally based on the premise of economies of scale. However, in the case of gas transmission sales, there is effectively zero economies of sale. Whether a pipeline owner has one customer or 10 (assuming the same aggregate volume), there is very little difference in terms of costs to the pipeline owner. In fact, there are probably benefits by diversifying risk across a greater number of customers. As such, there is no economic justification for volume discounts.

DEI accepts that in certain circumstances there are efficiency arguments in support of price discrimination. However, DEI does not accept that, of itself, the volume of gas being transmitted through a transmission pipeline represents a circumstance in which there is an efficiency argument for discounting.

As part of the formalisation of DEI's Non-Discriminatory Access Policy in July 2002, DEI commissioned NECG to prepare a report which assesses the merits of DEI's NDAP (Attachment 1). The report finds that the self-regulatory approach to providing access adopted by DEI aligns more closely with the original policy of access regulation, and that ultimately, NDAP will result in greater benefits for consumers in the long term.

DEI also notes that the Parer Review canvassed the option of some minimum enforceable standard of operation including development of standard contracts across the industry for common services. DEI is of the view that such an approach would not be appropriate for the gas transmission industry. The practicality of the transmission industry necessitates flexibility in contract design as individual terms, conditions and products are likely to vary widely. So long as a pipeline complies with some minimum information requirements, DEI sees very little, if anything, to be gained by moving towards a standardised contract.

## **7.1 Recommendations**

### Recommendation 7.1

**Unregulated pipelines should be obliged to comply with certain minimum requirements. These would include a commitment to open access, protection of confidential information and disclosure of affiliate deals.**

**These issues to be addressed through the industry code of conduct. Accordingly, it will not be necessary for the minimum requirements to be provided for in the Code. Although compliance with this code will be on a voluntary basis, non-compliance may result in a successful coverage application.**

## **8 Regulated Pipelines – Negotiate / Arbitrate**

The shortcomings of the cost of service approach to price setting highlighted above pave the way for consideration of alternative, light-handed, market-based solutions to price regulation.

It is DEI's view that, for transmission pipelines, the requirement for regulator approved Access Arrangements and associated reference tariffs set via the cost of service approach should be abolished. Instead, these arrangements should be replaced by a light-handed, negotiate-arbitrate model, with the arbitration role undertaken by an independent panel. In effect, this model represents development of the dispute resolution provisions of section 6 of the current Code, juxtaposed with a new set of information requirements and pricing principles to facilitate negotiation and guide the decisions of the arbitrator.

In addition to being consistent with the original intention of the Hilmer Report, CoAG further endorsed a negotiate-arbitrate model in the 1995 Competition Principles Agreement (CPA). The relevant paragraphs in Section 6(4) include:

- (a) Wherever possible third party access to a service provided by means of a facility should be on the basis of terms and conditions agreed between the owner of the facility and the person seeking access.*
- (b) Where such agreement cannot be reached, Governments should establish a right for persons to negotiate access to a service provided by means of a facility.*
- (c) Any right to negotiate access should provide for an enforcement process.*
- (d) Any right to negotiate access should include a date after which the right would lapse unless reviewed and subsequently extended; however, existing contractual rights and obligations should not be automatically revoked."*
- (g) Where the owner and a person seeking access cannot agree on terms and conditions for access to the service, they should be required to appoint and fund an independent body to resolve the dispute, if they have not already done so.*

*(h) The decisions of the dispute resolution body should bind the parties; however, rights of appeal under existing legislative provisions should be preserved."*

A negotiate-arbitrate model possess the following advantages over the existing price setting methodology contained in the Code:

- the light-handed nature of the model obviates the need for detailed costs analysis and subjectivity regarding specific parameters used by the regulator in setting rates of return;
- it eliminates the substantial costs associated with the development of an Access Arrangement, which include consultancy fees and the diversion of management time away from the necessary focus on commercial objectives;
- it is more closely aligned with the model originally advocated by Hilmer and the CoAG Competition Principles Agreement;
- the model has greater ties to commercial practice and eliminates the need for a regulator, with imperfect information, to stand between the service provider and the user;
- the specific nature of the market that gas transmission pipelines operate in tends to align more closely with a form of regulation for pipelines based on bilateral negotiations; and
- due to the lack of information asymmetry between the access seekers and the service provider, informed negotiations can proceed without the need for a regulator to extract detailed cost information from the pipeline company.

