Submission on the Productivity Commission's Review of the Gas Access Regime

Shell Development (Australia) Pty Ltd ("Shell") is pleased to comment on the Draft Report on the Review of the Gas Access Regime released by the Productivity Commission in December 2003.

In Shell's first submission to the Commission dated 3 September 2003, it was suggested that a stable and predictable regulatory environment was required to facilitate further investment and growth in this sector. Shell supports the Commission's overall conclusion in the Draft Report that the current regime has the potential to distort and deter investment and welcomes the recommended changes that seek to encourage a stable and predictable regulatory environment.

Executive Summary

Shell is a major participant in the Australian Energy sector through oil, gas and other related businesses across Australia. Shell aims to engage efficiently, responsibly and profitably based on core values of honesty, integrity and respect for people. Shell companies operate on a global basis in a variety of changing social, political and economic environments and in general, they believe that the interests of the community are served most efficiently by a market economy.

Shell would like to commend the Commission on a thorough and comprehensive review of the Gas Access Regime. Shell welcomes the Commission's acknowledgement that changes to the Gas Access Regime are required to promote the long term growth and development of an efficient and effective natural gas transmission and distribution sector throughout Australia.

Shell has considered and reviewed the Draft Recommendations in the context of 4 key concepts that aim ultimately to achieve a competitive and sustainable market. At the highest level, 'The Australian Perspective' considers an encompassing view of the Australian energy sector. This view drives the 'Regime Fundamentals', providing a framework ensuring a transparent and workable regime. These in turn shape the 'Commercial Arrangements' between the industry participants that will ultimately lead to the right 'Market Conditions'.

Shell's comments for consideration in the final review process of the Gas Access Regime can be summarised as follows:

- Australian Perspective – consider a wider pan-Australian view that seeks to become more standardised and less fragmented.
- Regime Fundamentals - include an Objects Clause but give it a wider scope and definition.
- Commercial Arrangements – implement a Monitoring Regime, however it should be subject to review if competitive factors change in a given market and should provide that the regulator has the overriding right to step-in, in well-defined circumstances.

- Market Conditions – include a Regulation Free Period but include a provision for acknowledgement of special circumstances which enable extended regulation free periods of longer than 15 years once certain criteria are met.

This Submission will develop these four concepts into more detail in the context of specific Recommendations made by the Commission in the Draft Report.

1. The Australian Perspective

The importance of security, reliability and diversity of supply is a very topical issue in Australia and indeed internationally. There is a need to have an 'Australian Perspective' that ensures a long-term vision of multiple competitive gas supply sources, serving the growing demand centres across Australia. The main demand centres are geographically dispersed and often vast distance from the gas resources. In Western Australian, for example, the Dampier to Bunbury Natural Gas Pipeline (DBNGP) serves gas markets in Perth and beyond, some 1,500 kilometres south of the gas source.

Trans-National/Trans-State Pipeline(s)

With the bulk of Australia's natural gas located in the North West of the country, one possibility for meeting the growing demand in the Eastern States is the construction of a trans-national transmission pipeline. In order for a transmission pipeline of this magnitude to be developed, national gas standards would need to be established covering both specifications and permitting, with a common approach across all States in Australia required to stream line processing. Technical issues in these areas can become an impediment to commercial developments.

In the USA, where the regulation of pipelines is a long-established activity, the problems of crossing numerous state jurisdictions has been solved by the presence of the Federal Energy Regulatory Commission (FERC) which controls most aspects of permitting and rate setting. This approach avoids the complexities of multiple regulatory authorities and multiple permits.

By contrast, within the European Union (EU) where regulatory models are either less mature or just emerging, the crossing of borders between multiple countries has tended to operate on the basis of bilateral national agreements. International pipeline agreements have tended to be negotiated by the national governments involved and implemented by national gas transmission companies. The emergence of Directorate General for Energy and Transport (DG TREN) within the European Commission as a quasi supra-national regulator responsible for the implementation of the Second Gas Directive has seen an ongoing effort to improve standardisation of permitting and rate setting. The EU Commission has a wider objective of improving the interconnectivity of national gas grids as a means of creating a single market for energy, but has limits in its authority over national governments. The proposed European Constitution includes clauses on the creation of supra-national energy authority to co-ordinate pan-European energy supplies, though this remains controversial.

