REVIEW OF THE GAS ACCESS REGIME

Supplementary Submission to the Productivity Commission

ON

DRAFT FINDINGS & RECOMMENDATIONS

3 May 2004

Table of Contents

(1) Introduction ... 3
(2) Rationale for Change to the Code ... 3
(3) Monitoring Regime ... 4
3.1 Characteristics of the Monitoring Regime ... 4
3.2 Monitoring Regime Guidelines ... 7
3.3 Information Disclosure Requirements ... 8
(4) Coverage Thresholds ... 11
4.1 Relativity of Coverage Thresholds ... 11
4.2 Initial Implementation of Two-Tiered Regulation ... 12
4.3 Credibility of "Heavy Handed" Regime ... 14
(5) Regulatory Truncation Premium ... 15
(6) Implementation: The Need for Cultural Change ... 17

(1) 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 further comment on a number of issues after having had an opportunity to read the hearing transcripts and submissions made to the Commission since the release of it's Draft Findings (the Draft Report).

(2) Rationale for Change to the Code

A common proposition underlying a number of submissions made to the Commission by some regulators and users following the release of its Draft Report, is that unless it can be incontestably demonstrated that the Code has had a significant detrimental effect on investment, then the Code should not be altered from its present form. GGT would like to make the following observations:

- (i) Investment in gas networks in Australia has grown since 1990.
- (ii) In the later half of this period, the Code came into being (amidst a suite of other industry reforms).
- (iii) Regulators claim therefore that the Code has;
  - (a) had no detrimental effect on gas investment,
  - (b) actually encouraged investment in infrastructure.
- (iv) Service Providers on the other hand claim that the Code has;
  - (a) not encouraged investment,
  - (b) deterred some investment either in total or in part (eg. affecting initial sizing), and that the investment that has occurred has done so despite the Code.
- (v) The Commission has concluded that;
  - (a) "wrong" regulatory outcomes will adversely affect investment,
  - (b) there is a greater chance of getting regulatory outcomes "wrong" than of getting them "right"[1],
  - (c) on the evidence before it, the Commission cannot objectively discern whether the Code has had any effect,[2]

[1] Some commentators consider that in fact there is a zero chance of regulators getting their decisions "right", eg. L.Collis & F.Menezes, Submission DR81, March 2004, page 2.

[2] That is the Commission considers that while evidence has been presented by industry participants that the Code has a detrimental effect on present and future prospects for

(d) the Code in its current form represents an expensive economic burden.

It seems that the logic that the case for change has not been made can be equally applied to consideration of whether a case has been made for the retention of the Code at all. Typically however, service providers are not averse to being subject to appropriate regulation. Nonetheless, consideration of the facts outlined above strongly indicates that the views put by some regulators and users as to the lack of justification for changing the Code, approach the issue from the wrong perspective. Rather, the Commission is urged to consider that unless the Code can be shown to have a demonstrably positive effect, it should at the very least be "fixed" – if not radically "wound back" to a more appropriate form in the interests of economic efficiency. From this perspective, the introduction of a non-invasive monitoring alternative to the present regime (along with a regulatory exemption period for new and contestable investment) must surely represent a minimum level of change necessary to the Code.

(3) Monitoring Regime

3.1 Characteristics of the Monitoring Regime

A number of commentators, including GGT, have expressed concerns about the implementation of the proposed monitoring regime. Underpinning the efficacy of the monitoring option is the need to refine the characteristics of the regime outlined in Draft Recommendation 8.2. GGT requests the Commission to consider that the characteristics of the regime – and the roles of both service providers and regulator subject to it - need to be clearly defined by the Commission and included as guidelines in the Code.[3] The following issues need to be addressed (which include but also extend upon the characteristics already recognised in the Draft Report):

(a) A published Third Party Access Policy needs to be developed by the service provider under guidelines that have been defined by the Commission and included in the Code. It seems essential to the practicability of facilitating light handed monitoring that a minimum set of standard guidelines be established within the Code in order to assure all parties that a pipeline access policy is sufficient without the need for onerous regulatory information disclosure. Details of what the guidelines should cover are discussed below.

---

investment in essential gas pipeline infrastructure and that the arguments are credible, this case remains "counterfactual" and hence cannot be definitively proven. On the other hand, it cannot be concluded from the evidence that any causal relationship exists between the introduction of the Gas Code and the investment that has occurred in gas pipelines, particularly given the substantial (and more likely to be causative) effects of structural reforms, privatisation and supply driven growth in gas demand. For its part, GGT can only comment that it does not consider that the GGP would have been a feasible investment proposition if it had been subject to the terms and risks imposed by the Code at the time that the investment decision was made. Subsequent capacity expansions have been feasible due to the absence of an approved access arrangement under the Code, rather having been facilitated under the GGP State Agreement in the belief that this afforded protection against the investment risks embodied in the Code.

[3] There appears to be bilateral support for this proposal, for example see ERA Submission DR116, April 2004, page 12.

(b) Scope also needs to exist for a service provider to be able to offer additional service features in response to commercial imperatives, including responsiveness to competition (eg. under a voluntary Code of Conduct). For this to happen, it is critical that such additional voluntary service offerings (in excess of the minimum standards defined under the guidelines in the Code) do not unduly penalise the service provider in the event of an access dispute, arbitration or subsequent coverage under the more heavy handed tranche of the Code. If this is not the case, it will probably be seen to be commercially imprudent for service providers to offer additional services in an environment where users continue to be offered regulatory gaming opportunities for realising commercial advantages.