While the current Code does not limit the ability of a service provider and a user to reach an agreement regarding access, in the event negotiations break down, users know that they can at least secure the terms and conditions outlined in the regulator-approved Access Arrangement. This includes a reference tariff set by the current section 8 methodology.

In practice, access seekers will generally seek access on the terms and conditions specified in the Access Arrangement in the first instance, rather than attempting to pursue bilateral negotiations.

### **8.1 Why Suitable for Transmission Pipelines**

DEI believes that, given the market characteristics of the transmission industry described below, a negotiate-arbitrate model would be the most appropriate mechanism to provide for third party access to regulated pipelines.

- The market for the services of transmission pipelines consists of a small number of large users that exhibit considerable countervailing market power, which can be used to secure a market-based tariff through the negotiation process.
- This countervailing market power exists by virtue of the significant financial loss that would result for the service provider in the event the negotiation process fails to secure or maintain a significant contract. Pipeline companies have a strong financial incentive to fill available pipeline capacity, and there may be a limited number of viable customers.
- The bilateral contract process that characterises transmission pipeline price determinations lends itself towards a regulatory mechanism based on the commercial negotiation process, as opposed to less flexible options under an Access Arrangement.

- The arbitrator has discretion in allocating its costs among both parties to a dispute so this provides a substantial incentive for the parties to reach an agreed position via the negotiation process. This will act as a buffer against vexatious applications for arbitration.
- In the event that a dispute results in arbitration, customers of transmission pipelines are unlikely to be disadvantaged relative to service providers in terms of the time and costs involved in an arbitration process. This is because the customers of transmission pipelines are of a sufficient size and transmission pipeline services represent a significant share of their input costs.
- There are no major information asymmetries associated with transmission pipelines – customers are well informed as to the nature of a pipeline’s costs;
- pipeline companies such as DEI have shown a propensity to offer a range of innovative new products – a negotiate-arbitrate model would provide sufficient flexibility to ensure that the incentive to innovate is not stifled by less suited price setting methods such as price or revenue caps.

## **8.2 Negotiation**

### **8.2.1 Minimum Information Requirements**

To facilitate the initial negotiation process, service providers must be required to provide access seekers with a minimum set of information to form a basis for negotiation. This information must be sufficient to facilitate bilateral discussions, without being overly intrusive for service providers to comply with. The current Code will require amendments to specify these minimum information requirements, effectively replacing the detailed Access Arrangements provisions, although it is envisaged that there would be some consistency with the Access Arrangement requirements.

Service providers would be required to provide the minimum information requirements to users within reasonable timeframes, in order to prevent deliberate stalling and ensure the negotiation process is as efficient as possible. The timeframe may vary for different customers, particularly where the service provider needs to undertake technical analysis (eg. modelling) based on a user’s request. However, if a reasonable timeframe has been exceeded after considering all the facts, the arbitration process could be triggered.

In practice, there are a number of ways that minimum information requirements could be conveyed to access seekers. For DEI’s unregulated assets such as the EGP and TGP, information is provided to prospective users via the DEI website, such as available capacity, currently available contracts, standard terms and conditions, contracts with affiliates. Essentially, the minimum information requirements should be based on standard conditions contained in Gas Transportation Agreements (GTAs).

In DEI’s view, pipelines should have discretion as to how the information is conveyed to users, provided all minimum information requirements are addressed.