Recommendation 7.3 - Standardisation of Approach

The Commission's Recommendation (7.3), which seeks to standardise the way regulators establish and maintain information, is a good step towards building a pan-Australian approach. Shell would like to see more initiatives in this area especially with regard to gas specifications and permitting across States.

Market Governance

The COAG Energy Market Review (2002) (EMR) identified issues regarding governance and regulation of the energy sector and stated that the multiplicity of regulators was a barrier to interstate trade. A Recommendation from the EMR was the establishment of a National Energy Regulator. Shell understands that this is not directly in the scope of the Commission's Gas Access Regime review, however Shell believes that this is an important overarching issue for the future regulation and governance of the Gas Access Regime as moves towards a whole Australian approach are taken.

2. Regime Fundamentals

Efficiency and effectiveness are two fundamental elements for any regime to operate successfully in the business environment. There is a need for an Australian regime that is:

- Clear in its objectives;
- Able to respond in a timely and decisive manner as needed;
- Cost effective to operate and comply with;
- Easy to understand.

Recommendation 5.1 - Clarity of Objectives

The Commission's Recommendation (5.1) to include an overarching 'Objects Clause' is a means of addressing the lack of clarity and underlying intent of the Regime. Shell supports this concept but suggests that careful consideration be given to ensuring that the Final Objects Clause encompasses a scope wide enough to cover the benefits to the interested parties throughout the value chain - upstream, midstream and downstream - and whether it is intended that the regime becomes overall more effective, or more streamlined, or faster in processes, or in general lighter handed.

Recommendation 11.1 - Timeliness of Response

The Commission's Recommendation (11.1) that the period for approvals of an access arrangement can be extended by only 2 months is a step towards streamlining the time taken to process access arrangements. This Recommendation, coupled with Recommendation (11.2) which seeks to remove the 'further final decision' from the approvals process, aims to reduce the current lengthy process to a more overall workable system.

Experience to date, especially in the Western Australian market, shows that the Gas Access Regime process can be extremely slow in a reaching a final decision. In particular, the experience with the dispute over the access arrangements for the Dampier to

Bunbury Natural Gas Pipeline is an example of this. The resolution of the dispute between Epic Energy Nominees Pty Ltd (Epic) and the Regulator had been a process protracted over a number of years and to the detriment of developing the WA gas market.

3. Commercial Arrangements

Australia is one of many international markets that depends on a combination of local and foreign investment to ensure development of key infrastructure that meets world standards. In order to retain Australia's international competitiveness and attractiveness as an investment destination, the Gas Access Regime needs to address the risk/reward expectations and commercial realities of all parties. Under the Gas Access Regime, parties should be able to freely negotiate and agree on mutually acceptable commercial access arrangements with the security of the Regime's support as a safety net if required.

Recommendation 7.1 - Investment Consideration

The Commission's Recommendation (7.1) suggests that in approving a reference tariff the relevant regulator should have regard to:

i) long run costs of providing services; and
ii) a return on investment commensurate with the regulatory and commercial risks involved.

Shell considers this to be a positive step towards addressing current market and regulatory investment risks, which enables potential investors to have more certainty about their return on investment and balances the risk/reward equation.

Recommendation 7.4 - Expansion Provisions

The Commission's Recommendation (7.4) that any expansion of a covered pipeline be treated as part of the covered pipeline is a good way of providing certainty about the terms and conditions prior to expansion, and meeting market expectations around expansion provisions.

Recommendations 8.1 and 6.7 - Monitoring Regime

The Commission's Recommendation (8.1) suggests that:

i) a monitoring regime should exist as an alternative to price regulation for covered pipelines that meet specific tests; and
ii) the application of the alternative regulation would only occur in more extreme circumstances.

This approach does indeed allow for market-based negotiations to occur within a commercial environment. Shell supports this move as a positive step towards moving from a fully regulated market towards a fully free market.

The Commission's Recommendation (6.7) regarding coverage under a monitoring regime should apply for a fixed minimum period, is a good way to reduce uncertainty around coverage. Shell would like to suggest however that this should be subject to review if competitive factors in a given market change and that the regulator should have the overriding right to step in, in well-defined circumstances.

