GGT

GOLDFIELDS

GAS

TRANSMISSION

REVIEW OF THE GAS ACCESS REGIME

Submission to the
Productivity Commission

ON

DRAFT FINDINGS & RECOMMENDATIONS

March 2004

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1.0 INTRODUCTION

Goldfields Gas Transmission (GGT) operates the Goldfields Gas Pipeline (GGP) which extends 1380 kms from gasfields in the north-west of Western Australia to Kalgoorlie. Commissioned in 1996, before the introduction of the National Gas Access Regime (the Gas Regime), it delivers gas to a small number of major mining and processing ventures in the Pilbara, Northern and Eastern Goldfields regions. The gas is used primarily for power generation.

The GGP was constructed pursuant to an Agreement with the State Government, which was ratified by the Goldfields Gas Pipelines Agreement Act 1994 (the State Agreement).

GGT made submissions to the Productivity Commission (the Commission) during the preliminary round of submissions in its review of the National Third Access Code for Natural Gas Pipelines Systems (the Code).

The purpose of this submission is to provide comment on the Commission's Draft Findings (the Draft Report) based upon GGT's experience with the Code.

Information Requests

To the extent that this submission includes discussion which is pertinent to requests by the Commission for responses to specific matters, GGT would refer to the following sections of this submission:

- *Appropriate ways for access seekers to demonstrate 'best endeavours' in negotiating access*: Section 3.3
- *its proposed framework for who can apply for coverage and revocation of coverage*: Section 3.4
- *the possible implications of introducing use-it-or-lose-it rules for unutilised contracted capacity*: Section 4.4
- *what data items should be reported under the proposed monitoring regime, the level of disaggregation that should be involved and how data should be presented*: Section 6.5

- *introducing a Gas Code provision for a dedicated truncation premium. In particular, the Commission welcomes suggestions on the most practical way to implement such a premium*: Section 4.5

2.0 DIRECTION OF THE DRAFT FINDINGS

The Commission's Draft Report has given laudable recognition to many of the more serious problems embodied in the Code - and its implementation - which have been identified by the gas transmission industry. It is encouraging to see what seems to be, on the whole, a balanced and objective appraisal of a regime which to date has fostered and been increasingly characterised by strongly polarised and generally irreconcilable perspectives. In general, GGT is supportive of the Commission's conclusions in regard to the need for evolutionary change in both the form and practice of economic regulation under the Code.

Unfortunately, the Commission's recommendations as currently drafted will not deliver the Code reforms as the Commission intends and as are so badly needed. In a previous submission to the Commission in its current review, GGT put forward the view that it was clear *"whatever other changes to specific provisions may be necessary, if the Gas Code is to be an effective tool in achieving the objectives of competition policy reform, significant guidance in regulatory implementation is also essential."* [1]

GGT wishes to re-emphasise that if the reforms that the Commission are proposing – many of which are crucial to the orderly development and sensible regulation of a vital element of national infrastructure - are to have any hope of achieving their objectives, then strong unambiguous implementation guidance is critical.

As much as possible, scope must be removed for the continuance of regulatory re-interpretation and the need for litigious interpretation of the contents and objectives of the Code.

In a more perfect world, regulatory latitude and scope for discretion would be desirable features of an economic regulatory regime. However Australia's experience under the Code, and many of the findings of the Commission regarding the problems which have arisen as a result of its implementation, provides a substantial body of cautionary evidence.

In GGT's view, the task of the Commission will not have been properly executed if it does not include a high level of definition in regard to the guidelines needed. Certainly this task should not be left to the NCC or any other regulatory agency. There is widespread concern that the scope for regulatory re-interpretation that this would provide would amount to defacto regulatory policy determination. In the view of GGT (and others

1 PC Review GGT Submission Access Regulation Issues August 2003, page 3.

in industry), it is critical that regulatory guidance be specified by the Commission for execution of its recommended reforms to the Code through the subsequent governmental drafting and finalisation processes. In the absence of such specific guidelines, the concern is that the reforms will be negated in a new version of the Code that permits regulators to continue to manifest the problems associated with the implementation of the current version.

3.0 BETTER DEFINITION REQUIRED FOR THRESHOLD TESTS

3.1 Tests of materiality for coverage thresholds (DR 6.1, 6.4, 6.5, 6.6)

In a number of the Commission’s recommendations, reference is made to proposed wording which is intended to raise and clarify the thresholds for testing whether or not, and to what extent, coverage under the Code might be warranted. In essence, the proposals are designed to provide greater clarity and guidance and to ensure that coverage decisions are based on more than mere theoretical prospects of yielding the intended economic benefits. In this regard, GGT commends and supports the Commission’s intentions in establishing the need for substantiation of prescribed levels of materiality in order to ensure as far as possible that the significant costs of regulation result in real and significant benefits.

The thresholds which the Commission has prescribed for demonstrating the materiality of outcomes under the Code, include the need to demonstrate that coverage is likely to yield benefits, or have an intended effect, which is either:

- "Substantial" (Draft Recommendations 6.1 and 6.6),
- "Material" (Draft Recommendation 6.5 and 6.6), or
- "Significant" (Draft Recommendation 6.4)

In a submission during the previous round of submissions to the Commission, GGT commented briefly upon the desirability of using the word "substantial" over the word "material" in respect to the proposed changes to criterion (a).[2] The Government’s response to the Commission’s recommendation from its view of the National Access Regime was to favour the use of “material” over “substantial”. Clearly there may be different interpretations as to specific definitions and therefore the implied materiality of the threshold imposed by the use of either word. However, while this in itself provides some scope for legal challenge, which would be desirable to avoid if possible, the use of either word would at least be indicative of the intent to raise the threshold higher than it would otherwise be in the absence of both words.

[2] PC Review GGT Submission Coverage Issues August 2003, page 10.

In the Commission's current proposals however, the words "substantial" and "material" are both used with the intended purpose of establishing two distinctly different threshold levels. The Commission is proposing to distinguish between the need for light and heavy-handed regulation and GGT considers that this is a commendable and progressive move. However GGT is concerned that no such clear, unambiguous or unassailable distinction between the meaning of the two words actually appears to exist in either common usage or jurisprudence.

In Appendix D to the Draft Report, GGT notes that the advice of the Australian Government Solicitor (the AGS) was sought in regard to this distinction and that it concluded that there is scope for confusion of meanings. The AGS suggests that consideration be given to including in the Code a specific definition of whatever expression is used to prescribe the coverage threshold. GGT agrees with that suggestion but would go so far as to urge the Commission to consider that such definition is not discretionary but is absolutely critical to achieving the intended outcome of the proposed changes.

GGT would however caution the Commission against accepting the AGS' suggestion (in paragraph 21) that the initial threshold for coverage should omit any qualification as to the extent to which competition would be increased. This would provide very little or no guidance for regulators and leave standing the present scope for strictly textual but impractical (and therefore inefficient) interpretation of the threshold for coverage, as illustrated in the following discussion.

Similarly, while GGT supports Draft Recommendation 6.4 for a new test to be included that coverage of a pipeline is likely to "*improve economic efficiency significantly*", clear definition of what is intended appears to be warranted.

An example of this (relevant to GGT's own experience) is illustrated in the response to the following submission made by GGT to the NCC in regard to the GGP Revocation Application:

> "*In any event, the retail market in the Kalgoorlie-Boulder area is clearly dominated by a retail gas and electricity duopoly. In this market, gas transportation cost represents approximately 15% of the delivered cost of gas to consumers, as GGT highlighted in its*

> *application. Under these circumstances, GGT requests the NCC give consideration to the limited scale and scope of potential for the Code to produce an outcome in this market in which "a likelihood of increased competition that is not trivial" might eventuate. (p. 10)"* (Cited on page 132 of the NCC's Final Recommendation).

The NCC's relevant response (in paragraph 5.335) to this request to consider the significance, in effect, of the impact which coverage would have, given the clear and substantial constraints on the scope and scale available for any impact to occur at all, was to state (with emphasis added):

> *"... The Council recalls, from paragraph 5.195 and 5.213 above, that a promotion of competition involves improving the opportunities and environment for competition. <u>It is not necessary that there will be, or will be within a particular period of time, an actual increase in competition for criterion (a) to be satisfied</u>."*

The view expressed by the NCC in this example would appear from the wider evidence, to be fairly representative of the application of the coverage tests. Given this view, it is not difficult to imagine the NCC (or any other regulator) arguing that what is "significant", is the prospect of improving the theoretical circumstances which might give rise to the possibility of improved economic efficiency - rather than any prospect of an actual improvement. The scope for such interpretation would appear to reverse the positive amendment to the Code being recommended by the Commission.

3.2 Prospectivity threshold, "likely to", requires definition (DR 6.1, 6.4, 6.5, 6.6)

In a number of the Commission’s proposed reforms to the Code (and elsewhere in the existing Code), the prospect of coverage - or certain other events - is defined in terms of whether it is "likely to" occur or have a certain effect. Specifically, this wording is used in Draft Recommendations 6.1, 6.4, 6.5 and 6.6. Whilst the more substantive aspects associated with these proposals are discussed elsewhere in relevant sections of this submission, the issue which GGT seeks to address here is the unclear extent to which these words establish a coverage threshold.

In the advice provided by the AGS in Appendix D of the Draft Report, the legal interpretations and distinctions between the words "likely" and "likely to" provide a fairly clear indication that ambiguity exists. Consequently, scope will continue to exist for debate and legal challenge over the prospectivity of outcomes in regulatory decisions concerning coverage, despite the Commission’s good intentions.

As was illustrated in the previous example of a regulator’s interpretation of the "likelihood" (and "triviality") of an intended outcome ever actually eventuating (in Section 3.1 above), very clear guidance is required as to the extent to which a threshold for coverage is prescribed.

The use of the words "likely" or "likely to" are not necessarily inappropriate, however, as the AGS points out, "likely" is not necessarily synonymous with "more likely than not". In the extreme, "likely" can apparently simply imply a "possibility" (consistent with the interpretation given to it by the NCC in the previous example). The critical issue is one of clearly specifying the threshold of prospective likelihood. In this particular case, it is not a difficult matter to define the required degree of probability of an outcome eventuating, in order to determine if coverage is warranted.

It may of course be a difficult and subjective task to determine the probability of a specified outcome actually eventuating. It is however a considerably easier task, to determine that if there is not a specified minimum probability of that outcome occurring, then it does not meet the minimum threshold of likelihood. In risk analysis, possible outcomes are routinely quantified in terms of their impact and probability in order to perform just such calculations (and many more complex ones besides).