The information requirements could include key service characteristics such as:

- the nature of service (eg. firm forward, as available);
- procedures for prospective users who wish to gain access to a pipeline;

- term;
- path (receipt and delivery points – basis for variation);
- charges (both for the basic service and any additional components such as odorising, treatment of user specific facility charges etc);
- nominations and nomination procedures;
- trading or assignment of capacity;
- gas quality specifications; and
- capacity information.

The information requirements would essentially mirror the requirements for unregulated pipelines mandated under an industry code of conduct. DEI makes the observation that the information it currently provides as part of its NDAP has proven to be sufficient to facilitate negotiations with prospective customers.

As the flow of information arising from an access request is a two-way process, access seekers must also be required to provide service providers with sufficient information, including technical and commercial requirements, to enable the access provider to respond to the request for access. Mandatory disclosure requirements should also be prescribed for users.

The role of the regulator under the proposed model would be to ensure service providers and users comply with the minimum information disclosure requirements, within reasonable timeframes. However, the regulator's involvement would only be triggered in the event of a dispute with the access seeker regarding the sufficiency of information – the regulator would have no mandate to assess the basis for the terms and conditions offered.

### 8.2.2 Ring Fencing and Associate Contracts

DEI believes that ring fencing requirements are an integral part of any regulatory regime that seeks to provide access and encourage competition in upstream and downstream markets. The separation of vertically integrated gas business has been the necessary first step in the reform of the gas industry in Australia over the last decade. In situations where gas transmission pipelines are also involved in a related upstream or downstream business, ring fencing ensures that these businesses do not receive favourable treatment, thereby hindering the ability of other firms to compete.

DEI operates its pipelines on the basis of an open access regime, consistent with its NDAP framework. Ring fencing is an integral part of DEI's approach to ensure that its affiliates do not receive any competitive advantage.

Essentially, the central objective of ring fencing is to ensure the protection of confidential information in order to provide reassurance to users and to facilitate competition. To this extent, DEI supports the thrust of the ring fencing requirements set out in section 4 of the current Code and believes it would be broadly suitable to apply as part of the negotiate-arbitrate model.

However, DEI believes the accounting guidelines currently published by the regulator under section 4.2 of the current Code are unnecessary. One issue that arises from these guidelines is the requirement for director-level sign-off for ring fencing reports submitted by the service provider. For internationally-owned companies such as DEI, this can present significant administration issues for some businesses where all company directors resides overseas.

A related issue concerns the requirement under section 7 of the current Code for service providers to obtain regulator consent prior to entering into a contract with an associate. DEI believes that this requirement results in unnecessary regulatory involvement. Any concerns regarding potential adverse effects on competition would be addressed by a requirement that service providers must offer services to external parties on the same terms and conditions as affiliates. This is an important feature of DEI's NDAP framework and could also be reflect in developing an industry code of conduct for the gas pipeline industry.

### **8.3 Arbitration**

#### **8.3.1 Arbitrator**

If the negotiation process failed to deliver agreement between the parties on the terms and conditions for access, assuming all relevant information has been disclosed, the parties would enter the arbitration phase.

The role of the arbitrator would be to provide binding dispute resolution for disputes between transmission pipeline service providers and access seekers regarding terms and conditions of access.

The arbitrator itself should be an independent statutory panel of industry specialists, possibly styled on the format for the existing Australian Competition Tribunal (ACT). A panel approach would provide a range of relevant cross-sectional skills, in fields such as law, economics or commerce, in order to give due consideration to all relevant aspects of a dispute. The arbitrator would be required to base its decision on a commercial approach guided by a set of pricing principles that would aim to strike a suitable balance between the interests of service providers and business and ensuring sufficient incentives to invest.

The arbitrator would have discretion to apportion its costs among the parties to a dispute.

#### **8.3.2 Scope of Arbitrator's Role**

In clarifying the boundaries to the arbitrator's involvement in determining the applicable price in an access dispute, the following points must be considered.

