PRODUCTIVITY COMMISSION

REVIEW OF THE GAS ACCESS REGIME

SUBMISSION IN RESPONSE TO DRAFT REPORT

SUBMISSION PDRS#1

MARCH 2004

Epic Energy Corporate
Shared Services Pty Limited
ABN 76 069 799 588
Level 7, 239 Adelaide Terrace
Perth WA 6000
CONTACT: Anthony Cribb
TELEPHONE: 9492 3803

1. Executive summary

1.1 On 15 December 2003, the Productivity Commission ("Commission") issued a draft report on its review of the Gas Access Regime ("Draft Report").

1.2 The Draft Report:

- contains a number of findings and recommendations to change the Gas Access Regime;
- seeks comment on those findings and recommendations; and
- requests further information in respect of certain issues.

1.3 It must be noted that since the Draft Report was prepared, there have been 2 decisions of the Australian Competition Tribunal[1] which should be reviewed in detail by the Commission as they contain important findings on a number of aspects of both the Gas Access Regime and its application by Regulators which are relevant to the Commissions draft findings and recommendations as set out in the Draft Report. Epic Energy also submits that these decisions provide further support for the recommendations being made in this submission.

1.4 Key conclusions to be drawn from these decisions are:

- It is not the task of the Regulator to determine values for parameters of an access arrangement which it thinks are consistent with the Code. Rather, its role is to assess whether the values proposed by the Service Provider are consistent with the Code and fall within a range of values that are reasonable.
- The regulatory approval process for assessing an access arrangement is, by its very nature, a high level planning exercise that will derive values for key parameters that can not be quantified with any significant degree of certainty. As a result, it is a highly risky commercial action to take the lowest figure found in any such exercise. It exposes the service provider to an asymmetric risk whereby the likelihood of underestimating the true actual value of particular parameters is much greater than the risk of serious commercial understatement of the expected value.
- Regulators of transmission pipelines have however, been acting unreasonably in all the circumstances by misapplying their statutory function falling beyond the boundaries of what a prudent commercial operator would be expected to do, thus adversely affecting a service provider's legitimate business interests.

[1] Decision dated 10 December 2003 in relation to the application by Epic Energy South Australia Pty Ltd concerning the MAPS access arrangement and Decision dated 18 December 2003 in relation to the application by GasNet Australia Operations Pty Ltd concerning the Victorian Principal Transmission System access arrangement.

1.5 In this submission, having regard to both the reasoning contained in the Draft Report and the recent decisions of the Australian Competition Tribunal, Epic Energy:

- comments on specific findings and recommendations; and
- provides further information on some of the issues of concern to the Commission.

1.6 Given its current circumstances, Epic Energy has been unable to fully develop all of its views on the Draft Report in this submission. Epic Energy will endeavour to provide further submissions in respect of some of the more mechanical aspects of the Draft Recommendations and, in particular, on those relating to the access arrangement (or Tier 2) tranche of regulation.

1.7 However, in the meantime, Epic Energy specifically endorses the following of the Commission's draft findings without providing any additional submissions:

2.1, 3.1, 4.3, 4.4, 4.5, 4.6, 6.9, 7.5, 7.6, 9.1, 9.2, 9.8, 11.1 & 12.4

1.8 Furthermore, it should be noted that Epic Energy was involved in the preparation of the submission prepared by the Australian Pipeline Industry Association. Accordingly, Epic Energy seeks to rely on the APIA submission setting out its views on those parts of the Draft Report which are not expressly dealt with in this submission.

1.9 As a final introductory matter, it is noted that the review of the Gas Access Regime is proceeding at the same time as significant changes are occurring in the ownership of Australian gas pipeline businesses. A major factor driving these ownership changes is inappropriate application of the current regulatory regime. In these circumstances, Epic Energy urges the Commission to ensure that the recommendations of its final report are unambiguous, and are accompanied by clear guidelines for the implementation and subsequent application. This is particularly important given the process, outlined by the Ministerial Council on Energy, that is to be followed before any changes are to be made to the Gas Access Regime.

1.10 If the Commission recommends changes to the Gas Access Regime, there must be limited scope for subsequent misinterpretation of its intentions by policy makers (in particular, by the Ministerial Council on Energy), and by regulators with responsibility for application of an amended access regime.

1.11 Epic Energy would welcome further discussion on any aspect of this submission with the Commission.

2. Response to section 5 of Draft Report – Objectives

2.1 The Commission proposes to better specify the objectives of the Gas Access Regime, with a view to enhancing its effectiveness, by:

- inserting an overarching objects clause (Draft Recommendation 5.1);
- removing the general statement of objectives in the preamble to the *National Third Party Access Code for Natural Gas Pipeline Systems* ("Code") (Draft Recommendation 5.2); and
- deleting five of the seven factors a regulator must take into account in approving an access arrangement in accordance with section 2.24 of the Code (Draft Recommendation 5.3).

2.2 The Commission's Draft Recommendations are:

Draft Recommendation 5.1

The following overarching objects clause should be inserted into the Gas Access Regime:

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

Draft Recommendation 5.2

With the implementation of draft recommendation 5.1, the following objectives in the preamble to the existing legislation and the related objectives in the introduction to the Gas Code should be deleted:

(a) Facilitates the development and operation of a national market for natural gas

(b) Prevents abuse of market power

(c) Promotes a competitive market for natural gas in which customers may choose suppliers, including producers, retailers and traders

(d) Provides for rights of access to natural gas pipelines on conditions that are fair and reasonable for the owners and operators of gas transmission and distribution pipelines and persons wishing to use the services of those pipelines

(e) Provides for the resolution of disputes.

Draft Recommendation 5.3

The following elements of s. 2.24 of the Gas Code should be deleted:

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

(d) the economically efficient operation of the Covered Pipeline

(e) the public interest, including the public interest in having competition in markets

> *(whether or not in Australia)*
>
> *(f) the interests of Users and Prospective Users*
>
> (g) *any other matters that the Relevant Regulator considers are relevant.*

2.3 Epic Energy is generally supportive of proposals to better specify the Gas Access Regime. However, unless the Commission's final report provides policy makers (in particular, the Ministerial Council on Energy) with clear guidance on the way in which the proposed objects clause is to be implemented, and provides regulators with guidance on the way in which it is to be applied, Epic Energy would be concerned that Draft Recommendations 5.1, 5.2 and 5.3 will have the effect of:

- fundamentally changing the nature of the Gas Access Regime in a way which, Epic Energy believes, would not have been acceptable to pipeline service providers at the time the Code was drafted, and which is not acceptable to pipeline service providers at the present time; and
- making the objectives of the Gas Access Regime less clear, and even more amenable to arbitrary interpretation, particularly by regulators.

Fundamentally changing the Gas Access Regime

2.4 Epic Energy notes that the Commission's stated reason for its making Draft Recommendations 5.1, 5.2 and 5.3 is the claim by stakeholders, and in particular by regulators, that regulators have difficulty in applying the Gas Access Regime. Regulators claim that this difficulty arises from the wide ranging discretion they are given under the Code. They claim that their exercise of this discretion must be undertaken having regard to a large number of diverse and often conflicting objectives, factors and considerations.

2.5 Epic Energy submits that the difficulties the regulators face in applying the Gas Access Regime do not arise from the diverse and conflicting objectives, factors and considerations they must take into account. Rather, they arise from regulator misconceptions about the role they have under access arrangement approval process under the Code. As has been borne out in recent decisions of the Australian Competition Tribunal in relation to decisions by the Australian Competition and Consumer Commission ("ACCC"), and by the decision of the Supreme Court of Western Australia in the *Epic Energy Case*[2], regulators have fundamentally misconstrued their statutory role when assessing the access arrangements of pipeline service providers. This issue will be expanded on later in this submission (see response to section 7 of the Draft Report).

