**Management Committee**
**Regional Minerals Program**
**Study of Gas in Northeastern NSW**
PO Box 536, St Leonards NSW 1590

25 February 2004

Mr Tony Hinton
Presiding Commissioner
Review of the Gas Access Regime
Productivity Commission
Locked Bag 2 Collins Street East
Melbourne Victoria 8003

Dear Mr Hinton

At the request of the Management Committee for the *Study of Gas in Northeastern NSW*, I submit for your consideration a concise outline of matters related to the Gas Access Regime that have been identified by our study as having an unfavourable impact upon endeavours to develop gas infrastructure in regional Australia.

The *Study of Gas in Northeastern NSW* was carried out under the auspices of the Australian Government's Regional Minerals Program, and was supported by the NSW State Government and concerned stakeholders. In the course of the study just completed, the input of numerous interested parties, including energy users, development groups and councils, was solicited. Our findings are therefore relevant and up-to-date, and we commend them to you.

The final report for the study, titled 'Facilitating the Development of Natural Gas in Northeastern NSW', will be released by the Australian and NSW Governments shortly. An advance copy of the report is enclosed for information and reference, but I must ask that it be held under embargo until its official release. I will advise you when this occurs.

Yours sincerely

R J Henderson

Roger Henderson
Chairman of Management Committee
Study of Gas in Northeastern NSW

Telephone: 0408 284 580

# Submission
# to
# The Productivity Commission
# Review of the Gas Access Regime

Submitted by the
Management Committee
of the
Regional Minerals Program
Study of Gas in North Eastern NSW

February 2004

## Contents



## Qualification

The views set out in this submission represent a consolidation of findings of the Study of Gas in Northeastern NSW, as reported in *Facilitating the Development of Natural Gas in Northeastern NSW,* February 2004, copies of which are available. The views set out in this submission should not be presumed to, and nor do they necessarily, reflect the explicit views of any individual participant in the Study.

## 1. Introduction

This submission has been prepared by Sleeman Consulting on behalf of the Management Committee of the recently completed Regional Minerals Program - Study of Gas in Northeastern NSW. It responds to the Productivity Commission Draft Report, *Review of the Gas Access Regime*, 2003. In particular, this submission outlines matters associated with the Gas Access Regime that were identified by the Management Committee as having an unfavourable impact upon endeavours to develop gas infrastructure in regional Australia.

The Study of Gas in Northeastern NSW was carried out under the auspices of the Australian Government's Regional Minerals Program, which encourages a coordinated approach by industry and governments to facilitating regional development of mining and mineral processing activities (including petroleum), and to promoting regional employment opportunities. Sponsors of the Study are listed below:

- Australian Government Department of Industry Tourism and Resources
- NSW Department of Mineral Resources
- NSW Department of State and Regional Development
- Arrow Energy N.L.
- Country Energy
- Eastern Star Gas Limited
- Epic Energy
- Gloucester Joint Venture
- Macquarie Generation
- Narrabri Shire Council
- Strike Oil NL
- Sydney Gas Ltd
- The Australian Gas Light Company

The main purpose of the Study of Gas in Northeastern NSW was to investigate barriers and impediments to development of a gas industry in the northeastern NSW study region, and to set out options and strategies for overcoming identified challenges. The study region covers almost one-quarter of the area of NSW, and is considered to be one of the most prospective areas of the State for discoveries of both conventional natural gas and coal seam methane. However, despite this prospectivity the region is not well explored and there is no infrastructure in place to allow export of gas from the region or distribution and utilisation of gas within the region.

The findings of the Study are presented in a Study Report titled *Facilitating the Development of Natural Gas in Northeastern NSW*. Copies of the Study Report are available. A number of important findings of the Study relate the Gas Access Regime and the opportunity to present those findings to the Productivity Commission is timely.