- The arbitrator must ensure that pre-existing foundation contracts are respected and not undermined by subsequent disputes presented for arbitration. This aligns with similar requirements under the current Code.
- In a similar vein, it should follow that the arbitrator should also respect the primacy of existing State Government agreements where tariffs are specified. Under the current Code, there has been a general reluctance on the part of regulators to take adequate account of pre-existing State tariff agreements when setting reference tariffs. This was evident in the recent GGT Draft Decision, where the regulator did not acknowledge the pre-existing tariff agreement between Epic and the Western Australian Government entered into at the time Epic purchased the pipeline.
- In addition to considering disputes relating to currently available capacity, arbitration could also extend to developable capacity. In this event, it would be crucial to maintain provisions similar to those contained in sections 6.22 and 6.23 of the current Code that stipulate that a service provider can not be forced to fund

capacity expansions. Instead, the user should be required to meet the cost of such expansions.

### 8.3.3 Appeals Process

DEI believes that the existing appeals process provided for under the current Code should be applicable to decisions made by the arbitrator.

## **8.4 Recommendations**

### Recommendation 8.1

**For regulated transmission pipelines, the requirement for the reference tariff methodology outlined in section 8 of the Code and regulator-approved Access Arrangement should not apply. Instead, prices shall be determined on the basis of a true negotiate-arbitrate model, with the following features:**

- **minimum information disclosure requirements for service providers and users shall be specified in order to facilitate negotiation;**
- **the service provider shall be subject to ring fencing requirements, although there shall be no need for regulator-specified accounting guidelines;**
- **service providers shall be required to publicly disclose all deals with affiliates, thereby eliminating the need for regulator approval of associate contracts,**
- **the process shall move to arbitration in the event the parties cannot agree on terms and conditions of access within a reasonable timeframe;**
- **the arbitration role will be undertaken by an independently constituted panel of experts along similar lines to the Australian Competition Tribunal;**
- **arbitration cannot override pre-existing State tariff agreements;**
- **the arbitration panel will base its decision on a set of pricing principles;**
- **the arbitrator's decision will be binding, however the judicial review process outlined in the Code shall still apply;**
- **the regulator's role will be confined to ensuring compliance with ring fencing requirements and disclosure of minimum information requirements within a reasonable timeframe, with no jurisdiction over the basis for the terms and conditions of access offered by the service provider.**

## **9 Pricing Principles**

The access seekers and users safety net that is provided by the negotiate-arbitrate model is the pricing principles that would guide the arbitrator in forming a binding decision. A set of clear principles prescribed in the Code would enable parties to a dispute to have a clear understanding of the likely result of an arbitrated process. This would mean in turn that both parties would be more inclined to agree on a commercial settlement. Pricing principles would need to be framed in the context of any overarching objects clause.

Under the current Code, section 8.1 provides a set of general principles to be considered by the regulator when setting reference tariffs. Section 2.24 also provides some guidance to the regulator on relevant considerations when assessing an Access Arrangement. However, while the broad sentiment of these two statements of general principles may be relevant, they can be potentially contradictory and are generally too focussed towards a cost-based method of price setting. Clearly the building blocks model is an inappropriate methodology to be used

by the arbitrator to reach a decision – the arbitrator has neither the time nor the resources to conduct the required process.

An agreed set of pricing principles in the context of the national gas access regime would serve to limit regulator misinterpretation and discretion and clarify potentially conflicting clauses and objectives contained in the regime.