2.6 The way in which section 2.24 of the Code establishes the role of the regulator is fundamentally important. Section 2.24 gives effect to the general framework for access regulation established by the Hilmer Committee, and by the Commonwealth Government, and the Governments of the States and the Territories, as parties to *the*

[2] *Re Dr Ken Michael AM; Ex Parte Epic Energy (WA) Nominees Pty Ltd & Anor [2002] WASCA 231.*

Competition Principles Agreement and the *Natural Gas Pipelines Access Agreement*. To dispose of the section 2.24 factors, as proposed in Draft Recommendation 5.3, will risk creation of a Gas Access Regime that no longer gives recognition to factors that are fundamental to the National Competition Policy reforms of which that Regime is, supposedly, and integral part.

2.7 Furthermore, it creates a real risk that the access regime is not an effective access regime. This will be discussed in more detail in the chapter of this submission that responds to section 7 of the Draft Report, but in summary this occurs because the reference tariffs that are established as part of an approved access arrangement are binding on an arbitrator. Pursuant to the effectiveness test contained in the Competition Principles Agreement, an access regime must require an arbitrator to have regard to a range of factors substantially similar to those factors contained in section 2.24 of the Code. So if the section 2.24 factors are removed but the reference tariffs are binding on an arbitrator, serious doubt must exist about the effectiveness of such an access regime.

National Competition Policy

2.8 As part of its wide-ranging review of matters which impacted on the competitiveness of the Australian economy, the Hilmer Committee drew attention to the "essential facilities" problem.[3] In markets critical to the further growth of the national economy – in particular, in markets for energy – competition could not be expected to develop unless competitors had access to certain facilities which could not be economically duplicated. These facilities – essential facilities – had natural monopoly characteristics, and public policy was required to ensure that this monopoly was not exploited to the detriment of users and the economy as a whole.

2.9 A new legal regime, under which prospective users would be granted rights of access to these essential facilities if the granting of such rights satisfied certain public interest criteria, was proposed by the Hilmer Committee. The Committee was well aware of the fact that many of the facilities for which access rights would be required were publicly owned. Governments, however, were proposing to privatise the enterprises that owned these facilities, and any attenuation of private property rights in the public interest needed to be carefully considered:

> "*The Committee is conscious of the need to carefully limit the circumstances in which one business is required by law to make its facilities available to another. Failure to provide appropriate protection to the owners of such facilities has the potential to undermine incentives for investment.*"[4]

2.10 Any restriction of private property rights in the of granting access to essential facilities to serve the public interest was, in the opinion of the Hilmer Committee, a complex matter which should be one for Government, rather than a court, tribunal or other unelected body. Access rights should only be created by Ministerial declaration under

[3] *National Competition Policy*, Report by the Independent Committee of Inquiry, August 1993, page 240.
[4] Ibid.

legislation, and a Minister should make a declaration of access to an essential facility only if:

- access was essential to permit effective competition in a downstream or upstream activity;
- a declaration of access was in the public interest having regard to the significance of the industry in the national economy, and the impact of effective competition in that industry on national competitiveness;
- the legitimate interests of the owner of the facility were protected through the imposition of an access fee and other terms and conditions that were fair and reasonable; and
- the creation of access rights was recommended by an independent and expert body.[5]

2.11 The Hilmer Committee proposed that rights of access to an essential facility be created in the public interest only if the legitimate business interests of the facility owner were protected through fair and reasonable access prices, and other appropriate terms and conditions. In the Committee's view, neither economic theory, nor general notions of fairness, could provide clear guidance on access prices.[6] A balancing of interests was required. Facility owners had an interest in receiving a high price for access, including the monopoly rents that were available. Prospective shippers had an interest in paying a low price. Low access prices may contribute to an efficient allocation of resources in the short term, but weakened the facility owners' incentives for innovation, investment and cost reduction. Policy judgements were required as to how best to implement an access pricing regime which permitted flexible response to the specific circumstances of particular industries and facilities, and to changes in industry conditions over time.[7]

2.12 One approach was to leave access pricing to an independent regulator, provided with some general guidelines as to the factors to be taken into account in balancing the relevant interests.[8] Another was to require Ministers to stipulate pricing principles in declaring rights of access to particular facilities. Once the principles were established by a Minister, a facility owner and prospective users would be free to negotiate access terms and conditions, including price. If agreement could not be reached on the price of access, either party could call for binding arbitration in accordance with the access principles established by the Minister.[9]

2.13 The Hilmer Committee favoured the second of these two approaches to access pricing, arguing that policy in respect of pricing would be made by an elected representative, and that once principles were in place the parties would have greater

[5] Ibid, pages 250 – 252.
[6] Ibid, page 253.
[7] Ibid, pages 254 – 255.
[8] Ibid, page255.
[9] Ibid.

certainty over their rights and obligations. Furthermore, this second approach would be less interventionist than leaving pricing to an independent regulator, and should facilitate the evolution of more market oriented outcomes over time.[10]

2.14 Ministerial declaration of access, with each access declaration specifying principles that would provide for fair and reasonable access prices, and with provision for binding arbitration in the event of the parties' failure to reach agreement, were key elements of the Hilmer Committee's recommendations in respect of the "problem of essential facilities".[11] They were subsequently adopted as principles of competition policy in the *Competition Principles Agreement* signed by the Commonwealth Government, and by the governments of the States and the Territories on 11 April 1995.

2.15 Under the *Competition Principles Agreement*, the Commonwealth was to put forward legislation to establish a regime of third party access to services provided by significant infrastructure facilities.

2.16 The Commonwealth regime was not to cover services provided by facilities subject to State or Territory access regimes which conformed to the access principles of the Agreement. Those principles were:

- the State or Territory access regime applied to services provided by means of significant infrastructure facilities where:
  - it would not be economically feasible to duplicate the facility;
  - access to the service was necessary in order to permit effective competition in a downstream or upstream market; and
  - the safe use of a facility by the person seeking access can be ensured at an economically feasible cost and, if there is a safety requirement, appropriate regulatory arrangements exist;
- third party access to services provided by a facility should be on the basis of terms and conditions agreed between the owner of the facility and the person seeking access;
- a right to negotiate access to the service, to be exercised in the event of agreement not being reached, should be established by government; and any right to negotiate should provide for an enforcement process;
- the owner of a facility that is used to provide a service should use all reasonable endeavours to accommodate the requirements of persons seeking access; and different persons need not be provided with access to a service on exactly the same terms and conditions;

[10] Ibid.
[11] Ibid, pages 266 – 267.

- where the owner of the facility and a prospective user cannot agree on terms and conditions for access, they should appoint and fund an independent body to resolve the dispute;
- the decisions of the dispute resolution body should bind the parties;
- in deciding on the terms and conditions for access, the dispute resolution body should take into account:
  - the owner's legitimate business interests and investment in the facility;
  - the costs to the owner of providing access;
  - the economic value to the owner of any additional investment that the owner or prospective user has agreed to undertake;
  - the interests of persons with contracts for use of the facility;
  - the firm and binding contractual obligations of the owner or of other persons already using the facility;
  - requirements for safe and reliable operation of the facility;
  - the economically efficient operation of the facility; and
  - the benefit to the public from having competition in markets; and
- the owner may be required to extend, or to permit extension of, the facility that is used to provide a service if necessary but this would be subject to:
  - extension being technically and economically feasible consistent with the safe and reliable operation of the facility;
  - the owner's legitimate business interests in the facility being protected; and
  - the terms of access taking into account the costs borne by the parties for the extension and the economic benefits to the parties resulting from the extension.

2.17 These principles established a general framework for access to essential facilities. The Commonwealth Government, and the Governments of the States and Territories intended that they be given effect in the specific context of access to gas pipeline systems, and their intentions were formally recorded in the *Natural Gas Pipelines Access Agreement* (signed by the Governments on 7 November 1997).

2.18 Recital B of the *Natural Gas Pipelines Access Agreement* is critically important:

"*The Parties, after consultation with industry and gas users, have agreed that certain principles are to apply to access negotiations and that there will be a National Third*

Party Access Code for Natural Gas Pipeline Systems. This Access Code is intended to comply with the requirements of the Competition Principles Agreement."