(c) The monitoring regime needs to facilitate commercially negotiated outcomes. A significant obstacle to this will exist if user's perceive that they have an opportunity to continue to use regulatory leverage through easy recourse to (or even the threat of) more heavy handed regulatory intervention in order seek commercially advantageous outcomes. As discussed by GGT in its previous submission to the Commission, the extent to which the demonstration of bona fide "best endeavours" negotiation is established as a rigorous threshold for seeking recourse to arbitration or regulatory intervention will therefore be critical to the success of the monitoring option. One means of providing an incentive for parties to engage in robust negotiations, is the recourse – upon qualified application - to binding arbitration, particularly where timing constraints on the arbitration process also limit gaming opportunities.

(d) Recourse to binding arbitration under the monitoring regime should pose no problems under the Code in circumstance where a contract is already in place, as the bases for arbitration will be defined either under the Commercial Arbitration Act or under the specific terms of the contract. To the extent that these might represent foundation contracts, these should be exempt from the effects of the Code anyway. However, in regard to a dispute over new access, the bases for arbitration will need to be provided by guidelines contained within the Code, but which are different from those which currently exist as these bind the arbitrator to terms established under an approved access arrangement. Under the monitoring option, no such access arrangement terms will exist. However it should be sufficient for the guidelines which define the minimum standards required of a service provider's third party access policy to also serve as the basis for an arbitrator's assessment. This must however be qualified with the constraint that an arbitrator should only assess access compliance against the minimum standards defined (for the purpose) within the Code, and not against any additional voluntary service offerings entered into by a service provider. (The latter may be subject to separate Trade Practices Act action if they are seen to represent false or misleading behaviour). The Commission is urged to consider the disincentives for service providers offering more flexible or market responsive services if these are likely to result in increased grounds for regulatory disputation or adverse commercial outcomes.

(e) It seems inevitable that if arbitration provisions are to be provided within the monitoring regime, guidance as to the basis upon which access pricing should occur must be also provided. Some regulators have expressed the view that this eventuality will require a cost of service tariff

calculation and hence necessitate a level of information disclosure at least equal to that which exists under the current implementation of the Code.[4] Clearly that is to be avoided if the monitoring regime is to serve its intended purpose. Nonetheless, arbitrators will need to be guided by some widely understood pricing principle, and this guidance should be clearly enunciated within the monitoring regime guidelines included in the Code. Such guidance does not necessarily have to involve intrusive data collation and theoretical analysis. One of the principles of third party access hinges upon "non-discriminatory access" (perhaps better described as "equitably discriminatory access", as price distinctions between different types of service offerings are permitted to be recognised). It would therefore seem both appropriate and adequate for an arbitrator to be given the guidance that access pricing for a particular service should lay somewhere between the Total Average Price paid by third party pipeline users, and the Service-Specific Average Price, being the average price paid by a similar class of existing user for a similar service to that being sought. This information would be based on empirical price evidence, relying on fact rather than theoretical derivation and not involve any great level of information disclosure in excess of that which might be reasonably expected to be available under the minimum third party access policy guidelines.

(f) The Commission has already referred to the desirability of the separation of pipeline operations from associated businesses in upstream or downstream markets (ie. often referred to as "ringfencing" requirements). Further, the voluntary Code of Conduct being suggested within the pipeline industry refers to the principle of public disclosure of dealings with affiliate entities. However, it has been suggested to the Commission that there exists a need under the monitoring regime to address the potential for transfer pricing within associate entities and that this implies a high level of regulatory vigilance in order to ensure the objective of pursuing economic efficiency.[5] However, GGT considers that this concern does not represent any significant barrier to the practicability of the monitoring regime. Under the proposed voluntary industry Code of Conduct, service offerings made to associates would also be available to third party access seekers on similar, non-discriminatory terms. Under some circumstances, this could lead to the economic benefits of vertical integration being shared with third party access seekers, as discussed by GGT in its previous submission (DR88, page 44). Moreover, if a service provider subject to the access monitoring regime chose to flaunt the ringfencing principle, it would be setting itself up for a successful application for a change in coverage to the more heavy handed tier of the Code. For this purpose, it is unnecessary to delve into the apportionment of economic transfers between related corporate entities – the monitoring

---

[4] It appears that some regulators have interpreted a monitoring role to involve continuous disclosure and assessment of the same level of information as is currently involved in a periodic access arrangement reviews, thereby exacerbating the concerns of service providers about the intransigence of regulatory implementation of new Code provisions.

