



29 August 2003

Attention: Mr John Salerian

Mr Tony Hinton
Presiding Commissioner
Gas Access Regime Inquiry
Productivity Commission
LB2 Collins Street East
MELBOURNE VIC 8003

Dear Mr Hinton

Response to the Issues Paper for the Review of the Gas Access Regime

I write to present Enertrade's views on the gas pipeline access regime and to propose reforms to improve the pipeline industry's contribution to Australian economic development.

Enertrade owns a small transmission pipeline in central western Queensland and is developing a new pipeline in north Queensland to supply coal seam gas to Townsville and the surrounding region. The new pipeline will give north Queensland consumers their first opportunity to adopt natural gas as an energy source.

Enertrade has invested in gas transmission pipelines. Nonetheless, the corporation is deeply concerned that the gas access regime is contrary to the nation's long term economic welfare because it distorts investment decisions. This distortion is achieved in two steps. First, the regime has the potential to capture pipelines that do not wield substantial market power. Second, regulated entities find themselves subject to intrusive and inefficient cost-of-service price regulation, rather than to a system which equalises bargaining positions so access can be freely negotiated on commercial terms and conditions.

Enertrade therefore considers two sets of amendments to the regime are required.

The first set concerns the gas access regime's objects and coverage test. The objects must give appropriate weight to investors' interests so that signals for efficient future investment are provided. The coverage test must ensure regulation is applied only to entities with substantial market power over access to nationally significant assets where abuse of that market power has been firmly established.

Second, the Hilmer Committee in recommending that a national open access regime be established emphasised that commercial negotiations should underpin access to essential facilities. Enertrade believes this original emphasis must guide the reform of the access regime. The corporation advocates driving regulated entities to conduct themselves in ways which neutralise their market power to an extent compatible with



balanced but robust commercial negotiations. Such a regime will ensure open access and help develop downstream markets while providing pipelines with market-based returns which encourage them to grow their markets and invest in new infrastructure in the future.

If this is not done, investors' focus will be distorted increasingly from building and operating pipelines in ways that enable efficient market growth to building and operating pipelines in ways designed to avoid regulation. Enertrade does not claim that investment will stop. The real issue is that the Regime distorts industry decision-making and diminishes the benefits Australia obtains from its gas resources.

The attached submission elaborates on the Gas Access Regime's objects, coverage test and form of regulation. In that context, I also would like you to know that Enertrade strongly supports the submission made to the Commission by the Australian Pipeline Industry Association. I look forward to discussing this important matter further with you and your colleagues.

Yours sincerely

Michael Cavell
Chief Executive Officer



Initial Enertrade Submission to the Productivity Commission's National Gas Access Regime Review

1. Summary of Recommendations

Enertrade recommends the Regime be amended:

- to include an object of encouraging future investment, and that the objects be enforceable;
- so that a person cannot seek coverage of a pipeline unless the person has genuinely sought to negotiate yet failed to obtain access to the pipeline;
- so that a substantial increase in competition would need to be promoted by coverage for coverage to be justified;
- so that a pipeline must be of national significance for coverage to be justified;
- to establish a negotiate-arbitrate model as the basis for regulation of covered transmission pipelines.

The details of these recommendations and supporting arguments are presented below.

2. Background

Open access regimes generally are justified on the grounds that they can:

- increase the nation's economic growth by promoting competition in markets upstream and downstream of a facility; and
- prevent the abuse of market power through the denial of access or monopoly pricing by facility owners.

Significant work was undertaken in Australia during the 1990s to consider the need for and develop open access regimes to apply to transport services provided by rail networks, airports, telecommunication networks, electricity distributors and gas transmission pipelines, among others.

In the early stages, a good deal of attention was placed on balancing price outcomes against the need to attract future investment. In 1991, the Industry Commission published a report on energy generation and distribution. That report in part considers ways of increasing competition, including by establishing open access to gas transmission pipelines to control the use of market power. The Commission examined light-handed and heavy-handed regulatory options, and its recommendation on price regulation is worth quoting at length:

In view of the undesirable effects of price and profit regulation, the Commission considers the 'light-handed' regulation including monitoring by bodies such as the PSA and the TPC may give rise to lower regulatory costs and fewer distortionary effects than would 'heavy handed' regulation. ... In view of these factors, the Commission considers that reliance should be placed on 'light handed' regulation in the first instance. If this is shown to be inadequate in constraining the



*behaviour of a market dominant firm, a heavier handed approach involving an industry-specific monitoring body and a price-capping formula is warranted.*¹

Two years later, the Hilmer Committee's report of its inquiry into competition policy considered the same issue and recommended the establishment of a national regime of open access to infrastructure facilities. The Committee took a view similar to that of the Industry Commission and emphasised the importance of a light handed regulatory regime to encourage the commercial negotiation of access terms and conditions.