The Commission previously acknowledged the need for high level pricing principles for Part IIIA of the TPA in its *Review of the National Access Regime*. In recommendation 12.1 of its report, the Commission recommended the following pricing principles:

*“The Australian Competition and Consumer Commission, in seeking to reduce access prices that are inefficiently high, must also have regard to the following principles:*

*(a) that regulated access prices should:*

- (i) be set so as to generate expected revenue across a facility’s regulated services that is at least sufficient to meet the efficient long-run costs of providing access to these services;*
- (ii) include a return on investment commensurate with the regulatory and commercial risks involved;*
- (iii) generate revenue from each service that at least covers the directly attributable or incremental costs of providing the service.*

*(b) that the access price structures should:*

- (i) allow multi-part pricing and price discrimination when it aids efficiency;*
- (ii) not allow a vertically integrated access provider to set terms and conditions that discriminate in favour of downstream operations, except to the extent that the cost of providing access to other operators is higher.*

*(c) that access pricing regimes should provide incentives to reduce costs or otherwise improve productivity.*

In its response to the Part IIIA review, the Government modified some of the principle’s in order to reduce the explicit focus on costs and the potential that this might lead to increased intrusive and complex regulation.

DEI accepts that the pricing principles proposed (by both the Commission and the Government) would be broadly appropriate for a regulatory model focussed on price setting through a building blocks framework. However, DEI does not believe that the suite of pricing principles proposed is appropriate for a negotiate-arbitrate model.

Rather, DEI believes that pricing principles should be more reflective of characteristics specific to the gas transmission market. Therefore, the appropriate set of pricing principles is likely to be a mix of industry-specific factors and general pricing principles relevant to any access regime. DEI believes that the arbitrator should be guided by the following pricing principles:

- Foundation contracts to set a floor for an arbitrators decision;

- Guidance should be taken from any current negotiated contracts and arbitrated decisions;
- Arbitrator to be bound by the principle of financial capital maintenance;
- Recognition of efficient investment incentives; and
- Adherence to the concept of workably competitive markets.

### **9.1 Foundations Contracts**

A pipeline is essentially constructed on the basis of one or more foundation contracts. All pipelines are contestable at the development stage, so the transmission pipeline company is devoid of market power at the time the foundation contracts are negotiated. If the proposed tariff is set above the market price, the user can seek an alternative company to construct the pipeline. Therefore, the foundation contract price (where such contracts have been entered into at arm's length) represents an appropriate, commercially-negotiated and market based price that will provide a minimum price to the arbitrator. In order to ensure the arbitration process does not undermine foundation contracts, subsequent access seekers must not be awarded a price below the price specified in the foundation contracts.

Where there are multiple foundation contracts, the highest (arms length) price would set the minimum level.

### **9.2 Previously Negotiated Contracts**

Any negotiated contracts that have been entered into since the foundation contracts were established would serve as a guide to the arbitrator, since the applicable contract price represents a commercially negotiated and agreed outcome.

### **9.3 Previous Arbitration Decisions**

The arbitration process would pay due regard to prices set in any previous arbitration decision.

### **9.4 Financial Capital Maintenance**

An investor will not invest in a firm if it could not expect to recover the amount invested. This "financial capital maintenance" principal is a critical driver of a firm's investment decisions. Therefore, the arbitrator must be guided by a firm's reasonable expectation that the full value of investments will be recouped and expenditure undertaken by the regulated business will be recovered.

### **9.5 Efficient Investments Decisions**

One of the key objectives of regulation is to promote the economically efficient use of, and investment in, essential infrastructure services. In addressing the balance between these potentially conflicting objectives, the effect of not achieving each objective needs to be considered.

If the arbitrator sets prices above efficient costs, supply will be restricted below the socially-optimal level. If prices are set below marginal costs, the regulated firm will no longer provide the service, resulting in large overall losses for both consumers and the firm. However, if prices are set to a level where only efficient short run costs are covered, customers may gain from short term price cuts but in the longer term, there may be reliability concerns as insufficient upgrades of infrastructure can occur. In addition, there will be greater congestion as demand expands, which will be facilitated by the discounting resulting from the regulatory process. Firms will have no incentive to expand facilities and develop new projects – this will stifle investment.

Therefore, at the margin, the effect on social welfare of setting access prices too low is considerable greater than if access prices are set too high. This gives rise to the asymmetric consequence of regulatory error, where the allocative efficiency loss resulting from customers paying too much in the short term is far outweighed by the loss of dynamic efficiency resulting from a lack of adequate facility expansion and new development.

