REVIEW OF THE GAS ACCESS REGIME

Submission to the Productivity Commission

August 2003

8 Marchesi Street
Kewdale WA 6105

Gas Access Regime Inquiry
Productivity Commission
LB2, Collins Street East
Melbourne VIC 8003

29 August 2003

Submission to the Productivity Commission in respect of Review of the Gas Access Regime.

Thank you for the opportunity to contribute to the Productivity Commission's inquiry.

CMS Energy Gas Transmission Australia (CMS) is the owner and operator of the Parmelia Gas Pipeline which runs from Dongara, 350 km south to Perth. The Parmelia Pipeline affords competition with the much larger scale Dampier to Bunbury Natural Gas Pipeline, as well as providing a strong competitive stimulus to the metropolitan gas distribution network within the limited geographical range of its reach. CMS is also a part owner of the Goldfields Gas Pipeline, and holds responsibility for the Commercial and Regulatory Services pertaining to that pipeline, which supplies gas from the Northwest Shelf Region as a competitive alternative energy source into regional markets in the Pilbara and central and southern Goldfields.

In early 2002, the Western Australian Government released a public discussion paper on what was apparently an already highly developed proposal to establish an Economic Regulatory Authority (ERA). Whilst yet unresolved (due to intra-government disagreements concerning mainly environmental issues), the proposal is that the ERA will subsume the role of the Gas Access Regulator in Western Australia, and combine this role with the regulatory oversight of rail, water and eventually, electricity. In addition, it is proposed that other aspects of regulation (eg. licensing) as well as other functions (eg. government policy advice) will be transferred to the new agency.

In April 2002, CMS made a number of submissions to the Western Australian Government in response to the ERA proposals. Upon review, CMS considers that many of the issues it discussed in those submissions are directly pertinent to the Productivity Commission's present inquiry into the Gas Access Regime. Of particular (but not exclusive) relevance, are those aspects of current proposals to establish a National Energy Regulator (NER) which have been considered in recent related reviews, and the subject of very specific recommendations in the Parer Report.

In consequence, CMS submits for your consideration a number of its previous submissions concerning the ERA proposal, with a brief synopsis of the issues dealt with in each submission, as follows:

Attachment 1 (formerly ERA Submission #2):

Highlights concerns with:

1) national and state regulatory implementation,
2) transparency of process which are equally applicable to the formation of the NER,
3) timing of the WA ERA proposal which stand as an example of the need to integrate changes in regulatory oversight,
4) the need to demonstrate the reality of assumed cost economies associated with establishing any centralised regulatory agency,
5) the issue of separation of powers between regulatory oversight and policy development,
6) the conflict of multiple regulatory roles allowing the potential to misuse power under one regulatory role to usurp the intentional limitations imposed upon a regulator within another regulatory role.

Attachment 2 (formerly ERA Submission #3):

Relating to implementation concerns about:

1) mechanisms for appointing regulatory "commissioners", numbers on the panel, skills mix and the need for staggered tenure, with direct applicability to the proposed NER,
2) risk associated with regulatory "independence" and the need for appropriate policy guidelines,
3) the need for transparency in the operational relationship between regulators and other regulatory agencies and givernment advisory roles.

Attachment 3 (formerly ERA Submission #5):

Primarily concerned with issues relating to the regulatory implementation of the role of the Access Regulator and the need to clearly define that role, with a discussion of the conflicts which can and do exist (noting that the Western Australian ERA proposal as its stands, compounds an existing deficiency). The comments made in relation to the proposed ERA are directly transferable to the proposed NER.

Attachment 4 (formerly ERA Submission #6):

In the context of the Productivity Commission’s present inquiry, this paper relates mainly to issues concerning the costs and benefits deriving from the Gas Access Regime, including:

1) highlighting some of the hidden costs of regulation, including issues associated with the cost of training to achieve the necessary (as espoused) levels of "core regulatory skills and expertise" which, in the context of the NER proposal, can be expanded to include the considerably more technically complex areas of upstream and downstream industry (ref. Parer Report, page 128),
2) establishment costs of a new regulatory agency (including staffing and relocation, office and equipment, etc),
3) challenging the assumptions that end users will benefit or that such expenditures are justified on the basis of this assumption,
4) a proposal that, to the extent that the such costs are justified on this basis and that it is considered equitable that the costs of regulation be borne by the beneficiaries (as widely espoused), then specific pass through provisions should be embodied in the access principles contained within the Gas Code,
5) issues of accountability and financial liability associated with the current implementation of the Code in Western Australia, from which lessons can be drawn in the national context.

Attachment 5 (formerly ERA Submission #7):

Discusses the specific nature of failings in regulatory practice and implementation of the Gas Code in Western Australia, which highlight many of the areas in which greater regulatory guidance is needed if the present form of intrusive regulation under the Code is to remain largely unchanged. Identifies deficiencies which CMS sees in the plan to establish a centralised regulatory agency (whether it be State or Nationally based), if this is to be a mere expansion of the current models. Some material contained within this submission has been updated where relevant.

Yours faithfully,

David A. King
Manager of Operations

Att. CMS Submissions 2, 3, 5, 6 & 7 on W.A. Government's Economic Regulatory Authority Proposal, 5 April 2002

CMS ENERGY
GAS TRANSMISSION AUSTRALIA

Attachment 1 to

Submission to the Productivity Commission

as part of its inquiry into

The National Gas Access Regime

August 2003

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SUBMISSION No. 2

in response to the

ECONOMIC REGULATION AUTHORITY
PUBLIC CONSULTATION PAPER

(5 April 2002)

Purpose of Document

This document is part of a series of submissions by CMS Energy Gas Transmission Australia ("CMS") addressing issues regarding the establishment and operation of the proposed Economic Regulation Authority ("ERA"). This submission is made in response to the invitation extended by the Government of Western Australia ("the Government") in its document "Economic Regulation Authority: Public Consultation Paper" dated February 2002 ("the ERA Consultation Paper").

Development of Regulation and the Matter of Public Confidence

This paper addresses a number of specific issues which are alluded to in the ERA Consultation Paper in Section 7.1, Proposed Framework and Timing, and Section 7.7, Ministerial Roles and Responsibilities and the Regulatory Policy Steering Committee. While each of the issues are specifically associated with aspects of the development of regulation in Western Australia, the central theme is concerned with the matter of public confidence in regard to both the development and implementation of the regulation of essential infrastructure. This is important not just as a matter of good public relations, but because of the risk of massive and long term potential damage to this State's reputation as a place to invest and conduct business if the regulation of privately owned but publicly essential infrastructure assets is poorly implemented.

State and National Regulatory Context

CMS understands that the existing regulatory regime for the natural gas transport industry has been identified as a model for the establishment and operation of the ERA.

CMS suggests that the development and implementation of the regulation of the state's natural gas transport industry has to date been ill-considered and an expensive and divisive failure.

The Western Australian Independent Gas Pipelines Access Regulator ("the Gas Access Regulator") currently[1] faces two separate legal actions in the Supreme Court of Western Australia regarding his Draft Decisions (pursuant to the National Third Party Access Code for Natural Gas Pipeline Systems, the "National Gas Code") for the Goldfields Gas Pipeline ("GGP") and the Dampier to Bunbury Natural Gas Pipeline ("DBNGP"). The State of Western Australia also faces legal action arising from the GGP Draft Decision.