It may not be a practical suggestion to incorporate into the Code coverage tests, a requirement to numerically quantify the probability of certain outcomes eventuating. However some greater form of guidance in regards to likelihood is nonetheless required in order to improve upon the vague requirement that outcomes are "likely to" occur.

3.3 "Best endeavours negotiation" (DF 6.9, Information request)

GGT supports the Commissions conclusions on page 194 in regard to the need "*to require access seekers to demonstrate 'best endeavours' in negotiating access, before the NCC accepts an application for coverage*". However GGT would urge the Commission to consider that this suggestion, contained in Draft Finding 6.9, should be upgraded to a recommendation in its Final Report.

Such a requirement in fact ought to be extended to any applications for arbitration or appeal concerning a purported failure to be able to negotiate access. This is a particularly important qualification in circumstances where recourse is available to existing or potential users to seek increased regulatory intervention, whether it be recourse to arbitration or coverage in a more heavy handed form. A failure to impose such a threshold requirement will see the continued practice of some users seeking to claim an inability to obtain the access they desire without any bona fide attempt to negotiate.

As the Commission has commendably noted (on page 258):

> "*In general, lighter handed regulation places greater emphasis on encouraging commercial negotiations than on prescribing the terms of transactions between businesses and their customers, or imposing constraints on financial variables (such as a cap on prices, expected revenue or profits). As noted in earlier chapters, the current Gas Access Regime has not facilitated commercial negotiations. The services provided and prices charged under the current regime have largely been confined to the reference services and reference tariffs approved by regulators.*"

As the Commission has also noted (page 259), a lighter handed form of regulation should:

> "*enable[] users to negotiate terms and conditions that meet their unique circumstances, rather than be limited to those approved by a regulator"*, and,
>
> *reduce[] opportunities for regulatory gaming and lobbying, since there is greater emphasis on commercial negotiations, rather than prescriptive rules on prices and other conditions of commercial transactions"*

However, while ever the possibility of recourse to regulator imposed price reductions exists, it will give rise to the prospect for transfers of economic rent. In such circumstances as it is known that the regulatory bias under the Code is (as has been shown) towards reduced prices regardless of the level or merit of pre-existing price levels, commercial negotiations can become merely a contrivance for initiating regulatory intercedence. Users of sufficiently large size such that the potential benefit outweighs the potential cost, will have every incentive to seek to dictate unreasonably low prices or terms of access - and then claim an access dispute when the service provider seeks to negotiate a reasonable commercial balance. As discussed in Section 4.2 of this submission, such attempts by users to capture the rent transfers apparently available to them under the Code represent a distinctly different outcome to the intended regulatory objective of pursuing "economic efficiency".

In this regard, GGT strongly commends the observation on page 194 of the Draft Report that:

> "*One solution might be to require access seekers to demonstrate 'best endeavours' in negotiating access, before the NCC accepts an application for coverage. The Commission recognises that such an approach would add costs at the start of an application, to the applicant (in undertaking commercial negotiations and then demonstrating they have undertaken those negotiations), the service provider (in undertaking commercial negotiations) and the NCC (in assessing whether applicants meet this requirement). Given the potential for cost savings from avoiding regulation if service providers and access seekers can agree on terms and conditions via negotiation, the Commission considers that some*

> *negotiation costs to applicants and service providers would not be inappropriate."*

The difficulty however is in determining how "best endeavours" can be demonstrated in circumstances where one party has no interest in negotiation but is merely seeking grounds for intervention.

One possible (and probably only partial) solution exists in the inclusion of appropriate information relating to access inquiries and negotiations (both successful and otherwise) as part of the information disclosure guidelines for a monitoring regime. This would be consistent with Draft Recommendation 8.3, although GGT has some concerns that such information requirements should be standardised rather than left to the discretion of the NCC on a case by case basis (refer Section 5.1).

An additional level of comfort would be provided by the voluntary subscription by a service provider to a published Code of Conduct that included clearly defined principles for how the service provider proposed to manage and resolve any access disputes. Such an undertaking would serve to augment the "*credible threat that the misuse of market power by a service provider would trigger use of the Gas Code's heavier handed regulation (an access arrangement with reference tariffs)"* as envisaged by the Commission (page 263).

On the other hand, to the extent that recourse to the "negotiate – arbitrate" model for lighter handed regulation would involve arbitration along the lines of commercial dispute resolution,[3] this might further dampen incentives for non-genuine access disputation. The Commission cites (on page 265) drawbacks with the negotiate – arbitrate model identified by the ACCC based upon its view of its experience in the telecommunications industry thus:

> *"… arbitrations can be slow and costly. This reflects the unavoidably resource intensive and time consuming processes due to the complex nature of the issues and the need to conduct the hearing fairly."*

While the ACCC appears content that complex, resource intensive and time consuming approvals and appeals processes under the

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3 Rather than regulatory price determination, with the problems this gives rise to as discussed by the Commission on page 265.

Code are acceptable burdens, it might nonetheless be that the prospect of such access arbitration processes would at least serve to counter balance regulatory gaming incentives to some extent.

3.4 Comment on proposed framework for who can apply for coverage / revocation (Information request)

There seems to be little case to be made for narrowing the qualifications for who should be able to apply for revocation of coverage. There would appear to be little scope for trivial or vexatious applications in this regard.

However, in regard to applications for coverage, these should only be sought in circumstances where – despite the problems discussed in the previous section associated with verifying that 'best endeavours' negotiations have occurred – clear evidence exists of market failure.

The current ability that exists within the Code for coverage to be initiated by a regulator should be removed. Regulators should not be provided the scope to determine (or attempt to determine) who they regulate – this is properly the role of a separate independent body. There are a number of good reasons for this arrangement however it should be sufficient to point out the scope for conflicted interest (or at least, compromised objectivity) and acrimony, which could arise in situations where such a coverage application was contested.

4.0 NEED FOR REGULATORY GUIDANCE

4.1 Objectives of "economic efficiency" in Gas Access Regime (DR 5.1, 5.2, 7.1)

In accordance with the federal government’s response to the Commission’s recommendations arising from it review of the National Access Regime, Draft Recommendation 5.1 suggests the inclusion and wording of an overarching objects clause which simply attests to the need;

> "*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 advocates the removal of the existing objectives in the preamble to the Code. The Commission suggests that other policy instruments might be used to pursue specific objectives beyond those identified or implied by the suggested objects clause.

However the Commission’s proposals raise a number of serious concerns. For example, the proposals widen the scope for interpretation of objectives and fail to provide guidance as to what should or should not be considered in regulatory considerations. As a result, the intended wider policy outcomes could be dampened or reversed by regulators (not limited to the self-defeating inclusion or omission of extraneous policy benefits or costs, as discussed in Section 5.3 of this submission).

One significant concern is that, while the proposed overarching objects clause makes mention of the need to include the promotion of investment in pipeline services, this objective is not supported in any other proposed amendment or existing clause within the Code. In fact, the Commission currently proposes (in Draft Recommendation 5.1) to delete from the preamble to the Code, the only development-oriented objective which currently exists – in sub-clause (a).

This omission poses a serious risk that the Code will be implemented in such a way that the need to foster longer term development of essential infrastructure will not receive due consideration. A reliance upon adequate weight being given to the dynamic and long term requisites of "economic efficiency" in the interpretation of regulators and their academically inclined advisers, is a high risk national economic strategy. If the Commission intends to recommend that an objective of economic regulation should include a consideration of the need to promote appropriate investment in the services being regulated (as GGT believes it should), then this objective needs to be supported by specific requirements for it to be given weight in regulatory decisions. This needs to include specific guidance in the Code as to what is intended by reference in the objects clause to the promotion of "*economically efficient* [...] *investment*" in the services being regulated.

Similarly, Draft Recommendation 7.1 contemplates replacing the existing s8.1 of the Code with changes that include (with emphasis added):

> *"(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* <u>*efficient long-run costs*</u> *of providing access to those services*
>
> *(ii)* *..."*

However, as the Commission points out on page 205 (with emphasis added), "*prices that promote economic efficiency – in the sense of encouraging the best use of existing resources – are generally required to be set equal to* <u>*short-run marginal cost*</u>*"*.

While the Commission notes the incongruent nature of these two approaches to economic efficiency, its recommendations fail to provide regulators with unambiguous guidance in order to be assured of the correct approach in practice. Instead, there remains wide scope for regulatory adoption of marginal costing in pursuit of the short run economic benefits to which regulators have demonstrated a strong propensity to date.

The need for quite specific guidance as to what is intended in regard to long run economic efficiency can be seen in another example provided by an assertion by the ACCC on page 230 of the Draft Report which considers that investors may consider that "*the* *timing of regulatory depreciation is immaterial"*. Such an argument might be applied by a regulator as being a justification for the imposition of short-run marginal pricing as, in the long term, that is what price levels in a competitive market would be expected to converge upon (according to the theory). Clearly, if such latitudes are to be excluded from possibility, strong guidance will be needed.

Included in such guidance should be the necessity to consider "investment efficiency" in a commercial context where that affords wider societal benefits. This might include such benefits as having low cost developable (spare) capacity available when a new pipeline is built as a result of being underwritten by foundation contracts which provide a price floor, for example. Such consideration – that is, in a commercial context - is currently not possible under the existing Code due to the "speculative investment" and "redundant capital" provisions and the investment threats that these represent.[4]

4.2 "Economic efficiency" and the coverage tests (DR 6.4, DF 7.2)

In Draft Recommendation 6.4, the Commission has suggested that:

> "*The coverage criteria in s.1.9 of the Gas Code should include a new test — namely, that coverage of the pipeline is likely to improve economic efficiency significantly.*"

GGT supports the Commission's proposal in so far as it goes, but notes that (as discussed in the previous section of this submission) neither this proposal nor any other provision suggested by the Commission or currently existing within the Code, adequately addresses the overarching objective proposed (in Draft Recommendation 5.1) in regard to the promotion of investment in pipeline services. Instead, the Commission appears to rely on the prospect of regulators giving appropriate weight to the dynamic

[4] In limited circumstances, the concept of "economic depreciation" – or the excising of investment in spare initial capacity from the capital base used to determine tariffs, but permitting a notional annual uplift in value to account for opportunity cost - has been used to mitigate the effect of the "speculative investment" provisions of the Code. Such a mechanism may serve to some extent to bridge the gap between the pursuit of theoretical economic efficiency (including the "optimal" timing of investment) and the practicalities of entrepreneurial investment. However it remains somewhat difficult to reconcile with the commercial expectations of investors, for who deferral of attributable returns contributes to increased investment uncertainty and hence, risk. The scope for partial asset stranding under the "redundant capital" provisions of the Code remains an unmitigated threat to capital investment.

and long term requisites (which include the need for investment) for achieving "economic efficiency" in their interpretation and implementation of the Code.

