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The Presiding Commissioner
Gas Access Regime Inquiry
Productivity Commission
LB2 Collins Street East
MELBOURNE VIC 8003

Dear Commissioner,

I refer to the Productivity Commission (Commission) Draft Report for the Review of the Gas Access Regime dated December 2003 (the Draft Report) and commend the Commission on a thorough and comprehensive review of the complex issues encompassing access regulation to natural gas pipelines. I also commend the Commission's emphasis on lighter handed regulation and support for market determined outcomes.

In the Draft Report the Commission comments;

> "Regulation should be introduced only if it leads to a better outcome than that which would occur in its absence, after accounting for the costs of implementing the regulation. From the community's perspective, an efficient market produces the best outcome where total welfare is maximised (the 'first best outcome'). However, this outcome is not achieved when there is market failure. Governments intervene (regulate) to improve the outcome towards the point at which welfare is maximised. Nonetheless, governments generally cannot regulate to achieve the first best outcome because, for example, their ability to intervene is limited and intervention introduces new issues and costs to the community. Regulation is thus often a second best outcome compared with competition - a notion that is well acknowledged." (p.77)

ExxonMobil concurs with this view that competition is the preferred outcome as it allows free market solutions to develop. We believe that regulatory control should only be applied where there has been a demonstrated market failure and where regulation can serve to produce a more efficient outcome. ExxonMobil believes this philosophy is in line with the Commission's review and recommendations, including that the Gas Access Regime should make provisions for a move to a lighter handed regulatory regime as conditions permit.

In the Draft Report the Commission considered the counterbalancing factors constraining the market power of a transmission pipeline and in their Draft Finding 2.1 concluded;

> "While transmission pipelines have natural monopoly characteristics, the market power of transmission pipeline owners is constrained by a number of factors, particularly:

- the availability of substitutes - that is, the presence of a competing pipeline in the end market and/or of alternative fuel and energy sources
- the size and concentration of users and the competitive nature of foundation contracts
- the elasticity of demand for the final products, for which natural gas is an input.

> The extent to which these factors constrain market power differs across pipelines."

ExxonMobil concurs with this view. Indeed ExxonMobil believes that the energy market in Australia is progressively maturing with retailers generally marketing both electricity (primarily produced by coal) and gas, and in some cases LPG. Retailers are therefore becoming relatively indifferent to a consumer's energy choice. With a portion of the market always in a position to alter their energy choice, growth in demand for gas would be curtailed if the value of gas to the consumer were to become seriously out of balance with alternative energy sources. Further, the potential for demand to simply be reduced or curtailed by some users should the cost of energy impact end product competitiveness again has the potential to curtail demand. Therefore, such interfuel competition and potential demand impact can place constraints on the possible market power of any segment of the gas supply chain including a transmission pipeline. Having accepted that principle, what is not so clear is how to assess the combined strength of these counterbalancing factors and whether/when they are sufficiently strong in any particular Australian context to ensure the absence of market failure.

Existing Regulation

In Chapter 4 of the Draft Report the Commission examined the current Gas Access Regime and found that there was a need for a gas pipeline industry specific access regime (Draft Finding 4.1). However, the Commission concluded that the current Gas Access Regime has deficiencies and improvements are possible (Draft Finding 4.7). The Commission found that the current Gas Access Regime deters and distorts investment possibly delaying construction or encouraging "built for purpose" outcomes (Draft Finding 4.3), and further adds significant compliance and administration cost and potentially costs of delay (Draft Finding 4.6).

Further, in Draft Finding 4.5 the Commission concluded;

> "Generally, regulation involving access arrangements with a reference tariff should be considered only where service providers have substantial market power. Where market power is not strong, such as where there is emerging competition in the gas industry, the long run costs of regulatory intervention are likely to outweigh the cost of the market failure that regulation attempts to correct."