2.19 In accordance with clause 2.1 of the *Natural Gas Pipelines Access Agreement*, Code was to:

- facilitate the development and operation of a national market for natural gas;
- prevent the abuse of monopoly power;
- promote a competitive market for natural gas in which customers may choose suppliers, including producers, retailers and traders;
- provide rights of access to natural gas pipelines on conditions that are fair and reasonable for both service providers and users; and
- provide for resolution of disputes.

2.20 A consistent view of access regulation flows through the work of the Hilmer Committee, the *Competition Principles Agreement*, and the *Natural Gas Pipelines Access Agreement*:

- public policy must provide for rights of third party access to the services of monopoly infrastructure facilities so as to permit effective competition in downstream and upstream activities;
- with this right established, the owner of a facility and a prospective user are to be free to negotiate access to service provided using the facility;
- provision is to be made for a process for dispute resolution, with outcomes binding on the parties, in the event of access negotiations not leading to agreement; and
- in deciding on terms and conditions for access, a dispute resolution body should take into account, among other things, the facility owner's legitimate business interests and investment in the facility were protected through fair and reasonable access prices, and other appropriate terms and conditions.

2.21 As Recital B to the *Natural Gas Pipelines Access Agreement* makes clear, this view was to be reflected in the Code through the Code giving effect to the access principles of the *Competition Principles Agreement*.

2.22 From the work of the Hilmer Committee, and through the *Competition Principles Agreement* and the *Natural Gas Pipelines Access Agreement*, a scheme of access was established within which the policy requirements of government, and the interests of pipeline service providers and pipeline users, could be accommodated and reconciled. Government established the legal framework which created rights of access to natural gas pipeline systems. Within this framework, service providers and users were to be free to negotiate the terms and conditions of pipeline access, with a defined process of arbitration being available in the event of negotiations not leading to agreement.

In effect, a scheme of access was established within which there would be a balancing of the interests of pipeline service providers and pipeline users within a legal framework created by government.

2.23 As Recital B to the *Natural Gas Pipelines Access Agreement* makes clear a scheme of access within which there would be a balancing of the interests of pipeline service providers and pipeline users was adopted after consultation with those service providers and those users.

2.24 This was endorsed by the WA Supreme Court in the *Epic Energy Case*, where the Court concluded that the access regime had political, social and public interest dimensions which must be accommodated by Regulators in making decisions under that Regime.[12]

2.25 In their application of the Code, the regulators have misconstrued the original intent of the Hilmer Committee, of the parties to the *Competition Principles Agree*ment and the *Natural Gas Pipelines Access Agreement*, and of the pipeline industry and gas users. Requirements to take into account the costs of service provision, existing obligations to other parties, safety and reliability, economically efficient facility operation, and benefit to the public, within the broader context of a negotiate-arbitrate approach to establishing access terms and conditions, have become the foundations of a non-commercial and highly intrusive approach to access regulation.

2.26 In practice, the commercially focused negotiate-arbitrate approach to establishing access terms and conditions has been replaced with an intrusive regulator-centred approach in which concern has shifted from market-oriented outcomes, to a narrow focus on market power and the elimination of monopoly rents. Commercial negotiation between business entities, supported by the statutory framework necessary to ensure rights of access, and to provide for binding arbitration in the event of access disputes, has been "watered down" in favour of control of access driven by a static and simplistic economic theory of monopoly pricing.[13]

2.27 In the implementation of the Code, the Hilmer Committee's view of "light-handed regulation", a view acceptable to many owners of infrastructure facilities who expected that it would form a key element of a uniform national framework for access to pipeline systems, has been abandoned. Although elements of a light-handed regulatory scheme may still be discerned, in their application of the Code regulators have adopted a narrow focus on economic efficiency. There is no longer much concern with the difficult issue of balancing the interests of pipeline owners and prospective users so as to secure the best long term outcomes for both.

2.28 Were the Commission's Draft Recommendations 5.1, 5.2 and 5.3 to implemented as recommendations of its final report, without a clear statement of what these recommendations were intended to reflect, there is a significant risk that the original intent of the Hilmer Committee, and of the parties to *the Competition Principles*

[12] Epic Energy Case, para 178

[13] Although section 2.50 of the Code seeks to preserve the prominence of negotiated outcomes, as is demonstrated later in this submission, the practical effect of the Code is that there is a reluctance to negotiate outside the regulatory framework.

Agreement and the *Natural Gas Pipelines Access Agreement* could be subverted. This subversion of an approach to third party access which was accepted by pipeline service providers, and by users of the services they provide, may occur either during the deliberations of the Ministerial Council on Energy on changes to the Gas Access Regime, or in the subsequent application of an amended Gas Access Regime by regulators. In particular, without clarification of the original intent, there is a major risk that a narrow and technical concept of economic efficiency will become the primary objective of the Gas Access Regime, in place of the original intention of a balancing of the interests of service providers and users within a legal framework created by government.

2.29 This is particularly of concern given the deliberations of the WA Supreme Court in the *Epic Energy Case*, which investigated whether such terms as "economic efficiency" had a uniform and accepted meaning. There the court concluded that they do not have such a meaning. Furthermore, the court concluded that while these terms are in common use in the field of economics which is concerned with regulation of essential infrastructure, there is only a principle or theory which, although the essential tenets of which are widely understood, there is no uniform acceptance of them:

"While the evidence does not establish that particular terms in issue had uniform accepted and certain meanings, it does establish that some words or phrases used in the Act and the Code are in common use in that field of economics which is concerned with competition policy or more particularly with the regulation of essential infrastructure. In this context the words or phrases convey a meaning to those familiar with this field of economics which differs from that which the words themselves suggest in ordinary everyday usage. As the subject matter is by nature conceptual, there is no uniform accepted and certain meaning but there is a principle or theory, the essential tenets of which are widely understood, though there need not be uniform acceptance of them."[14]

2.30 When the objectives of section 2.24 have been ignored, as was the practice of at least the WA regulator before the decision of the Supreme Court of Western Australia in the *Epic Energy Case*, specific concern for the interests of service providers and users, within the policy framework established by government, was replaced with a focus on economic efficiency.[15] As the findings of the Court made clear, economic efficiency did not provide regulators with an unambiguous guide to the application of access regulation. Regulator focus on efficiency – to be precise, on the achievement of least cost outcomes – resulted in failure to reflect a public interest broader than the mere understanding and application of economic theory by taking account of wider political and social considerations.

Making the objectives less clear and more amenable to arbitrary interpretation

2.31 Without qualification and clarification, economic efficiency is an abstract concept. A focus on economic efficiency has removed the practice of regulation from the real

[14] *Re Dr Ken Michael AM; Ex Parte Epic Energy (WA) Nominees Pty Ltd & Anor [2002] WASCA 231*
[15] ibid

world, the world in which pipeline service providers must operate to satisfy their customers, shareholders and other stakeholders. The practice of regulation has been removed to a hypothetical world which bears no relation to the world in which pipeline businesses must operate. Asset values are established by reference to hypothetical pipelines, sometimes facing hypothetical competitive entry. Extreme views are taken: economic efficiency demands that a hypothetical pipeline be built using the lowest cost pipe, even though a real pipeline operator would consider a range of factors, including price, in making a decision to purchase pipe.[16] Rates of return are established by reference to imprecise theoretical models, and hypothetical values are adopted for key parameters (for example, the capital structure of the business). No reference is made to actual asset values, or to the actual rates of return sought by those who finance investment in pipelines. Furthermore, forecast capital and operating expenditures are determined by reference to "efficient" levels set with little or no reference to the specific circumstances in which these expenditures must be made. They are determined using high level desk top methodologies which, as the Australian Competition Tribunal has recognised, are subject to a high risk of regulatory error and run the risk of seriously impacting on the legitimate business interests and investments of service providers.