Unfortunately, the evidence suggests that regulators would translate the proposed new coverage criterion, as drafted, to mean outcomes quantified in terms of “efficient economic costs”, quite feasibly equated to short-run marginal costs. It is noteworthy that elsewhere in the Draft Report (page 255) in relation to the less obvious costs associated with regulatory error, the Commission itself alludes to the presumption that "*in the short term, users* [would] *benefit from low reference tariffs*". As the Commission appears to have acknowledged, this seems to be, if not the precise objective of the Code according to regulators (as argued by many), then at least the direction in which experience indicates regulators are inclined to err.

However, the real issue is not whether users do or should receive lower tariffs as a result of regulatory intervention but whether the outcomes of regulation serve the purposes of economic and regulatory policy. "Efficient economic cost" levels are simply a quantifiable proxy for an optimally performing industry and economy. Unfortunately, even quantifying the proxy is subject to such uncertainty that it embodies an "*inevitable imprecision and subjectivity*" as the Commission notes in its Draft Finding 7.2, and concludes (on page 83):

> "*However, just as the prices sought by service providers might not reflect the prices that they would charge without regulation, the prices approved by the ACCC might not reflect ‘efficient prices’, given the potential for regulatory error (chapter 7). Such regulatory error not only has effects on prices, but it can have wider implications on market outcomes and investment.*"

In GGT’s view, this is a correct summary of the situation. Similarly, the Commission correctly observes (ibid) that upstream producers with sufficient market power might capture rents "*so there is no overall benefit to downstream users in the form of lower prices*" and (on page 84, with emphasis added) that;

> "*… access regulation might result in transfers being redistributed from service providers to users. <u>Such transfers are not efficiency gains</u>. The private benefits in terms of the net transfer of income to*

> *gas producers and/or users are not part of the overall benefits of regulation. Rather, the benefits of access regulation to society will depend on the extent to which the regulation reduces inefficiencies that otherwise would arise from the exercising of market power."* [5]

Consequently, the inclusion of such a criterion as that proposed above, must be qualified with sufficient guidance as to what is intended to be achieved such that it will not be subverted by the propensity of regulators to simply err in favour of imposing lower prices by regulatory intervention.

The Commission (on page 263) appears to have recognised that this is a concern in regard to the proposal for a lighter handed regulatory alternative:

> "*The Commission acknowledges that the introduction of the monitoring regime would create a risk that those making coverage decisions will err on the side of caution by deciding to cover pipelines that would not have been covered under the current Gas Access Regime. In putting forward the monitoring regime as an option, the Commission emphasises that the proposed coverage criteria should be applied rigorously so the extent of coverage would be no greater (and probably less) than what would occur under the current Gas Access Regime (including with the refinements proposed in this chapter)."*

GGT strongly supports the Commission's emphasis on the need for rigorous application of the coverage criteria such that the extent of coverage should be no greater and probably less than that which would otherwise occur. However, it would seem that this is a strong argument in favour of a considerably higher degree of unambiguous regulatory guidance than that which the Commission has so far recommended.

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5 The Commission's Draft Finding 4.2, which derives from the considerations cited here, however is not quite consistent with the Commission's discussion and states only that, "*The Gas Access Regime has determined terms of access to pipelines and lowered prices for gas transmission and distribution*". As it stands, this finding understates the evidence of rent transfer and other long term inefficiencies which have arisen from the lowering of tariffs and which the Commission otherwise appears to recognise.

4.3 Marginal costing and the need to recover total investment cost (DR 7.1)

Compounding the problems with interpretation of what is intended by “economic efficiency”, is the tendency for regulators to ignore the time value of money – as well as specific risks which might be unique to a specific pipeline, for instance, one which only serves to connect two complimentary but similarly finite extractive resource industries as the GGP does. The Draft Report refers to this proposition (pages 232 and 296), citing the ACCC's view that;

> "*… capitalisation of financial losses is the preferred mechanism. This enables a more satisfactory return to be achieved even in a black sky [downside] scenario but over a longer timeframe.*"

In combination with the Capital Redundancy provisions that currently exist in the Code, the effect of this approach by regulators is to defer – potentially indefinitely - the recovery of capital investment.

The impact of these considerations upon achievable rates of return are discussed separately in the section of this submission dealing with the concept of the truncation premium and the limits of economic theory (Section 4.5).

Where price determination based on economically efficient costs is interpreted to mean marginal cost pricing – particularly where this is constrained to being based upon “look forward costs” – a number of serious problems arise. Critically these include:

- For a firm having a typically downward sloping cost function – as most pipelines would – average costs (which exceed marginal costs) cannot be recovered.

- Hence prior investment can not (even in theory) be recovered.

- No incentive exists for new investment.

Ultimately, any price determination methodology which does not recognize the need for full cost recovery, commercially acceptable rates of return commensurate with business risk and the need for incentives to invest, is short sighted and economically harmful.

4.4 Foundation Contract Issues (DF 5.3)

GGT supports the acknowledgement by the Commission of the importance of foundation contracts as outlined on page 30:

> "*Foundation contracts are long term and beneficial for pipeline investors and foundation users.*
>
> - *For pipeline investors, long term contracts are essential for underwriting the investment in the pipeline (given that these investments are long term in nature).*
> - *For foundation users, long term contracts provide long term security of supply, which is especially important if they have invested in long term capital associated with natural gas use. Foundation users might also be able to negotiate contracts that are evergreen — that is, there is an option to renew at the end of the contract.*"

The Commission identifies (on page 30) that "Most Favoured Nation" (MFN) clauses:

> "*ensure that if a pipeline owner sells capacity to other users at a lower price, the foundation user is also charged this price and thus is not competitively disadvantaged.*"

This and other clauses such as, for example, a <u>preferential</u> right of access to a defined quantity of transmission capacity, are examples of the exercise of countervailing market power that can be negotiated by a foundation customer (as also acknowledged by the Commission on page 30).

It should also be acknowledged however, that these types of clauses are not without cost. The nature of commercial negotiation and the balance of countervailing market power ensure this. The commercial trade-offs that are agreed to by the parties to foundation contracts determine the price that is paid by the respective parties in order to establish their relevant property rights.

It is important that the imposition of economic regulation respects these property rights in order to avoid inequitable outcomes and effects that distort existing market efficiencies and future investment decisions. However, the pursuit of theoretical efficiencies by means of regulation can all too often threaten the proper operation of foundation contracts and upset the outcomes intended when they were negotiated.

An example of one such threat, is raised by the Commission in section 7.8 of the Draft Report in regard to the prospect of "capacity hoarding" by shippers who might over-contract capacity in order to restrict access by new entrants and competitors. However, the Draft Report does not consider the validity of the efficiency, cost or commercial desirability to a foundation customer to reserve (and contribute financially towards) additional capacity for future needs. Instead, the Commission alludes to the prospect of forcing shippers to trade their unutilised contracted capacity[6] and has requested feedback in regard to the implications for 'use-it-or-lose-it rules' (pages 247-250).

While there may be a theoretical issue in regard to efficient pipeline utilisation, it should be noted that customers who reserve capacity in excess of their current requirements incur a cost and hence have determined that the investment is economically optimal for them. If the consequence of that investment decision were to preclude competition then it could well be that the outcome is sub-optimal for the wider economy. However, as the Commission points out, under the Code, other users who might not be able to gain access to current unutilised capacity, can fund an expansion of the pipeline to gain this capacity if none is otherwise available. Therefore the Commission might like to consider that a current user who is paying for capacity in excess of current needs will presumably incur a higher cost of production in the market in which it is competing and hence will tend to provide the price signals which are required in order for new market entrants to appear.

[6] Covered pipeline service providers are already obliged to permit user transfers or assignments of contracted capacity under the Trading Policy provisions of s.3.9-3.11 of the Code. Other service providers such as Duke Energy International and GGT have offered – in the absence of the Code - to facilitate capacity trading under voluntary codes of conduct governing non-discriminatory pipeline access. While this is desirable, it should be noted that in some markets, characterised for instance by a small number of industrial users, all requiring long term contractual certainty, capacity trading is unlikely to occur on any significant scale as it is unlikely to fulfil the needs of users.

If the Commission determines to pursue a proposal to force users to trade or otherwise relinquish unutulised capacity, GGT would urge it to consider that:

- such a mechanism can only properly function in a market in which a sufficient degree of fluidity exists, that is the market must be sufficiently diverse and mature (see footnote 6),
- due to the inescapable laws of hydraulics, the redistribution of gas offtake along a pipeline can have marked effects upon its capacity to deliver gas at other points along its length and may necessitate expenditure in additional capacity (or make redundant investment which has already occurred),
- such a mechanism could have potentially significant adverse consequences for the property rights of foundation users, possibly to the extent of adversely influencing future reliance upon the foundation contract mechanism which is generally needed in order for investment in pipeline infrastructure to proceed.

The Commission also notes on page 30:

> *"Another benefit of long term* [foundation] *contracts is that they reduce the scope for opportunistic behaviour whereby one party refuses to do business except on unreasonable terms."*

However, the GGP represents a case study in the problems that can arise when regulatory intervention upsets commercial outcomes. On pages 90-1 the Draft Report refers to the effect that MFN clauses can have when regulation - which sets prices in quite a different way to that by which prices are arrived at between service provider and foundation customers - is superimposed. GGT supports the Commissions observation that "*for a pipeline to gain market share in a competitive setting, the price depends upon market conditions and does not necessarily follow a path over time based on the cost of service method*" and that "*the coexistence of these two different price approaches might make capital recovery impossible for a business facing both regulation and competition*".

When regulators are intent on imposing regulation and completely unmindful of existing competitive effects (for example, because they are dismissed on the basis of theoretical substitution threshold tests)[7], the problems for capital recovery identified by the Commission, become inescapable.

In section 5.7 of the Draft Report, the Commission considers the effect of pre-existing contractual obligations and the adverse implications for future investment in pipelines from regulation impinging upon them. Accordingly Draft Finding 5.3 recommends that s.2.24(b) should be specifically retained in the Code. However the Commission does not consider this issue in the context of the effect of MFN clauses and its recommendations fail to address the need to provide very specific guidance to regulators in this regard. To date, regulators have been arbitrary in such considerations – in one instance perhaps considering MFN clauses as being a mechanism by which lower tariffs under the Code might be given wider effect[8], and in another being ignored as being outside regulatory consideration of the negative financial impact of imposing marginal (or 'sub-efficient' capital recovery) pricing[9].

