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**Submission to the  
Productivity  
Commission's  
Inquiry into the Gas  
Access Regime**

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## Introduction and Objectives of Submission

FRH Pty. Ltd. ("FRH") is representative of the many small enterprises which provide services to the natural gas transport industry.

While some of these small concerns have derived benefit from the exponential growth of the 'regulatory industry', far more have suffered from the detrimental effects of the application of the National Third Party Access Code for Natural Gas Pipeline Systems ("the Code"). The negative impact on the 'small end of town' has prompted this submission.

FRH understands that various natural gas pipeline owners and operators and various industry groups will make submissions to assist with the Productivity Commission's review of the Code. FRH further understands that topics addressed by such submissions may include:

- objectives of the Code;
- the benefits and costs of Code regulation;
- guidance for regulators and regulatory discretion;
- alternative regulatory mechanisms;
- Code coverage criteria and application; and
- risk, incentives, and investment.

Such submissions may address specific issues and offer specific solutions to identified problems.

This submission does not seek to tread these paths. Rather, it seeks to address wider issues relevant to the scope of the inquiry at hand as stated in the "Review of the Gas Access Regime: Issues Paper July 2003" ("the Issues Paper").

Examples are used to illustrate a number of the points made in the discussion below. Choice of such examples has been guided by familiarity with the circumstances at hand.

## Empirical Studies

The Issues Paper poses (amongst others) the questions (at page 13):

*How has the Gas Access Regime affected upstream and downstream industries? To what extent has the Regime promoted competition in these markets?*

*What has been the impact of the Regime on end-user gas consumers? What is the evidence that the Regime leads to lower prices and/or improved quality and range of service for gas and energy consumers?*

*What are the efficiency gains resulting from the Regime, as opposed to any transfers from pipeline owners to other market participants?*

and at page 14:

*To what extent, if at all, has the Regime led to unmet demand, where consumers would be willing to pay more to increase supply but service providers are unwilling to make the necessary investment?*

*What and how significant an effect does the Regime have on investment in upstream and downstream markets? Does it encourage efficient investment in these markets?*

Implicit in these questions are the considerations:

- who gains and who loses from the application of the Code;
- to what extent are such parties advantaged or disadvantaged;
- what are the consequences of such advantage or disadvantage.

A review of the Code should extend beyond consideration of the intent expressed by regulators, and address actual outcomes delivered by them.

Representative empirical studies could identify the nature and impact of such actual outcomes. In particular, such studies could address quantifiable matters such as:

- the impact (in percentage terms) of regulated tariff variations on the cost structures and earnings of representative members of the 'gas chain' - upstream producers, pipeline owners and operators, downstream consumers, and gas traders and aggregators;
- the relativity between such impacts on these members of the 'gas chain' (i.e. who stands to gain / lose the most / least from tariff variations);
- the extent to which representative members of various consumer classes (e.g. heavy industry, essential services, small business, residential consumers, etc.) are affected by tariff variations (i.e. to what extent do gas transport costs contribute to the delivered cost of gas to the various consumer classes);
- the impact of tariff variations on the businesses of representative members of these consumer classes, with particular reference to the impacts on cost structures and earnings resulting from tariff variations

compared with the effects of fluctuations in other exogenous factors such as prices for 'finished' goods and services in end user markets;

- the relativity between such impacts (i.e. who stands to gain / lose the most / least from tariff variations);
- the extent to which the ongoing financial viability of pipelines and distribution systems is affected by tariff variations.

Public submissions made in the context of the administration of the Code have addressed certain specific aspects of the issues raised above. These include (but are not limited to):

- a submission by CMS Gas Transmission of Australia titled "Public Submission No. 7" dated 5 April 2002 to the Western Australian Government regarding the latter's proposal to establish the Economic Regulation Authority, which provides representative analysis of the cost structure of the 'gas chain' faced by gas retailers in Western Australia, and comparative analysis of gas transportation costs within gas distribution systems owned and operated by AlintaGas Networks Pty. Ltd.;
- the application by Goldfields Gas Transmission Pty. Ltd. to the National Competition Council for revocation of Code coverage of the Goldfields Gas Pipeline dated 26 March 2003, which discusses (at pages 48 - 51) the impact of tariff reductions on operating costs of mining operations in the Goldfields region of Western Australia.

These submissions, while specific in their focus, may possibly serve as directional pointers to the type of empirical analysis being suggested.