2.32 There is a major risk that, without proper guidance on the historical intent of National Competition Policy reform, an overarching objective of economic efficiency will be interpreted from the perspective of a tightly specified theoretical model of perfectly competitive markets. That model does not deal with the "actual conditions of competition in any industry". Nor does it apply to "real-life commercial situations". These were findings of the Supreme Court of Western Australia in *Epic Energy*:

"The expert evidence before the Court identified four distinct notions or usages of competition - free competition, perfect competition, contestability and workable competition. Of these, only perfect competition and workable competition are said to be in current economic usage. Perfect competition is a concept said to be still used in economic analysis, but it is a theoretical concept which is not met in the actual conditions of competition in any industry. Workable competition is said originally to have been developed over half a century ago by anti-trust economists. In simple terms it indicates a market in which no firm has a substantial degree of market power. While the evidence of the three witnesses differed in some respects, I am left with the clear impression that in the field of competition policy, especially market regulation, the prevailing view and usage among economists is that a reference to a competitive market is to a workably competitive market. In the particular context of the promotion of a competitive market for natural gas it would be surprising if what was contemplated was a theoretical concept of perfect competition, as the subject matter involves very real-life commercial situations. Workable competition seems far more obviously to be what is contemplated. This is clearly consistent with the approach of the Hilmer Report and is the notion of competition that was explored in the Queensland Cooperative Milling Association Ltd case quoted above."[17]

[16] See *Application by Epic Energy South Australia Pty Ltd [2003] ACompT5*.

[17] *Re Dr Ken Michael AM; Ex Parte Epic Energy (WA) Nominees Pty Ltd & Anor [2002] WASCA 231*, paragraph 124.

2.33 Although the Commission does not make such a reference, reference might be made to the explication of economic efficiency in terms of three components, technical (or productive) efficiency, allocative efficiency and dynamic efficiency. The Hilmer Report, for example, defines these aspects of economic efficiency as:

"Technical or productive efficiency, which is achieved where individual firms produce the goods and services that they offer to consumers at least cost. . . .

Allocative efficiency is achieved where resources used to produce a set of goods and services are allocated to their highest valued uses (ie, those that provide the greatest benefit relative to costs). . . .

Dynamic efficiency reflects the need for industries to make timely changes to technology and products in response to changes in consumer tastes and productive opportunities."[18]

Explication in terms of these three components may appear to provide a more pragmatic view of economic efficiency, removed from the usual textbook explication within a tightly specified theoretical model of perfectly competitive markets, but this is not the case. Outside of such a model, there is much scope for debate on what are the lowest costs of service provision, on what are the highest valued alternative uses of resources, and on the way in which the effects of innovation and technological change are to be recognised.

2.34 What is clear, however, is that regardless of whether there is an overriding objectives clause, it is imperative that the factors and considerations outlined in section 2.24 of the Code must be retained, although Epic Energy would accept that there is merit in the deletion of the last of the section 2.24 factors in order to more properly reflect the true role of the regulator when assessing an access arrangement proposed by a service provider.

[18] [Hilmer Report, full reference]

Epic Energy's views summarised: objectives

Inclusion of the Commission's proposed overarching objects clause is likely to enhance the effectiveness of the Gas Access Regime only if policy makers and regulators are provided with clear guidance on how the objectives of the promotion of economic efficiency and investment are to be interpreted in the context of National Competition Policy reforms. Without this guidance, there is a real risk that the current narrow theoretical focus of the regulators will be reinforced, deterring investment in gas pipeline systems, and limiting the prospects for economic development from the promotion of competition in upstream and downstream markets.

Section 2.24 of the Code is fundamental to giving effect to the National Competition Policy reforms. It defines the role of the regulator as one of assessment of access proposals, and makes explicit the requirement that the regulator must balance the interests of pipeline service providers and users of the services they provide. This requirement for the balancing of interests flows through the view of access regulation proposed by the Hilmer Committee, and adopted by the Commonwealth Government, and the Governments of the States and the Territories, in the Competition Principles Agreement and the Natural Gas Pipelines Access Agreement.

Elements (a), (b), (c), (d), (e) and (f) of section 2.24 of the Code must not be deleted, however Epic Energy would not object to the deletion of element (g).

3. Response to section 6 of Draft Report – coverage issues

3.1 Epic Energy has been involved in the preparation of the submission by the Australian Pipeline Industry Association and endorses the comments it has made in relation to this section of the Draft Report.

3.2 In addition to the comments made by the APIA, Epic Energy makes the following points.

3.3 Firstly, it must be noted that the decision of the Australian Competition Tribunal in the Eastern Gas Pipeline Coverage Application was that coverage of a transmission pipeline should only occur if coverage would be likely to substantially promote competition in a market other than the market for transmission pipeline services. If that test was not satisfied, then the pipeline would not be required to be subject to any form of third party access regulation.

3.4 So it has to be said that the proposed two tiered access regime being proposed by the Commission in its Draft Report is to increase the scope for more pipelines to be regulated, albeit on a tiered approach. While it is accepted that the proposed test for tier 2 regulation (ie an access arrangement) does not conflict with the reasoning of the Australian Competition Tribunal, Epic Energy would be concerned if the Tier 1 regulation (ie monitoring) were to end up as a de facto access arrangement.

3.5 There is significant potential for this to occur if the NCC or coverage decision maker is to be able to set guidelines for information provision to assist it in assessing an application.

3.6 Accordingly, Epic Energy recommends that the Commission set down guidelines that should be considered to be adopted by the NCC (or coverage decision maker) to avoid any potential for "regulatory creep" in the future.

3.7 The second additional point is one of clarification. Epic Energy requests that the Commission make it clear whether it is intended that a decision on no coverage is to remain in effect for at least 15 years, or for no more than 15 years. Draft Recommendation 9.1 and Draft Finding 9.9 create an uncertainty in this respect.

3.8 Epic Energy submits that, consistent with the Parer Report, the position should be for at least 15 years.

3.9 The third additional point relates to whether the body which assesses a coverage application should also be the body that decides on the form of regulation that should apply or at least determines what is to be contained in the monitoring form of regulation. While it is acknowledged that the form of regulation function could not be vested with the same body that assesses an access arrangement, it is noted that the Commission accepts that policy type functions should be separated from

administrative type regulatory functions[19]. Given the potential for the form of the monitoring regime to be one of the most contentious areas of a new regime, and could significantly impact on policy functions, the need for a separate, independent, body to decide on its contents is critical.

3.10 The fourth additional point relates to the first criterion for the coverage test. It is proposed that access to Services provided by means of the Pipeline would be likely to have the effect of increasing competition to a substantial degree in at least one market (whether or not in Australia), other than the market for the Services provided by means of the Pipeline.

3.11 Epic Energy acknowledges that there is a significant degree of judicial precedent on the definition of "market". It is also noted that the NCC, as the coverage recommendation body, has adopted an extremely narrow approach to the definition of this term. The result is that if the NCC concludes that any market, no matter how small, would benefit from coverage, then coverage is warranted. This would give greater scope for infrastructure to be covered in circumstances where coverage is unnecessary or inappropriate. Epic Energy considers that regard should be had to providing some clear definition to the term "market" so that the overarching intent of the Commission as to limiting the unnecessary intrusion of regulation is not undermined by "regulatory creep".

Epic Energy's views summarised: coverage

Epic Energy endorses APIA's comments on coverage. Clear guidelines need to be established by the Commission as to the content of the "monitoring" form of regulation. The content of this form of regulation should not be left to the coverage decision maker to determine.

A decision that a pipeline should be uncovered must apply for at least 15 years.

[19] Draft Report, page 187

4. Response to section 7 of Draft Report – Access Arrangements

4.1 This section of the submission specifically focuses on the following recommendations from the Draft Report:

Draft Recommendation 7.1

Section 8.1 of the Gas Code should be replaced with the following:

The relevant regulator must have regard to the following principles when approving a reference tariff or reference tariff policy:

(a) that reference tariffs should:

(i) be set so as to generate expected revenue across a service provider's regulated services that is at least sufficient to meet the efficient long-run costs of providing access to those 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 reference tariff structures should:

(i) allow multi-part pricing and price discrimination when it aids efficiency

(ii) not allow a vertically integrated service provider to set terms and conditions that disadvantage competitors of its associated businesses in upstream or downstream markets, except to the extent that the cost of providing access to these competitors is higher.