On page 297, the Commission refers to s.8.30 of the Code regarding the relationship between Rate of Return and the risk involved in delivering the Reference Service, concluding that:

> "*It could be argued that the above section of the Gas Code requires regulators to reduce a pipeline's regulatory rate of return when it approves a symmetric truncation mechanism. This assumes that it is possible to transfer risk from service providers to users.*"

In the presence of MFN clauses however, the assumption regarding the possibility of transferring risk from service providers to users cannot be made and any adjustment to a service provider's rate of return in consequence of the inclusion of some form of symmetric truncation mechanism, will be self-defeating.

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7 As employed by the NCC in its evaluation and dismissal of the very real competition the GGP faces in its serviced markets from other forms of energy.

8 e.g. Final Recommendation - Application for revocation of coverage of the Goldfields Gas Pipeline under the National Gas Access Regime, NCC, November 2003, page 152.

9 e.g. Final Decision – Moomba to Adelaide Access Arrangement, ACCC, September 2001, page 203.

4.5 Truncation premium and the limitations of economic theory (DF 9.3, 9.6 etc)

GGT notes the Commission's observations (on page 290) in regard to the risk that regulators:

> *"...would not commit beforehand to a truncation premium that would later apply, given the legal, political and practical constraints on regulators*."

However, it is not apparent that these impediments withstand scrutiny. If a truncation premium were to be applied according to clearly defined guidelines which were contained within the Code under which regulators are required to exercise their authority, then this should not give rise to any issues of legality. Further, one of the great virtues of regulatory "independence" (that is the establishment of an "independent regulator" free from government intervention or public accountability) – as regulators would have it – is that they are free from political or even, arguably, practical constraints.

The Commission goes on the observe:

> "*These constraints could include community concerns that high returns are a sign that the regulator has failed to prevent monopolistic behaviour."*

However, as GGT has already identified to the Commission, the effect of introducing a truncation premium would primarily be confined to addressing the question of whether or not new pipeline investment will occur at all under the Code.[10] Hence in regard to the foregoing concern identified by the Commission, community concerns would be balanced by an informed appreciation of the benefits to be derived from the construction of the relevant new gas pipeline. This would include consideration of the prospect that the new pipeline might otherwise not proceed under the provisions of

[10] As GGT noted in a previous submission (and cited on page 290 of the Draft Report), the "truncation premium" identified by the Commission in regard to addressing the Code's contribution to investment risk, primarily addresses the first order investment risk (ie. that new investment will not proceed at all). Although there maybe some flow on effect to redressing the second order investment risk (ie. "capacity truncation" in those pipelines which proceed despite the Code), for the latter issue to be adequately addressed, it requires the "speculative investment" and "redundant capital" provisions of the Code to be removed.

the Code without the application of a truncation premium (or similar adjustment mechanism).

The circumstances of the construction of the GGP and the State Agreement that underscored the basis for this investment, along with the community response that has been associated with other regional infrastructure developments which can be identified, support this approach. Hence, GGT directionally supports the conclusion of the Commission in Draft Finding 9.6 (with emphasis added) that:

> "*A fixed truncation premium would at least address the asymmetric truncation of returns to some extent. A fixed premium would be a low cost mechanism to promote investment, given its low administrative costs and the limited scope for gaming.*"

Nonetheless, GGT notes the Commission's concern (on page 291) that:

> "*...by providing a truncation premium, a regulator might feel obliged to truncate upside returns, because users have paid a premium for it...*"

GGT considers that without any mechanism in place to prevent such a response, this concern is quite valid.

However it should also be noted that this, as well as the preceding concerns cited by the Commission, relate to a tacit acknowledgement of the existing behavioural propensities of regulators, and the wide degree of discretion in executing the functions required of them.

To restate GGT's previous qualification, for industry to have any confidence in the application of a truncation premium (or any similar concept) as an effective mechanism to address the sovereign regulatory risk to sunk investment posed by the Code, clear and unambiguous regulatory guidelines are crucial. Without such guidance within the Code, regulatory outcomes will default to the biases which have been demonstrated to be inherent in current economic regulatory intervention. This includes the over-reliance on theoretical tools, methodologies and constructs that too often bear little or no semblance to real market conditions.

The Commission provides an example of this (on page 83) which refers to an ACCC assertion that the difference between the prices service providers apparently wish to set, compared to the prices which the ACCC sets by regulation, appears to be evidence of the existence (and quantum) of monopoly pricing in the absence of regulation. However, as the Commission has identified, the theoretical methodologies employed to determine regulated prices do not allow for – and in fact specifically exclude – a number of commercial and real world considerations for which service providers must make actual allowances in their cashflows and expected returns. For instance, pricing under present regulatory practices does not provide for asset specific risk or the ability to fund innovation or take entrepreneurial risks. It similarly does not provide for incentives for commercial negotiation but rather it makes defined services available to the market at the theoretical minimum price at which the service provider can stay in business. This is confirmed in the discussion in the Draft Report, which leads to the Commission's conclusion[11] that, "*On balance, the regime has inhibited commercial negotiations*" (page 70) despite the assertion of the ACCC (cited on the same page) that:

> "*The primary intent of the Code, through the approval of access arrangements is to facilitate commercially agreed access through the disclosure of sufficient information to assist parties in negotiations. The Code is not intended to be a substitute for commercial access.*"

Fortunately however, the Commission appears to have recognised that this statement cannot be true in circumstances such as are currently imposed under the Code, whereby prices have been set (supposedly) to reflect theoretical long term efficient costs. Under such a regime, there can clearly be no scope for negotiation of prices that are lower than those deemed to be required to achieve long term efficiency. Any such price outcome would not be sufficient to meet long term efficient costs. The negotiation of service offerings at prices higher than those mandated for generally available services will be similarly hampered in terms of the regulatory consequences of perceived deviation from long term

[11] In fact the Commission's Draft Finding 3.1 which states, "*The Gas Access Regime is a form of price regulation based on a cost-of-service model. It is, therefore, at the more intrusive end of regulation*", does not entirely represent the discussion from which it derives. It should properly be amended by the addition of the Commission's conclusion that, "*On balance, the regime has inhibited commercial negotiations*".

efficient levels, as well as the real or perceived price cap expectations which will have been established. Without some modification, the application of theoretically derived economic cost based pricing, provides no scope at all for negotiation of access prices (although other non-price aspects may still be negotiable).

In a similar vein, on page 151, the Commission suggests that on the one hand the compliance costs of service providers meeting safety regulations are implicitly included in the long run costs that arise out of Draft Recommendation 7.1. On the other hand, the Commission concludes that users will be protected from "*excessive safety expenses*" by the requirement that only "*efficient costs*" be included in the derivation of tariffs. This proposition exposes considerable scope for irreconcilably different interpretations on what might constitute reasonable or efficient levels of safety regulation. The service provider will be obliged to conform to safety regulations – even where these might be considered by the economic regulator to be excessive and unwarranted for the purposes of inclusion in the service provider's cost base which is used to determine the prices users should pay.

Such latitude should not be permitted to remain in the Code. In this case, it can be simply addressed in the form of the inclusion in the Code of a requirement that economic regulators must accept the necessary costs of mandatory compliance with other forms of regulation to which the service provider is subject.

There are other practical constraints on the application of present one-size-fits-all regulatory application of economic theory. On pages 232 and 296, the Draft Report discusses the views expressed by the ACCC that its preferred mechanism for accommodating the downside risks to which service providers may be exposed is through the capitalisation of financial losses. In the view expressed by the ACCC, this permits a "*more satisfactory return to be achieved ... over a longer timeframe*", allowing "*eventual recovery when the market matures*".

However the ACCC's views regarding the acceptability of deferring returns over a longer timeframe which allows time for markets to mature (that is, to grow), may not reflect valid assumptions in certain markets. Certainly in the case of the GGP, 99% of its business involves the supply of one finite extractive resource (gas) to projects engaged in the extraction of other finite resources (in this case, nickel, gold and iron ore). Exposure to international commodity volatility and reserves depletion in the markets served by the pipeline, heavily qualify the prospects for the relevant markets to "mature" in terms of the downstream gas market. Without a large urban base load underpinning a pipeline's prospects for load growth, the "no-limits-to-growth" assumption implicit in this theoretical approach to regulatory induced capital under-recovery, is dangerously flawed. Investors see this and the consequences of such assumptions for the prospects for regional development in Australia are dire.

The Commission is correct in its conclusion that:

> "*By capitalising losses, a service provider would defer sharing those losses with users until future access arrangement periods. This approach assumes that greater than expected returns eventuate some time in the future, from which losses can be covered.*"

Of course, under the Code as it is currently implemented, regulators see their role to include being there to ensure that "greater than expected returns" are never permitted to be earned by "bottleneck" infrastructure. Similarly, if competition develops - as ought to be anticipated if coverage exists as this is the premise of coverage criterion (a) – then the opportunity for greater than expected returns is unlikely to arise at all.

There are a number of other assumptions also implicit in this approach. The most obvious relates to the time-value of money. While it is theoretically possible to provide for indexation of that portion of the capital base which remains for the time being unrecovered, this is unlikely to account for the capital recovery requirements of stakeholders in the investment. Gas transmission pipelines are long-lived assets involving a high proportion of fixed costs. Mandated deferrals of capital returns based on possible future business prospects – particularly those determined by a regulator whose view may not align with the market assessment of investors – further increases the risk of capital recovery not fully eventuating. There does not appear to be any mechanism by which investors would be compensated for this increase in the risk of their investment, imposed by the regulator.

The Commission discusses the mechanism by which some components of tariff policy can potentially be locked in for longer than a single access arrangement period on page 282. Draft Finding 9.3 notes that:

> "*Fixed principle provisions that allow some regulatory parameters to be locked in for a certain period have the potential to reduce the risk of future changes in a regulator's behaviour (parameter risk). However, the extent to which risk is reduced depends on the fixed period allowed by regulators and on which parameters can be fixed*."

As the Commission also warns however (page 282);

> "*... given the uncertainty associated with setting regulatory parameters, there is a possibility that having a fixed principle will lock in a regulatory error for an extended period. This possibility may cause regulators to err on the side of caution by requiring regulatory parameters that are less advantageous for a service provider. In addition, the extent to which regulatory risk is reduced by a fixed principle depends on the fixed period allowed by a regulator and on which parameters can be fixed."*

Given the risks of regulatory error, as well as the inability under the present regulatory methodologies employed to take asset specific risk into account in determining permissible rates of return for determining tariffs, it would seem unlikely that market specific risks (including prospects for load volatility) will be given proper weight under such arrangements. That is, the mechanism of using the existing fixed principle provisions which exist within the Code is unlikely to adequately address issues which are unique to particular markets – either in terms of nature, magnitude or duration – primarily due to the problems associated with regulatory implementation.