## 2. The Economics of Regional Gas Developments are Challenging

Like many other parts of regional Australia, the economy of northeastern NSW is agriculturally based and major industrial activities are few in number. Prospective gas loads of the region generally comprise residential, commercial and small industrial customers in the larger towns that provide services to their surrounding communities. Although these loads are high in value, they are relatively small and have very high servicing costs.

In the absence of major gas-based industrial activity, the prospective gas loads of towns within northeastern NSW are unlikely to be of sufficient size to support investments in gas pipeline infrastructure[1] that would be required to transport gas over the typically large distances to, or between, individual towns. Gas industry developments within the region will therefore be:

- limited to towns that have or can attract a material industrial presence; or
- dependent upon initiatives such as:
  - the identification and development of regional gas reserves. Although the ultimate target market for any substantive regional gas reserves will be Sydney-Newcastle, regional opportunities may present an initial basis for early monetisation of smaller reserves, or might be supplied from infrastructure that connects to Sydney-Newcastle; and/or
  - aggregation of the loads of adjacent towns so as to achieve a revenue base sufficient to underwrite infrastructure investments, or the identification of mechanisms to reduce the cost of gas transportation.

In any event, the economics of developing new regional gas distribution of pipeline infrastructure will be particularly challenging, with issues including the following to be addressed:

- Gas customers will need to be encouraged to switch from existing fuels. This will be a time consuming activity with no guarantee of success. From a risk management perspective, it is essential that the developers of gas infrastructure have a role in this process, rather than to be dependent upon the marketing actions and initiatives of third-parties; and
- Gas will be sold into a mixed energy market, where it will compete with energy forms including oil, coal, LPG, electricity, wood and solar, and where different customers will have different conversion costs. The delivered price of the gas will be the prime determinant of marketing success. It is essential there be flexibility to structure sales arrangements innovatively so as to differentiate between customers and maximise project revenues.

Coverage of new regional infrastructure by the Gas Access Regime would have adverse consequences in terms of management of these issues.

[1] The findings of the Study of Gas in Northeastern NSW are consistent with those of other similar studies, notably the report titled 'Potential for Further Commercial Expansion of the Victorian Gas Network' prepared for the Victorian Essential Services Commission in May 2002.

## 3. Regulatory Coverage Aggravates Regional Challenges

The risk that a proposed, regional gas infrastructure project might, at some time after completion of construction and commencement of operations, be subject to coverage by the Gas Access Regime gives rise to concerns that compound those already faced by a project proponent and, in some cases, could render a project unattractive. The key causes for concern are set out below.

### 3.1. Coverage Risk

It might reasonably be presumed that, in considering whether to commit to development of a new gas infrastructure project, the project proponent would seek to identify and put in place strategies to deal with all project risks. The mechanisms for dealing with project risks are to avoid them, to manage them, or to accept them and build their cost into project risk-return decision making.

Under the Gas Access Regime as it presently exists, the risk that gas infrastructure might be subjected to regulatory coverage is not one that can be avoided or managed. An infrastructure owner can exert no control over the coverage decision-making process. Accordingly, the implications of regulatory coverage, however uncertain they may be, need to be contemplated and taken into account when making a commitment to proceed with a project.

It is worth noting, as it is relevant to the recommendations made in section 4 of this submission, that it is not regulatory coverage per se that is cause for concern, it is the consequences of coverage, as addressed in sections 3.2 and 3.4.

***A mechanism is required to give the proponents of new gas infrastructure projects certainty regarding their entitlement to manage their affairs without interference.***

### 3.2. Ring Fencing Requirements

Whilst the requirement for separation of gas distribution and pipelining activities from gas retailing activities may be desirable in established markets, it is a potential impediment to new regional developments. This is because ring fencing can:

- lead to both operating cost and margin[2] increases by necessitating the involvement of multiple parties; and

[2] The infrastructure owner will require a return on investment and the gas retailer(s) will require a margin on their activities. With an integrated approach, all margin is available to service infrastructure costs.