One of the fundamental concerns with the application of the current Code has been the failure of regulators to adequately address the balance between the short term interests of users and the need for longer term investment in gas infrastructure. This may be brought about in part by the complex set of accountability relationships governing the activities of regulators. Therefore, there is merit in including a pricing principle that addresses this issue.

DEI believes that this can be addressed by adopting a pricing principle along the lines of the following principle, proposed by the Commission in recommendation 12.1 of the Review of the National Access Regime, which states:

*“include a rate of return on investment commensurate with the regulatory and commercial risks involved.”*

## **9.6 Workably Competitive Markets**

The primary rationale for regulation is to act as proxy for competition in the marketplace, in situations where a bottleneck facility has the ability and incentive to misuse its market power. However, the pricing methodology in the current Code is largely predicated on replicating the theoretical concept of “perfect competition”, as opposed to the concept of “workable competition”. In practice, perfect competition can be viewed as being an unrealistic assumption.

The recent Epic Energy decision set a precedent for establishing workable competition as the appropriate competitive benchmark for regulatory purposes. The Court found that<sup>17</sup>

*As such, a workably competitive market will react over time and according to the nature and degree of various forces that are happening within the market. There may well be a degree of tolerance of changing pressures or unusual circumstances before there is a market reaction. The expert evidence and writings tendered in evidence suggest that a workably competitive market may well tolerate a degree of market power, even over a prolonged period. The underlying theory and expectation of economists, however, is that with workable competition market forces will increase efficiency beyond that which could be achieved in a non-competitive market, although not necessarily achieving theoretically ideal efficiency.*

The concept of a workably competitive market should therefore be a guiding principle for the arbitrator.

## **9.7 Recommendations**

### **Recommendation 9.1**

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<sup>17</sup> Re Dr Ken Michael AM; ex parte Epic Energy (WA) Nominees Pty Ltd & Anor [2002] WASCA 231, at para 128.

**The arbitration panel in the proposed negotiate-arbitrate model for transmission pipelines shall base its decisions on the following pricing principles:**

- **foundation contracts set minimum price;**
- **existing contracts provide guidance;**
- **ensure consistency with previous arbitration decisions;**
- **financial capital maintenance must be preserved;**
- **provide efficient investment incentives; and**
- **guided by the concept of workably competitive markets.**

## **10 Facilitating New Investment**

The arguments for applying economic regulation to new transmission pipelines are considerably weak. This is illustrated by the following characteristics of typical new pipelines:

- transmission pipelines are built in response to new market opportunities;
- transmission pipelines are fully contestable at the development stage, therefore, pipeline companies possess no market power at the time contracts are agreed with foundation customers;
- pipeline companies will have a significant financial incentive to fill spare capacity, in order to assist in the recovery of large capital construction costs;
- there is a low likelihood transmission pipelines will fill all available capacity in the early years of an investment, therefore pipeline companies are unlikely to possess market power during this period;
- the market for the services of transmission gas pipelines consists of a small number of large users with significant countervailing market power; and
- transmission pipelines are the backbone to developing new gas markets and encouraging basin on basin competition - if the regulatory process has a chilling effect on transmission investment, there will be wider implications for the development of Australia's natural gas market.

A number of recent reports and various Ministerial statements suggest that the adverse impact of regulation on investment incentives is widely acknowledged. The Commission's report on the Review of the National Access Regime and the subsequent Parer Report acknowledged this and proposed a number of options to facilitate new investment.

Although DEI supports the introduction of new measures to promote greenfields investments, it is important to be mindful of the fact that there is significantly more investment tied up in existing pipelines than being allocated to new investment projects. Therefore, the introduction of greenfields measures alone will not alleviate all industry concerns regarding the uncertainty and regulatory risk arising from the current gas access regime.