4.6 Regulatory preconception and inertia

The institutional arrangements that govern the implementation of the Code, are dealt with only lightly in the Draft Report. This appears to be mainly due to the concurrent development of structural reform proposals being pursued by the Ministerial Council on Energy. However, GGT commends the Commission's findings in regard to the need for reform of the body which monitors the implementation and change process of the Code, and supports the conclusion (on page 382) that Code change approvals should rest at a ministerial level rather than with any regulatory agency.

The only other specific comment that GGT would like to make in regard to structural arrangements relates to the fundamental need for institutional change of regulatory roles, objectives and accountabilities. Pivotal to this is the need to redefine certain regulatory roles in order to institutionalise the distinction between the objectives of "consumer advocacy" and "economic regulation". This is not to say that these differing facets of regulation (and economic development) do not need to be reconciled – they do - but this should be a function of government at a ministerial level, and not a composite regulatory function.

The failure of the existing institutional arrangements to make this distinction, directly underscores many of the problems associated with economic regulation under the Code which the Commission has acknowledged. As a result, the challenge of successfully reforming the Code is all the greater. It is not just a matter of incorporating into the language of the Code, "benign" guidelines for regulators to objectively follow. What must now be overcome is the regulatory paradigm (that is, the perceived social role) that has developed within those engaged in regulatory practice.

Consequently, a critical consideration of the need for strong and unambiguous regulatory guidance, is the evidence of substantial inertia that exists in regulatory implementation. This is characterised by preconceived regulatory outcomes, which accord more with precedent and long-standing theoretical precepts held by regulators, rather than evaluation of specific circumstances relevant to individual cases. In extreme cases, it manifests itself in an open intransigence towards accepting legal interpretations arising from regulatory appeals.

Recent examples in GGT's experience of the existence of this syndrome include the following comment in a report[12] produced for the Office of Gas Access Regulation and compiled by a joint working group comprising of staff from the Office of Gas Access

12 "Review of Rate of Return Methodologies and Practices; FINAL REPORT", The Institute for Research into International Competitiveness, September 2003.

Regulation and the Office of the Rail Access Regulator (now both within the Western Australian Economic Regulatory Authority), Economic Consulting Services, and Curtin University of Technology (with emphasis added):

> *"We make this distinction in light of the recent Supreme Court decision in regards to the Dampier to Bunbury Natural Gas Pipeline, whereby the Court decision may require the Regulator to consider economic development and other issues, due to the existence of Section 2.24 of the Code. <u>Whilst this decision may be correct in law, it is not, in our opinion, a good foundation for economic regulation based on sound economic principles</u>. The issue would seem to lie in Section 2.24 of the Code, which may require revision, when next the Code is reviewed*." (Footnote 22, page 32)

Given the significant involvement of regulatory staff in the formulation of the report, it would not seem appropriate that it should be used as a vehicle for undermining the legal framework to which the regulator is bound. This is even more alarming when it is considered that it was the purported intention that:

> "*The aim of the report is to consider evolving best practice in the determination of allowed rates of return in utility regulation to assist further discussion and public consultation. The review draws from both the theoretical literature and regulatory practice around Australia and in other parts of the world. A special focus of the review has been on the treatment of diversifiable and non-diversifiable risk."* (Page 3).

In fact, in regard to the treatment of diversifiable and non-diversifiable risk, the report confined itself to repeating the now standard regulatory conclusion in respect to each risk identified - that they were almost all non-systematic. Hence the report concluded that investors were free to diversify away, and thus negate, their exposure to any specifically identifiable risk.

In response to a call for comment on the report, GGT made a submission to the regulator. In this, GGT noted that the release of the report was untimely as although it had been known to have been in production for in excess of 12 months, it was released on 31 December 2004 - more than two weeks after the release of the Commission’s Draft Report. In addition, GGT pointed out that many of the conclusions contained in the OffGAR report appeared to be based on restatements of old regulatory arguments and represented a static and seemingly outdated view of regulatory rate of return practice. This was in contrast to the evidence provided in the Commission's Draft Report, which strongly suggested that regulation is in fact evolving, and which identified numerous problems with the application of the CAPM methodology and treatment of investment specific risks.

In a letter responding to GGT's submission, the regulator wrote (in mid-February, some nine weeks following the release of the Commission's Draft Recommendations) that:

> "*The Productivity Commission's recent draft report does not have any bearing upon the exercise of the Authority's current functions and powers under the Gas Pipelines Access (Western Australia) Act 1998 ("GPA Act").*"

Strictly speaking of course, the Commission's draft findings do not have any formal power to modify the current functions and powers of regulators under their respective legislation. However this hardly seems of relevance in the consideration of "*evolving best practice in ... utility regulation to assist further discussion and public consultation*", particularly in a review which *"draws from both the theoretical literature and regulatory practice around Australia and in other parts of the world.*"

Unfortunately, such concerning views as expressed in these examples, are not an uncommon experience for service providers who deal with economic regulators on a range of issues under the Code. Evidence of similar behaviour appears to exist in other regulatory jurisdictions, for instance, in the context-independent reliance[13] by the NCC upon a report commissioned by itself in regard to the MSP and conducted overseas by Ordover and Lehr.[14] Another example was the release by the ACCC of a notably un-modified Final Decision on the MSP Access Arrangement, following the highly relevant decision by the Minister revoking coverage of a substantial portion of the pipeline which obviously had significant consequences for the structure of the proposed Access Arrangement.

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[13] See for example, Final Recommendation - Application for revocation of coverage of the Goldfields Gas Pipeline under the National Gas Access Regime, NCC, November 2003, paragraph 5.223.

[14] Should Coverage of the Moomba-Sydney Pipeline be Revoked?, Janusz A. Ordover and William Lehr, November 2001.

In short, all the evidence suggests that without strong and unambiguous regulatory guidance, the Commission cannot rely on its proposed reforms to the Code, to be carried out as intended, or to achieve the economic and social benefits intended as outcomes. Nor can industry, investors, the elected governments or the people of Australia.

In fact, as discussed in Section 5.3 below, the evidence of regulatory behaviour to date strongly suggests the need for greater accountability by regulators for the consequences of the manner in which they execute their functions and the continuation of Ministerial involvement as the socially responsible decision maker.

5.0 NCC AS DECISION MAKER

5.1 NCC not to specify information disclosure for monitoring purposes (DR 8.3)

The Commission's Draft Finding 8.1 recommends that:

> "*Information disclosure under the monitoring regime would be assisted by disclosure guidelines. The National Competition Council (rather than a regulator) would need to develop and update such guidelines. Ideally, this would involve a consultative process that is open and transparent with interested parties*."

This is also reflected in Draft Recommendation 8.3, which specifies that the NCC should determine what information a service provider should supply to the relevant regulator under the monitoring regime.

However, what is missing from the Commission's recommendations is a requirement to specify the purpose to which it is intended that the information disclosed to the regulator be put. This emphasis is critical to ensure that the degree of detail demanded by regulators does not degenerate to the level of specific expenditures and that the use to which the information is put does not negate the intentions of the proposed monitoring regime. This is discussed further in Section 6.5 of this submission, which highlights the need to direct regulators away from pure "price monitoring" towards more effective "access monitoring" for the purpose of identifying instances of genuine market failure. The need for this is reflected in the statement by the ACCC cited is the Draft Report (on page 264) that;

> "*Price monitoring is a reasonably resource intensive process and may require the same level of resources as the current regime. This is especially the case where a judgement needs to be formed on the reasonableness of the prices imposed. (sub. 48, p.32)*"

While GGT has no objection to the requirement for relevant and appropriate disclosure to the regulator for monitoring purposes,[15] it is not clear why the degree of latitude contemplated in the

[15] As discussed elsewhere in this submission, GGT already fulfils disclosure requirements for monitoring purposes under the terms of the State Agreement to which it is subject.

Commission’s proposals should remain in the Code. If the intention is to accommodate specific and unique circumstances, it is not clear that the NCC would be either the appropriate body or suitably qualified – given its ‘national’ focus - to determine relevant reporting requirements.

GGT supports the sensible and fundamental principle of the separation of powers which therefore implies that regulators should not write – or be provided the scope to re-interpret – the tools of policy. Consequently, it is not appropriate for the NCC in its regulatory role, to determine the nature and extent of the information disclosure requirements. The precedents established under the Code tend to indicate that the outcome of a regulator determining the extent of the information which regulators (whether or not it is the same regulator) should have at their disposal, is likely to negate much of what was intended in proposing a monitoring option.

Whilst a case-specific consultative process (as the Commission appears to be tentatively suggesting) might achieve a balance of views for what information is required (although this is by no means certain given the likelihood of conflicting vested interests and the evidence of regulatory predisposition towards heavy handed intervention), one might argue that it should be possible to determine a standard form of information requirement which could be written into the Code. With care to avoid too high a burden of information imposed on both the service provider and the regulator, this could greatly assist efficient implementation of the monitoring regime without any significant loss of flexibility.

5.2 NCC not to be Decision Maker for binding rulings (DR 9.1, Figure 9.1)

In Draft Finding 9.4, the Commission concluded that:

> "*Binding coverage rulings reduce regulatory risk by providing investors with the option of knowing a coverage decision before they commit funds for a new project.*"

In Draft Recommendation 9.1, the Commission appears to convey to the NCC the entire responsibility for determining a ruling. However, at a minimum, ministerial approval of all NCC recommendations in its role of regulatory "gate keeper" are essential.

In this regard, there would appear to be an oversight in Figure 9.1 (page 286) of the Draft Report. It is not clear whether or not the need for ministerial approval of a recommendation by the NCC regarding an application for a binding ruling, has been intentionally omitted from the diagram. However, GGT would strongly urge that such a step in the process outlined in the diagram is crucial to the integrity and credibility of such a process. (Specifically, the diagram needs to be modified to include the role of Minister as "decision maker" in the last two branches on the right hand side of the diagram, following from the NCC role, "recommending" – rather than "ruling" – that the applicant pipeline should be either monitored or not covered, respectively).

This is consistent with the conclusion in Draft Finding 12.5 that, "*ultimate responsibility for decisions on pipeline coverage and the form of regulation should continue to reside as the Ministerial level*."