- remove a business ingredient that has historically been a key component of successful gas business development in regional areas, namely, the ability to deploy a small but focussed team with whole-of - project responsibilities that can carry out on-the-ground marketing campaigns, proactively seek market opportunities as infrastructure is rolled-out, and respond quickly to market changes. Removal of this business ingredient means the developer of regional infrastructure would no longer be in control of marketing of the commodity, sales of which are fundamental to project economics, but would be dependent upon the efforts of retailers who, as discussed in section 3.3, may be disinclined to invest in regional, greenfields market development.

It is noted[3] that Regulators have demonstrated flexibility by waiving ring fencing requirements where the costs of ring fencing exceed the benefits, but such flexibility cannot be presumed to be enduring.

***Developers of new, regional gas infrastructure should be allowed to have integrated pipelining, distribution and marketing activities.***

3.3. Franchises

The Draft Report *Review of Gas Access Regime*, 2003 makes little mention of the impact of changes made to franchising arrangements[4] in association with introduction of the Gas Access Regime. However, the importance of franchises to new regional gas projects is clearly demonstrated by:

- The recent[5] introduction by the Western Australian Government of legislative amendments including specific provision for the granting of exclusive distribution and trading franchises for a period up to 10 years. The stated objective of this amendment was to promote ‘opportunities for gas reticulation in regional communities’; and

- The Tasmanian Government’s August 2003 submission to the Productivity Commission’s Review of the Gas Access Regime in which, on the basis of first-hand experience, is was noted that ‘franchising arrangements would be necessary to ensure comprehensive gas network roll-outs in greenfield areas’.

[3] Draft Report *Review of the Gas Access Regime* 2003, at page 326
[4] Present arrangements are set out in Annex E to the 7 November 1977 Inter-Governmental ‘Natural Gas Pipeline Access Agreement’.
[5] Approved by the Western Australian Government on 8 October 2003.

In carrying out the Study of Gas in Northeastern NSW it has been identified that, in the absence of complementary distribution and retail franchises:

- although competing gas retailers may be active in the marketplace they will have little incentive to invest in the pursuit of gas market growth as there is no certainty they will make a return on such investment; and

- there is increased risk that project returns will be diluted, below the level required at the time of a project commitment, through loss[6] of key customers.

***Exclusive franchises are an important mechanism for reducing the risks associated with a new, regional gas infrastructure development. Consideration should be given to clarifying and strengthening the franchising provisions as part of the Gas Access Regime.***

### 3.4. Setting of Reference Tariffs

In the event a pipeline is covered by the Gas Access Regime, Reference Tariffs will need to be established. This gives rise to two concerns:

- First, in assessing Reference Tariff levels, Regulators use theoretical approaches to determine allowable rates of return on investment. There is widespread concern that rates[7] determined by Regulators will not reflect commercial realities, including the risks that were faced when a project commitment was made.

- Second, the setting of a Reference Tariff (or even a multitude of Reference Tariffs for possible different services) will have a destabilising impact upon the ability of the project proponent to develop differential pricing structures that are suited to each customer's (or class of customer's) needs, and which help to ensure a return on the project investment. The aspiration of the project developer will be to develop the gas market as quickly as possible and, to this end, it must be recognised that in a greenfields context gas is undoubtedly a fuel of choice - customers will not covert to it if it is not attractive for them to do so. Selling gas into a mixed energy, greenfields marketplace, where customers' conversion costs and project needs may vary markedly, requires a flexible approach to gas pricing.

***Application of the tariff setting provisions of the Gas Access Regime (should a new, regional gas development be covered) is a substantive deterrent to investing in new, regional gas infrastructure.***

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[6] Often referred to as 'cherry-picking'

[7] This concern may also be referred to as 'parameter risk', reflecting uncertainty about the regulatory parameters that will be applied in determining rates of return and tariffs.