[5] For instance, ERA Submission, DR116, April 2004, page 19. The issue of how regulators will need to functionally reconcile the objective of pursuing long term economically efficient outcomes with the need for them to restrain themselves from intervention whilst the market develops workably competitive outcomes, is a matter dealt with in many submissions to the Commission. It will clearly require both definitive qualification within the Code of what is intended, as well as strong unambiguous guidance for regulators in implementing the regime.

of trends in access behaviour and third party prices should suffice as indicators of the success of the regime. It should also be considered that any pipeline subject to the monitoring regime is nonetheless a covered pipeline and hence ought in principle to have been assessed against the coverage criteria (to do otherwise is to perpetrate the injustice of a presumption of guilt). One might consider that account would have been taken of the adequacy or otherwise, given the specific circumstances, of ringfencing arrangements at the time that the need for coverage was assessed.[6]

(g) There is a need to clearly define the role of the relevant regulator under any monitoring regime.[7] It will be critical to the success of the access monitoring option to emphasise unambiguously that it is not the intended role of the regulator to sit in judgement of the extent to which outcomes may or may not be seen to be "economically efficient". Nor should it be the regulator's role to punitively police service providers with the intention of 'catching them out' on the basis of sub-optimal economic efficiency (however that may be measured). Rather the role of the regulator should be to police service provider compliance with the pre-defined information disclosure requirements of the Code, and perhaps to monitor or at least stay informed about the general state of the relevant markets. Any greater prospect of regulatory intervention will exacerbate the problem identified in (c) above, regarding potential barriers to negotiated outcomes being achievable in the presence of regulatory gaming opportunities. The challenge is to get the right balance between making the prospect of more heavy handed regulatory intervention under the Code sufficiently onerous for service providers but sufficiently difficult for access seekers to invoke so as to provide incentives for commercial negotiations to be undertaken in good faith. In this regard, the five year minimum term applicable for access monitoring contemplated in Draft Recommendation 9.1, along with the proposed possibility of blanket coverage under the monitoring regime suggested by GGT in its previous submission (DR88, page 40), would be of considerable benefit.

3.2 Monitoring Regime Guidelines

Third party access policy guidelines for the monitoring regime should be contained within the Code, as discussed above. The following list includes requirements as well as some suggestions which the Commission might wish to consider should be included.

(a) The guidelines should represent only the minimum standard that a service provider's third party access policy should need to comply with in order to provide assurances that sufficient standards have been met whilst also providing scope for negotiation and market responsiveness. The guidelines should also establish the basis upon which an arbitrator should be constrained to base any arbitration in the event of a dispute. Specific recognition of the scope available for service providers to offer services in addition to the minimum standards without prejudice to the

[6] Such consideration was given by the Australian Competition Tribunal in the EGP Decision, [2001] ACompT2, for instance at paragraphs 111, 112 and 115.

[7] The need for the role of the regulator to be clearly defined is also supported (both explicitly and in the nature of the views expressed) in the ERA submission, DR116, on pages 12-13.

minimum standard against which they would be assessed in the event of a dispute should also be provided in the Code, particularly by way of implementation guidance.

(b) The requirements for public disclosure of a prescribed set of standard minimum information need to be defined in the guidelines. (This subject demands a discussion in its own right and is dealt with in section 3.3, below).

(c) The problematic need to substantiate bona fide "best endeavours" negotiation as a precursor to any access dispute, arbitration or other attempt to seek regulatory intervention, might be assisted by the maintenance of a confidential "information register" in which it is know that all correspondence relating to access requests will (and must) be stored. The manner in which this might be provided for could be specified in the guidelines. It is important that the Code should also provide that any such register would be treated with the utmost confidentiality and should probably be available only to the arbitrator and only under defined circumstances. (This suggestion needs to be qualified with the need for further industry consultation in order to ascertain the potential impact on perceived regulatory risk and to identify potential unintended commercial consequences).

(d) In addition to the need to demonstrate compliance with the minimum set of standards outlined in the Code, it would seem likely that in order to establish the credibility of a third party access policy developed with a certain level of discretion by a service provider, some guidance regarding the manner and means of changes to the policy may be required. This may involve no more than a notification requirement, or it might suggest minimum commitment periods (ie. how long a particular access policy should be valid for prior to change being permitted). It might also provide conditions for a "change process" in order to enhance access seeker confidence, for example, restricting the modification of an access policy without bilateral agreement during the course of an access negotiation process.

3.3 Information Disclosure Requirements

The challenge for defining the information disclosure requirements that should exist under the monitoring option under the Code is to provide an adequate level of definition without being overly prescriptive and undermining the intent of the monitoring option. Furthermore, the disclosure guidelines that should be contained within the Code need to restrict the natural propensity of regulators to seek ever greater amounts of information. The Commission has recognised this problem in its Draft Finding 7.3, rightly concluding that regulators' attempts to extend their powers of intrusion add unnecessarily to costs. That this currently continues to be a disposition which must be addressed in the Commission's final recommendations is evidenced in recent statements by the Western Australian Regulator regarding the continuing efforts to pursue increased information gathering powers in the Regulators Forum under the

guise of seeking "standardised information requirements".[8] It is an alarming feature of this particular initiative that, following unsuccessful attempts by regulators to push for a change through NGPAC for increased information collection powers under the Code, the initiative continues to be pursued. The details of the proposals have not however been made publicly available.[9] Such continuing pressure for increased power by regulators, and the manner in which it has been pursued, undermines confidence in the transparency of process or the purported independence of regulators, and militates against public confidence in the practical implementation of the monitoring option achieving the light handed oversight intended, without the inclusion of clear regulatory guidance.

Hence, as also identified by APIA in its submission (DR100) and generally in line with the Commission's Draft Recommendation 8.3, there is a strong case for regulatory guidance to be incorporated into the Code in the most unambiguous terms. In this regard however, GGT shares the concern of a number of other submissions that the specification of information requirements should not be left to the NCC, but should be defined by the Commission, at least in principle, in its Final Recommendations.