The results of such analysis may serve to contextualise the inevitable tension between the business interests of pipeline owners and other stakeholders, and provide insight into issues such as the impact of the Code on stakeholders' interests<sup>1</sup>, and the promotion of competition.

Empirical analysis of the extent to which the Code has provided incentives or disincentives to investment is more problematical. It is difficult to quantify the value of projects which have either not eventuated or whose scope and extent has been constrained by adverse perceptions of the Code as currently administered. It is more difficult to quantify the impact on the 'multiplier effect' deriving from such investment.

However, empirical analysis of the kind proposed above may support and facilitate the necessarily more subjective but nevertheless critical judgements regarding benefits and costs at the broader level.

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<sup>1</sup> It is relevant to note that section 2.24 of the Code constrains regulators' considerations to the "Service Provider's legitimate business interests", but specifies consideration of "the public interest" and "the interests of Users and Prospective Users" without qualification.

## The Role and Impact of Assumptions

The Code and its administration embody a number of implicit and (largely) unspoken, but nevertheless taken for granted, assumptions. Some extend beyond the 'as written' provisions of the Code, while others preclude action which is not specifically prescribed in the text of the Code, notwithstanding the broad discretion it accords to regulators. A third form of implicit assumption concerns the nature of the gas transport business.

It is instructive to characterise each in turn by way of example.

### Initial Coverage

One assumption extending beyond the articulated intent of the Code concerns initial Code coverage of existing pipelines and distribution systems.

The Code provides for coverage to be applied or rejected following the explicit consideration of four coverage criteria. However, these criteria were not applied to existing pipelines at the time the Code first came into effect. Rather, it appears that the implicit assumption that all pipelines listed in Schedule A of the Code satisfied all four coverage criteria was simply taken for granted, despite the existence of a specific coverage test.

### A Priori Determination of Reference Tariffs.

A second example of an implicit assumption which extends beyond the 'written word' of the Code is provided by the WA Regulator's a priori determination of regulated tariff levels in his Draft Decision for the Parmelia Pipeline Access Arrangement<sup>2</sup> ("the Parmelia Draft Decision").

The following extract (emphasis added) from page B80 of the Parmelia Draft Decision regarding the determination of the Initial Capital Base for that pipeline provides an example of the WA Regulator establishing regulated tariffs on the basis of an a priori assumption of what tariff levels should be:

The Regulator's estimates of Reference Tariffs that would result from different valuations of the Initial Capital Base are described in section 7.8 of this Draft Decision. An indicative Reference Tariff of \$0.57/GJ would arise from the maximum value of the Initial Capital Base (\$65.8 million) and allowing for an increase in throughput to 60 TJ/day by the end of the Access Arrangement Period. ***The Regulator considers this tariff to be unacceptable as it is greater than the current average tariff for the Pipeline. To determine an acceptable value of the Initial Capital Base, the Regulator calculated the value that would return a Reference Tariff of \$0.55/GJ under the same assumptions of increasing throughput.*** This value of the Initial Capital Base is \$62.5 million, including \$0.5 million for working capital.

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<sup>2</sup> Code coverage of the Parmelia Pipeline was subsequently revoked in March 2002.

Using this value of Initial Capital Base, the WA Regulator then calculated the value of Reference Tariff to be his 'target' value - i.e. \$ 0.55 / GJ. Such a result is inevitable given the circularity of the WA Regulator's methodology.

The WA Regulator did not expand upon his assumption that a Reference Tariff could not be greater than the "average" value of previously applicable tariffs. Thus, it is apparent that the upper bound for tariff levels was established on bases other than those explicitly articulated in the Code.

### Cost and Viability Issues

A philosophically countervailing implicit assumption adopted in the administration of the Code is that decisions by regulators made solely through the application of methodologies and consideration of factors mentioned in the Code will necessarily deliver appropriate outcomes. In other words, it is implicitly assumed that the explicit provisions of the Code are sufficient in themselves to deliver outcomes which fully realise the stated objectives of the Code.

Assumption of this form assume even greater significance when the 'written word' of the Code is applied selectively, with inordinate attention being paid to some provisions while other provisions are ignored.

The circumstances surrounding the Dampier to Bunbury Natural Gas Pipeline ("DBNGP") provide a case in point. At the time of writing (August 2003) the future of the DBNGP has been identified by various stakeholders and media commentators to be uncertain.

A large part of this uncertainty derives from controversy over the ongoing financial viability of the DBNGP.