Such legal action provides substantive evidence of the unsatisfactory state of affairs afflicting gas regulation in Western Australia. This is particularly so given that the GGP and the DBNGP are two out of a total of only three major

[1] As at April 2002

natural gas infrastructure assets in the State,[2] and that both of these assets have separately been the subject of previous State representations, undertakings and regulatory regimes. Furthermore, it is common knowledge that the third major gas asset covered under the National Gas Code, the AlintaGas gas distribution network, adopted a particularly legalistic approach in its negotiations during its own regulatory approvals process, and also now has a major involvement in the current DBNGP legal action.

CMS intends to discuss in further detail whether gas regulation serves as a suitable model for the ERA in a separate submission. At this point, however, it is sufficient to observe that the implementation of the re-regulation of the Western Australian natural gas transport industry to date constitutes a tangible manifestation of sovereign risk. Such risk discourages investment in essential infrastructure. In turn, this compromises the economic and wider social well-being of the State of Western Australia and the Australian nation as a whole.

In fact the development of regulatory reform in Western Australia is but a part of a national process of re-regulation of essential infrastructure. There are lessons to be learned, both conceptual and specific, from the wider regulatory experiences and consequential outcomes seen outside Western Australia. At a broad level, the regulation of infrastructure providing essential goods and services has received considerable public, commercial and political attention both elsewhere in Australia and overseas.

The outcomes delivered from the operation of the National Electricity Market in the Eastern States receive daily attention in the press. Artificial market models based on theoretical precepts and contrived pricing mechanisms have resulted in sharp price increases, price instability, and subsequent government intervention. Consumers have ignored the much-publicised full retail contestability in the electricity market in droves. Australian and international investors in electricity infrastructure in the state of Victoria have suffered massive losses. As a consequence, a superficially paradoxical but unfortunately tangible 'lose-lose' situation prevails on both the supply and demand sides of the electricity market.

The disastrous events of the comparatively recent past in the Californian electricity industry, where the major infrastructure owners and operators were driven to bankruptcy and consumers (household, commercial and industrial) were subjected to prolonged and disruptive supply interruptions, have been widely reported in the press, the professional and academic literature, reports by consultants, television documentaries, 'think tanks', etc.

[2] In addition to the three major gas infrastructure assets covered under the National Gas Code, there are also two other covered pipeline systems, although these are effectively single dedicated user laterals, as well as the Parmelia Pipeline, which was recently revoked from coverage following an application which demonstrated that it did not meet three out of the four the criteria necessary for coverage to be warranted. It is noteworthy that when the current regulatory regime was introduced, no process was ever conducted to evaluate, according to the regulatory criteria, whether coverage of any of these assets was warranted. This in itself reflects an aspect of regulatory failure of process and inefficiency.

The deterioration of the regulated water supply and rail industries in the United Kingdom, while not receiving as wide international coverage, has nevertheless attracted considerable interest and concern in the affected areas. It is not until the situation breaks down to produce dire consequences that the outcomes of regulatory implementation receive general media attention, as the recent series of rail disasters in the UK which have been widely reported in Australia attest.

Beyond the lessons they hold, these regulatory failures have served to bring into disrepute the whole notion of economic (re)regulation, with many service providers, investors and members of the general public. It should therefore be obvious that the issue of public confidence in both the development and implementation of regulation is a critical one, and demands consideration beyond lip service.

CMS is concerned that the (high-profile) examples cited above appear not to have been considered in the ERA Consultation Paper, and that no attempt to benefit from 'lessons learned' within Western Australia and elsewhere, has been made, nor any framework for their consideration identified.

CMS requests that the members of the Implementation Committee (individually and collectively) further consider the issue of public confidence in the wider context and give clear recognition to the available lessons concerning regulatory implementation. Further, CMS requests that they make their recommendations regarding the establishment of the ERA with clear regard to the context that the consequences of its manner of operation will have far reaching and long lasting implications for the reputation and economic well being of this State.

Transparency of Process

The ERA Consultation Paper claims transparency of process as one of its regulatory objectives. CMS wholly endorses the need and desirability for regulatory transparency. However the transparency must be genuine.

There is an argument to be made that the current level of transparency in the present implementation of the National Gas Code in Western Australia is more illusory than real.[3] It bodes ill for the future transparency of regulatory process if the development of the ERA is itself found to be lacking. In this

[3] To provide a single "hard" example, the Gas Access Regulator's ruling on the Parmelia Access Arrangement (since revoked), has been lauded by some user representatives as being a transparent process, however the tariff which was mandated (the heart of the matter given that third party access was never the issue) was "reverse engineered" from an outcome which was clearly predetermined within the agency. However this is not apparent until you reach page B-80 of the Gas Access Regulator's Draft Decision, the 105th page out of 172, and then the explanation is easily lost on anyone not immersed in the esoteric methodology. In the Regulator's Final Decision, the maths remain but the explanation as to the reason for the outcome derived is obfuscated within the discussion concerned with Redundant Capital Policy (page B-60 to B-62). So while it is clear (to the well informed) exactly what the Regulator has done, it is hardly consistent with the normal meaning of a "transparent" process.

regard, it should be noted that this present call for submissions on the ERA proposal appears to be the first and, from all indications, the only chance for interested parties outside of State Government Departments to contribute their views.

Public statements at recent presentations by Government representatives indicate that the timetable for implementing legislation will mean that "there probably will not be time" for public consultation on the legislation before it is passed through parliament. Yet this directly contradicts the Gallop Government's commitment to full community and industry consultation on issues of important community interest. Industry experience is that even in processes where it has had the opportunity to contribute its views to government, the "devil in the detail" can distort final legislation from what was agreed between the interested parties.

We are concerned that, based on the contents of ERA Consultation Paper, and comments from some Government agency representatives, the establishment of the ERA may already be presupposed, using the existing Office of Gas Access Regulation ("OffGAR"), as a model for the operation of the ERA.

CMS submits that if this is the case, it would render hollow any claims of transparency of process in the formulation of this highly significant regulatory development. This perception would be further reinforced if the legislation is pushed through Parliament without a properly available opportunity for public and stakeholder comment.

In addition to transparency of process, there is also a matter of appropriate representation. The ERA Implementation Committee that has been formed - without public consultation - is comprised solely of Government employees. It contains no representation from key stakeholders, such as the end users of the goods and services provided by regulated infrastructure, the users of the infrastructure itself, or the private sector owners and operators of the infrastructure assets themselves. Without such representation, it is not clear exactly how an objective implementation of the structural checks and balances necessary for the smooth and efficient operation of the proposed ERA is to be achieved. And if nothing else, experience indicates that in circumstances where public sector positions will need to be filled and that the selection process is determined entirely by bureaucrats, the applicant most desired by the bureaucracy tends to get the job.[4] Such perceptions do little for regulatory or government credibility.

We question how such limited representation on the implementation committee is likely to contribute to perceptions of transparency of process or by extension, to improving public and industry confidence in regulation, which has become fragile in the face of the present ongoing regulatory experience in Western Australia and elsewhere.

[4] This issues is dealt with in further details in a separate submission by CMS which discusses the process of appointing commissioners to the proposed ERA.

Finally, there is no indication or solicitation of how the proposed ERA might facilitate the concept of "regulatory withdrawal". This is cited in the discussion paper as being another of the Guiding Principles for Best Practice Regulation according to the OECD. Given the current growth in scope and magnitude of the "regulation industry", it might seem prudent to at least attempt to structure some form of requirement for a formal periodic effectiveness review into the charter of any regulatory agency being newly formed.

Timing of Proposal

CMS notes that both the timing of the ERA proposal and the timetable for its implementation, effectively pre-empts the impending mandatory review of the Western Australian state based Gas Access Regulator.[5] Further, given that the outcome of the review of the State based Gas Access Regulator (in effect a review of the existing gas access regulatory structure) was not presupposed, how would any conflicts that might arise between that review and the proposed ERA be reconciled? This is particularly relevant if the existing gas model is to be adopted as the foundation for the new centralised regulatory agency.