(c) *that reference tariffs should be set so as to provide incentives to reduce costs or otherwise improve productivity.*

Draft finding 7.1

Since the Productivity Commission's review of the national access regime, there has been further research on the scope to use benchmarking techniques to regulate infrastructure industries. This research has not provided a convincing case that benchmarking techniques can remove the problems with the building block approach currently used for the Gas Access Regime. At this stage, the Commission sees little merit in more research on benchmarking, but seeks further comment from participants.

Draft Recommendation 7.4

Section 3.16 of the Gas Code should be amended so that any expansion of a covered pipeline will be treated as part of the covered pipeline, unless the service provider

nominates otherwise and the regulator agrees.

Draft finding 7.5

There is high potential for regulatory error when approving reference tariffs. The Gas Access Regime requires regulators to make decisions about future market circumstances that are uncertain. This has led regulators to use many debatable assumptions. There is a consequential tendency for regulators to seek additional information from service providers and further studies by consultants. This is unlikely to reduce uncertainty significantly.

Draft Finding 7.6

The current regulatory approach of having access arrangements with reference tariffs is costly, especially in relation to the market impact. Therefore, while some refinements to the existing regulatory approach are needed, there is a sound basis for an alternative less costly approach.

4.2 In addition, Epic Energy deals with other aspects of the access arrangement approval process which it considers require amendment.

The Role of the Regulator in the regulatory approval process

4.3 As has been submitted already in this submission, one of the key problems with the Gas Access Regime has been the misapprehension by Regulators as to their statutory function under the Code, particularly in relation to the assessment of access arrangements. This has been confirmed most recently in decisions by the Australian Competition Tribunal and the WA Supreme Court.

4.4 In short, Epic Energy submits that Regulators have incorrectly assumed the role of a body which must ***set*** terms and conditions, including the price, of access ("price setting"). However, Epic Energy submits that, having regard to the recent judicial decisions, the proper role of a regulator is one of ***assessing and establishing*** such terms and conditions ("price assessing and establishing"). While this might appear a fine distinction, it is critically important as one requires an assessment of what is put forward by the service provider to determine whether it is reasonable having regard to the factors set out in section 2.24 of the Code (and therefore assessing whether the proposal fits within a range of reasonable outcomes) while the other approach requires a regulator to impose an outcome which, in the eyes of the regulator, is considered the "most reasonable" outcome. Epic Energy submits that the Code requires the Regulator to adopt the price assessing and establishing function only – a view which has been endorsed by the Australian Competition Tribunal and the WA Supreme Court in the *Epic Energy Case*.

4.5 Once this approach is accepted, it is submitted that much of the confusion that the Regulators claim exists with the application of the Code falls away and ensures that outcomes can be achieved which are consistent with the original intent of National Competition Policy reforms of the mid 1990s.

4.6 Justification for this position is found first in the core section that sets out the Regulator's role in relation to access arrangements – section 2.24 of the Code. It provides as follows:

"*The Relevant Regulator may approve a proposed Access Arrangement only if it is satisfied the proposed Access Arrangement contains the elements and satisfies the principles set out in sections 3.1 to 3.20. The Relevant Regulator must not refuse to approve a proposed Access Arrangement solely for the reason that the proposed Access Arrangement does not address a matter that sections 3.1 to 3.20 do not require an Access Arrangement to address. In assessing a proposed Access Arrangement, the Relevant Regulator must take the following into account*:

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

(b) firm and binding contractual obligations of the Service Provider or other persons (or both) already using the Covered Pipeline;

(c) the operational and technical requirements necessary for the safe and reliable operation of the Covered Pipeline;

(d) the economically efficient operation of the Covered Pipeline;

(e) the public interest, including the public interest in having competition in markets (whether or not in Australia);

(f) the interests of Users and Prospective Users; and

(g) any other matters that the Relevant Regulator considers are relevant."

4.7 In the *Epic Energy Case*, the Full Court of the Western Australian Supreme Court carefully considered the nature of the assessment process required by s.2.24. The Full Court found:

"*the Code establishes a single process of assessing a proposed Access Arrangement and deciding whether or not to approve it*";[20]

"*in that process, the Regulator is required by s.2.24 to take the stipulated factors into account and to give them weight as fundamental elements*";[21]

"*the process of assessment includes giving weight as a fundamental element to the s.2.24 factors in the consideration of s.3.1 to 3.20, including the consideration of s.8 as incorporated through ss.3.4 and 3.5*";[22]

[20] *Epic Energy*, paragraph 58.
[21] *Epic Energy*, paragraph 55.
[22] *Epic Energy*, paragraphs 61-69.

"*consideration of ss.3.4 and 3.5 involves an evaluation and exercise of judgment and discretion, taking due account of inter-related matters*";[23]

"*assessing whether a proposed Reference Tariff and Reference Tariff Policy comply with s.8 principles does not involve the Regulator undertaking calculations producing fixed results and a fixed "yes" or "no" answer, but involves considering whether the proposed Reference Tariff and Reference Tariff Policy are consistent with the stated "principles" (not prescriptions) – the notion of compliance does not involve a single uniquely correct outcome, but a determination whether the proposal is reasonable within s.8*";[24] and

"*in evaluating the application of ss.3.4 and 3.5 (ie, in considering compliance with the s.8 principles), the factors in s.2.24 are applicable and guide the Regulator in the exercise of the discretions contemplated by the last paragraph of s.8.1*".[25]

4.8 Further justification for this position is found in the recent Australian Competition Tribunal decision for the GasNet transmission system.[26]

4.9 Therefore, the correct approach to assessing a proposed access arrangement and deciding whether it should be approved may be explained as follows:

- there is a single, overall process of assessment, which involves inter-related components or elements – it does not involve a series of individual, final decisions which severally and mechanically produce an outcome;
- of necessity, the initial consideration of matters of detail under s.3.1 to 3.20 (including s.8) will be to an extent provisional in nature, for the proposal must be assessed overall and in an integrated manner, taking full account of the interaction between factors with proper weight being given to the s.2.24 factors, before final views are formed; and
- a central feature of the process is an evaluation of the proposed Access Arrangement, and the supporting case propounded by the service provider, having regard to the s.2.24 factors and the weight to be accorded to them as fundamental elements in the particular circumstances of the case.

4.10 In its judgement, the Full Court of the Western Australian Supreme Court expressly rejected interpreting the three sentences in section 2.24 as independent and in effect sequential commands to the regulator, and the view that the Regulator does not come to the stage of considering the factors in section 2.24(a)-(g) unless the requirements of sections 3.1-3.20 are satisfied. The Full Court held that the factors in section 2.24(a)-(g) are to be accorded weight as fundamental elements in an assessment process, and are to provide guidance to the regulator in considering the

[23] *Epic Energy*, paragraphs 57-63.
[24] *Epic Energy*, paragraphs 64-68.
[25] *Epic Energy*, paragraphs 69, 203.
[26] Australian Competition Tribunal, Application by GasNet Australia (Operations) Pty Ltd [2003] ACompT 6

elements and principles contained in sections 3.1-3.20, subject to the nature of these elements and principles indicating otherwise.[27]

4.11 In dealing with a proposed access arrangement submitted by a pipeline service provider, the sole issue for a regulator is to assess whether the access arrangement should be approved. The regulator's task is not one of calculating its own reference tariff, or of putting forward its own reference tariff policy or access terms and conditions. Furthermore, any attempt to segment the process of assessment and approval into sequential and component parts denies the fundamental nature of the process as a single one, and precludes attainment of the harmony and consistency which is achieved by a proper understanding and application of the section 2.24 factors.

4.12 The way in which section 2.24 of the Code establishes the role of the regulator is fundamentally important. Section 2.24 gives effect to the general framework for access regulation established by the Hilmer Committee, and by the Commonwealth Government, and the Governments of the States and the Territories, as parties to *the Competition Principles Agreement* and the *Natural Gas Pipelines Access Agreement*. To dispose of the section 2.24 factors, as proposed in Draft Recommendation 5.3, will risk creation of a Gas Access Regime that no longer gives recognition to factors that are fundamental to the National Competition Policy reforms of which that Regime is, supposedly, and integral part.