The WA Regulator's Final Decision for the DBNGP Access Arrangement requires that the DBNGP's owners operate the pipeline prudently and safely and service outstanding debt from earnings derived from the application of tariffs determined on the basis of revenues<sup>3</sup> prescribed in that Decision. These revenues are substantially less than those originally sought by the pipeline's owners in the DBNGP Access Arrangement.

Deutsche Bank, which is both a financier and a part owner of the DBNGP, identifies the uncertainty facing the DBNGP and its potential consequences in a submission to the WA Regulator dated 4 April 2003 which states (in part):

The potential implications of a final determination inconsistent with the \$1.00/\$1.08 tariff level is particularly significant and far-reaching. Such implications are discussed below.

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<sup>3</sup> Notably, these revenues were prescribed on the basis of an a priori assumption made by the WA Regulator.

- A final determination which will not sustain the financial obligations of Epic Energy under the senior debt facilities is likely to result in enforcement of the Bank Syndicate's secured rights and foreclosure of the Pipeline. Such outcome is inconsistent with the objectives of the regulatory regime in promoting a sustainable investment and expansionary environment for the benefit of the Pipeline users and Epic Energy. Nor is such an outcome in the interests of the State of Western Australia and Pipeline users.
- Failure to adopt Epic Energy's approach of factoring future capital expenditure in the current tariff would diminish Epic Energy's incentive and capacity for investment in the Pipeline's expansion.

It is evident that Deutsche Bank considered the financial viability of the DBNGP to be at considerable risk at the time it made its submission, prior to the release of the Final Decision.

The publication of the Final Decision has not dispelled this concern. Simple analysis provides prima facie support for this conclusion.

It has been widely reported in the press<sup>4</sup> that the DBNGP's outstanding debt is of the order of \$ 1.85 billion. Annual principal plus interest repayments for this amount on a credit foncier<sup>5</sup> basis over 20 years at 6.5% per annum come to approximately \$ 168 million. In his relevant Final Decision, the WA Regulator prescribed annual revenues of around \$ 190 million per year, which included provision for operating costs of around \$ 40 million per year, thus leaving around \$ 150 million for debt servicing, return of equity capital, and return on equity capital. This 'back of the envelope' analysis points to the DBNGP not remaining financially viable if the assumptions regarding debt amount, term, repayment schedule and interest rate are anywhere near to the mark.

It is entirely feasible that one or more of the assumptions above are inappropriate. If this is the case, then the results obtained above may be misleading.

However, the degree of accuracy of the analysis at hand is not what is relevant.

What is relevant is whether the WA Regulator did and should consider the ongoing financial viability of essential infrastructure when issuing Decisions which directly influence the financial fortunes of those assets, and the extent to which the Code obliges him to do so.

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<sup>4</sup> For example "The Australian Financial Review" Thursday 28 August 2003; "The Australian" Tuesday 12 August 2003; "The West Australian" Friday 8 August 2003.

<sup>5</sup> Where principal plus interest payments are equally spaced in time and the same total payment is made in each period. A conventional household mortgage is an example. This schedule has been assumed in the interests of simplicity.

Examination of the DBNGP Final Decision suggests that the WA Regulator has chosen to subordinate the issue of the ongoing financial viability of the DBNGP to other considerations.

At paragraph 503 of the DBNGP Final Decision (emphasis added), the WA Regulator states:

I accept that the values determined for the Initial Capital Base and Reference Tariff established under the Access Arrangement can have an effect on the financial viability of Epic Energy. However, I recognise that financial viability is also contingent upon many other factors that are beyond the direct impact of Reference Tariffs, including Epic Energy's own financial management, the possibility of equity injections into the company and growth in the market for gas transmission. In circumstances where I have found that Epic Energy's purchase price was not based on sound commercial assessment, consequences of this for *financial viability should be given less weight in balancing Epic Energy's legitimate business interests against the interests of Users and the public interest* in having competition in markets and in a supply of competitively priced gas.

In turn, this raises three questions.

The first of these is whether the WA Regulator should consider matters which have the potential to significantly impact the future of natural gas supplies to the South West of Western Australia<sup>6</sup>.

The second is the extent to which the Regulator should consider stated State Government policy, which included the maximisation of the DBNGP sale price.

The third question is whether the WA Regulator's decision to subordinate considerations of financial viability resulted from a perceived constraint emanating from the lack of explicit guidance in the words of the Code. It is notable that references in the Code to the business interests of pipeline owners are confined to a few sentences<sup>7</sup>, while the interests of pipeline users and other stakeholders are extensively catered to through the over-riding emphasis on price fixing at minimum levels and the assumption of price reduction.