The guidelines in the Code should emphasise unambiguously that the intention of the information disclosure requirements are to facilitate a focus on "access" monitoring and should address the following considerations (in roughly the order of priority):

(1) For the purpose of facilitating access monitoring, a pragmatic approach is required which should primarily involve the reporting of relevant access negotiations and respective outcomes. The level of detail required only needs to be sufficient to indicate that robust access is available on a non-discriminatory basis to genuine access seekers. Consequently the information reported might include;

   (a) number of access negotiations commenced,
   (b) nature of services sought,
   (c) number of access negotiations withdrawn by access seeker,
   (d) number of access negotiations completed (and indicative outcomes),
   (e) number of access disputes commenced,
   (f) basis of access disputes,
   (g) number of disputes completed (and nature of outcomes).

(2) There needs to be a clear emphasis on monitoring performance trends and these need to be steered away from problematic measures of profitability. Attempts to measure profitability are certain to give rise to problems associated with interpretation, derivation, allocation and context in regard to the measures themselves. In addition, attempts to measure profitability have already, under the Code, demonstrated the scope for information issues to arise relating to levels of detail, the need for verification, accounting mechanisms and various aspects of theoretical manipulation. Instead, the Code should clearly and explicitly steer regulators towards the use of access indicators (such as percentage

---

8 eg. Refer Productivity Commission, Inquiry into Gas Access Regime, Transcript of Proceedings, Perth, 1 April 2004, page 995, as well as ERA Submission, DR116, pages 9-13.

9 Refer OffGAR Submission (submission 40), 5 September 2003, Attachment 2.

change in volume or throughput measures), which inform of capacity utilisation and availability. In reality, considering that all significant pipelines in Australia which are currently covered under the Code have had some form of government sanctified tariff established, the only financial indicators that are required should be the published prices for publicly available third party access services. Under the voluntary industry Code of Conduct, these might be expected to be available from each service provider's website. It is critical for the purposes of regulatory guidance however, that the Code require that published prices so derived be taken in the specific context of the specific service offerings to which they relate.

(3) Clear guidance to regulators is needed as to what should be excluded from disclosure requirements (as well as requirements for subsequent public reporting by regulators). For example, foundation contracts and "non-core services" should be excluded from regulatory involvement, even to the extent of being exempt from disclosure for monitoring purposes in order to protect the commercial role that such arrangements have to play in the market. This is likely to necessitate an additional element of guidance as to how these exemptions from the overall information available about a particular pipeline are to be managed in order to maintain the integrity and usefulness of the information that is disclosed. This guidance might include indications as to the use of aggregated information about capacity availability and utilisation for example (including perhaps "weighted baskets of service offerings", if and where required). The guidelines should in any event recognise the exemption of financial information relating to exempt services from the disclosure requirements. The possible exception to these exemptions might be in regard to information that should be made available to the arbitrator in the event of a dispute. The guidelines should therefore also provide details of the circumstances under which information would need to be supplied to an arbitrator and the purpose for which it was intended (for instance, establishing price outcomes as discussed in section 3.1(e) of this submission), along with clearly defined limitations on the nature of the information provided and the uses to which it might be put.

(4) The guidelines should reiterate that the reporting requirements under the monitoring regime are to be limited to the provision of "post-event" reporting, and are not required to be anticipatory in nature or (besides complying with the minimum standards set by the Code) to require any form of regulator approval.

(5) The required frequency of reporting should be established within the guidelines. This should set a minimum standard for public disclosure, perhaps requiring the relevant regulator to do no more than include a set of summary statistics for public dissemination in either the regulator's annual report, or in a dedicated access monitoring report. The implications of most commentary on the issue appear to indicate that reporting should be annual and any more frequent reporting than this would seem excessive. It should also be considered that much (if not all) of the summary information that should be required for a sufficient standard of access monitoring, will most likely be available on a continuously updated basis from the service provider's website (if the service provider has adopted the voluntary Code of Conduct).

(6) Concerns have been expressed that there needs to be some form of guarantee that the information provided by service providers for monitoring purposes is complete and genuine. If regulators, users and competitors need to be assured of this as is argued, then the APIA proposal that CEOs should sign off on the information supplied for this purpose should be sufficient guarantee.

The Commission is also urged to consider that the option of initial blanket coverage under the monitoring regime of all existing transmission pipelines for a mandatory period would provide both the opportunity and incentives for service providers to develop market-based information requirements. (For other benefits, see section 4.2 of this submission). A standard five-year period would not be inappropriate, however a shorter initial period of blanket coverage which could be reviewed after maybe three years could also feasibly be incorporated into the implementation process of the proposed Code changes. Such a review would be solely intended and specifically limited to the purpose of assessing the actual information requirements developed within the dynamic tensions of the market, in order to formalise their inclusion in Code at the time of the review.

(4) Coverage Thresholds

4.1 Relativity of Coverage Thresholds

For the purposes of clarity, GGT wishes to reiterate its understanding of the Commission's description at the public hearing of its intention to;

(a) preserve the threshold for coverage under the Code at its current level (albeit that the first tranche of coverage will be under a lighter handed monitoring option than currently exists in the Code), and

(b) to maintain the parity of the coverage thresholds between the Code and the Part IIIA provisions of the Trade Practices Act.

That is the existing Code coverage threshold is intended to equate directly to the proposed threshold for "material" merit. This is intended to also equate directly to the threshold for declaration under Part IIIA.