4.13 In its Draft Report, the Commission has consistently recommended the inclusion of pricing principles in access regimes.[28] In the case of the Code, the Commission considers that these principles are required to "provide guidance on how the broad objectives of the regime should be applied in setting reference tariffs, providing greater certainty for regulated businesses and access seekers and reduce the scope for regulatory risk and error".

Section 2.24 factors are required to ensure regime is effective

4.14 The inclusion of pricing principles in an access regime does not, however, automatically require the setting of tariffs by a regulator. Tariff setting by a regulator is not essential for an effective access regime. Indeed, there is some doubt as to whether an access regime in which tariffs, regardless of the basis on which they are set, are binding on an arbitrator, is an effective regime for the purposes of Part IIIA of the *Trade Practices Act 1974*.

4.15 However if pricing principles are to be included and tariffs are to be set by a regulator, the pricing principles must be consistent with the effectiveness test.

4.16 This is because despite s2.50(d) of the Code, an Arbitrator arbitrating a dispute is obliged to apply the Reference Tariff. A regulator is therefore a "de facto" arbitrator when carrying out a regulatory approval process.

[27] Reasons paras 57-62.
[28] See Draft Report, section 7.1, page 204

4.17 The section 2.24 factors substantially reflect the considerations, as outlined in the test for effectiveness set out in clause 6 of the Competition Principles Agreement, that an arbitrator must take into account when arbitrating an access dispute. If the section 2.24 factors were therefore removed, the de facto arbitration would run the risk of be contrary to the effectiveness test.

4.18 Furthermore, to not retain these considerations would be inconsistent with the original intent of National Competition Policy reform, the details of which are set out in more detail in section 2 of this submission.

4.19 To remove these considerations in order to remove or at least substantially limit the discretion of regulators in regulatory approval processes would therefore be wrong for the following reasons:

- It exposes the Gas Access Regime to the risk of not being certified as an effective access regime;
- The Code is intended to be a flexible document which is able to be applied to the specific circumstances of each pipeline for which an access arrangement is being assessed. Removing the discretion of the Regulator exposes stakeholders to the real risk that we will end up with a uniform set of terms and conditions, pricing formula and values for key elements in that pricing formula being adopted for all covered pipelines that are required to undergo an access arrangement approval process. This ignores the very reality that each pipeline's circumstances differ and as such flexibility to required to enable those differences to be addressed and factored into the regulatory approval process.

Extensions/Expansions Policy

4.20 It is noted that Draft Recommendation 7.5 provides as follows:

Section 3.16 of the Gas Code should be amended so that any expansion of a covered pipeline will be treated as part of the covered pipeline, unless the service provider nominates otherwise and the regulator agrees.

4.21 Epic Energy would be concerned if this were to be endorsed in the Commission's final report as it runs contrary to the approach adopted by the Australian Competition Tribunal in Epic Energy's challenge to the access arrangement for the Moomba to Adelaide Pipeline System.

4.22 In that application, Epic Energy objected to a decision by the ACCC to require a particular expansion to be included as part of the covered pipeline. The Tribunal upheld Epic Energy's application in this respect, making it clear that coverage of expansions to an existing covered pipeline must be assessed on a case by case basis. To do otherwise perpetuates the current thinking of regulators and some stakeholders of a presumption of coverage.

4.23 In the MAPS decision, the tribunal reinforced its reasoning from the EGP decision about when an asset should be regulated. It concluded that coverage should only be pursued if a "not trivial" increment to competition can be expected to follow. The tribunal rejected the ACCC's view that any level of market power justifies coverage.

> 113 What needs to be addressed is whether the alleged ability of Epic to exercise market power is such as to have a commercially and socially significant impact, both in quantum and in sustainability. It must be non-trivial, and non-transient. It must have a significant effect on some aspect of competition in a relevant market. The Tribunal is of the opinion that the existence of market power, and the ability to exercise it systematically, have not been satisfactorily established by the ACCC and the ACCC does not point to any of the factual materials which were available to it which would sustain a conclusion that such market power exists.

4.24 The tribunal was also critical of the ACCC's failure to consider section 2.24(a) on the issue of market power. This is consistent with the reasoning of the Supreme Court in the *Epic Energy Case*.

> 118 Even if market power exists, it is still necessary to ask whether the ACCC acted reasonably in exercising its discretion in requiring coverage of the Pelican Point expansion? One of the factors to be considered in assessing an AA is the legitimate business interests of the service provider (s 2.24(a) of the Code), and there is no mention of that factor in the ACCC's assessment of the inclusion of the Pelican Point expansion in the covered pipeline, even though Epic raised it in its submissions on the Final Decision. Coverage of the Pelican Point expansion capacity would entail a significant reduction in the Reference Tariff because the proportional increase in capacity is significantly greater than the proportional increase in costs.

4.25 It should be noted in that case that the Tribunal was highly critical of the ACCC's assessment of market power issues:

power of a significant nature in the market for IT service. The ACCC did not provide any cogent explanation of what the mechanism was, through which Epic could systematically act to exercise any market power, nor did it provide any evidence as to what the effects would be, or who would be affected, and for how long the effects would last. The ACCC could do no more than say that in the absence of proof that the Pelican Point expansion *'was fully contracted in every sense of the word'* then it was correct for it to conclude that Epic could potentially exercise market power in the supply of IT service. That, in the view of the Tribunal, was not a sufficient basis upon which to conclude that the Pelican Point expansion of capacity ought to be covered and included in the SPC of the Pipeline System available for the provision of a FT service being the Reference Service in the AA Epic lodged on 1 April 1999. Nor was it open to the ACCC to come to the decision which it did without due consideration of the legitimate business interests of Epic which the ACCC failed to consider.

In the view of the Tribunal, the decision of the ACCC to include the Pelican Point expansion capacity in the SPC of the pipeline system was in error, and unreasonable in all the circumstances, and ought to be set aside.

New Facilities Investment Provisions of Code

4.26 Another aspect of the Code that Epic Energy considers requires immediate review relates to the New Facilities Investment Provisions of the Code.

4.27 Epic Energy considers that the provisions as they are currently drafted may not afford a service provider the opportunity to recover the costs of an expansion if the expansion can not be justified on "system wide" benefits or "safety and integrity" grounds, and the anticipated incremental revenue expected to be generated from the expansion does not exceed the cost of the expansion.

4.28 Attachment 1, which is provided to the Commission on a confidential basis, sets out a practical application of the provisions of the Code. Epic Energy would be prepared to explain the attachment to Commission staff in more detail.

4.29 Should the provisions remain, the likely consequences that will result are:

- Epic Energy will fund an expansion outside of the regulatory framework and on the basis that developable capacity is fully contracted before the expansion is built, so as to avoid any regulatory risk. This will lead to inefficient outcomes given the economies of scale generated by building spare capacity up front (see Epic Energy's submission IPS#1).

- Epic Energy may fund an expansion within the regulatory framework but only on the basis that shippers pay the incremental tariffs associated with the expansion. In circumstances where the incremental cost of capacity is more expensive than the average cost of capacity (demonstrated in Attachment 1), some shippers will be required to pay a surcharge. This will lead to a set of "second class citizen" shippers, giving rise to an immediate barrier to competition in both upstream and downstream markets.

Epic Energy's views summarised: access arrangements

It should be made clear in the Final Report that in assessing an access arrangement, the role of the Regulator is to assess what is submitted by the Service Provider with a view to determining whether the proposal is reasonable, having regard to the factors set out in section 2.24 of the Code. To remove the 2.24 factors will risk creating a Gas Access Regime which is not longer effective and more importantly, is no longer consistent with the original intent of National Competition Policy reforms.

There should be no presumption that expansions or extensions to a covered pipeline's capacity should be automatically covered. To do so would be inconsistent with the reasoning of the Australian Competition Tribunal.

Section 8.16 of the Code requires immediate review to afford a service provider with the opportunity of recovering its investment in expansions on the same basis as is the case for new pipelines.

5. The solution – light handed regulation

5.1 Epic Energy proposes the following solutions to the problems outlined in the previous sections of this submission. These solutions, Epic Energy believes, will:

- maintain consistency with the objectives of National Competition Policy; and
- ensure that the policy settings of governments foster an environment that will give the best chance of achieving the objectives referred to in section 4.