A second case in point is provided by the WA Regulator's Draft Decision concerning the "Recovery of costs associated with the introduction of Full Retail Contestability in the Mid-West and South-West gas distribution networks" ("the FRC Draft Decision").

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<sup>6</sup> The DBNGP is 'full', and unlikely to be expanded in the current climate.

<sup>7</sup> For example, section 2.24(a). It is notable that section 2.24 does not specifically enshrine the protection of the legitimate business interests of pipeline owners, but rather includes them as one of several factors to be considered.



AlintaGas Networks Pty. Ltd. ("AGN") initially made application to the WA Regulator<sup>8</sup> in June 2002 for costs deriving from its contribution to the implementation of full retail contestability ("FRC") in the end user natural gas market in Western Australia to be included in the AGN Access Arrangement. The WA Regulator rejected this application in December 2002 because he considered that "costs of the type proposed to be recovered by AGN did not fall within the terms of section 8.21 of the Code".

The National Gas Pipelines Advisory Committee subsequently recommended that the Code be amended to permit recovery of capital costs such as those sought by AGN. This recommendation was accepted by the relevant Ministers, and came into effect in Western Australia in April 2003.

In June 2003, AGN re-submitted its application for inclusion of FRC capital costs into its Access Arrangement, and sought "a non-binding acknowledgement that FRC non capital costs are likely to satisfy section 8.37 of the Code".

In his FRC Draft Decision, the WA Regulator accepted the capital costs proposed by AGN but refused to provide a non-binding view regarding operating costs.

It would appear that the WA Regulator has taken his current position concerning capital costs because the Code (following explicit modification) now permits him to accept capital costs such as those accruing from the implementation of FRC, but has rejected the request for a non-binding view on operating costs because the relevant Code amendment did not specifically address such an eventuality. Such action suggests a narrow and 'fundamentalist' interpretation of the Code.

It is relevant to note at this point that the "Draft greenfields guideline for natural gas transmission pipelines" issued by the Australian Competition and Consumer Commission in June 2002 specifically offered (at page 33) to provide prospective Service Providers with a "preliminary non-binding view on reference tariffs".

### Termination of Operations

An implicit assumption made by the Code regarding the nature of the gas transport industry is that Code covered pipelines will continue to operate indefinitely.

A Service Provider is obliged to offer a Reference Service to any and all comers. This implies that the owners of a covered pipeline are obliged to operate that pipeline while any demand (whatsoever) exists for its ("Reference") services, regardless of the financial viability of the pipeline's ongoing operation.

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<sup>8</sup> The Draft Decision outlines the history of AGN's submissions.

A mature covered pipeline could be faced with declining usage due to loss of upstream supply and / or downstream demand. Such a decline in pipeline load could render the operation of the pipeline uneconomic. A rational response to such a situation would be to honour all pre-existing contractual obligations, and then terminate the pipeline's operations. However, parties which sought to continue utilising the pipeline at a sub-economic value of total load could demand that its requirements be met through the provision of a Reference Service.

The assumption of indefinite operation may be valid for publicly owned assets whose fortunes are dictated by public policy, but it is simply not valid for privately held assets which are necessarily operated under the profit motive.

### Consequences of Implicit Assumptions

The adoption and subsequent application of implicit assumptions in the administration of the Code may have both positive and negative consequences.

The fact that a significant number of pipelines and distribution systems originally covered by mandate have subsequently had Code coverage revoked points to shortcomings in the original assumption, and reflects a 'central planning' view which is particularly inconsistent with the requirement for diversity which underpins the operation of the private enterprise system. In certain instances, the cost of making application for revocation of coverage constituted a considerable financial burden to both small and large operators. While it is too late to apply coverage to only those pipelines shown to satisfy all four coverage criteria following explicit assessment, it is relevant to consider the 'universal coverage assumption' as a prime exemplar of an unstated but taken for granted assumption which extends far beyond the scope and intent of the Code, and has resulted in adverse outcomes.

A priori assumptions regarding regulated tariffs could under certain circumstances be viewed as the exercise of discretion to deliver commercially realistic outcomes. The acceptance of the "regulatory compact" between the owners of the DBNGP and the Western Australian state government could have provided a topical example. However, the a priori assumptions regarding tariff levels underpinning the WA Regulator's Decisions concerning the Access Arrangements for the Parmelia Pipeline and (later) the DBNGP have served to aggravate the demonstrably adversarial relationship<sup>9</sup> which has over time developed between various Service Providers and other stakeholders and the WA Regulator.