In the late 1990s the National Access Regime established in Part IIIA of the *Trade Practices Act 1974* ("TPA") and industry specific regimes such as that applying to gas pipelines were established. Despite the earlier warnings and recommendations by the Industry Commission and the Hilmer Committee, and additional warnings by commentators that the restriction on owners' property rights inherent in access regulation could deter investment, the Gas Access Regime has been implemented heavy handedly. First, regulators have taken the view that most if not all infrastructure businesses are natural monopolies and satisfy the tests for imposing regulation. Second, once a business is regulated it is subjected to the application of intrusive and inefficient cost-of-service regulation. The latter shifts much of the control of a business from its management to the regulator and reduces the firm's capacity and incentive to respond to its market.

The result of this approach is that in the short term customers enjoy low prices but innovation in service provision is restricted, while over the longer term investment decisions are complicated and hindered with significant potential economic distortions. The design and consequent implementation of the Gas Access Regime is having these results in the gas transmission pipeline sector of the energy industry.

This submission addresses two aspects of the Regime: its objects and coverage test, and the form of regulation that should be imposed should a pipeline business become regulated. The submission also discusses how Enertrade has responded to the current Regime in making pipeline investment decisions.

3. Objects and Coverage Test

3.1 Objects

The major policy objects of the Gas Access Regime are set out in the Preamble which states the purpose of the Regime is to provide a framework that:

- a) *facilitates the development and operation of a national market for natural gas; and*
- b) *prevents abuse of monopoly power; and*
- c) *promotes a competitive market for natural gas in which customers may choose suppliers, including producers, retailers and traders; and*

¹ *Energy Generation and Distribution*, Industry Commission, Report No.11, May 1991, p.90.



- d) *provides rights of access to natural gas pipelines on conditions that are fair and reasonable for the owners and operators of gas transmission and distribution pipelines and persons wishing to use the services of those pipelines; and*
- e) *provides for resolution of disputes.*

Enertrade has no concerns about these objects which, of themselves, are commendable. The corporation is very concerned that the list is incomplete for it does not include the need to encourage investment in gas pipelines. Enertrade also understands the Regime does not require these objects to be applied in the Regime's administration, which leaves them as mere aspirations. Decision-makers should be required to apply the objects and explain, in particular cases, how each was assessed. Further, any amendments to the Regime – other than to the objects themselves – should be required to be consistent with the objects. To the extent that trade-offs between objects may be required in amending or making a decision under the Regime, the rationale for each trade-off must be explained.



The possibility for future investment to be deterred by an open access regime's inherent intrusion on the property rights of current pipelines' owners has been recognised elsewhere. For example, a research paper on the national competition policy provided to members of the Commonwealth Parliament in 1994 states:

An obvious risk associated with the third party access proposals is that the granting of access rights might undermine the viability of long term investment decisions by adding greater risks and uncertainty. As a result future investment in important infrastructure projects could be deterred...²

Given this issue was recognised relatively early in the development of nationally applicable access regime it is unusual that the need to encourage future investment was not set down as an explicit object of the Regime. Enertrade recommends strongly that the objects of the Regime should include an investment-related object, consistent with that proposed by the Productivity Commission for Part IIIA of the TPA, such as to "promote economically efficient use of, and investment in, natural gas pipelines".

3.2 Coverage Test

Enertrade considers that the Regime's coverage test also requires strengthening to prevent unnecessary, costly regulation of pipelines. Generally Enertrade supports the arguments raised in the Australian Pipeline Industry Association's ("APIA") submission to the Commission about the coverage test in the Regime. Nevertheless, the corporation would like to draw particular attention to three issues: when an application for coverage may be made, the level of competition that coverage would promote and the significance of the pipeline to which regulated access is sought.

The Regime currently enables a person to lodge an application to have a pipeline covered without having attempted bona fide negotiation with the pipeline. This is a significant flaw but one that can be redressed easily by an amendment requiring a person to have made reasonable attempts to obtain access to a pipeline before lodging a coverage application.