In addition, there is a further issue which is relevant to both the formulation (itself) of the proposed ERA and the fact that it has to date been formulated behind closed doors. The Australian Productivity Commission recently completed a review of the National Access Regime that is pertinent to the regulation of access to essential infrastructure throughout Australia, including the National Gas Code which underpins gas access regulation in Western Australia. Although yet to be released publicly as it was intended, the ensuing report by the Productivity Commission has for some months been in the hands of various federal government agencies.

Recent public comments from the Chairman of the Productivity Commission[6] reflect not only a growing frustration that the report has not yet been released but also allude to the nature of the report's conclusions. It would seem that considerable scope for improvement over the existing arrangements and practises have been identified, and this should be fully – and publicly – considered in formulating the ERA

It could be seen as presumptuous if the ERA were to be established prior to the public release of the Productivity Commission report.

One last issue remains to be highlighted in regard to the timing of the ERA proposal. As noted previously, the present Gas Access Regulator, supported by OffGAR, is currently joined in legal action over matters of regulatory

[5] The review is scheduled to commence in November 2002 under Section 88 of the Gas Pipelines Access (Western Australia) Act 1998.

[6] See "Competition regulation of infrastructure: getting the balance right", Gary Banks, Chairman, Productivity Commission, March 2002, as well as the "Annual Report 2000-01", Productivity Commission, tabled in Parliament February 2002.

interpretation and implementation. For justice to have any chance to be done, it must be ensured that any change to an ERA or any other centralised regulatory authority, does not in anyway affect the present litigation, or alternatively, that any important rulings in terms of regulatory process are properly adopted by the ERA.

An unfortunate dent in public and investor confidence could easily result from the abolition of a government office whilst that office was engaged in an ongoing legal dispute.

Claimed Cost Benefits

Superficially it seems to be a reasonable assertion that the establishment of a centralised regulatory authority should afford a number of benefits over a fragmented approach. However, besides some very loose assertions to this effect in the ERA Consultation Paper, no attempt has been made to either clearly identify or, more importantly, quantify the claimed "potential cost economies" and expertise synergies arising from the ERA proposal.

This is inconsistent with the current government trend towards adopting commercial imperatives, from which (in theory at least) the recent widespread programme of privatisation of public utilities arises. The ERA Consultation Paper confirms this view, stating in Section 3.1, Rationale for Government Regulation;

> "*In recent years National Competition Policy and related microeconomic reforms have resulted in major changes to the way in which these utility services are provided."*
>
> *"...gas and rail freight activities have now been privatised, and while the Government is committed to retaining the electricity and water authorities in public ownership, these services are provided on a commercial basis and in an environment that will become increasingly competitive.*
>
> *The introduction of commercial objectives and the discipline of competition can provide strong incentives for suppliers to ensure utility services are organised and delivered efficiently."*

A central tenet of the adoption of commercial objectives is the need for expenditures to be weighed against the benefits they are expected to bring. Accordingly, under the existing regulatory framework, there is little that is proposed by industry that is accepted by regulatory authorities without some form of cost benefit justification.

It seems reasonable that this standard should apply equally in regard to the establishment of a regulatory agency, particularly when the motivation is that of improved efficiency. Without quantifiable benefits, one must question how

efficiency gains can ever be substantiated, or even the necessary budget limits established. In the current era of privately funded essential state and national public infrastructure, it should be no more than a matter of course and due process that the benefits of any such proposal as the ERA be quantified and that the Authority should be held accountable for achieving such savings.

Further on the matter of regulatory economies of scale, CMS notes that in the ERA Consultation Paper, the Victorian Office of the Regulator General ("ORG") has been used by way of a comparative justification for the need for the proposed ERA. CMS also notes that ORG also regulates grain handling and ports in Victoria. Western Australia similarly has both grain handling and port authorities and yet there is no apparent proposal to include these as part of the ERA. While not claiming any particular expertise in the relationship between these existing authorities, it may be possible that if economies of scale in the implementation of regulation can be demonstrated to exist, then there may be even greater economies to be had if these agencies are not overlooked. In any event, an explanation of why all such regulatory authorities should or should not be amalgamated is surely warranted.

Principle of "Separation of Powers"

There is a principle enshrined in the Australian Constitution which dictates that a separation of authority should exist between those who are elected to represent the people (ie. the Parliament) and who are thus empowered to make the laws which govern the people, the government Executive (ie. the bureaucracy) which is tasked with applying the laws, and the Judiciary which is responsible for interpreting the laws and determining if and how they have been contravened. However, in referring to this principle here, it should not be inferred that a literal reference is being made to the requirements of the Constitution (which has its own interpretative vagaries). Rather the issue at hand is more a matter of the practice of good governance being founded upon a sound principle.

For the same reason that the police are not empowered to write the laws that they must enforce, it is clear that a regulator (or regulatory authority such as the proposed ERA) should have no part in either the development of specific regulations or regulatory policy development. This is clearly a notion to which regulatory authorities around Australia are opposed, however – no matter how frustrating it may seem to regulators - it remains a principle of sound governance.

A specific example of regulatory frustration with the requirement to work within the rules which set out the framework to which all parties are obliged to comply, is the constant call by regulators within Australia for greater information gathering powers. That fact that this is only an issue because regulatory authorities, at least in so far as the National Gas Code is concerned, have considerable latitude in their implementation of the regulations and choose to adopt a heavy handed and highly intrusive

approach. Besides the obvious lack of need or justification underlying this approach, it is little wonder that these calls are vigorously opposed by industry when regulatory agencies have generally demonstrated a distinct lack of appreciation of commercial integrity and information sensitivity.

Nonetheless the pressure continues. And in this regard, the reference to information gathering powers alluded to in Section 5.2, page 21 of the ERA Consultation Paper require specific comment. For the reasons outlined in this submission, as well as those discussed in other submissions by CMS on this matter, any inference that information gathering powers would be increased beyond existing regulatory obligations as a result of the State legislation enabling the ERA, should be strongly opposed. Any attempt to circumvent the present perceived restrictions (perceived by certain regulatory authorities that is) of the information gathering powers granted under the National Gas Code (or any other regulatory regime for that matter), would further and seriously undermine public and investor confidence.

As such, CMS urges that whatever form of charter is formulated to govern the behaviour of the proposed ERA, it contain safeguards to protect against infringements of the general principle which quite rightly ensures that the policeman (ie. the regulatory authority) is not the one to write the laws which are entrusted to him. At the very least, and if no other measure is determined, it is imperative that the role of Ministerial approvals in the regulatory decision process not be diluted.

However, it should be recognised that the requirement for any decisions by the regulatory authority to be ratified by Ministerial approval is no more than a minimum safeguard requirement. Procedures need to be structured such that the Government would not be placed in the default position of having to comply with any advice received from the ERA unless it were able to provide convincing justification as to why it should not. This is how the arrangement is proposed in Section 7.5 of the ERA Consultation Paper.

The implication is that the Government would, unless it could give good reason, be compelled to follow any conclusions determined by the ERA on any matters referred to it. In such circumstances the ERA would effectively be in the "driver's seat" in determining regulatory policy. Such an outcome would be in direct conflict with the role of the Treasurer as described in Section 6.1 of the ERA Consultation Paper.

Conclusion

While CMS is not opposed to the development of a centralised regulatory authority for Western Australia, concerns exist as to the transparency of process, timing and structure of the ERA proposal as it stands. There is little to indicate how this proposal will shore up the already badly damaged credibility of infrastructure regulation and public (and investor) confidence.