5.3 Need to maintain role of relevant Minister (DR 5.1, 5.2)

On the 19 November 2003, the relevant decision maker for the MSP Revocation Application, Minister MacFarlane, issued his Decision, which overruled substantial portions of the recommendation of the NCC. Relevantly, in his Statement of Reasons, the Minister observed (at paragraph 107) that in its recommendation in regard to criterion (a), the NCC:

> *"...does not distinguish between the extent to which curtailing market power through access regulation would actually promote competition or simply result in a transfer of monopoly rent upstream or downstream (7.413 and 7.458)."*

The Minister went on to conclude (in paragraph 146) that:

> "*Access regulation should not be justified on the basis that it transfers economic rent."*

Nonetheless, a little over a week after receiving the Minister's views on the MSP recommendation, the NCC issued its Final Recommendation regarding the Revocation Application for the

GGP in which it determined that coverage was warranted in regard to criterion (a), as it would reduce prices, primarily for the benefit of existing users (paragraph 5.410).[16] Furthermore, the NCC also stated its view (at paragraph 5.213) that:

> *"It is not necessary to establish that more competitive outcomes will actually occur, or will occur within a particular period of time. Rather, what is required is an improvement in the environment for competition in a dependent market, compared with conditions absent coverage."*

It is clear that the outcome the NCC anticipates from coverage in this case is a theoretical improvement in the competitive environment, rather than any foreseeable real changes. That is, although the NCC advocated the transfer of economic rents to existing users, it sees little or no scope for these to translate into any actual growth in the market in response to the theoretical improvement in the competitive environment.

Clearly the highly pertinent views of a relevant Minister have been ignored or dismissed by the NCC. However, it is the Minister's views that have been reinforced by the Commission in its current review, rather than those of the NCC. For example, on page 75, the Draft Report concludes "*that using access regulation to redistribute income would be inefficient*" and that *"other policies generally target income distribution more effectively and efficiently"*.

This provides a clear example of the need for ministerial oversight in order to provide a check on policy integrity (and public accountability[17]) arising from the license too often taken by regulatory agencies. Moreover, this becomes a more serious threat to the attainment of intended regulatory outcomes in light of the effect of Draft Recommendation 5.2 (page 149), which contemplates omitting certain important objectives contained in the existing preamble of the Code. The trouble with relying upon the effect of so limited an objects clause as that proposed in Draft Recommendation 5.1 to encapsulate the specific objectives which Draft Recommendation 5.2 contemplates deleting, is – besides the scope for interpretation – that regulators will simply factor in any

16 Given the reasonably flat load growth predictions acknowledged by the NCC in, for example, paragraphs 4.57 and 4.58, the extent to which any new third party users would benefit from reduced prices must be small relative to the extent to which the NCC anticipated existing users would benefit (paragraph 5.410).

17 As discussed in Section 6.3 of this submission.

extraneous "policy benefits" they consider to have arisen or be likely to arise and thus further reduce tariffs.

A high degree of unambiguous regulatory guidance has already been demonstrated to be necessary in order to circumvent regulatory enthusiasm for pursuing entrenched theoretical preconceptions by regulators at the expense of intended government policy and real social benefits. In GGT's view, ministerial review and approval of NCC decisions has been shown to be a valuable check in the public interest. This needs to be at least maintained and arguably, considerably strengthened.

Further to this, it would seem advisable to maintain the requirement for a periodic ministerial level review of the effectiveness of the Code and its implementation. The Commission's consideration of institutional arrangements in section 12 of the Draft Report does not extend to the issue of periodic review, however the current review has clearly demonstrated the need that such an implementation check be put in place. Accordingly, GGT would urge the Commission to include the proposal for a periodic review of the effectiveness of the implementation of the Code according to the objectives that arise out of the current reform proposals, in its Final Recommendations.

6.0 PROCESS ISSUES

6.1 Limitation of extensions (DR 11.1)

Draft Recommendation 11.1 proposes an amendment to the Code such that regulators would be restricted to having an ability to extend the period for approval of an access arrangement by two months only once. By this, the Commission would appear to mean that the time taken for each stage of the regulatory process – draft decision, final decision and further final decision – could each be the subject of only a single extension of two months. This needs clarification. However, in principle and as long as appeal rights are not diluted, GGT supports the proposal.

It should be possible to restrict the maximum period of time available to a regulator for determining a draft or final decision in regard to an access arrangement, without impinging upon the rights of appeal by affected parties. This is a critical qualification. Certainly expediting the regulatory process would have the advantage of imposing a much needed efficiency constraint upon regulatory decision making and the resource intensive information gathering which has tended to underlay it. The evidence strongly suggests that the propensity of regulators to finesse the information they wish to have before they make their decisions has done nothing to improve the quality of those decisions. And in reality, it will almost certainly be the macro effects of the Code and the regulatory decisions made under it, which will determine the efficacy of the regime.

6.2 Back dating of regulatory decisions (DR 11.1)

In addition to proposing a limitation on regulatory extensions, Draft Recommendation 11.1 proposes that regulators should have the discretionary power to backdate reference tariffs. The Commission however notes (on page 343) that:

> "*A drawback of discretionary backdating is that it might increase uncertainty for those who are required to make a backpayment.*"

The Commission also notes (on page 344) that:

"In allowing for backdating provisions, it is necessary to consider the interaction of backpayments with 'most favoured nation' clauses. Depending on how the most favoured nation clause is drafted, the backdated decision could apply to the foundation contract customers as well as third party access seekers. Arguably, the service provider would need to backpay a large amount of money. This could increase the service provider's investment risk and make it more difficult for the service provider to factor that risk into decision making."

The problems identified above are significant issues which have the very real potential to undermine many of the other reforms to the Code which the Commission is proposing. In particular, the increased uncertainty for service providers is substantial, particularly where (as noted) MFN clauses exist. To the extent that new pipelines might not qualify for a regulatory exemption, the cashflow effect of the need to refund a substantial portion of retrospective revenue could be critical to the trading viability of a pipeline. In an environment where regulators are inclined towards pursuing substantial price reductions based on theoretical precepts, it is not hard to visualise a protracted case in which the accumulated liability could possibly even give rise to the spectre of retrospective violation of the solvent trading provisions of Corporations Law.

Furthermore, it should be considered that an access seeker will require investment in gas infrastructure – be it lateral pipelines or the gas consuming equipment the user intends to run at the end of the lateral – and generally this takes some considerable time to be put into place. For new access seekers, this dilutes any benefit arising from the potential retrospectivity of an access decision. For existing pipeline users however, the potential benefits of back-dating could be very attractive. However these users already enjoy access and, to the extent that they will benefit from a third party access decision, they will still see the benefit when that decision is made. Hence this proposal, particularly in circumstances where MFN clauses exist, would appear more likely to involve a mere transfer of economic rent to existing pipeline users than do anything to promote genuine third party access.

As the Commission observes (on page 343);

"... it is reasonable to assume that a business will factor the possibility of a backpayment into its business decision making, provided it has some indication of how the backpayment will be calculated (including the date from which it will apply)."

This consideration may however equally apply to the prospective beneficiary of an access decision which would, in a situation for instance whereby a large corporate existing user were to anticipate a substantial economic windfall, provide an economically rational basis for regulatory gaming by that user. This would tend to exacerbate the situation regarding incentives for gaming and the problems associated with demonstrating bona fide access disputation, outlined in Section 3.3 of this submission.

However, there appears to be a notable contradiction in the combination of the two proposals in Draft Recommendation 11.1. The need for back-dating a regulatory outcome arises from the time taken for previous regulatory decisions to be finalised. It would appear that the need to include provision for backdating in the Code is negated by the Commission’s proposal for more timely regulatory decision making (as discussed in Section 6.1, above).

6.3 Automatic acceptance of NCC recommendations (DR 11.2)

Draft Recommendation 11.2 contemplates an automatic acceptance of a recommendation by the NCC on coverage in the absence of a Ministerial objection within 21 days. This proposal appears to have arisen from a single instance (at the time of writing) where the relevant Minister was obliged to critically re-examine the recommendation of the NCC because the analysis it had undertaken and the conclusions it had reached were identified as being flawed. In the circumstances, the consequences of the NCC's flawed recommendations were not insubstantial and hence the Minister was correctly fulfilling his role in accordance with the objectives of his involvement in the regulatory process.

In light of Draft Recommendation 11.2, it is necessary therefore to consider a number of relevant issues.

The NCC is an august body of government economists and has a history of being highly regarded within government regulatory circles. In recent times it has been assigned the authority to effectively determine the distribution of very substantial competition payments to those states it considers have made worthy justifications to it regarding their progress in competition reform. It is no small thing for a Minister to overrule a recommendation by the NCC. And yet, as has been demonstrated on appeal, the NCC does sometimes "get it wrong" in interpreting the Code, analysing relevant circumstances and constructing its recommendations.

Moreover, the NCC is not directly accountable for the recommendations it makes in the sense that it is under no threat of any adverse consequence from making errors of judgement or misinterpreting the Code in the execution of its responsibilities. On appeal, it merely takes note and perhaps stands corrected. Its recommendations are founded firmly and solely in a body of economic theory which is itself arguable and open to interpretation. It is not empowered to be the decision maker - nor should it be. That is quite properly the role of the relevant Minister who must answer to the electorate for the social and economic welfare decisions he makes.

It might be convenient for regulators to argue that "best practice" economic regulation should be based entirely on (their own interpretation of) rational economic theories and should exclude any Ministerial involvement. This is justified on the basis that Ministers are held accountable (ultimately to the electorate) for broader social welfare concerns and hence they sometimes need to balance the consequences of their decisions, rather than strictly adhere to the dictates of economic rationalism. However, just as private enterprise must work within the justifiable constraints of government regulation to ensure public interests are balanced, so too (for the time being) does the supposedly benign – but nonetheless centrally planned - economic rationalism pursued by regulators, need to be balanced by the constraints of public accountability and democratic scrutiny.

The risk with the Commission's proposal in Draft Recommendation 11.2 is that the responsibility of the Minister and the accountability engendered by his involvement will be diluted. Furthermore, in circumstances of complexity or controversy, there is the risk that the NCC will attain the defacto power of decision maker. There is sufficient evidence (in respect to coverage decisions alone) that the NCC, despite its widely acknowledged theoretical expertise and authority, yet requires a check on the logic and lack of appreciation of real-world circumstances which it sometimes demonstrates.[18]

Consequently, Draft Recommendation 11.2 is based on the false premise that Minister's generally take an amount of time to assess the recommendations before them, which is excessive and not commensurate with the weight of the decision or the integrity of the specific recommendation itself. This does not appear to be the case. Rather Minister's quite rightly require more time to properly consider the decision before them when they have received a recommendation from the NCC which appears to be flawed, omits to consider matters of wider social importance or other relevance, and suggests itself to appeal.