Indeed in the Draft Report the Commission found that the current Gas Access Regime process effectively amounts to price regulation that discourages commercially negotiated solutions and has the potential for inefficient outcomes. ExxonMobil supports the findings by the Commission in Chapter 4 and believes fundamentally that regulation in the form of the Gas Access Regime with emphasis on reference prices should only apply where there is a clear case of market failure. We believe such cases of market failure have been identified in the southeastern markets.

In our submission to the Commission on 28 August 2003, we stated, "ExxonMobil fundamentally believes that coverage of transmission pipelines should be restricted to pipelines where free and fair commercial negotiations have failed or are not possible due to absence of competitive forces and monopoly behavior". ExxonMobil therefore favours an approach which primarily limits regulatory coverage to pipelines meeting these criteria where regulatory coverage may provide market efficiency benefits. Where regulatory coverage is deemed necessary, ExxonMobil favours a lighter handed approach which encourages commercial outcomes. The implementation of a heavy handed approach (as is espoused in the existing Gas Access regime) should only occur in extreme market failure circumstances where there is little or no potential for such commercial outcomes. While believing that there will remain the need for a regulated tariff regime in many elements of the southeastern market, ExxonMobil endorses the direction of many of the Commission's findings and recommendations within the Draft Report.

As an aside and for completeness while considering Chapter 4 of the Draft Report the Commission has quoted a BHP Billiton statement regarding the "deferral" of "ExxonMobil's proposed Papua New Guinea-Queensland project" that: "Contrary to views held by the pipeline industry, it is our view that the failure of these two projects to proceed to date is attributable entirely to competitive economic forces, and is unrelated to deficiencies in the regulatory framework". To set the record straight, the PNG Highlands Gas Project (the PNG Project) operated by ExxonMobil is currently seeking markets in eastern Australia and believes that it is offering a very competitively priced product. The Project represents an enormous investment and its timing is dictated by the need to obtain synchronously sufficient volume commitments. To date, any market perceived delay to the PNG Project has not been caused by the regulatory framework per se. However, as commented in our submission to the Commission on 28 August 2003, the inflexibility of the tender process to cater for re-design of pipeline routes as market opportunities develop, leads to an uncertain basis under which such a project moves forward. ExxonMobil is concerned that BHP Billiton's statement fails to reflect the nature of the competitive forces (being the synchronous timing of volume commitments) and the deficiencies in the regulatory framework (particularly the inflexibility, excess time and cost) that have an impact on large new gas projects such as the PNG Project.

On the issue of the tendering provisions process under the Gas Access Regime, ExxonMobil supports the Commission's recommendation that the provisions should be "simplified to make them more flexible and less costly" (Draft Recommendation 7.2). While ExxonMobil supports the tendering approach in principle, we believe that for it to provide valuable outcomes for the market it must be easier to implement, outcomes must provide flexibility for project development and it must be cost effective.

Gas Access Regime Objectives

In Chapter 5 of the Draft Report the Commission considers there is merit in simplifying the objectives clauses of the Gas Access Regime to ensure they provide clearer guidance and to remove potentially conflicting objectives. The Commission recommends that the over-arching objects clause become "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 5.1) with the deletion of the existing list of objectives within the Gas Code Preamble (Draft Recommendation 5.2). The Commission further recommends a simplification of the guidance provided to regulators under s.2.24 of the Gas Code when assessing access arrangements, limiting considerations to "firm and binding contractual obligations of the Service Provider or other persons (or both) already using the Covered Pipeline" and "the operational and technical requirements necessary for the safe and reliable operation of the Covered Pipeline" (Draft Finding 5.3 and Draft Recommendation 5.3)