DEI's key first-order preferred outcomes from the Review of the Gas Access Regime are ensuring the coverage test is strengthened and the introduction of an enhanced negotiate-arbitrate model based on a set of clear pricing principles. Indeed, addressing these issues in isolation, even in the absence of specific proposals to address greenfield investments (although DEI believes such measures would be useful), would greatly assist in alleviating investor uncertainty.

The main measures to facilitate new investment proposed by the Commission in the Review of the National Access Regime and the Parer Report are discussed below.

## **10.1 Regulatory Free Periods**

Under an access holiday proposal, or as DEI prefers to call it, a regulatory free period, a transmission pipeline would not be subject to price regulation for a specified period of time.

### **10.1.1 Application**

DEI believes that the regulatory free period should automatically apply to all new greenfield transmission pipelines. This would have the maximum effect as it would remove regulatory uncertainty for the length of the regulatory free period.

### **10.1.2 Length of Regulatory Free Period**

DEI believes that the length of the regulatory free period should be a fixed period of 20 years.

DEI notes, that the Parer Report made the observation that the length of the regulation free period should be sufficient to allow a company to earn a reasonable rate of return on its investment. The Parer Report ultimately recommended a 15-year price regulation free period.

Energy infrastructure projects have long effective lives. In DEI's experience, the period of time before a new gas pipeline reaches an acceptable rate of return is generally in the order of 20 to 25 years. On this basis, a regulatory free period of 15 years would be an absolute lower limit of acceptability from an investment point of view. DEI believes that the regulation free period should be extended to at least 20 years in order to minimise the potential of marginally profitable pipeline projects not proceeding due to any residual regulatory risk.

DEI also makes the observation that a regulatory free period of 20 years is consistent with the Commonwealth Government's statutory effective life caps for depreciation purposes in relation to the taxation treatment of pipelines.

Given that it may take at least 15 years to earn a profit from the investment, if the regulatory free period was set to 15 years and a pipeline became covered after this time, the profits necessary to offset negative returns in the early years would fall outside the regulatory free period. These profits would therefore be subject to a "regulatory truncation" under the current price setting mechanism in the Code, where returns are capped at levels that are deemed to be economically efficient by the regulator.

Although regulation truncation would still exist for a pipeline covered after a 20-year regulatory free period, a 20-year period is more in keeping with the typical investment horizon of a pipeline, and would allow a greater ability to recover earlier losses, than a 15-year period.

Although the justification for a 20 year regulatory free period is based on a timeline of expected returns for an average pipeline, DEI believes that it is better to specify a fixed period rather than determine the optimal length of the regulatory free period on a case by case basis. DEI believes if the latter approach were adopted, the regulator would have too much discretion in the process and determinations of the optimal regulatory free period length would be too subjective. This process of determining the optimal length of the regulatory free period could take a considerable amount of time, adding to uncertainty and possibly leading to project delays.

### 10.1.3 Treatment at End of Regulatory Free Period

DEI believes that at the end of the 20 year regulatory free period, the pipeline should remain unregulated until a bona fide user submits a successful coverage application.

This is likely to be the only feasible option. It would be counter-intuitive to assume that a pipeline would be automatically covered at the end of the regulatory free period, as greenfields pipelines are unlikely to satisfy the coverage criteria. Furthermore, it would be inappropriate to apply mandatory coverage to a pipeline in 20 years time, when the regulatory framework and market conditions would be unknown.

The Parer Report suggests that, at the end of the regulatory free period period, an assessment would be made of whether the pipeline company is exercising market power in its negotiations with customers. To the extent that this suggests an alternative test other than the coverage test under the Code, DEI notes that the current criteria (a) of the coverage test implicitly involves an assessment of abuse of market power.

DEI also believes that issues such as the appropriate methodology to determine asset valuations in the event of coverage after the regulatory free period expires (ie whether or not to use DORC etc) would not be so relevant under the proposed negotiate-arbitrate model of price setting for covered transmission pipelines.