Proposed Third Party Access Frameworks

5.2 Epic Energy's proposal does not amount to a wholesale change to the existing Gas Access Regime. Epic Energy is of the view that much of the existing framework for third party access should be retained, but there should be a reassessment of the relative importance of the components of the regime. Following is Epic Energy's view of the access regime that should be implemented to reflect the policy objectives referred to earlier in this submission and to ensure that there are no disincentives to the further investment that is required.

5.3 Epic Energy's original submission to the Commission outlined its preferred form of light-handed regulation. **Attachment 2** provides a flow chart setting out Epic Energy's proposal.

5.4 The key features of Epic Energy's proposal are as follows. There should be no regulatory oversight in situations where the capacity being sold is new and tariffs are a product of market based negotiations, not only for new pipelines but also for the expansion of existing pipelines.

5.5 **Retention of a two part legislated access regime –** In the case of existing capacity, a two part legislated access regime must be maintained. However, while the National Gas Code and the National Access Regime both are two part access regimes, they are starkly different in their substance.

5.6 **Part One – Retention of a Declaration/Coverage test -** This entails the retention of a threshold "declaration/coverage" test consistent with the principles embodied in clause 6 of the Competition Principles Agreement, and as reflected in Part IIIA of the TPA.

5.7 To afford certainty to all pipeline service providers, and to existing and prospective shippers, all pipelines that are currently covered under the National Gas Code, should be assessed against the declaration/coverage test.

5.8 Those pipelines which are determined not to be declared/covered or stated not to be declared/covered would be so at the commencement of the new regime. This should properly reflect the historical context in which these pipelines were developed.

5.9 New pipelines would not be declared/covered. This is consistent with the Australian Competition Tribunal's ruling in the Eastern Gas Pipeline case that a regulatory

regime should only be imposed if there is a *substantial* likelihood that it will promote access and competition.

5.10 This would mean that all new pipelines, all augmentations of existing pipelines (including extensions and expansions of existing pipelines), and existing pipelines where there has been no actual or constructive denial of the right of access (ie a demonstrated market failure) would not be required by law to submit to the legislated access regime.

5.11 The final decision on declaration/coverage must be made by a Minister, to ensure that any decision that is made is consistent with the policy objectives of the Competition Principles Agreement. An independent body such as the Productivity Commission should provide a recommendation to the Minister, but the Minister must be required to apply the test "de novo" and therefore the recommendation would not be binding on the Minister.

5.12 All declared pipelines are to be listed and are to remain declared/covered for a stated period. As previously noted in this submission, this period should be at least 15 years. This will create additional certainty for all stakeholders.

5.13 Undeclared/uncovered pipelines will remain undeclared/uncovered for a stated period. In the case of new pipelines, this period must be consistent with the duration of the foundation contracts entered into for the construction of the pipeline.

5.14 **Part Two – Negotiate/Arbitrate access model –** a negotiate/arbitrate model along the lines of that in Part IIIA of the TPA should apply to gas transmission pipelines. This is consistent with the principles in clause 6 of the CPA and affords shippers a legislated and guaranteed right to access to a pipeline. It reflects the wholesale nature of the transmission pipeline industry.

5.15 The access regime should make it clear that negotiation is the first method of seeking access to gas pipelines.

5.16 In the event that a party can not successfully negotiate access within a reasonable period, that party should have a legislated right to refer the dispute to an arbitral body.

5.17 **The arbitrator** - The arbitrator should be a body structured along lines similar to the Australian Competition Tribunal. Epic Energy considers that having such a body would assist in a balanced approach being taken by the arbitrator.

5.18 Fundamental to perceptions of independence of the arbitrator, and to its ability to take a balanced approach, are the backgrounds and calibre of the persons appointed to it.

5.19 On that basis, the arbitrator should have at least the following features:

- at least three members actively involved in any arbitration at all time;

- Those members must be able to be drawn from a panel that is sufficiently numerous to ensure that the panel members have a variety of disciplines but not so numerous that the quality of members is compromised.

- Some of the members should be employed on a full time basis while others need only to be employed on a part time basis. At any time the body must be comprised of both part time and full time panellists.

- Each member must have relevant industry experience (apart from regulatory or government experience) – say at least 10 years experience.

- All panel members should be appointed for a specified tenure. To minimise the ability for politicising the appointments of panel members, it is also recommended that their appointments be staggered and the tenure of each member be for differing periods.

- The panel to hear any issue must comprise of members with a balance of interests from service providers and shippers/prospective shippers.

- Members of the panel should also have experience in a cross section of disciplines. Relevant disciplines include law, engineering, economics, finance and safety.

5.20 Any supporting administrative office that may be required must be part of the arbitral body itself, and not a separate entity as is the case in Western Australia with the Office of Gas Access Regulation (now part of the Economic Regulation Authority). Epic Energy's experience with the Office of Gas Access Regulation has shown that this separation of functions and powers has lead to a more protracted and inefficient decision making process, with the potential for communication breakdown between the final decision maker (the regulator) and staff. This must be avoided: members should be directly involved in all aspects of the arbitral process. Further direct support or previous connections with government departments has led to perceptions of a regulator's lack of independence from government.

5.21 **The arbitration process –** in assessing any dispute in relation to a declared/covered pipeline, the arbitrator should be bound to assess the proposal that has given rise to the dispute against the factors and principles in clause 6(4)(i) of the CPA and, if relevant, other factors and principles so long as they are consistent with the clause 6(4)(i) principles. An example of such other factors exists in Part 8 of the *Petroleum Act (QLD) 1923*.

5.22 The arbitrator may have regard to the following additional factors:

- other contracts entered into for similar services; and

- any access principles that the service provider has developed and published, although it would be acknowledged that these are not automatically deemed to be an outworking of the clause 6(4)(i) principles.

5.23 The decision of the arbitrator will be binding on the parties to the dispute, subject to the review rights described below.

5.24 **Review of arbitrator's decision** – if there is an arbitral body styled along the lines of the Australian Competition Tribunal, then there is only a need for judicial review of its decisions.

5.25 **Additional Legislative Requirements for Declared Pipelines – Shipper Protection Provisions –** in addition to the negotiate/arbitrate framework, the access regime should incorporate the following additional features to afford shippers greater protection to secure access and to minimise the potential for unnecessary arbitrations:

- The establishment of a register to contain details of:

  - all contracts entered into by the service provider of the declared/covered pipeline; and

  - any notices of an intention by a service provider to enter into an associate contract.

  The register will be maintained by an independent body. While any notices relating to associate contracts will be publicly available, the remainder of the register will be confidential and only accessible by the arbitrator and the body making the decision on declaration/coverage for the purposes of determining the dispute or declaration application, as the case may be.

- The requirement to disclose information (such as information relating to system capacity, indicative tariffs, investigations to expand or extend the pipeline) that will form the basis of parties' negotiations.

- The requirement to adhere to certain minimum behavioural standards. These would include the following:

  - The development and publication of access principles which must contain, as a minimum such policies as a tariff and service policy, queuing policy, extensions/expansions policy, minimum terms and conditions and a capacity management policy. There would be no requirement to have these principles approved as the arbitrator is not bound to apply them in the event of a dispute.

  - Ring fencing requirements similar to those in section 4 of the National Gas Code, at least in so far as they ensure confidentiality of information is not compromised.

- As an alternative to proceeding with an application for declaration/coverage, a service provider should also be afforded the right to elect whether to lodge an access undertaking similar to the procedure allowed under Part IIIA of the TPA. The undertaking would be assessed against the relevant CPA principles and

would be binding upon an arbitrator in the event of a dispute. This would afford greater certainty to both shippers and the service provider.

5.26 **Approval of Associate Contracts -** All associate contracts in relation to both declared and non declared pipelines must be disclosed to an independent body (the arbitral body) for approval in accordance with the following principles:

- This obligation would only apply in relation to those non declared pipelines where the service provider has been required to prepare access principles.
- All foundation associate contracts must be approved and measured against the clause 6(4)(i) CPA principles and any other foundation contracts.