The apparent presumption of outcome, advanced stage of development prior to public consultation, and apparent choice of timing reflect poorly on any claims of transparency of process. In addition, the degree to which specific operational detail has been glossed over does not allow for fully informed public comment. This would hardly complement the recommendations of the Machinery of Government report.

Public Submission

CMS confirms that this document is a public submission and looks forward to its early posting on the Department of Treasury and Finance website.

CMS ENERGY
GAS TRANSMISSION AUSTRALIA

Attachment 2 to

Submission to the Productivity Commission

as part of its inquiry into

The National Gas Access Regime

August 2003

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ECONOMIC REGULATION AUTHORITY
PUBLIC CONSULTATION PAPER

(5 April 2002)

Purpose of Document

This document is part of a series of submissions by CMS Energy Gas Transmission Australia ("CMS") addressing issues regarding the establishment and operation of the proposed Economic Regulation Authority ("ERA"). This submission is made in response to the invitation extended by the Government of Western Australia ("the Government") in its document "Economic Regulation Authority: Public Consultation Paper" dated February 2002 ("the ERA Consultation Paper").

Appointment, Operation and Independence of Commissioners

This paper addresses a number of specific issues that are alluded to in the ERA Consultation Paper in Section 7.2, Statutory Authority with up to Three Commissioners, and Section 7.3, Independent Gas and Rail Access Function.

The intent of this submission is to raise a number of issues that CMS believes will need to be clarified and explicitly addressed in the formulation of the proposed ERA if the operation of the new agency is to have credible independence and real as well as perceived objectivity. In particular, the issues addressed in this paper concern;

- the basis of appointment of commissioners,
- issues relating to independence of regulator,
- operational and reporting relationships.

1. Basis of Appointment of Commissioners

On page 20, Section 5.2, Economic Regulation Authority Bill, the ERA Consultation Paper states;

> "*The proposed Economic Regulation Authority Bill would establish the Authority as a statutory authority with perpetual succession and a common seal. It is proposed that the Authority would comprise at least one, and up to three, Commissioners, with one being the Chairperson. The Treasurer, as responsible Minister, would decide on the number of Commissioners to ensure the Authority functions properly."*

On the following page, the ERA Consultation Paper further states;

> "*The proposed legislation would also provide for:*
> *• [...]*
> *• the framework for appointments of Commissioners and a General Manager and establishment of the supporting administrative office;*
> *• ..."*

Based on the small level of detail provided in the ERA Consultation Paper, it is not possible to comment on the specific merits or otherwise, of what is being proposed in the Economic Regulation Authority Bill (the "ERA Bill"). However it is possible to make a number of comments in regard to broad principles which concern the general proposal and the process of its establishment.

In terms of the basis upon which one or more commissioners would be appointed, it is critical that an opportunity which allows adequate time to formulate considered responses be provided for public comment on the specific wording of the proposed ERA Bill. Publication of expressions of general intentions or general principles are entirely insufficient to address industry and investor concerns about the "devilry" which has been all too often demonstrated to be hidden in the detail of final drafts of regulatory legislation.

Matters which need to pass the test of public acceptability include (but is not necessarily limited to) the following issues:

(a) The basis for appointing one or more commissioners. CMS supports the principle of having a panel of commissioners to make regulatory decisions, believing that this is likely to enhance the quality of decisons and provide a better balance of interests. However, from the ERA Proposal it is not clear whether the number of commissioners to be appointed will be fixed or whether it will vary from time to time, or from case to case in question. If it were to vary, what factors would determine the requirement for one or more commissioners? Will it be completely at the discretion of the Treasurer, and if so what guidelines (if any) will he be bound by? These are issues which must be subjected to public scrutiny if due process is to be served diligently.

(b) The mechanism by which commissioners are appointed. Past experience tends to indicate that the appointment of individuals to positions of the nature of "independent" government authorities are tightly controlled by government bureaucracies. A common perception is that position descriptions and selection processes are specifically designed such that a predetermined applicant gets the job. Consequently the processes associated with filling such appointments are often viewed with some concern and are not conducive to public confidence in the regulatory process, whether or not they are well founded. In order to overcome these perceptions, it is essential that proposed mechanisms by which commissioners would be appointed by subjected to public scrutiny.

(c) Composition of the commission (ie. the panel of commissioners). The present proposal for the ERA is entirely the work of government bureaucrats. So is the composition of the Economic Regulator Implementation Committee.[7] In order to facilitate better regulatory decision making, the composition of the commission should reflect a

[7] ERA Consultation Paper, page 5.

broader representation than being confined to the public sector. The basis upon which any new commissioners are selected should, to some degree at least, take into account the existing skills and experience reflected in the pre-existing incumbents. Hence the appointment of commissioners should be such that a balance of interests be at all times reflected in the decisions of the ERA.

(d) Tenure of commissioners. A further issue in ensuring the ongoing integrity of the commission is that there be an overlap of tenure. Commissioner appointments should be such that it is not possible to replace the entire commission at a single point in time (aside from the case – hopefully unlikely – of dismissal on the basis of failure to perform the office). Tenures should be staggered so that sudden changes in political climate, government policy, or any other external influence, cannot manifest through to regulatory inconsistency.

2. Regulatory Independence

The ERA Consultation Paper states in Section 3.2, Guiding Principles for Best Practice Regulation, (emphasis added);

> *"The Organisation for Economic Cooperation and Development (OECD) considers independent economic regulatory bodies to be "highly regarded institutions of modern regulatory governance". The benefits the OECD has identified include "the shielding of market interventions from political interference, and improvements in regulatory transparency, stability and expertise". It considers the establishment of such bodies to be integral to the development of effective competition in utility industries."*

...and...

> *"Furthermore, granting independence to the regulator, particularly where government is an industry participant, would address any community concern over actual or perceived conflict of interest. To maintain a high level of public confidence, regulation needs to be transparent and operate within a statutory framework specifying clear functions, responsibilities and powers."*

This paper seeks to explore two aspects of regulatory independence in the context of its application and applicability in Western Australia. The first issue deals with the perceived need for independence and highlights the fact that whatever benefits are associated with regulatory independence, it has some substantial risks attached to it which must be addressed with appropriate government guidance.

The second issue relates to the reality of the independence of the regulation which has already been established in this state and the extent to which this

demonstrates a need for better formulation of regulatory guidance in the formative stages of the establishment of the proposed ERA.

The Risk Associated with Regulatory Independence

For the reasons identified above, the objective of establishing an independent regulatory authority is easily understandable. However, one can argue as to whether this is really a desirable mechanism of governance, even if it can be achieved in reality. For instance, an independent regulator has the ability to engage in legal action that can expose the government to significant costs and potential liabilities, without the relevant Minister having any form of control over either the courses of action adopted, or the extent to which liabilities are accrued. This is an important custody of accountability issue which must be addressed in the formulation of the proposed ERA.

In Western Australia, the Independent Gas Access Regulator has brought about exactly these circumstances in regard to two out of the three major infrastructure assets for which he has been charged to oversee. Moreover, as we have seen in regard to these same assets, the actions of a regulator who is charged with implementing government regulatory policy but who is independent of government direction, can act in a way which is in direct conflict with previous government undertakings (and without any benefits arising out of the inconsistency).[8] The investment market, particularly from an international perspective, will view such outcomes as being a significant adverse factor in its assessment of the sovereign risk associated with investing in Western Australia.

Hence a regulatory agency that is independent of government direction can operate to the detriment of government objectives in terms of both policy and expenditures, in ways which are both significant and uncontrollable.