4. Market Conditions

The Australian gas market is in transition from being a fully government owned utilities market, towards a more de-regulated competitive market. Given the limited interconnectivity across the various Australian States, sub-markets have formed which are at different stages and levels of development. As an 'emerging competitive market' develops more and more across Australia, regulation such as the Gas Access Regime will need to be flexible enough to allow for further growth to occur and competition to enter the marketplace, whilst maintaining a balance to prevent any monopolistic behaviour by the market participants.

Recommendation 9.1 - Lighter Handed Monitoring and Regulation Free Periods

The Commission's Recommendation (9.1) to move more towards a 'lighter handed monitoring regime' is a positive step towards encouraging new investment and growth of the gas market in Australia and to reducing the current uncertainty. Giving the National Competition Council (NCC) the power to provide prospective investors with binding rulings for a fixed term period on coverage before investment is a means of clarifying the current regulatory coverage risks. As recommended by the COAG Energy Market Review (2002) (EMR) and in line with the Commission's finding, Shell supports a fixed 15 year regulation free period as an appropriate timeframe for any new transmission pipeline that does not exhibit undue market power and that satisfies the applicable regulatory tests including, the demonstration of sufficient vertical separation of ownership and the publishing of tariffs for access to the pipeline.

However, there should also be a provision for acknowledgement of special circumstances that enables the regulation free period to be extended for more than 15 years if certain criteria are met. For example, major infrastructure investments such as a Trans - Australia pipeline may well require longer than a 15 year Regulation Free Period to underpin its economic sustainable development, in contrast to new shorter or smaller volume pipelines.

To give an illustration in the European Union (EU) gas market, the 2003 Second European Gas Directive (Article 22) allows investors to apply for an exemption to regulated Third Party Access rules for a sufficient period to recoup their investment. A party may apply to its national regulator for a regulatory exemption on a piece of infrastructure, on the basis that it would not otherwise be built given the increased risk inherent in regulated third party access. The application must also satisfy criteria regarding enhancing security of supply and the integration of European Gas Markets. Within national jurisdictions of the EU, national regulators have also used their powers to encourage the development of vital new infrastructure by establishing a regulatory ring fence that allows the asset owner to earn a superior rate of return on key facilities, compared to that elsewhere on the gas or power network.

Other Considerations

Other markets conditions which could be considered by the Commission in developing a competitive gas environment include tax incentives which facilitate new investment and the use of a Volume Tranche Pricing mechanism that allows for different tariff rates for different volumes.

Tax Incentives

Tax incentives have been used widely to help facilitate the development of gas infrastructure, either via the direct relief of tax liabilities on fixed assets, or via indirect fiscal means to stimulate market growth. Some international examples of these include:

- The allowance against tax of network conversion costs for British Gas when undertaking the task of converting 18 million off-take points from manufactured to natural gas.
- The Japanese approach that provides for an excise duty waiver on imported LNG regasification equipment, plus an advanced rate of depreciation on re-gasification, transmission and distribution facilities. This can substantially improve the rate of return available to investors and thus provide an incentive for required investments.

Variable Volume Base Tariffs

The allowance of variable, volume-based tariffs is an aspect of pipeline tariffs that is also finding favour with some international regulators. Some early regulator designed (or approved) tariffs placed emphasis upon ensuring identical unit costs for all users, regardless of the volumes of gas actually shipped.

More recently there has been a movement towards allowing more market related aspects of pipeline economics to come into play. As such, variable volume-based tariffs are allowed, provided that overall returns do not exceed the allowed rate set by the regulator. The approach is being applied in "open seasons" for US gas transmission pipelines, where pipeline capacity is sold by owners to shippers either on the basis of volume related tranches or on the basis of a sliding scale formula. This approach does much to reintroduce normal economic factors such as economies of scale into pipeline tariff design.

The overriding principle in any incentive mechanism is to enable and encourage all participants, rather than picking winners.

Internationally, the overall trend is towards a lighter style of regulation that places equal emphasis on security of supply and competitive consumer prices and adopts a pragmatic stance in achieving its objectives.