5.27 **Retention of Parts 4, 4A and 5 of the TPA** – the retention of these provisions is essential as these are the appropriate customer protection and penal provisions in the event of anti-competitive conduct by a service provider.

5.28 **Voluntary Code of Conduct for Non Declared Pipelines –** In addition to the above minimum behavioural requirements that will apply to declared/covered pipelines, non declared pipelines commit to an industry "code of conduct" that ensures a high level of transparency and imposes minimum behavioural requirements on pipeline service providers.

- Epic Energy notes that the APIA has outlined the proposed code of conduct in its submission to the Commission.

5.29 **Funding** – given the benefits that are to accrue to the community, it is only appropriate that the costs of administering the regime are sourced from consolidated revenue. This was dealt with in some detail in Epic Energy's earlier submission to the Commission.

6. Response to section 12 of Report – Institutional Arrangements

6.1 Following a brief examination of the institutional arrangements which currently govern the Gas Access Regime, the Commission found:

- although the Council of Australian Governments ("COAG") is still considering its response to the proposals from the Energy Market Review, and to the Ministerial Council on Energy's response to that Review; COAG's decisions are expected to have a direct impact on the Commission's Inquiry into the Gas Access Regime;
- there would be benefits in having a national energy regulator oversighting both electricity and gas markets, and reforms proposed in the Commission's report would fit within the structure of a national energy regulator;
- recommendations about coverage and the form of regulation should not be made by the same agency;
- separate agencies should be responsible for administering the regulation of gas pipelines, and for recommending whether to regulate and the form of regulation to be adopted;
- ultimate responsibility for decisions on pipeline coverage and the form of regulation should continue to reside at ministerial level; and
- NGPAC has not worked effectively, and changes are essential.

6.2 On the basis of these findings, the Commission made the following recommendation:

> **Draft Recommendation 12.1**
>
> *The agency responsible for making recommendations on pipeline coverage decisions (currently the National Competition Council) should be separate from the regulator responsible for administering the terms of pipeline access. The agency that recommends coverage of a pipeline, should also be responsible for recommending the form of regulation to apply to the pipeline.*

6.3 Epic Energy endorses Draft Recommendation 12.1, and concurs with the Commission's view that were a national energy regulator to be created, that regulator should not have a role to play in the approval of changes to the Gas Access Regime. (However, as Epic Energy argues later in this submission, the case for a national regulator has not been made.) Epic Energy sees the proposal of the Energy Markets Review, whereby a national energy regulator would approve Code changes and administer the changed Code, as potentially compromising both processes. Code changes are matters of policy, to be dealt with by a suitably structured Code change body. Consistent with the original intention that the Code would reflect a balancing of interests, the structure of the Code change body should permit direct representation of the interests of pipeline service providers and pipeline users in the Code change process, and not their indirect involvement as advisers to government

officials. Epic Energy does not accept the view that the voting membership of the Code change body must be restricted to government officials. It is the body itself, which makes policy recommendations, not the members of that body individually. That the body responsible for Code change is able to draw directly on industry experience (among other things) is essential for a Gas Access Regime which has the support of the pipeline industry.

6.4 No recommendation has been made by the Commission concerning the creation of a national energy regulator. Instead, the Commission appears to support the proposals of the Energy Market Review, and COAG's likely response, and has focused its comments on the perceived benefits of a national regulator. This focus is inappropriate. Creation of a national energy regulator will not bring the benefits claimed, and will not change the way in which gas access regulation is applied.

6.5 Amalgamating the functions of the jurisdictional regulators into a national energy regulator is unlikely to reduce the costs of companies operating in more than one jurisdiction. Under the Gas Access Regime, it is individual assets, and not the companies owning those assets, that are regulated. Reducing the number of regulators will not reduce the number of regulatory decisions required.

6.6 Creation of a national energy regulator will not, as claimed by the Energy Market Review, deliver greater regulatory consistency across the country. Already, consistency and uniformity is achieved through a perception that the ACCC and the Essential Services Commission in Victoria are "industry leaders" in the application of access regulation in Australia, and that the others are "followers". There is little difference of substance in the decisions of the current national and jurisdictional regulators. Furthermore, the Utility Regulators' Forum acts as a body for the dissemination of the views of the industry leaders. Indeed, further concentration of regulatory decision making will increase the risk of regulation being applied in a way consistent with the views of the regulators, and not in the interests of energy suppliers, the suppliers of infrastructure services, and energy consumers.

6.7 Consistency and uniformity are being achieved because the regulators have abandoned the fundamental element of the scheme of access regulation outlined by the Hilmer Committee, and further articulated in the *Competition Principles Agreement*, the *Natural Gas Pipelines Access Agreement* and, the Code. In place of a scheme in which regulators would, in the event of agreement not being reached, undertake the task of balancing the interests, energy suppliers, the suppliers of infrastructure services, and energy users, the regulators have substituted a scheme of their own making with a focus on market power and the elimination purported monopoly rents, driven by a static and simplistic economic theory of monopoly. Under such a scheme of regulation, consistency and uniformity in application may, indeed, be desirable. However, promotion of consistency where the regulatory regime anticipates divergence of interests, and calls for regulator balancing of those divergent interests when negotiating parties cannot reach agreement, may well frustrate the regulatory process.

6.8 If the original intent of the Hilmer Committee, the parties to the Competition Principles Agreement and the Natural Gas Pipelines Access Agreement, and pipeline

service providers and pipeline users is recognised and retained, the value of greater regulatory consistency is not immediately clear. Greater consistency could well mean a formulaic approach to the application of access regulation, and to regulator failure to assess and appropriately balance the interests of service providers and users.

6.9 Epic Energy agrees with the finding of the Commission (Draft Finding 12.6) that the National Gas Pipelines Advisory Committee ("NGPAC") is not working effectively, and that changes are essential. In supporting the Commission's finding, Epic Energy notes that it has had direct involvement with NGPAC. Epic Energy was the initiator of one of the Code changes examined by NGPAC, and has participated in NGPAC meetings as an industry representative.

6.10 Epic Energy is concerned that, although the Commission has recognised the need for change, it has not made recommendations which might lead to the required changes. Again, the Commission seems to support the proposals of the Energy Market Review, and COAG's response to them. Those proposals include the creation, by statute, of a rule making body (separate from the national energy regulator) funded by industry levy. While a rule making body separate from the regulator is desirable and necessary, Epic Energy has concerns about:

- representation on the rule making body;
- procedures to be followed by the rule making body; and
- control of expenditure in the event of the rule making body being funded by industry levy.

6.11 One of the principal defects of NGPAC has been its representation. A number of those appointed to NGPAC have not had the authority to make decisions of the type NGPAC has been called upon to make. In consequence, NGPAC decision making has been convoluted and slow.

6.12 NGPAC's effectiveness in making decisions has been further impaired by the requirement that the Code be amended only on the unanimous agreement of the relevant ministers of the participating jurisdictions. Unanimous agreement between the ministers has been difficult to obtain.

6.13 The convoluted and slow process of decision making on proposals for Code changes has, Epic Energy believes, resulted in NGPAC incurring substantial costs through its employment of legal and other external advisors. While NGPAC is funded from budget appropriations, government expenditure review processes ensure that a degree of control is exerted over its expenditures. Removal of this control, by making NGPAC an industry funded body, is likely to result in a direct pass through of its costs to pipeline service providers and little control being exerted over the level of those costs.

Epic Energy's views summarised: institutional arrangementsA regulator should have no role to play in Code change processes.

No case has been made to justify the creation of a single national energy regulator. It will not change the way in which gas access regulation is applied, and is most likely to result in additional costs being incurred.

NGPAC is not effective in making Code changes. Any Code change body that is recommended must have direct industry representation given the impact the Code has on the property rights of pipeline service providers.

Attachment 1

Analysis of application of New Facilities Investment provisions of Code

See attached

CONFIDENTIAL AND COMMERCIAL IN CONFIDENCE

Proposed Negotiate Arbitrate flowchart

See attached

3RD PARTY ACCESS FRAMEWORK