The recent paper by the Chairman of the Australian Productivity Commission discusses the need for regulatory guidance by government. The paper alludes to findings of this nature in its recently completed review of the National Access Regime, the results of which have yet to be released publicly. CMS suggests that the guidelines for the proposed ERA be drafted with

[8] The two cases in point are the Goldfields Gas Pipeline ("GGP") and the Dampier to Bunbury Natural gas Pipeline ("DBNGP") which is owned by Epic Energy. In the case of the GGP, the State Government had entered into a State Agreement to provide a number of guarantees of investment certainty in exchange for terms which ensured commercially fair and free access to any additional parties who may wish to use the gas pipeline. In the case of the DBNGP the State Government entered into an asset sale with a publicly stated tariff and infrastructure expansion objective. In both cases the Independent Gas Access Regulator has handed down regulatory decisions based on a stated presumption that his objective is to reduce consumer gas costs, and which ignore the previous undertakings of the State Government as well as the contractual rights of the pipeline owners. This has forced the asset owners to resort to legal action, caused investors to write down significant shareholder valuations, cast doubt upon future state development prospects and not resulted in any appreciable end-use consumer benefits. In fact, many present and potential consumers of transmission services look to be considerably worse off as a result of the regulatory decisions made.

recognition of the contents of this paper, as well as with recognition of the need to curtail the risks associated with unfettered regulatory independence.

The Reality of Regulatory Independence in Western Australia

On page 20, Section 5.2, Economic Regulation Authority Bill, the ERA Consultation Paper states (emphasis added);

> "*The legislation would also provide for independence from Ministerial direction with respect to the Authority's determinations, recommendations and conduct of duty. In this regard, the Authority's independence would be at least as strong as that provided to the gas and rail access regulators."*

As a significant industry participant, CMS is qualified to discuss the outcomes that have ensued in the application of the regulatory regime which covers access to gas transportation infrastructure in Western Australia.[9] The following graphs provide some useful insights into the manner in which regulation has been applied to this highly significant sector of the State's industrial and social infrastructure.

Figure 1.

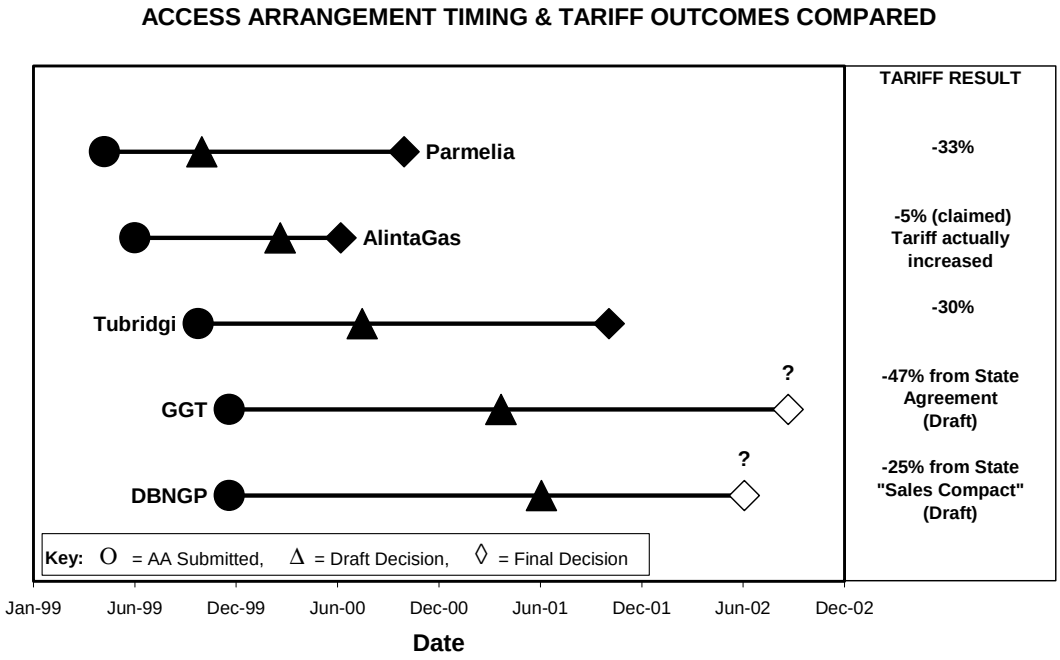


Figure 1 illustrates the relative duration of regulatory processes as well as the relative impact of mandated tariff outcomes, across the various gas transportation infrastructure assets that have been subject to the regulatory process.

[9] It is also pertinent to refer to a separate CMS submission on the ERA proposal concerning the nature of the "gas model" of regulatory implementation in Western Australia.

It should be noted that both the Tubridgi and Parmelia pipeline systems are privately owned and, at the time of assessment, were not parties to any particularly unique pre-existing form of State Government agreement or regulatory coverage.

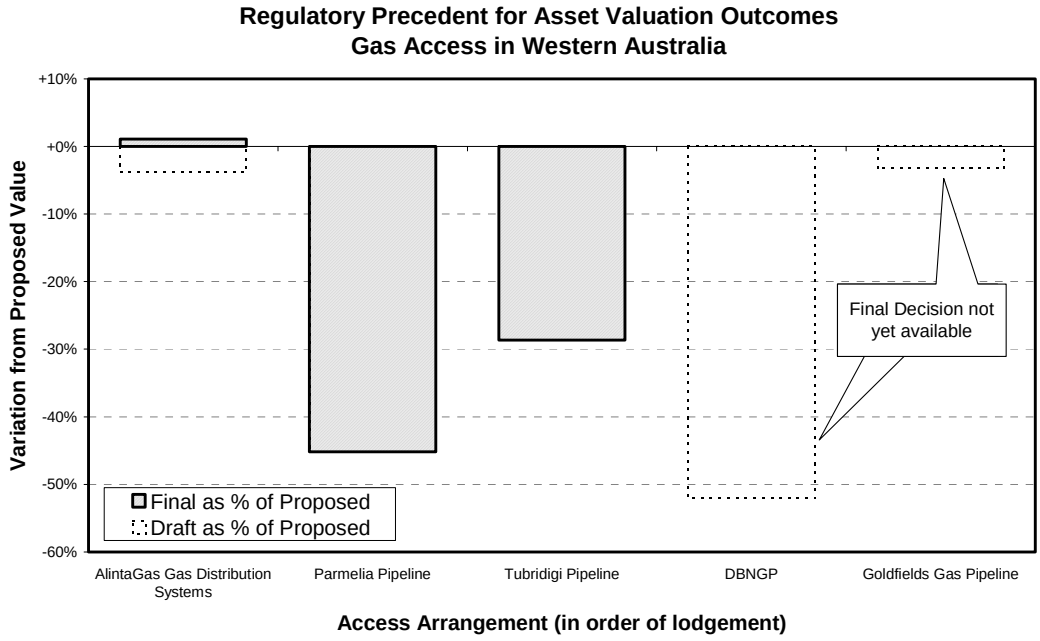
The Goldfields Gas Pipeline was and continues to be subject to a State Agreement, enshrined in its own act of State Parliament, and entered into for the initial purpose of facilitating the owners investment in that pipeline. Part of the investment certainty afforded by this State Agreement (in exchange for certainty of public access amongst other things) was the basis upon which price of gas transportation was established.

The DBNGP had recently been the subject of privatisation by the State Government at the time its access arrangement was submitted. While the legal merits of the "sales compact" upon which its sale price was established are yet to be determined in a court of law, the public position of the State Government was, in CMS' view, unambiguous. The tariff was to drop by approximately 25% from that previously established (under the preceding regulations and government ownership) to a clearly enunciated level (of approximately $1/GJ to Perth). The new pipeline owner was also to assume certain obligations to extend the pipeline and expand capacity.