### 10.1.4 The Need for Mandatory Minimum Requirements

Minimum requirements to provide open access, publish tariff information and allow capacity trading should be a mandatory requirement for pipelines wishing to operate in an unregulated environment. Such minimum requirements provide a framework consistent with the development of “free and fair trade” in natural gas - the cornerstone of the Council of Australian Governments’ 1995 agreement to the general principles of competition policy reform. This approach is also consistent with DEI’s Non-Discriminatory Access Policy (NDAP).

The pipeline industry is currently in the process of developing an Industry Code of Conduct. DEI believes that this will provide sufficient constraints on pipeliners’ activities during the regulatory free period to prevent the need for further ongoing regulatory assessments of compliance in order to maintain the regulatory free period.

## **10.2 Binding Up--Front Coverage Ruling**

In the absence of regulatory free periods, DEI would support the introduction of binding up-front coverage rulings from the relevant regulator, provided that the rulings are for the life of the asset. However, DEI notes that the process of obtaining a binding ruling, which is likely to include public consultation and the possibility of an appeal, may be costly and would almost certainly introduce delays in the development of the pipeline project, to the detriment of the future development of the market. Once a binding ruling has been obtained, this option would result in greater certainty (as it lasts the life of the asset) compared to a regulatory free period.

## **10.3 Up-front Determination of Key Regulatory Parameters**

This option would not be relevant under the negotiate-arbitrate model proposed for transmission pipelines.

#### **10.4 Sharing of Profits and Higher Returns for Greenfields Investments**

DEI believes that these options give rise to significant regulatory discretion, and therefore these options would not be useful in minimising regulatory uncertainty. In any event, these options would not be relevant under the negotiate-arbitrate model proposed for transmission pipelines.

#### **10.5 Primacy of State Agreements**

An important source of regulatory risk that has emerged in recent times has been the reluctance of regulators to take appropriate account of agreements entered into by governments with businesses. A recent example of this is the NCC in its final recommendation dated November 2002 where it found that the Queensland Access Regime is not an effective regime under the *Trade Practices Act* due to the presence of certain derogations. This is in spite of the fact that these derogations were agreed to by all CoAG signatories to the Natural Gas Pipelines Access Agreement (1997) as being transitional in nature. It was considered that it was in the public interest that these transitional provisions be included, as the pipeline to which the derogations apply will eventually be covered by all aspects of the Code. In this case, it is clear that the NCC is operating in direct contradiction of the expressed wishes of all governments.

A similar problem has arisen in Western Australia where there has been a lack of recognition of historical agreements between government and business. In that case, the joint venture partners of the Goldfields Gas Pipeline entered into an agreement with the Western Australian government. Under that agreement, the joint ventures believed certain obligations would be met. However, ultimately the state Regulator entirely disregarded the State Agreement.

Where a pipeline enters into an agreement with a government under a certain understanding, it should not be permissible that that understanding be overridden at a latter date by an independent regulator. This is one aspect of the Australian regulatory environment which is having a significant impact on investors willingness to invest.

#### **10.6 Recommendations**

##### Recommendation 10.1

**DEI believes that there is merit in introducing regulatory free periods as part of a suite of changes to the current Code in order to promote investment incentives for pipeliners.**

**The preferred regulatory free period model would possess the following attributes:**

- **it would automatically apply to all new greenfields pipeline developments;**
- **regulatory free period would be for a fixed period of 20 years;**
- **At the end of the 20 year period, the pipeline would remain unregulated until a bona fide access seeker lodged a coverage application;**

**Pipeliners are in the process of developing an Industry Code of Conduct – this will provide sufficient constraints on pipeliners’ activities during the regulatory free period to prevent the need for further ongoing regulatory assessments of compliance in order to maintain the regulatory free period.**

##### Recommendation 10.2

**In the absence of access holidays, DEI supports the introduction of binding up front coverage decisions on the proviso that the decision lasts for the life of the pipeline asset.**