The threshold for invoking the more intrusive "heavy handed" Code regime (that is, represented by coverage being anticipated to have "substantial" merit) is to be higher than both the existing coverage threshold under the Code and the threshold for declaration under Part IIIA.

While GGT is aware that definitional problems arise in the establishment of these relative thresholds, and that the Commission is working on resolving the issues relating to this, on the basis of this understanding, GGT supports the Commission's intentions regarding threshold parities. However GGT would draw to the Commission's attention the fact that it regards the NCC's interpretation of the application of the coverage criteria to date to be substantially flawed and heavily biased towards the maintenance of coverage wherever it can be even remotely justified. In particular, the NCC has shown a reluctance to recognise competitive effects that exist in the absence of the Code. It has also demonstrated a very specific reluctance to recognise competition between gas and alternative energy forms where these are available, even where the introduction of gas infrastructure into regional

markets has resulted in reduced energy prices, redefined market shares and ongoing competitive responses. As a consequence, the application of the Code is more widespread than is justified and the current threshold for coverage under the Code is in practice, artificially low.

4.2 Initial Implementation of Two-Tiered Regulation

Draft Recommendation 8.1 states, with emphasis added:

> *"The Gas Access Regime should be amended to provide for a lighter handed form of regulation whereby the application of the alternative regulation involving an access arrangement with reference tariffs would only occur in the more extreme circumstances. 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."*

The monitoring regime has clearly been identified by the Commission as being a major means of addressing many of the shortcomings of the existing heavy handed, resource intensive and economically damaging regulatory approach represented by the Code to date. For this to be so, a significant proportion of the pipelines currently adversely affected (in excess of what might be actually warranted) under the Code would need to move to the monitoring option. This expectation appears to be, quite logically, what is intended by the Commission in Draft Recommendation 8.1, whereby all but the "more extreme" cases would be monitored. This is also consistent with the Commission's statement (on page 261 of the Draft Report) 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. It could also become a transitional measure towards a deregulated market for pipeline services in the longer term."*

The question that arises upon the introduction of the monitoring regime option, is the means by which the transfer of existing covered pipelines which may warrant the transition from heavy handed regulatory intervention is facilitated. There appear to be three obvious mechanisms. Upon the introduction of the monitoring option;

(a) All existing covered pipelines remain under the heavy handed option, but are entitled to apply for a coverage ruling if they consider they meet the criteria for the monitoring option,

(b) All existing covered pipelines remain covered, however they default to the monitoring regime option unless a coverage application is made and assessed to warrant heavy handed regulatory oversight, or

(c) On the basis of a set of predetermined but obvious criteria (which will of necessity be somewhat arbitrary in nature), some existing covered pipelines are moved to the monitoring option and others remain under the heavy handed option.

GGT recognises the difficulty facing the Commission of recommending that all existing covered pipelines should automatically be moved to the monitoring

regime option. Nonetheless, there are a number of issues which the Commission needs to address in regard to how the transition between regulatory options is to be achieved. A primary consideration is social and economic efficiency.

An important efficiency consideration ought to be an objective to minimise the number of coverage applications and assessments which need to be undertaken in order to implement the new two-tiered regulatory regime. This is particularly so when it is recalled that it is only the regulatory oversight mechanism that is being changed – all pipelines presently covered under the Code would continue to be covered by the Code.

However the Commission seems to consider (and it seems reasonable to conclude) that the majority of presently covered pipelines can be expected to migrate to the monitoring regime. Therefore, initial blanket coverage under the monitoring option would substantially reduce the number of intra-regime coverage assessments that would need to subsequently be prepared and processed (and possibly appealed).

It would be even more efficient (in terms of minimising the total number of coverage assessment processes eventually required) if it were possible to determine a mechanism which closely matched the outcome that would eventuate if a rigorous coverage assessment were to be undertaken, but permitted an arbitrary allocation of currently covered pipelines into each regulatory option. To achieve this would depend upon the identification of some objective criterion or criteria which would serve as a reasonable proxy for coverage screening without the need for rigorous assessment. This is of course likely to be both problematic and controversial, however it is nonetheless practicable and the implementation advantages in terms of efficiency and bringing certainty swiftly to the market, make it worthy of serious consideration. Some reasonably simple screening criteria for automatic transferal to the monitoring regime which might be justified, include:

(a) All transmission pipelines, or

(b) Only transmission pipelines which do not service a major population centre, or

(c) Any pipeline for which no spare installed capacity exists (and hence no scope for third party access exists without additional investment).

Despite the problems associated with the suggestion that initial blanket coverage under the monitoring regime be instated for all presently covered transmission pipelines (problems which may be more political than economic), the Commission is requested to consider the following matters before arriving at its final conclusions:

(a) All significant currently covered pipelines have had a regulator or at least a government approved tariff established (including the GGP and the DBNGP), therefore unless currently approved tariffs are significantly under-priced due to regulatory error (as seems likely for some to be[10]),

---

10 Whilst it seems reasonable to assume that some pipeline price settings will currently suffer from regulatory error to some degree (in accordance with the Commission's draft findings), the freedom under the monitoring option to correct prices will be constrained by the threat of future re-instatement of heavy handed regulatory coverage. This threat

the only significant issue for regulatory oversight is a matter of monitoring access behaviour and future price trends.