Finally, it must be noted that AlintaGas was about to be privatised and was in the process of being prepared for sale by the State Government.

A critical part of this regulatory process is the determination of a regulatory asset valuation; one of the major determinants of the regulated tariff and directly related to the revenue which the pipeline owner is permitted to earn. Figure 2, below, illustrates the range of outcomes which have been established by the Independent Gas Access Regulator is Western Australia.

Figure 2.



It is fundamental to an understanding of the regulatory outcomes illustrated in Figures 1 and 2 to also have an understanding of the differing and specific circumstances pertaining to the ownership of each of the regulated assets affected. From this perspective the evidence raises doubts over claims of regulatory objectivity in regard to the regulation of open access to gas transportation infrastructure in Western Australia.

Clearly, the circumstances demonstrate that there has been considerable disparity between regulatory decisions and that the effect of these decisions has been a fortuitous favouring of what might be construed to be the short term interests of the elected government of the day. While this may be sheer coincidence the benefits derived from such decisions are more illusory than real, and derive from academic dogma rather than any quantifiable benefits.[10] The effect of such regulatory processes, decisions and outcomes defy common sense and have the unfortunate consequence of leading to perceptions of sovereign risk.

What this illustrates is evidence of a apparent lack of independence in the application of a regulatory regime which has been specifically structured to ensure such independence. Certainly the legislation which establishes the position of the Regulator is clear on the intention of his independence. However, the regulator may be technically independent but his decisions are based on a large body of work which must be undertaken by his supporting department.

From the evidence, it seems clear that the regulatory independence intended is not being realised in practice.

[10] These issues are addressed in greater detail in CMS' other submissions on the ERA proposal.

The ERA proposal is stated as stemming from the Machinery of Government report which also highlights the need for public confidence. The ERA Consultation Paper makes reference to the OECD "Principles for Best Practice Regulation". These include, amongst other things, effective communication and consultation, transparent regulatory processes engendering credibility, predictability and consistency within and across industries and effective and efficient attainment of the objectives of regulation.

Clearly, regulation in Western Australia is in dire need of adopting these principles, as the outcomes witnessed to date demonstrate. CMS contends that the ERA proposal, if approached and executed appropriately, is the ideal opportunity to make the necessary corrections to regulatory process and credibility. For this process to have any chance of success, the ERA proposal needs to be (re)drafted with inclusion of the public comments received in response to the current consultation paper. The (re)drafted ERA proposal then needs to be provided with adequate time provided for review and for public comment. Finally, the timetable for formulating the proposed legislation must include provision for public review of the specific wording which is being proposed as law. Anything less is likely to see a continuation and expansion of the existing substandard regulatory implementation process occurring in Western Australia.

3. Operational Relationships

From Section 3.2, page 7, of ERA Consultation Paper:

> *"The OECD also warns that regulatory regimes need to be flexible and respond to changes in operating environments and promote regulatory withdrawal as markets mature towards open competition.*
>
> *Western Australia's historic spread of regulatory supervision across separate regulatory authorities and Ministers results in duplication of fixed and operational costs and diffusion of scarce regulatory expertise. There has also been a perceived conflict of interest due to non-independently regulated matters (for example, price and dividend policies) being set by the same body."*

However, elsewhere in the document is Section 6.1, Ministerial Roles and Responsibilities, the following statements appear:

> "*The Treasurer would be primarily responsible for the overarching regulatory policy framework and the legislation that sets the rules that the Economic Regulation Authority operates under. This would involve the Treasurer being responsible for coordinating regulatory policy that supports access regulation and the broad regulatory frameworks applying to the relevant industries. In addition, the Treasurer will be*

responsible for appointments, resourcing and issuing any terms of reference to the Authority for inquiries."

These statements raise the question as to whether, if the Treasurer is to be responsible for "overarching regulatory policy", this will subordinate specific industry regulation. Such a move would seriously jeopardise the attainment of regulatory objectives in specific industries.

However, the more serious consequence is in terms of the potential to compromise the independence of regulatory implementation. Certainly such a relationship is unlikely to do anything to assuage perceptions of conflicts of interest between the objectivity of regulatory decisions and the imperative of government revenue considerations.

The ERA Proposal includes provision for the authority to provide advice to government, suggesting that this should stem from the "Regulator's independence and expertise".[11] As we have seen, there is already cause for concern as to the reality of the independence of such advice. Furthermore, on page 31 of the ERA Consultation Paper, the following statement is made.

"*The provision of expert independent advice implies a responsibility on the part of Government to allow the Authority's views to be publicly available. It is therefore proposed that the Authority's advice would be published. If necessary, the Government may have to explain its reasons for departing from the independent advice it has received from the Authority on retail pricing matters"*

Leaving aside the implications associated with the Government being accountable for not following the advice of the ERA, and to the extent that the ERA provides advice to the government, CMS strongly endorses the principle that such advice should be published as a mandatory requirement. This stipulation however should not provide for convenient exception.

Finally the need for Memoranda of Understandings (MOU) as referred to on page 33 of the ERA Consultation Paper, raises certain questions as to the extent to which duplication between other state and national regulators is implied. The extent to which regulatory boundaries are not already clearly defined should be made explicit in the next round of public consultation. In addition, specific proposals as to what MOU's are proposed and for what purposes, should be made explicit.

Public Submission

CMS confirms that this document is a public submission and looks forward to its early posting on the Department of Treasury and Finance website.

[11] ERA Consultation Paper, page 3.

CMS ENERGY
GAS TRANSMISSION AUSTRALIA

Attachment 3 to

Submission to the Productivity Commission

as part of its inquiry into

The National Gas Access Regime

August 2003

Originally Published by CMS as:

SUBMISSION No. 5

in response to the

ECONOMIC REGULATION AUTHORITY
PUBLIC CONSULTATION PAPER

(5 April 2002)

Purpose of Document

This document is part of a series of submissions by CMS Energy Gas Transmission Australia ("CMS") addressing issues regarding the establishment and operation of the proposed Economic Regulation Authority ("ERA"). This submission is made in response to the invitation extended by the Government of Western Australia ("the Government") in its document "Economic Regulation Authority: Public Consultation Paper" dated February 2002 ("the ERA Consultation Paper").

Confusion of Regulatory Objectives

This paper addresses a number of specific issues that are alluded to in the ERA Consultation Paper in Section 7.5, Price and Inquiry Function as well as Section 4 which sets out to describe the Current Regulatory Authorities and Framework in Western Australia.

The central theme of this submission is concerned with regulatory implementation. The basis for the ERA proposal is the promise of more administratively efficient, better qualified decision making, and more cost effective regulatory implementation. This is positive as good regulation requires both good drafting in the first instance, and then good implementation. Certainly there is room for improvement over existing standards of regulatory implementation.

However good regulatory implementation must be founded on a clear understanding of the objectives that are being sought. In this regard, the ERA Consultation Paper makes a number of worrying statements that indicate a degree of confusion as to certain regulatory objectives. Specifically these include;

(i) the primary role of the Independent Gas Pipelines Access Regulator ("the Gas Access Regulator"),
(ii) the conflicting roles of consumer advocate, price setter for public utility services, regulatory overseer of third party access to infrastructure, government franchise administrator and policy development adviser,
(iii) the contradiction between laudable regulatory objectives and the growing levels of sovereign risk resulting from regulatory implementation of the type foreshadowed.

These issues and their relationship to the ERA proposal are each expanded upon in the following sections.