ExxonMobil believes there is merit in simplifying the stated objectives and guidance provided to the regulator and favors an objects clause that puts emphasis on the need to support the development of new supplies to service existing and new markets. ExxonMobil continues to be concerned that in applying the Gas Access Regime regulators provide little attention to the foundation customers and indeed, as discussed in our submission to the Commission dated 28 August 2003, we are concerned that regulator-mandated reference tariffs, where lower than a foundation tariff, have the potential to diminish the ongoing competitiveness of the foundation shipper as well as the pipeline owners' viability. ExxonMobil believes that the guidance provided to the regulator under the Code should include consideration of the foundation shipper's ongoing competitiveness in the market. After all, the foundation shipper has taken substantial risk, has provided a vital role in the development of the pipeline, with its financial under-pinning, and therefore has been pivotal in introducing competition to the market in the first place. ExxonMobil believes that the guidance given to the regulators in assessing access arrangements should also include consideration of 'the interests of the foundation shippers already using the Covered Pipeline'.

Proposed Lighter Handed Regulation

ExxonMobil's understanding of the Commission's Findings and Recommendations in Chapter 6 of the Draft Report is that it essentially proposes changes to the Gas Access Regime that enable a lighter handed Monitoring Regime to be applied as an alternative form of regulation to the existing heavy handed regulated access arrangement / reference tariff. The proposal would require that the National Competition Council (NCC), in considering a coverage decision, apply the test that access will have the effect of increasing competition to a 'material' degree in order to apply a Monitoring Regime to apply for five years. In order for the NCC to apply the existing heavy handed regulated access arrangement / reference tariff system it would have to conclude that access will have the effect of increasing competition to a 'substantial' degree. However, even if this higher threshold is confirmed, the NCC would still have the flexibility to apply the lighter handed Monitoring Regime to the pipeline unless it considers the heavier handed form of regulation "would improve economic efficiency".

The Commission proposes in its Draft Finding 6.9 that "there might be merit in limiting coverage applications for uncovered pipelines to access seekers that demonstrate they have undertaken 'best endeavours' in commercial negotiations that failed". ExxonMobil agrees and believes that the Code should provide guidance in this area which directs the regulator to examine the process of negotiation rather than simply a failure of the parties to agree a tariff price. The guidance could include the legal concepts of "good faith" in negotiations.

The guidance could further include an expectation that the access seeker would have been afforded fair, impartial and timely treatment by the pipeline owner/operators.

As identified early in this submission ExxonMobil believes that regulation should only apply to pipelines where there is demonstrated market failure and as such the regulatory environment should fundamentally support commercially negotiated outcomes. In this light ExxonMobil believes it is important that changes be made to the Gas Access Regime to ensure that it supports such principles and limits coverage to those pipelines where there has clearly been a market failure. ExxonMobil believes that the Commission's findings and recommendations in Chapter 6 provide a model consistent with encouraging market determined outcomes and could provide significant economic efficiency benefits over the existing system. Importantly by setting a higher hurdle for coverage than the existing 'promotion of competition' it would ensure regulatory coverage under the Gas Access Regime only applies where it will create such significant benefits. ExxonMobil notes that access to the major transmission pipelines and distribution networks in southeastern Australia would currently have to be regarded as leading to a substantial contribution to competition in upstream or downstream markets.

In Chapter 9 of the Draft Report the Commission recognises the deficiencies under the current Gas Access Regime and in particular the Australian Competition and Consumer Commission's Draft Greenfield Guideline (Draft Finding 9.1). The Commission finds that upfront binding coverage decisions reduce regulatory risk and recommends that a non-coverage decision should apply for 15 years while a light handed coverage decision (ie. providing a monitoring regime only) should apply for 5 years (Draft Finding 9.4 and Draft Recommendations 9.1). ExxonMobil considers these findings and recommendations by the Commission, a worthwhile improvement over the current Gas Access regime. We believe they provide a greenfield pipeline with the ability to apply for a 15 year binding non-coverage ruling prior to construction that will provide regulatory certainty. We believe it important however that under this scenario, a rejection of the 15 year binding non-coverage application by the NCC does not in effect mandate coverage of the pipeline from that point in time. ExxonMobil believes that the developer should maintain the option of constructing the pipeline without either a monitoring or access arrangement regime applied. The pipeline would then be subject to a later coverage application made to the Minister from an access seeker who has been unable to obtain access despite having made "best endeavours" commercial negotiations that failed.