(b) Service providers would be under an incentive to establish standards of information disclosure sufficient to meet the requirements of market participants due to the threat of future (re)coverage under the heavy handed regulatory option under the Code. The dynamic tensions of the market can be expected to see a tailoring of information disclosure in response to market demands.

(c) A defined minimum period of widespread access monitoring would provide an opportunity for the realisation of commercial outcomes to be demonstrated which can not occur under the more heavy handed regulatory regime. As discussed in GGT's previous submission, the realisation of commercial outcomes is threatened where users see recourse to regulatory intervention as a commercial lever for achieving unreasonably favourable terms.

(d) It should be possible to institute a subsequent "one-off" regulatory review (by the Commission) as a part of the implementation process after perhaps three to five years. This might provide an opportunity to finalise the formal incorporation of appropriate (market derived) information disclosure requirements within the Code for monitoring purposes, as well as an opportunity to refine the monitoring guidelines if problems have been identified.

4.3 Credibility of "Heavy Handed" Regime

The primary focus of this submission has been on the proposed monitoring regime. It is also worth mentioning that whilst heavy handed regulation needs to be a "credible threat" for pipelines subject to monitoring, it also needs to be sensible when it is invoked. Therefore, while the monitoring option is a positive amendment to the Code, the Commission is urged to also give adequate consideration to recommendations for changes to the existing price setting regulatory regime.

Many of the specific issues relating to the need for change to the existing provisions and implementation of the price setting regime have already been ventilated before the Commission. However the strength and persistence of the need for these matters to be addressed is demonstrated in continuing statements made by regulators. For example, all regulators continue to argue against the recognition of asset and investment specific risks in regulated rates of return, arguing instead for reliance on theories of notional investment diversification. That this position is maintained in the face of all evidence or argument to the contrary – including the recognition given by the Commission in its Draft Report – is demonstrated in the ERA Submission (DR116), and in particular in the report attached to that submission in which the staff and consultants of the regulatory agency took an active part.[11]

---

is, as is intended, likely to make service providers somewhat circumspect about the extent and the mechanisms by which they seek to correct tariff paths.

[11] Specific reference is made to ERA Submission, DR116, pages 7-8.

In fact, the inclusion of that particular report[12] in the ERA Submission to the Commission, is worthy of some further comment as it provides a worked example of a number of the problems service providers have identified as being wrong with the role adopted by regulators and of their ongoing implementation of the Code:

- The Commission should be aware of the negative responses to the report, including that it focuses on outdated justifications for prior regulatory practices rather than contributing to "evolving best practice" as purported.

- The report has been attached to the ERA submission with no contextual justification, having only two minor references to the body of the report, both of which are highly controversial, that is that regulatory risk is not relevant to setting a commercial rate of return (page 7) – and that CAPM is the methodology of choice in establishing compensation for equity risk in a diversified portfolio (page 8), which is not even established within the report itself.

- The submission of the report appears to be an attempt to legitimise an analytically poor and biased report by association with the Commission's national review of the Code.

- The cost of the report was involuntarily but directly funded by service providers in Western Australia on what service providers consider to be an ill-conceived and unjustifiable basis, without any degree of proprietary or reasonable recourse to appeal.

These issues and others are more fully treated in the responses received by the ERA following its release of the report at the end of December. For the Commission's ease of reference, these are attached to this submission.

While the inadequate treatment of risk and other conflicts between commercial realities and the theories employed by regulators may be avoided under the application of the monitoring regime, these issues will continue to be faced by service providers who remain subject to the heavy handed tier of Code coverage. This may serve to make the more intrusive form of the Code a "credible threat" for moderating the behaviour of those pipelines not subject to it, however it does nothing to make it a credible regime, or one that is likely to yield credibly beneficial economic outcomes. Consequently, the Commission is urged to fully consider the changes needed (and already put to the Commission) regarding the Code in making its final recommendations.

(5) Regulatory Truncation Premium

The issue of adopting a regulatory truncation premium has not received much attention during the Commission's review (as the Draft Report acknowledges), possibly because there has been some confusion as to what it has meant and what it would be intended to address. The Draft Report deals with the issue in

[12] Review of Rate of Return Methodologies and Practices, jointly produced by the Institute for Research into International Competitiveness and Associate Professor Lakshman Alles, both of Curtin University of Technology, the Office of Gas Access Regulation and the Office of the Rail Access Regulator (both now part of the ERA), and Economics Consulting Services, September 2003.

respect of representing an upwards adjustment to the allowable rate of return for a new pipeline in order to compensate for regulatory truncation of potential investment upside. Limited to this role, the suggestion that new investments might automatically qualify for a regulatory exemption (or "holiday") period appears to render – to a degree - consideration of the need for a truncation premium redundant. This must however be qualified by two considerations.

Firstly, the regulatory free period is proposed to be 15 years and there remains some concern (shared by GGT) as to whether this is sufficiently long to compensate for future regulatory truncation given the normal timeframe for assessing pre-investment returns, particularly for long lived assets which may under-recover in earlier years.

Secondly, the Commission has not in fact recommended regulation free periods should be automatic or that they will apply to new investments which might otherwise qualify for coverage. Hence there remains an issue of the applicability of a truncation premium for new investments which do not qualify for a regulatory free period, or for which a 15 year regulatory free period is potentially inadequate to mitigate the future impact of regulatory truncation on lifecycle investment economics.