In relation to the second issue, the Productivity Commission recommended in its review of the National Access Regime that section 44G(2)(a) of the TPA be amended so that declaration could occur only where "access (or increased access) to the service would promote a substantial increase in competition ...".³ Enertrade supports this proposal also being incorporated into a revised Gas Access Regime as it would impose a requirement that the increase in competition would need to be non-trivial for a pipeline to satisfy that part of the test. For example, the Oxford Dictionary defines "substantial" as meaning "of considerable importance, size or worth". In addition, "substantial" is used now in Part IV of the TPA so there is an understanding of its meaning in the context of competition legislation.

² *National Competition Policy: Overview and Assessment*, Kain, John, 21 February 1994, http://parlinfoweb.aph.gov.au/piweb/view_document.aspx?ID=1933&TABLE=PRSUB, p.31

³ *Review of the National Access Regime: Inquiry Report*, Productivity Commission, Report No. 17, September 2001, p.192.



Conversely, the Commonwealth Government's stated preference for "material" in respect of the National Access Regime would seem to weaken the test by implying that coverage's promotion of any discernible or measurable increase in competition would be sufficient for a pipeline to meet the test. Given the costs of regulation, it is conceivable that applying "material" would produce a net loss from coverage and thereby actually decrease economic efficiency.



The National Access Regime requires that a service be of national significance to be declared. It is odd that the coverage test in the national Gas Access Regime varies from the test in Part IIIA of the TPA by not containing this requirement. There appears to be no policy reason for this inconsistency and Enertrade strongly recommends that the Gas Access Regime be amended to include the national significance criterion.

4. Form of Regulation

Enertrade regards the current cost-of-service approach to regulating gas transmission pipelines to be fundamentally flawed. The corporation considers that the Regime would be more effective if it drove covered transmission pipelines to behave in ways that effectively remove their market power by placing the pipeline and the access seeker in equal bargaining positions. Enertrade believes it is essential to remove transmission pipelines from the cost-of-service regulatory model imposed by the Gas Access Regime and therefore supports the negotiate-arbitrate model presented in the APIA submission.

4.1 Flaws of Cost-of-Service Regulation

The flaws of the cost-of-service method lie in principle and in the detail. If any issue in economics is agreed in light of experience, it is that capped price controls do not lead to the efficient production and consumption of goods and services, the general result of such policies being a loss of welfare through excess demand yet inadequate supply. (This is not unlike the situation regulation of monopolies seeks to prevent). Why price controls to address market power possessed by transmission pipelines would be the exception and deliver efficient outcomes has never been explained. It is true that were perfect information about supply and demand available then a perfect price could be set, but no person has such information. So use of the cost-of-service method is bound to cause poor outcomes.

The level of intrusion into pipeline businesses by cost-of-service regulation places extraordinary limits on the capacity of pipeline managers to run their businesses while imposing large compliance costs. Managers have no incentive to develop their market; rather they are forced to focus on managing their business according to the exactions of the regulator. This rules out significant improvements in dynamic efficiency. In addition, cost of service regulation has at its core the flawed premise that the value of a service is defined by its costs. Not only is this contrary to fundamental economic and business management tenets, but it leads to extraordinary results through such pricing methods as depreciation rates that wholly distort business objectives because of perverse regulatory outcomes.

The availability of cost-of-service regulation also encourages customers to seek regulatory intervention in the expectation of obtaining access and prices on much easier terms and conditions than commercial negotiation would produce. This means that in the presence of cost-of-service regulation, there is little value to be gained from providing or even requiring negotiation at earlier stages of the access process because customers have little incentive to bargain.



Last, the present application of cost-of-service regulation does not recognise regulatory and commercial risks. The Capital Asset Pricing Model (“CAPM”) only prices systematic market risks; it does not recognise project specific risk. This is wholly at odds with the way in which businesses actually make investment decisions by assessing where they can expect to obtain a reward commensurate with the particular risks posed by a project. Put crudely, pipelines are capital intensive investments with returns expected over the long-term but which carry significant commercial risks, but application of the CAPM prices risk at the stock market average.



Enertrade considers that all of these problems lead to the conclusion that a more effective Regime would be one that drives covered pipelines to behave competitively rather than imposing on them an inefficient simulation of a perfectly competitive outcome that could never be obtained.

4.2 Negotiate-Arbitrate

Acceptance of the negotiate-arbitrate model, originally proposed in concept by reformers over ten years ago, would recover the dual advantages offered by open access to transmission pipelines and market-reflective prices that drive efficient levels of investment and consumption in the industry. Enertrade argues not that this approach will result in a perfect price. Rather the negotiate-arbitrate model will establish a price discovery and setting mechanism as free and fair as those operating in similar wholesale markets with similarly efficient economic outcomes.