Thus, it is apparent that assumptions predicated on sweeping generalisations may lead to undesirable consequences.

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<sup>9</sup> The WA Regulator has faced three Supreme Court challenges to various of his actions, and is currently facing a fourth; see below.

On the other hand, assuming that the specifically articulated provisions of the Code will of themselves completely accommodate all circumstances can also lead to problems.

Interpretation of the Code in an apparently 'fundamentalist' manner has further exacerbated the deterioration in relationships between the WA Regulator and his stakeholders. The WA Regulator's choice to subordinate considerations of the "regulatory compact" between the owners of the DBNGP and the Western Australian state government has led to perceptions of sovereign risk in many quarters. Inordinate time delays, narrow interpretations, and apparent fence sitting staidly in the interests of "complying with the Code" serve to generate further frustration and animosity.

At a wider level, implicit assumptions concerning the nature of the gas transport industry (such as 'indefinite operation') which do not recognise and accommodate critical aspects of private sector operation are counter-productive.

It is inevitable that implicit assumptions must be made in the construction and administration of the Code. It is simply not possible to commit to paper every basis underpinning the perceived solutions to the regulatory 'problem'.

However, it is possible and desirable that, to the extent possible, implicit assumptions which have significantly affected the operation of the Code to date be identified and then articulated. Their consequences might then be evaluated, with special attention being paid to particularly expansive and particularly restrictive assumptions. Such evaluation could facilitate the 'rehabilitation' of an economic regulatory regime which is in need of 'repair'. In particular, the surfacing of 'hidden' assumptions might serve to provide guidance to regulators regarding both the ambit and practical exercise of the discretion which must necessarily be applied in the achievement of workable outcomes.

## **The Code to Date: Evaluation and Conclusions**

The Code is demonstrably 'broken' in Western Australia. History to date, which includes:

- four Supreme Court actions<sup>10</sup> against the WA Regulator, which have to date gone against that regulator<sup>11</sup>;

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<sup>10</sup> These comprise actions by Epic Energy regarding the DBNGP Access Arrangement and funding of the WA Regulator, action by the owners of the Goldfields Gas Pipeline regarding the Access Arrangement for that pipeline, and action by WMC Resources Ltd. regarding the jurisdiction of the WA Regulator.

<sup>11</sup> It is generally accepted that the WA Regulator lost both actions initiated by Epic Energy. The DBNGP Draft Decision was found to contain substantial errors of law, and the WA Regulator is unable to recover from Epic Energy (or any other Service Provider) his ensuing legal costs under WA funding regulations. The WA Regulator conceded that the errors of law contained in the DBNGP Draft Decision also manifested themselves in the Goldfields Gas Pipeline Draft Decision. As a consequence,

- the findings of the 'Epic Decision' (concerning the DBNGP Draft Decision) which identified fundamental errors of interpretation of the Code by the WA Regulator;
- the absence of approved Access Arrangements for the DBNGP and the Goldfields Gas Pipeline some three years and eight months after their submission;
- the revocation of Code coverage of six of the eleven "pipeline systems" identified at Schedule A of the Code;

(and most recently)

- the potential adverse impact on the implementation of full retail contestability flowing from the FRC Draft Decision;

points to substantial malfunction of economic regulation of natural gas "pipeline systems" under the Code.

The Code's state of 'health' in other parts of Australia is little better. Formal action against various aspects of the Code's administration or application is being pursued in South Australia, Victoria, and New South Wales.

Thus, in reviewing the Code, consideration should be given to its fundamental bases in terms of both construction and administration. 'Wallpapering over the cracks' will serve only to compound existing problems.

This points to the need for a fresh start from first principles in defining the economic regulatory regime applying to gas transport systems, rather than a re-working of the Code in its present form. Further, a change of mindset by the individuals administering the Code is required. Neither is easy, with the latter presenting a far greater challenge than the former. However, if the attempt is not made, 'full' pipelines will not be expanded and new pipelines, if built, will be sized strictly to accommodate foundation contracts with subsequent capacity expansions incurring avoidable cost premia.

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the action by the pipeline's owners was withdrawn. The action by WMC Resources Ltd. is proceeding at time of writing (August 2003).