## 4. Regulation Free Period is Supported

Recommendation 9.1 of the Draft Report Review of the Gas Access Regime 2003 provided, among other things, that '*The Gas Access Regime should be amended so that the National Competition Council, on request from a potential pipeline investor, can provide a binding ruling on coverage. …A binding ruling that a pipeline would not be covered should apply for 15 years. …*'

While the concept of a regulation free period, to be available to new pipeline investments, is supported, the following changes are recommended to ensure the regulation free period proves to be an effective mechanism in facilitating new, regional gas infrastructure developments:

a) The regulation free period should be available to all new pipelines without application of coverage tests. There is nothing to be gained by limiting the availability of the regulation free period. Rather, retention of coverage tests will lead to ongoing risk that new developments, capable of extending the availability of gas to regional Australia, might not proceed because of regulatory concerns;

b) The regulation free period should also be available for distribution system investments where the distribution system is a new greenfields development rather than an extension of an existing system; and

c) Consideration should be given to regulation free periods longer than 15 years. Infrastructure investments to service regional communities will require significantly longer periods to generate returns, with high levels of market penetration potentially not achieved for 20 to 25 years, and this will be taken into account in investment decisions.

The introduction of a regulation free period, incorporating the changes proposed above, will effectively deal with the majority of concerns addressed in section 3 of this submission. This is illustrated in the following table.

Concerns Addressed by Introduction of Regulation Free Period

| Issue | Addressed |
|---|---|
| Coverage Risk | Yes |
| Ring Fencing Requirements | Yes |
| Franchises | No |
| Setting of Reference Tariffs | Yes |

Finally, while the introduction of a regulation free period is supported, and will be a significant step toward removing regulatory barriers to gas industry development, there is no suggestion that it will be the panacea that sees regional development proceed. Significant issues regarding the underlying economics of regional developments will remain, and the franchising issue also needs to be addressed.

## 5. Franchising

The franchising provisions of Annexure E to the Inter-Governmental Natural Gas Pipelines Access Agreement are inadequate.

To complement the introduction of a regulatory free period, it is recommended that:

a) the Gas Access Regime incorporate clear provision for the proponents of new, regional gas project developments to secure exclusive distribution and retail franchises.

   Exclusive franchises should be available for a period up to at least 10 years, as adopted in Western Australia, or potentially for a period to match that of the regulation free period.

b) the prices oversight requirement that is presently integrated with the grant of an exclusive retail franchise is inappropriate, for reasons identical to those set out in section 3.4 of this submission, and needs to be modified.

   It is acknowledged that there is good reason for prices oversight in relation to small (particularly residential) customers but, in a regional context, the present threshold level for prices oversight is too high. In order for the developer of regional infrastructure to have flexibility to price gas at multiple levels to suit customer requirements and stimulate market growth, the threshold level for prices oversight should be reduced to 0.1 TJa.

## 6. Conclusion

By way of conclusion, the matters raised in this submission may be abbreviated as follows:

### 6.1. The Challenge

The economics of extending supplies of natural gas into regional Australia are challenging to say the least. Prospective gas demands are skewed toward residential and commercial requirements which are high in value but are small in size and have high servicing costs. Coupled with the generally large distances between regional centres, it is unlikely that gas infrastructure investments will be justified in regional locations where there is no major industrial presence. For developments that are potentially economic, there will still be a plethora of challenges and risks to be addressed. It is important that regulatory risks, that are within Government control, not be among them.

### 6.2. The Problem

In addition to technical, commercial and market related risks, the proponent of a regional gas infrastructure project faces regulatory risks. Regulatory risks cannot be avoided or managed, but have the potential:

- to compromise the ability of the project proponent to manage other risks and to make a return on investment; and therefore
- to prevent a project from proceeding.

### 6.3. A Credible Solution

The availability of a regulatory free period for new project developments, during which the project may be nurtured, will effectively remove regulatory concerns from the project commitment decision.

As a complement to the regulatory free period, the availability of exclusive, 10 year distribution and retail franchises should be enshrined in the Gas Access Regime.