It is also a consideration that in Draft Recommendations 5.1 to 5.4, the Commission has suggested the removal of a number of guiding principles, relying instead on the various specific facets of outcomes that will be efficient over the longer term being given appropriate weight of consideration by regulators in their decision processes. A number of submissions to the Commission have pointed to the difficulties of leaving such assessments of "economically efficient" outcomes, particularly in regard to efficient investment returns, to regulators - and the lack of confidence in the efficacy of the proposed changes to which this reliance leads. (This is also discussed further in the next section of this submission).

A good example relating to concerns about the critical issue of the derivation of permissible rates of return (equally applicable to the quantification of a truncation premium) is illustrated in the ERA submission (DR116). On page 20, the ERA states that it considers that an allowance for asset-specific risk doesn't need to be recognised by the Code as "*the existence of a flexible incentive mechanism*[13] *under the Code therefore clearly questions the need for any truncation premium*". This is predicated on the view that "*given that the Code only applies to natural monopoly infrastructure there is a real need to be clear on whether such businesses actually face any appreciable downside risk*" (ERA Submission, DR116, page 19).

This view is revealing of a failure to comprehend the nature of the risks faced by pipelines, the variety of circumstances which can affect these risks, or the potential impact which regulatory intervention can have. For GGT this has been reinforced given that in its (admittedly now rescinded) draft access arrangement decision, the GGP was granted a regulated rate of return which was essentially the same as most other pipelines or distribution networks servicing major population centres.[14] This is despite the fact that the GGP

---

[13] In practice, regulators have taken the incentive mechanism to refer merely to a real-terms revenue sharing mechanism, either through a CPI-X mechanism or directly through returning a significant proportion of any upside that a service provider might realise from its investment, to users. The "incentive" tends to be all stick and no carrot.

[14] Refer ERA Submission, DR116, Attachment A, Table 5, page 41.

serves an identifiably different customer base with significantly greater risk associated with the potential for loss of downstream demand, being over 95% reliant upon less than ten users with little industry sector diversification and all being exposed to international commodity volatility.

To compound a contradiction faced by GGT, the ERA states in its submission that any downside risks which do exist would be more appropriately addressed in specific circumstances "*through some form of Government guarantee or subsidy*" (ERA Submission, DR116, page 19). In fact, GGT has just such a Government guarantee under mutually complimentary terms expressed in the State Agreement to which it is subject as well as the Act that enabled the Code in Western Australia. Nonetheless, this has shown itself to be vulnerable to the regulatory gaming opportunity afforded to users upon the superimposition of the Code. For its part, except to the extent dictated by a series of litigious challenges and resulting directions by the Supreme Court of Western Australia, the Regulator has demonstrated no particular deference to the circumstances which led to these particular and explicit government guarantees, citing instead only the relevant obligations owed under the Code. Hence the Code has demonstrably facilitated the trampling of a pre-existing contractual guarantee even though this had been ratified by Acts of parliament.

Such an outcome as that experienced by GGT in regard to the interaction of the Code and government undertakings which exist outside of the Code, demonstrates the potential need for both a truncation premium to be permitted under the Code, as well as clear guidance to Regulators so as to preserve the effect and intent of such a measure.

(6) Implementation: The Need for Cultural Change

The Commission has recommended changes to the Code such as the introduction of a lighter handed monitoring approach, which it quite correctly appears to consider should apply to the majority of covered pipelines, where the application of the existing more heavy handed option would "only occur in the more extreme circumstances". [15] Further, the Commission's recommendations represent a shift towards emphasising the social importance of long term considerations in respect to economic efficiency and the need for continued investment incentives. These changes reflect a philosophical maturation of the Code and necessitate a corresponding cultural change within the organisations responsible for the implementation of the Code if the Commission's recommendations are to be given the intended effects.

The need for stronger regulatory guidance has been clearly and strongly indicated to the Commission, including by some regulators themselves (eg. OffGAR cited on page 125 of the Draft Report, as well as the central theme of the ERA transcript at the Commission's public hearing). Whilst regulatory discretion seems like it should be a desirable and pragmatic feature of a regulatory regime in theory, the evidence suggests (in line with the concern recognised by the Commission on page 124 of its Draft Report) that the effect that its use under the Code has led to;

- outcomes and statements by regulators which on the whole reveal an institutionalised bias towards the role of consumer advocacy, pursuit of short term price reductions and a lack of concern with commercial

[15] Draft Recommendation 8.1.

investment imperatives (particularly in regard to infrastructure), rather than being balanced economic regulators,

- hence strong incentives for well resourced user groups and large corporate existing users to lobby regulators and game the system in pursuit of rent transfers to the detriment of genuine future third party users (amongst others),

- resulting in socially inefficient regulatory delays, outcomes, appeals and expenditure of resources, including the diversion of funds and expertise which would be more constructively employed in the pursuit of investment opportunities and market development.