In this regard, the Commission makes a noteworthy comment (on page 345) that:

> "*The role of the Minister under the Gas Access Regime is confined to assessing the NCC's recommendation, rather than a more extensive retrying of the case.*"

However, it is not clear upon what constraint under the Code, the Commission bases this comment. There appears to be no such restriction upon the matters that the Minister must consider within the Code and, for the reasons discussed above, nor should there be.

Given the potential complexity of issues which may need to be addressed in a ministerial review of an NCC recommendation, it does not seem reasonable to require a minister to provide specific grounds within 21 days for rejecting a recommendation. It should be sufficient for a minister to indicate that the recommendation – for whatever reasons – is not *prima facie* acceptable within the initial timeframe. In effect, this does not appear to require any amendment to the relevant current provisions of the Code.

6.4 Scope and grounds for appeal under s.38 and s.39 (DR 11.5, 11.6)

On page 358, the Draft Report cites the ACCC as noting that;

> "… *an extensive public inquiry process* [as employed in the Code process] *justifies:*

[18] This is touched upon in Section 5.3 of this submission.

> *… the exclusion of merits review in relation to the relevant regulator's consideration of an access arrangement or revisions to an access arrangement*."

On page 357, the NCC is also cited as recommending that coverage review should be curtailed.

These views (on the part of the ACCC and the NCC) are revealing of a presumption of regulatory omnipotence based on an implication of objectivity, which is not borne out in practice. The concern summarised by the Commission (ibid) that "*service providers might hold back arguments if they consider they will achieve a better outcome from the appeal body*", is indicative of the flaw in such propositions. If regulators were acting reasonably or objectively there would be no basis for any distinction between the outcome determined by a regulator and that determined by an appeals body.

Fortunately the Commission has recognised the need to protect the property rights of service providers in the interests of the wider economy, including – in the long term - users. Accordingly, GGT supports Draft Recommendation 11.5 concerning the removal of the limitations of grounds of appeal, which currently apply to a section 39 appeal under the Code.

In contrast however, the Commission is proposing in Draft Recommendation 11.6, to limit the scope of material which might be presented under a section 38 appeal under the Code, to only such material as has already gone before the primary decision maker. The effect of the changes that the Commission is proposing to sections 38 and 39 are such that the constraints to the scope of material that might be presented under either section will be substantially the same.

However, GGT is concerned that it does not seem prudent to exclude from an appeal under either section, any consideration of matters of relevance that might have arisen during the course of the regulatory process. This might include, for instance, a matter of pertinent regulatory jurisprudence arising from a somewhat concurrent regulatory process or appeal. It would seem obtuse to require an appeal outcome to be made in isolation of consideration of relevant matters that have been concluded prior to the appeal decision being finalized.

In addition, there is a distinction in the nature of the processes to which each of the appeals under sections 38 and 39 apply. Section 39 is applicable at the end of an Access Arrangement Approval process in which the opportunity for new, altered or expanded material to be included exists (e.g. after a Draft Decision but before a Final Decision). A section 38 appeal may however be feasibly made in regard to a decision for which no such opportunity exists. A blanket restriction on new, altered or expanded material being taken into account in a section 38 appeal, risks omitting pertinent information which could therefore result in poor, irrelevant or inefficient appeals decisions.

6.5 Issues relating to a monitoring regime (DR 8.1, 8.2, 8.3, 8.4, Information Request)

GGT agrees with the Commission's rationale and proposal in Draft Recommendation 8.1 that, in regard to the proposed lighter handed regulatory option;

> "*The lighter handed alternative should be a monitoring regime. It is important that the monitoring regime not develop into an intrusive and costly form of regulation.*"

This is consistent with the State Agreement mechanism under which the construction of the GGP was facilitated and under which subsequent third party access has been guaranteed. However, GGT would urge the Commission to consider that its proposal should ensure a focus on "access monitoring", rather than a purely price focused approach as suggested by the ACCC on page 264 of the Draft Report.

In this regard, GGT also notes the Commission's proviso (on page 261) that:

> "*The intention of a lighter handed approach is to harness the potential of commercial negotiations to deliver more efficient outcomes, while giving security to those concerned about the misuse of market power*",

and that;

> "*a credible threat that the misuse of market power would lead to the imposition of regulation that more directly controls the terms of commercial transactions."*

The Commission contemplates the application of more heavy-handed regulation in cases which, "*include those where the misuse of market power becomes evident after a period of lighter handed regulation*" (page 262). However the problem that arises is the ability to distinguish between the genuine misuse of market power by the service provider and the opportunistic rent seeking behaviour of users who anticipate windfall price reductions from more interventionist regulation. As discussed in Section 3.3 regarding the necessity for users to demonstrate "best endeavours" in regard to access negotiations, users – particularly those large well resourced corporate users who might stand to make substantial windfall gains from rent transfers – will have incentives to continue to game the system while ever the option of exposing the service provider to a more onerous form of regulation exists. This situation is exacerbated due to the difficulty in substantiating the distinction between commercially determined terms of access (including price) and a contrived access (or tariff) dispute.

One means of addressing this problem would be to reduce the immediate potential for inducing regulatory intervention by gaming, through the fairly simple mechanism of making all existing covered transmission pipelines subject to the monitoring regime for a defined initial period of time. A suitable period would be the now standard regulatory period of five years. This proposal has the advantage of being administratively simple, alleviating the currently burgeoning national regulatory impost, and of potentially providing a relevant basis upon which market behaviour subsequent to the structural reforms which have taken place, can be properly assessed.

Whether or not wholesale coverage under the monitoring regime is implemented, a certain level of monitoring will need to be instituted. The Commission's suggestion (on page 263) that, "*As part of the monitoring regime, the behaviour of service providers could be made more transparent by requiring them to report information about their operations"* is consistent with GGT's existing obligations under the State Agreement access regime to which it is subject. To this extent, GGT considers that Draft Recommendation 8.2 makes a positive contribution to economic regulation.

However, as discussed in Section 5.1 of this submission, GGT has considerable reservations about the latitude given to the NCC in regard to specifying the information disclosure requirements. One aspect of this, might be a tendency to focus on price monitoring to the exclusion of commercially negotiated and flexible access outcomes, if for no better reason than that prices are easily monitored. Access monitoring may include the monitoring of prices, particularly for the purpose of confirming that discriminatory practices are not being engaged in, however this should not be the sole or primary focus. Unfortunately, the existing evidence suggests that this is exactly the focus that is likely to result from current regulatory attitudes in the absence of better guidance, as indicated for example in the quote from the ACCC cited on page 264 of the Draft Report (and repeated in Section 5.1 of this submission).

The purpose of establishing an oversight role needs to be very specifically defined in the Code. The clear emphasis needs to be on the role of monitoring for the purpose of identifying potential instances of "market failure" associated with pipeline access, arising from the abuse of market power. In this regard, the Commission needs to incorporate into its recommendations;

- definitive statements concerning the nature and extent of market failures that would warrant concern,
- the use to which information disclosed to regulators for monitoring purposes should be put, and
- the nature of regulators' response in the event of a concern arising.

A focus on "price monitoring" rather than "access monitoring" is also likely to raise difficulties for regulators in interpreting commercial and, in particular, competitive behaviour.[19] In the absence of clear competitive price indicators, but where a situation of countervailing market power exists, there is the possibility that regulators may misinterpret price differentials negotiated for

[19] One example of just such difficulty experienced by a regulator is provided in the discussion given in paragraphs 5.23 to 5.35 of the NCC's Final Recommendation regarding the application for revocation of coverage of the Goldfields Gas Pipeline under the National Gas Access Regime, November 2003.

different services to be a trend that should be constrained or otherwise altered by regulatory intervention.

Furthermore, this concern might be exacerbated due to the requirement for annual reporting, particularly as proposed in Draft Recommendation 8.4. This proposal would potentially see users constantly responding to the regulator with the view that they would prefer to pay lower prices – regardless of any merit, or the effectiveness of access already being provided by commercial negotiation.

Hence GGT has concerns that the information disclosure requirements alluded to in Draft Recommendation 8.3 as currently proposed, particularly in relation to profitability trends, combined with the disclosure proposed in Draft Recommendation 8.4, may undermine the efficacy of the monitoring option.

It would be preferable for the information disclosed to be the minimum (in order to protect the commercial interests of parties to existing contracts) required for new access seekers to enter into new contracts with sufficient confidence that they are not being disadvantaged. It should even be possible for the Commission to prescribe a list of information requirements that should be written into the Code. However, the proposal for blanket coverage under the monitoring regime of all existing covered transmission pipelines mentioned earlier, would also provide an opportunity for the market to determine the appropriate levels of information required as an outworking of voluntary nondiscriminatory access policies by service providers.

7.0 FOR THE RECORD (OTHER ISSUES)

7.1 Correct timing of Code relative to GGP development (PC 3.1)

On pages 55 to 57, the Draft Report refers to the timing of the COAG agreements which led to the introduction of the Code. The Commission identifies that the establishment of the Gas Reform Task Force to undertake its scoping study for gas reform occurred in mid 1995, that the earliest draft version of the Code did not appear before late 1996, and that intergovernmental agreement was not reached until late in 1997.

This timing is an important consideration in respect to the claims made by some regulatory agencies regarding the effect which the Code has had since the early 1990's. Regulation may have been "in the wind" since the early and general discussions within COAG between 1992 and 1994, but the actual chronology clearly shows that no-one in industry could have known the form of the Code before 1996-7. The record shows that until this time, the eventual form of the Code was disguised behind talk of light handed oversight of unencumbered market forces engaged in 'free and fair trade in natural gas'. It was not until the Code began to be implemented in various states between 1998 and 2000 – and ACCC commissioners began talking in their public presentations about the naivety of some people in industry thinking that it was ever intended that there would be light handed regulation – that it was possible to see that "the wheels had fallen off" during implementation.

From GGT's perspective, it is important to note that the investment decision to proceed with the GGP, and the creation of the State Agreement which facilitated that development under a set of rights and obligations which guaranteed third party access, occurred in 1994 (with final approval in early 1995). This was, as the Commission correctly points out on page 52, subsequent to the early COAG agreements which however at that stage, provided no hint of anything other than the proposition of a light handed regulatory regime, primarily intended to ensure access to mostly public (i.e. government held) monopolies.