In Chapter 8 of the Draft Report, the Commission provides more detailed findings and recommendations in relation to the proposed light handed monitoring regime. In making these recommendations the Commission states that "....... It is important that the monitoring regime not develop into an intrusive and costly form of regulation" (Draft Recommendation 8.1). In Draft Recommendation 8.2 the Commission proposes the monitoring regime "should have the following features,

- a third party access policy formulated by the service provider
- separation of pipeline operations from associated businesses in upstream and downstream markets
- public disclosure of information by the service provider (which would be well short of the 'access arrangement information' currently required under the Gas Code)
- scope for the service provider to adopt, at its discretion, additional pro-competitive features, such as a code of conduct".

ExxonMobil believes that in order for the lighter handed monitoring regime to provide economic efficiency benefits it must continue to deliver fair third party access but be less intrusive and costly than the current access/reference tariff arrangements. ExxonMobil therefore supports the Commission's aim and believes the proposed features under Draft Recommendation 8.2 are in line with this aim. ExxonMobil believes that the success of the lower cost lighter handed monitoring regime in delivering the economic efficiency benefits to the community will be seen if it delivers fair access to all users and access seekers. ExxonMobil believes that appropriate ring fencing of pipeline activities from affiliated downstream businesses will remain vital to achieving these benefits. We place significant emphasis on the second bullet of the Commission's Draft Recommendation 8.2. The importance of ring fencing is discussed further below.

With respect to the information required to be disclosed to the regulator under a monitoring regime the Commission proposes that the NCC specify the required information when making a coverage monitoring decision. The Commission further proposes that the information involve focus on trend performance (including profitability), post event reporting and monitoring and particular monitoring of cases where access negotiations have been unsuccessful (Draft Recommendation 8.3). ExxonMobil concurs with the principle that the service provider be advised of the disclosure requirements by the NCC at the time of coverage. In order to maximise the efficient outcome from the monitoring regime it is important that disclosure only relates to information that assists the regulator to confirm the effectiveness of the regime and compliance with the regime. ExxonMobil believes situations where regulators can require additional information without guidance, clear justification and at an apparent whim add significant cost and inefficiency. To this extent ExxonMobil supports the consultative development and maintenance of disclosure guidelines by the NCC (Draft Finding 8.1). To ensure transparency, ExxonMobil believes it beneficial that the regulator collate and publish information disclosed by the pipeline operator (Draft Recommendation 8.4) with the proviso that sensitive commercial information should not be disclosed in a manner where it can be readily identified.

Where a regulator has a need for additional information to assess the effectiveness of, or compliance with, the monitoring regime, ExxonMobil would propose that the merits of the specific requirement be assessed independently by the NCC on a case by case basis. As described previously, under a monitoring regime compliance with ring fencing requirements is vital. It is critical that the information disclosure include elements which enable the regulator to assess the potential risk and level of compliance. Indicators such as proportion of total volume contracted to affiliated businesses and a measure of tariff deviations may provide the regulator with tools that can assist their assessment and that could be provided transparently to the industry.

With respect to access arrangements, ExxonMobil agrees that information requirements be standardised as close to existing gas industry accounting or record keeping practices as possible. An extension of regulator powers to obtain information between access arrangement reviews would add unnecessary cost (Draft Recommendation 7.3 and Draft Finding 7.3). ExxonMobil believes that there may by occasions where an additional information requirement by the regulator is justifiable, but these requirements should be assessed independently by the NCC on a case by case basis.