It has been stated that the aim of the negotiate-arbitrate model is to equalise the bargaining power of the pipeline and the access seeker. The keys to achieving that aim are transparent provision of information by pipelines owners about their businesses, the imposition of accountability for failure to be transparent, and the threat of independent arbitration where negotiation has failed.

4.2.2 Information Transparency

The Regime should establish the type of information about a pipeline an access seeker requires to negotiate freely with a pipeline owner, and require pipeline owners to publish that information. The information required by access seekers includes:

- transport path (for example, delivery points);
- available capacity;
- priority (firm or interruptible);
- services;
- tariffs;
- term;
- load profile;
- timeframes and procedures for negotiating access (within a statutory requirement that these be reasonable)

The Regime in general would not enable a regulator to stipulate the content of the information as this would open the path for a return to the current form of regulation.

4.2.3 Accountability

The regulator would conduct regular audits of the provision of information and compliance with the processes for conducting negotiations. It also would be required to act on complaints lodged by parties seeking to negotiate access that the pipeline has failed to provide the necessary information or establish reasonable procedures for negotiation. It should be noted that covered pipelines will have every incentive to comply with the Regime to avoid arbitration.



If the regulator considers that the pipeline owner has committed a breach it should be able to pursue penalties through the courts, including fines substantial enough to constitute an effective incentive for covered pipelines to comply with the Regime.



4.2.4 Arbitration

The arbitration provisions of the Regime should be designed to encourage the settlement of negotiated access agreements so that pipelines and access seekers equally regard arbitration as a step to be avoided if at all possible. The major incentives should include:

- the arbitrator's decision is to be final and binding, with judicial ratification to prevent subsequent litigation (this will encourage pipelines to behave reasonably in negotiations); and
- pricing principles to be adhered to by the arbitrator that are designed to deliver market-reflective prices (if the principles instead direct the arbitrator to cost-of-service pricing, regulatory outcomes will remain inefficient, and access seekers will be encouraged to behave in ways that make arbitration inevitable);

Enertrade considers that the following are the principles necessary for establishing market-reflective prices:

- foundation contract prices to be a price floor - this is reasonable since they are market-based prices agreed between pipelines and typically large and strong customers in negotiations at a stage when the pipeline by definition cannot possess market power;
- financial capital maintenance - this recognises that investors do not invest in businesses where they consider they cannot get their money back, and while all major investors realise there is always a chance the market will turn against them it is not reasonable that they lose their money by the artificial method of regulatory second-guessing; and
- consistency with workably competitive markets outcomes – this reflects how the economy, particularly in capital intensive sectors where entry costs are high, actually works.

5. Enertrade's Response to the Current Regime

Enertrade wishes to grow the north Queensland gas market and has decided to build a pipeline with capacity significantly in excess of that needed by foundation customers. In so doing, Enertrade has absorbed the regulatory risk that access to the excess capacity may be regulated.

The corporation has taken on this risk because it will offer services on the basis of a voluntary open access policy. This will be similar to that applied by Duke Energy International on its Eastern Gas Pipeline, and which was a notable factor in the Australian Competition Tribunal's decision that that pipeline is not covered. The north Queensland gas pipeline is a greenfield project which by definition cannot have market power. In addition, Enertrade considers that the pipeline faces competition from existing electricity supplies and other inputs to manufacturing processes. Nonetheless, if Enertrade ever acquires market power through its north Queensland pipeline, the application of this voluntary open access policy will prevent that power being abused by



effectively removing it. The corporation considers that this approach means that coverage of the north Queensland gas pipeline could not be justified.

The principles underlying Enertrade's access regime are:

1. market-responsive pipeline services;
2. non-discriminatory tariffs;
3. public disclosure of dealings with affiliates;
4. public disclosure of key contract details;
5. protection of confidential information;



6. facilitation of capacity trading;
7. independent, external audit of compliance with the principles; and
8. binding independent dispute resolution.

The purpose of these principles is to ensure potential customers have comprehensive product information and certainty of their treatment in respect of other customers (and particularly in relation to affiliates of the pipeline). This openness is supported by the major incentive on the owner of a new pipeline to fill the asset to capacity. Even where the pipeline is mature with relatively little spare capacity, the facilitation of capacity trading means that there will be competition for gas sales within the pipeline itself. A paper explaining these principles in generic terms is attached.