What could be foreseen at that time was that governments were clearly pursuing the benefits of structural reform and privatisation -

that is breaking up public utilities and taking them out of the hands of public servants and turning them over to the rigours of private enterprise. It was however impossible to predict that the benefits of privatisation would be largely undone by the imposition of highly intrusive economic regulation by public servants (regulators and their agencies). The irony is that of the few of these who have had any real-world experience in the industries they regulate, this appears to have been gained through prior involvement as public servants associated with public monopolies, many of which were identified as being in need of privatization in order to improve performance.

It is relevant to note that the GGP has never been a publicly owned utility and that it has, from inception, facilitated third party access to serve a competitive energy market. The terms under which it was constructed are not achievable under the Code as it exists today. Hence it is a reasonable assertion that the GGP would either not have been built at all under the Code, or that the developable capacity to accommodate future third parties which was factored into its initial construction, would not exist today.

7.2 Regulation free periods (and when vertical integration can be beneficial) (DF 9.9)

In regard to its discussion in section 9.3 of the risks and merits associated with the prospect of introducing regulation free periods for new pipelines, the Commission raises a number of issues upon which GGT would like to comment, as they are relevant to GGT's own circumstances.

Two of the aspects considered in this regard by the Commission (on page 306) are the pre-qualifying requirements needed to satisfy the relevant regulator that a new transmission pipeline has "sufficient vertical separation of ownership" and that it "will publish tariffs for access to the pipeline".

Regarding the granting of an initial regulation free period, the Commission also expresses the concern (on page 307) that,

> "*the basic problem with this approach is that there would be a risk that a pipeline would then be in a position to exert market power that inhibits upstream and downstream competition*".

This concern is reflected in Draft Finding 9.9 along with the suggestion that,

> *"the case for providing regulation free periods to all new pipelines is weakened further by the Commission's recommendation to have a monitoring option in place of a regulated access arrangement with reference tariffs."* [20]

The first point that GGT would like to make is that consideration of the extent to which vertical integration of pipeline ownership might exist, should be qualified with the need to consider whether the vertical linkages have a beneficial or detrimental bias. For instance, GGT at inception was comprised of a number of vertically integrated corporate entities – some of which extended from gas producer to end user. This was the situation until some years after operations commenced and the original owners sold out of the joint venture. However the nature of the role of the pipeline, facilitating as it did both upstream development and downstream energy price and reliability improvements, was such that it would not have served the interests of the owners to inflate access prices.

This bias towards lower pricing which resulted from vertically integrated ownership was reinforced for the benefit of future access seekers by the simple mechanism contained within the State Agreement (under which auspices the pipeline's construction and operation are governed) of requiring non-discriminatory access for third parties.

Consequently, GGT requests the Commission to recognise that there can exist circumstances where, as long as non-discriminatory access principles are adhered to, a degree of vertical integration actually serves to produce lower third party tariffs.

The second point that GGT wishes to make relates to the efficacy of having proposed tariffs published during the earliest phases of the development of a pipeline proposal. Relevant to this, the Commission notes the conclusions of the COAG Energy Market Review (on page 309) that;

[20] While recognising that the light-handed option suggested by the Commission is a positive recommendation, the concerns that GGT has with regard to the efficacy of the proposal as currently drafted, are discussed in Section 3.3 of this submission.

> *"Typically a proposed transmission pipeline is seeking to respond to a market demand. … the prospective initial users of the pipeline ('foundation users') have a significant degree of countervailing power – such that if a pipeline company seeks to charge excessive tariffs, they can approach another pipeline company to build the pipeline for them. As such, any transportation agreement reached between the pipeline company and users prior to construction of the pipeline should be reasonable for both parties – so long as there are no control issues arising from vertical ownership. …"*

Despite this acknowledgement (and the qualification needed in regard to the specific form and effect of any vertical ownership which might exist, as discussed above), the Commission expresses the concern (on page 307) that:

> "*Rigorous binding decisions on coverage* [relating to a regulatory free period] *would require details about the proposed pipeline and how it would operate. However, when a coverage decision would appropriately be sought, many of the details of a Greenfield proposal would still be under negotiation (for example, contracts)."*

It might however be possible for a pipeline company to publish a pre-construction tariff proposal, which included a schedule of possible pipeline tariffs that declined in proportion to the initial pipeline capacity to which users were prepared to commit prior to construction. Such a practice would tend to pursue efficient outcomes by effectively incentivising negotiated access. The pipeline company would see the benefit of an increased and possibly more diversified customer base and load profile (achieving operational benefits), along with the ability to capture greater economies of scale in the construction and subsequent operation of the pipeline. Users would have the incentive to receive the price benefits arising from the construction of a more cost effective pipeline (due to the economies of scale it was able to realize).

That such an outcome can be achieved in practice was demonstrated in the manner in which the State Agreement facilitated the construction of the GGP. Part of the pre-requisite package of proposals that the successful tendering pipeline proponent had to submit for government approval, was a schedule of proposed tariff setting principles. In the event, these were specifically designed to promote early demand for gas in an existing energy market – albeit a greenfields gas market – by using a levelised NPV approach to defer early revenue requirements into later years of project life. At the same time, tariff discounts were offered for any potential third party users who were prepared to make a commitment to gas usage sufficient to warrant increased investment in additional initial pipeline capacity. Initial "pre-approved" tariffs were established as a guide for potential "non-owner" initial access seekers, and once design parameters were established, a package of third party access proposals, including initial tariffs and subsequent principles to apply, was finalised for ministerial approval.

In the case of the GGP, the specific nature of the initially integrated vertical ownership (with the pipeline being developed by its own primary end-user customer base), as well as the State Agreement requirement for published non-discriminatory access pricing, was an additional guarantee that initial prices would not include monopoly rents.

7.3 Systematic understatement of Beta and hence risk (Appendix B.1)

One of the most important aspects of the Code that has contributed to the problems for infrastructure investment – both current and prospective – identified by the Commission, is associated with the failure to appropriately recognize investment risk and appropriate rates of return. As the Draft Report notes, under the Code, asset-specific risk is dismissed and investors are only permitted recognition of 'systematic' risk (that is so-called non-diversifiable or market risk).

In Appendix B.1, the Draft Report identifies (on page 390) that, "*the expected systematic risk premium is a function of the pipeline asset beta… which is multiplied by the difference between the average expected ROR for all equities in the economy (market portfolio) and the risk-free ROR, such as government bonds…*" The assumed beta of a pipeline project therefore has a significant bearing on the investment rate of return permitted for regulatory purposes. The Commission also provides the qualification that the market portfolio "*is a portfolio of all assets, not just shares. It includes bonds, land, buildings and much else...*[but] *It is not possible to measure returns on all these assets. So the market* *portfolio is approximated in practice by the All Ordinaries Share Price Index…”*

In practice, regulators take the results of these calculations as being definitive statements of quantified investment performance. However, it ought to be acknowledged that the measure by which “the market portfolio is approximated” is by reference to what is generally accepted as being the most volatile form of equity available in the broader “portfolio of all assets”. Accordingly, this proxy provides a poor representation of the total equity market as it fails to account for the dampening effect of the countervailing response characteristics of different forms of equity to economy wide factors. That is, it doesn’t recognize relationships such as the inverse responsiveness of investment in bonds, or equity in real estate (for example), compared to equities in the share market and therefore tends to overstate the average market movement in value. Consequently, focus on the share market as a proxy for the wider equity market, means that the basis against which the relative performance of investment in a specific industry sector is measured, will tend to understate the relative volatility of that sector.

This is precisely the basis upon which the volatility of an individual industry sector (or stock) is assessed in order to calculate its beta for regulatory purposes. Consequently it can be seen that there is a systematic bias in the methodology that understates individual betas which, as identified above, strongly affect the rates of return permitted under the Code.

Not only does a systematic understatement of individual asset beta exist in the standard methodology, in recent years the effect of this understatement has been magnified due to the apparent increased level of overall stock market volatility due to the rapid rise and fall of various e-commerce and other technology stocks. The inclination of regulators to adopt short term comparative measures for determining benchmark returns, mean that this effect, combined with the record low interest rate environment which developed during the 1990's, has resulted in artificially low short term betas being calculated in relation to long-lived infrastructure investments.

This approach has been compounded with the philosophical exclusion from regulatory recognition of asset-specific risk to produce a sublimely theoretical regulatory perception of an almost risk-free climate for investment in gas transmission and distribution infrastructure. It is then little wonder that regulators have seemed unable to comprehend the commercial rates of return actually demanded by investors in the real world. Or that they have demonstrated an incapability of distinguishing between a rate of return appropriate to a distribution network in a major population centre, from that appropriate to an entrepreneurial greenfields transmission pipeline which has to contend for market share within an uncertain regional market, dominated by alternative energy sources.

8.0 CONCLUSIONS

GGT considers that the Commission has correctly identified many of the problems that exist with the Code in its current form. However, GGT is also strongly of the view that without very specific and unambiguous regulatory guidance, the net result of the reforms which have been proposed will be negated by re-interpretation during drafting of the reforms and their subsequent implementation. The outcome will be a reversion to the malaise that exists under the Code in its current form, with all of the negative implications for future investment and hence stifled economic growth that goes with it.

At perhaps a higher level of government, without some acknowledgement of the confusion of regulatory roles and the need to separate economic regulation from consumer advocacy at a fundamental working level, any proposed reforms are likely to be subverted.

The Commission has identified many specific improvements to the Code itself and these are commendable. However, a major structural flaw which the Commission has not yet addressed, is the nature of what has gone wrong with the implementation of the Code to date. Notwithstanding whatever other structural reforms are implemented in terms of facilitating the necessary separation of regulatory roles and powers, the submissions before the Commission provide ample evidence of the need for strong regulatory guidance.

In practice, what this means is that every key expression needs to be a rigorously defined term. The application of every test or criterion needs to be explicitly described. Where a specific outcome is intended, it needs to be clearly identified.

Given the problems acknowledged by the Commission with the current heavy handed and indiscriminate application of the Code, this might seem somewhat paradoxical. However, quite the opposite is true and the proposal to provide stronger regulatory guidance is intended to:

- Raise and increase the certainty associated with coverage thresholds.
- Clearly distinguish in purpose and application, the distinction between the monitoring option and the need for more intrusive economic regulation.
- Without eroding either access or property rights, reduce the prospects for litigation and improve the timeliness of regulatory processes.

- Prevent the continuation of re-interpretation and consequential subversion by regulatory agencies having their own agenda of Code outcomes intended by government.
- Support and make explicit the intended role and outcomes of the Code as a tool of government policy.