1. Role of the Independent Gas Pipelines Access Regulator

It is important to consider the role played by the Gas Access Regulator (and the agency which supports him in his office) in the context of regulatory implementation in Western Australia, for a number of reasons. Firstly, the implementation of gas access regulation is at the forefront of recent regulatory development. Secondly, and at least in part because of the previous reason, there is every indication (from informal comments by government representatives through to the implications of recent regulatory appointments as well as the wording of the ERA Consultation Paper itself) that this will form the basis of the proposed centralised regulatory authority, either in principle or in person. And thirdly because, as a major element of the overall regulatory experience in this State, the efficacy with which current regulatory implementation is credited will substantially influence proposals for future implementation. Finally, any consideration of efficacy must be based upon a correct view as to the role and objectives of the regulation being implemented.

According to the Section 4.2 of the ERA Consultation Paper;

> "*The primary role of the Independent Gas Pipelines Access Regulator is to review and approve fair and reasonable reference, or maximum, tariffs for access to gas transmission and distribution networks (pipelines), in accordance with the Gas Pipelines Access (Western Australia) Act 1998 (the Act). The Gas Pipelines Access Regulator is supported by the Office of the Gas Access Regulation (OffGAR)."*

This statement clearly interprets "fair and reasonable reference tariffs" to mean "maximum tariffs". This is fundamentally incorrect and the fact that it is expressed in this manner at all should be a cause for serious public and political concern.

The reasons why this statement is so incorrect and such a cause for alarm are set out below.

According to the introduction to the National Third Party Access Code for Natural Gas Pipeline Systems ("the National Gas Code"), which each state jurisdiction has agreed to uphold;

> "*The objective of this Code is to establish a framework for third party access to gas pipelines 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*

(d) provides rights of access to natural gas pipelines on conditions that are fair and reasonable for both Service Providers and Users; and

(e) provides for resolution of disputes."

According to the Gas Pipelines Access (Western Australia) Act 1998 which establishes the role of the Regulator and defines his functions and powers in Section 36;

"... The Regulator has —

(a) the functions conferred on the local Regulator under the Gas Pipelines Access (Western Australia) Law; and

(b) the functions conferred on the local Regulator under the National Gas Agreement."[12]

Nowhere in either of the documents mentioned above is reference made to the objective of the Gas Access Regulator being to set "maximum" tariffs. In fact, the statement of general principles at the start of the section of the National Gas Code that deals with tariff setting principles states the following;

"The Reference Tariff Principles are designed to ensure that certain key principles are reflected in the Reference Tariff Policy and in the calculation of all Reference Tariffs. Within these parameters, the Reference Tariff Principles are designed to provide a high degree of flexibility so that the Reference Tariff Policy can be designed to meet the specific needs of each pipeline system. The overarching requirement is that when Reference Tariffs are determined and reviewed, they should be based on the efficient cost (or anticipated efficient cost) of providing the Reference Services.

The Principles also require that, where appropriate, Reference Tariffs be designed to provide the Service Provider with the ability to earn greater profits (or less profits) than anticipated between reviews if it outperforms (or underperforms against) the benchmarks that were adopted in setting the Reference Tariffs. The intention is that, to the extent possible, Service Providers be given a market-based incentive to improve efficiency and to promote efficient growth of the gas market (an Incentive Mechanism).

The Reference Tariff Policy and all Reference Tariffs should be designed to achieve a number of objectives, including providing the Service Provider with the opportunity to earn a stream of revenue that recovers the costs of delivering the Reference Service over the expected life of the assets used in delivering that Service, to replicate

[12] ie. The agreement which embraces the National Gas Code.

the outcome of a competitive market, and to be efficient in level and structure."

The preceding text tells us how a reference tariff should be designed. The preamble to Section 3 of the National Gas Code, "Content of an Access Arrangement", provides a functional description of what is intended in establishing a reference tariff (emphasis added):

> "***Reference Tariff*** *- An Access Arrangement must contain one or more Reference Tariffs (the Relevant Regulator may require more than one Reference Tariff when appropriate). A Reference Tariff operates as a* ***benchmark*** *tariff for a specific Service, in effect giving the User a right of access to the specific Service at the Reference Tariff, and giving the Service Provider the right to levy the Reference Tariff for that Service."*

It is clear that the establishment of a benchmark tariff for a benchmark service is merely a mechanism to ensure a minimum right of access to essential infrastructure. It should be recalled that the starting point for the establishment of the National Access Regime, was the principle that third party (ie. anyone - not just those party to a pre-existing contract) "Open Access" should be available to essential public infrastructure, despite it generally having monopoly characteristics.[13] Thus monopoly control would not stand as a barrier to new market entrants wishing to compete in established markets, and hence wider market development would be promoted.

The provision of the right of access to a "standard" service overcomes the barrier of monopoly power, however the essence of competition is about the contest to best satisfy customers' individual needs. This requires the freedom to negotiated individually tailored services. Section 2 of the National Gas Code provides for this. In the preamble, it states (emphasis added);

> ***"2. ACCESS ARRANGEMENTS***
>
> *Where a Pipeline is Covered, this section of the Code requires a Service Provider to establish an Access Arrangement to the satisfaction of the Relevant Regulator for that Covered Pipeline. An Access Arrangement is a statement of the policies and the basic terms and conditions which apply to third party access to a Covered Pipeline. The Service Provider and a User or Prospective User are free to agree*

[13] It should also be noted that the majority of essential infrastructure was originally owned and operated by government utilities. The structure of access regulation has been determined by this view. While recognising the trend of government privatisation, the regulations have generally been written on the assumption that without contrived government pressure, private ownership will tend to act in the same traditional monopolistic manner as public utilities, rather than competitively. This may be true of semi-government owned, or recently privatised utilities, however the evidence suggests that it is unnecessary and in fact counter-productive, once a true "private enterprise ethos" has had time to permeate the corporate culture.

to terms and conditions that differ from the Access Arrangement (with the exception of the Queuing Policy)."[14]

This principle is unambiguously provided for in Section 2.50, which states in part;

"***2.50 Access Arrangement not to limit Access***

For the avoidance of doubt, nothing (except for the Queuing Policy) contained in an Access Arrangement (including the description of Services in a Services Policy) limits:

(a) the Services a Service Provider can agree to provide to a User or Prospective User;"

From the preceding evidence, the opening quote summarising the "primary role" of the Gas Access Regulator is clearly incorrect. Sadly, it reflects the role that appears to have been adopted and which is certainly that espoused by OffGAR as being its view of how the National Gas Code should be interpreted.[15]

Clearly the statement which appears in the ERA Consultation Paper reflects the simplistic "consumer advocate" role which has become a hallmark of many regulatory authorities throughout Australia. This view holds that the stamp of regulation, by definition, means that prices must fall or at least be capped, regardless of the level at which they exist prior to regulation being imposed. It represents a gross oversimplification and inaccurate transliteration of academic economic theory and has become, for a large proportion of Australian regulators and their advisers, unassailable dogma.

It is essential to note that the use of the expression "consumer advocate" in this context should not be taken to represent an argument that there is not a regulatory role to protect the interests of consumers. Nor should it be taken to imply an argument that such efforts are opposed by, or somehow necessarily against the interests of industry generally and infrastructure developers in particular. However it should also be considered that access regulation pertaining to essential infrastructure does not have as its objective consumer protection - either stated or implied - but rather is aimed at long term social (including and perhaps, especially, consumer) welfare. The view from industry is merely that lowering prices for the short term benefit of consumers is not what such things as the National Gas Code stipulate – nor does such action necessarily serve the real interests of consumers.