NON-DISCRIMINATORY ACCESS PRINCIPLES

An unregulated gas pipeline transmission assets must be operated on a non-discriminatory access basis. The following core principles describe the key characteristics of this policy.

These principles will ensure the long term sustainable operation of pipeline assets within a market based environment not subject to unnecessary economic regulation. These key principles include commitment to:

9. developing market-responsive pipeline services;
10. the use of non-discriminatory tariffs;
11. public disclosure of dealings with affiliates;
12. public disclosure of key contract details;
13. protection of confidential information;
14. facilitate capacity trading;
15. performing independent external audits of compliance with the principles; and
16. binding independent dispute resolution process.

It is generally believed that a voluntary behavioural approach to access to so-called “natural monopoly” infrastructure can only be implemented in the absence of prescriptive regulation under the Code. However, provided there is a willingness on the part of the Shippers in a regulated pipeline to contract with the Service Provider for the services of the pipeline, then regulated tariffs defined by ACCC are not relevant.

Market-responsive Pipeline Services

Intent

To develop and promote effective pipeline services with market participants in response to market needs.

Requirements

Procedures to be established to develop effective pipeline services. This shall include:

- timely response to customers’ needs;
- available pipeline capacity and services information to be advertised.

General Discussion

The Service Provider must ensure that reasonable time frames are established for responses that adequately meet customer expectations.

Non-Discriminatory Tariffs

Intent

To ensure that all customers can be certain that they have equal access to the tariff for a given service offering.

Requirements

Procedures must be developed to ensure that all customers have access to the same tariff for the same service. The definition of “the same service” shall include the following:

- the term of the contract;



- the transportation path, including direction of flow;
- the service priority;
- load profile;
- presence of a price link; and
- other factors which may materially impact on the financial risk of the parties.

There should be no tariff differentiation in respect of: type of customer, type of gas, or volume of gas.

Disclosure of Dealings With Affiliates

Intent

All participants must be convinced that there is no preferential treatment for affiliates.

Requirements

Key aspects of all contracts with affiliates must be made public and the same conditions of service offered to all other customers for the same service.

General Discussion

All affiliate deals will be posted on the web site in a manner that provides sufficient detail for customers to be able to accept an offer for a similar service. This is consistent with the non-discriminatory tariff principle and also consistent with disclosure of non-affiliate arrangements. In addition, disclosure under this principle will involve clear indication that the counterparty to the contract is an affiliate. Further, all contracts entered into with an affiliate will remain on the web site for a minimum period or until that service offering is withdrawn.

Disclosure of Key Contract Details

Intent

To assure all market participants of the non-discriminatory nature of our service offerings by ensuring ready and equal access to key service information.

Requirements

Key characteristics of all service contracts must be made public.

General Discussion

Disclosure of non-affiliate deals will not disclose the identity of the counterparty and details will only be posted while the offer is current.

Protection of confidential information

Intent

Confidential commercial information will only be used for the purposes for which it was provided.

Requirements



The Service Provider must ensure that confidential commercial information provided by customers and prospective customers is used only for the purposes for which it was provided.

General Discussion

Information will not be passed on or used for any purpose other than the purpose for which it was provided. To make this auditable, systems have to be put in place to ensure that only specific employees will be able to gain access to an use confidential information.

Facilitate Capacity Trading

Intent

To enable customers trade pipeline services.

Requirements

Customers and prospective customers must be able to trade pipeline capacity. Facilities and services must be provided via a web-based trading system that is easy to use and secure.

Independent Audits

Intent

To provide a high degree of transparency to all market participants as to the extent of our compliance with these Principles.

Requirements

Performance must be regularly audited by an external independent auditor, to identify the extent of compliance with these Principles and the associated procedures. Any deficiencies identified during these audits shall be subject to timely corrective action. Audit outcomes shall be made public.

General Discussion

In general the approach to be adopted would be consistent with financial audit. An initial audit will need to be undertaken to assess whether the supporting procedures and work instructions actually deliver the policy intent as discussed in the higher level documentation. This audit should be carried out annually.

Binding Independent Dispute Resolution

Intent

To provide all customers or prospective customers with the confidence that in the event of a dispute they would have access to independent arbitration.

Requirements

Timely and binding independent dispute resolution shall apply in all circumstances where customers or prospective customers have a grievance they are unable to have settled to their satisfaction via negotiation. Dispute resolution may be initiated by either party.