Also with respect to the application of the heavier handed access arrangements, ExxonMobil supports the Commission's proposal for removal of limitations to the grounds of appeal to allow a full merits review on access arrangements drafted and approved by the regulator (Draft Recommendation 11.5)

Importance of Ring Fencing

ExxonMobil stated in its submission to the Commission on 28 August 2003, that "While ExxonMobil supports a regulatory processes moving toward light handed regulation, we believe that it is best supported in an environment of strong, demonstrated and enforced ring fencing of pipeline businesses from affiliated downstream activities". In Chapter 10 of the Draft Report the Commission discussed the ring fencing issue and finds that "The ring fencing and associate contract provisions of the Gas Code are warranted and are important for an effective regulatory regime." (Draft finding 10.1). The Commission further proposes that the Gas Code be amended to lower the requirement for regulatory authorisation of associate contracts to one of notification by the service provider (Draft Recommendation 10.1). While ExxonMobil can accept that authorisation of such arrangements may not add efficiency to the regulatory environment, ExxonMobil maintains that critical to the efficient operation of the market and the introduction of lighter handed access regulation is strong, demonstrated and enforced ring fencing between pipelines and affiliated downstream businesses.

The efficiency of the market will not benefit by cross-subsidisation by third party users of a competing business affiliated to the pipeline service provider. Such cross-subsidisation could occur where services are provided to an affiliated business under a transfer pricing arrangement or where an asset management business passes its costs through to the shippers. The Commission has identified these issues and has requested further information on whether and how these should be addressed. ExxonMobil believes that once a coverage decision is made for a pipeline (regardless of whether the coverage is on the basis of a light handed monitoring regime or the heavier handed regulated access/reference tariff arrangement) there should be a requirement that the pipeline owner demonstrate to the regulator that third parties seeking access on a similar basis to affiliated businesses are treated on a fair and impartial basis. ExxonMobil would support a position that where reasonably required by the regulator to assist this demonstration, the regulator should be able to examine costs of asset management businesses and/or asset management businesses should be required to comply with relevant ring fencing obligations under the Gas Code.

Shipper Capacity Rights

In chapter 7 of the Draft Report the Commission explores some of the issues pertaining to shippers' capacity and in particular unutilised capacity. The Commission requests comment on the the possible implications of introducing use-it-or-lose-it rules for unutilised contracted capacity and how owners of contracted capacity under such a scheme should be compensated. ExxonMobil would strongly oppose any imposition of such a use-it-or-lose-it system as being counter to the development of free market solutions. ExxonMobil believes the regulated removal of a contracted right in such a manner significantly devalues the good planning and risk mitigation that firm rights provide. ExxonMobil does not believe the issue is one that warrants a heavy handed regulatory approach. In the first instance there is little economic incentive for a capacity owner to hold unutilised capacity over the long-term and further such capacity can be offered on a interruptible or spot basis by the service provider. ExxonMobil does, however, see merit in service providers facilitating commercial capacity trading by enabling shippers to voluntarily post on a website information on unutilised capacity that they wish to trade (Draft Finding 7.4).

Conclusion

ExxonMobil commends the lighter handed approach proposed by the Commission in its Draft Report as an important step in improving economic efficiency benefits for the industry and community as a whole. Although there remains a sound basis for many existing pipelines to be closely regulated due to market failure, ExxonMobil believes that market determined outcomes should be encouraged. ExxonMobil strongly supports the Commission's key proposals enabling 15 year binding non-coverage decisions for greenfields pipelines, a lighter handed monitoring regime as a possible alternative to the access arrangement/reference tariff regime, and the requirement for failure of 'best endeavours' negotiations prior to applications for coverage by an access seeker.

ExxonMobil strongly opposes the proposal for use-it-or-lose-it rules for unutilised contracted capacity.

ExxonMobil thanks the Commission for the opportunity to comment on the Draft Report and would welcome a further opportunity to discuss any of these matters with the Commission.

If you have any questions regarding this submission or would like to arrange a time to discuss it further please do not hesitate to contact me on (03) 9270-3457 or Nigel Collins on (03) 9270-3682.

Yours faithfully,

N M Heath
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