At best, the exercise of regulatory discretion available under the Code to date has demonstrated that regulators have been unable to use their discretion to achieve pragmatic outcomes, but rather appear to suffer a form of institutional paralysis which binds them to literal interpretations of the vagaries of the language employed in regulations, economic theory and legal debate. This is confirmed in a number of regulatory decisions concerning both coverage and access arrangements. It is exemplified in the ERA submission, which highlights the problems perceived by a regulator in implementing the Commission's recommendations due to the difficulty in reconciling various theoretical concepts (such as the overarching objective of pursuing economic efficiency) with other more pragmatic suggestions (such as the need for "economic efficiency" considerations to take account of the specific factors which the Commission has recommended deleting from the Code in Draft Recommendations 5.2, 5.3 and 7.1).[16]

The out working of this paradigm is that institutionalised regulatory practices all too often demonstrate that the pursuit of process is more important than the actual outcome embodied in the regulatory decision and the circumstances to which it subsequently gives rise.

The polarisation arising from the protracted, litigious and often very public resolution of dichotomous regulatory issues has compounded and securely entrenched the existing regulatory cultural perspective. This is clearly evidenced in a number of the written and verbal submissions made to the Commission in response to its Draft Report – most notably by the sentiments expressed by the ACCC and the NCC.

The current regulatory cultural perspective represents a significant barrier to the successful adoption and implementation of the Commission's recommendations for much needed change to the Code.

Compounding the regulatory biases that currently exist, the Commonwealth Government appears to be intent on the pursuit of "user-pays" funding arrangements for regulatory institutions. Unless carefully designed, there is a significant risk that this could result in an extension of the problems that exist in Western Australia in regard to the dilution of regulatory accountability and complete lack of budgetary control of regulatory agencies. As a matter of principle, government agencies should ideally be funded by the governments to whom they owe responsibility and to whom the agencies should be held accountable. However the incentive is strong for governments to broaden their effective tax base by shifting whatever cost burdens they may be able to, back

[16] Refer ERA Submission, DR116, pages 4-8, etc.

on to the private sector. Besides the equity issues which arise from such moves, particularly if industries being levied are not permitted to explicitly pass through the direct costs of additional government levies to the supposed beneficiaries of government policies, a significant detrimental impact on government accountability arises. This has been evidenced in Western Australia where a lack of fiscal accountability due to the regulatory funding mechanism, combined with the "regulatory independence" of the government agency, has created a regulatory model which provides;

- no constraint on expenditure,

- no checks on regulatory efficiency or accountability (and clearly no enforceable obligation to honour past government undertakings and assurances), and

- the potential to incur substantial government liabilities (arising from regulatory appeal processes and litigious outcomes which might go against the regulatory agency) over which the government has no control and for which the agency cannot be held to account in any way.

Regulatory accountability is currently extremely limited, being restricted to a need for public justification (however strained), the risk of ministerial decisions not according with agency recommendations (affirming the continued need for ministerial involvement in decision making), and budgetary accountability to the public purse. The funding arrangements currently being pursued for the cost recovery of regulatory agencies – including but not limited to those responsible for implementing the Code – hold the very real prospect of exacerbating the current freedom enjoyed by regulators in pursuit of their existing personal and institutional convictions, raising the barriers against successful implementation of the Commission's recommendations even further.

The Commission only lightly touches on the issue of the limitations and practicalities of regulatory implementation under the Code due to the "Incentives facing regulators" on pages 125-128 of its Draft Report. However if this structural aspect of the Code, the implementation of the changes recommended by the Commission, and the cost recovery mechanisms being currently investigated are not adequately addressed, then the regulatory excesses and inefficiencies already evidenced under the Code will get worse.

The solutions to these issues are both structural and cultural. In a structural sense, they include (besides the specific recommendations of the Commission for technical changes and implementation guidance within the Code itself) the need to:

- Fund regulatory mechanisms from consolidated revenue or, if government is intent on avoiding the cost burden for its own activities, then permitting the explicit pass through of regulatory levies in a manner analogous to the GST in order to make the costs of regulation explicit, but in any event, improving the accountability of regulatory agencies for the expenditures they incur as well as their efficiency, effectiveness and behaviour, and

- Recognise the current regulatory dichotomy by separating the important but quite different roles of (traditional) consumer advocate and economic regulator, in order to provide scope for the objective and balanced

implementation of economic regulation such as that embodied in the Code.

The latter mechanism – the separation of the traditional role of being the consumers' advocate (so strongly embraced and recognisable in most regulatory statements and decisions) from the role of economic regulator (which entails a broader and more balanced, long term social perspective) – would suggest the need for a wider regulatory perspective than currently persists within the regulatory community in Australia. For those appointed to the task of economic regulation *per se*, a cultural shift away from the traditional regulatory paradigm would be necessary.

However, whether or not separate regulatory institutions are established, this sort of cultural shift is going to be a necessary precondition for successful implementation of the Commission's recommendations. Any student of management or institutional behaviour will be aware that institutional culture permeates down from the examples set by senior management. It is also commonplace for corporate entities to redefine themselves in terms of the business they do or the way they do their business, according to the commercial needs they perceive. Specialist private agencies exist who are experts in defining the need for, and how to go about achieving the cultural modifications associated with such changes. Corporate culture and institutional ethos are recognised as prime factors in the success or otherwise of corporate entities and institutions.

The Commission is urged to recognise the critical necessity for cultural change within the regulatory implementation of the Code, and to include in its recommendations a proposal for the institution of a "change mechanism" in order to ensure that the existing regulatory paradigm is better aligned to the intended outcomes of the Code, or at least widened to achieve a more balanced assessment of divergent considerations.

/Attachments: Public Responses to Attachment A of ERA Submission (DR116)