The notion that prices must fall as a result of regulation is false, as is discussed in a recent paper presented by Mr Gary Banks, the Chairman of the

[14] The Queuing Policy stands as otherwise access to capacity might be used to reassert monopoly power by a Service Provider so inclined.

[15] This and other characteristics of the "OffGAR model" of regulatory implementation of the National Gas Code is discussed in a separate submission by CMS on the ERA proposal.

Australian Productivity Commission.[16] It is clear from the preceding quotations that in so far as the National Gas Code is concerned at least, the true regulatory objective has more to do with creating the conditions which will promote competition than with setting prices *per se*.

As Banks puts it;

> *"National competition policy and related policies were based on an understanding by all governments that, by and large, competition leads to greater productivity, lower costs and improved service, and so eventually to higher incomes and standards of living."* [17]

The paper quite correctly goes on to add the qualification that competition is a means and not an end in itself, and that there certainly are situations where competition cannot produce the desired outcomes.

However the issue at hand is that the foundations upon which the ERA is being proposed are, at this stage, poorly constructed. Either the authors of the ERA Consultation Paper have not consulted with the office of the Gas Access Regulator to describe his "primary role" correctly, or they have been supplied with a description which reveals more accurately an attitude towards implementation than it does the defined role.

In either case, the statement reflects a poor basis from which to expect any improvement from the current "consumer-biased" and counter-productive implementation of access regulation that is beginning to seriously damage Western Australia, and the nation's investment reputation.

2. Conflicting Regulatory Roles

The ERA Consultation Paper states on page 19 (emphasis added);

> *"There is scope within the current industry-specific arrangements to reduce the duplication of resources, consolidate regulatory expertise, and remove the potential for conflicting objectives and responsibilities."*

CMS wholly endorses any proposal which will result in much needed improvements over the existing regulatory arrangements that it is experiencing within its own industry sector.

However statements in the ERA Consultation Paper gives rise to serious concerns as to the possibility of increased potential for conflicting regulatory objectives and responsibilities arising from the current ERA proposal.

In summary the ERA proposal anticipates the following roles;

[16] Competition regulation of infrastructure: getting the balance right, Gary Banks, Chairman, Productivity Commission, 14 March 2002.
[17] ibid, page 5.

(1) Consumer advocate,
(2) Access regulator,
(3) Government franchise administrator,
(4) Retail price setter for government monopolies, and
(5) Government policy adviser.

The evidence for this claim along with the reasons why the conflicts between these roles should be a cause for concern, are discussed below.

(1) ERA as Consumer Advocate

The ERA Consultation Paper contains a number of statements expressing the view that the primary regulatory objectives of OffGAR (see previous discussion regarding the role of the Gas Access Regulator) and the Electricity Reform Task Force ("ERTF")[18], are to cap prices for the benefit of consumers. So in the first instance, we see the role of the ERA being that of consumer advocate (whether or not correctly, according to industry specific regulation).

(2) ERA as Access Regulator

This role requires little justification as the intention is clearly stated in the proposal. However, as we have discussed previously in this paper, access regulation has objectives which relate to the promotion of a competitive market-based environment in which development, and hence the broader economy, can prosper.

This is regulation that is only in its early stages of development in Australia, however it is based on international precedents which have resulted in some spectacularly expensive failures. As we have seen (and is discussed in a separate submission by CMS), the implementation of this particular regulatory regime has, at least in so far as access to Western Australia's vital gas transportation industry is concerned, led the responsible regulatory authority and the State Government into expensive, time consuming and wholly unnecessary litigation. This has arisen largely as a result of the conflict caused by regulatory adoption of a consumer advocacy role. Both the manner of regulatory implementation and the ensuing legal conflict has the potential to seriously undermine the reputation and economy of the State for many years to come.

(3) ERA as Government Franchise Administrator

In Section 5.1 on page 20, in an overview of the proposal, the ERA Consultation Paper states;

> *"it is proposed that an independent Economic Regulation Authority would be established with responsibilities, as relevant, across the electricity, gas, rail and water industries for:*

[18] ERA Consultation Paper, page 17.

- *regulating access for significant economic infrastructure under industry-specific access regimes;*

- *granting industrial licences and ensuring compliance with the terms and conditions applying to licences, including such matters as maximum price, minimum quality, desired standards of service, or industry codes of conduct in accordance with industry-specific frameworks; and..."*

Hence, besides the role of access regulator, the ERA would have another quite separate and distinct role. That is administrator of government franchise licences, yet independent of Ministerial control. This involves the screening of candidates and issuing of limited numbers of licences thus granting a franchise – sometimes exclusive – to undertake a defined activity. Thus this role endows control of a significant barrier to market entry in respect to the regulated industry. This responsibility has also associated with it the role of managing compliance with the terms and conditions associated with such licences, as well as compliance with other (but presumably related) industry codes and requirements.

Such a role has of course a huge potential for leverage over new and existing industry participants. Given the adversarial approach to implementation which regulators appear to have chosen to adopt in regard to access regulation, this leverage in the hands of an access regulator is a very powerful instrument and represents a serious risk to objective regulatory implementation.

Furthermore, the ability to exercise licence control over market entrants wishing to compete against dominant government owned or controlled incumbents providing utility services, must necessarily be completely separated from "*the continued public provision of such services as a means of achieving broader social objectives".*[19] The ERA proposal does not seem to imply any such separation.

CMS suggests that the whole philosophy underlying the Government's role as custodian of the community's resources and thus its responsibility for licencing control, is incompatible with any role in ensuring the attainment of the specific social objectives of government owned utilities in the face of competition.

(4) ERA as Government Monopoly Price Setter

The overview in Section 5.1 goes on to state that the ERA would have responsibility for;

"...

[19] ERA Consultation Paper, Section 3.1 Rationale for Government Regulation, page 6, which seems to reflect a lack of distinction between the social objectives of the Government and the operational objectives of the regulatory authority.

- *making transparent recommendations to Government about tariffs and charges for government monopoly services and for other referred matters"*

Additionally, Section 7.5 of the ERA Consultation Paper elaborates on the role envisaged for the ERA in the setting of prices for government monopoly services thus;

> "*Government (at Cabinet level) to retain responsibility for setting retail prices for government monopoly and near monopoly services, with advice from the Authority. The Authority would also have the capacity to provide advice on other matters referred to it by the Government"...*

and (emphasis added),

> *..."The Authority would therefore report annually on the tariffs <u>to apply</u> in the regulated industries. In undertaking this advisory role, it is envisaged that the Authority would take into consideration the following issues:*
>
> - *the long-term interests of consumers of regulated goods and services with regard to the dimensions of price, quality and reliability;*
>
> - *the legitimate business interests of investors and service providers in regulated industries; and*
>
> - *economically efficient outcomes and competitive markets, including by mitigating the effects of natural monopoly or abuse of market power."*

It would seem clear that at the very least, the ERA would thus also have a role which made it, in effect, commercial adviser (if not commercial manager) for government monopoly utilities.

Moreover, from the nature of the considerations identified above, it would seem that the view which has already been adopted is that the ERA would in effect be the price setter for these public utilities. This expectation is made clear in a number of statements contained within the proposal. Although the proposal states (on page 30 of the ERA Consultation Paper) that "*Government (at Cabinet level) [would] retain responsibility for setting retail prices for government monopoly and near monopoly services',* the statement is also made on page 24 that, *"[o]ther roles for the Authority may therefore arise from this process, possibly including a role in the oversight of market rules and gas retail prices."*

Furthermore, on page 31 of the proposal, the weight to which the pricing "advice" obtained from the ERA is envisaged to have ascribed to it, is illustrated in the statement that, *"[i]f necessary, the Government may have to*

explain its reasons for departing from the independent advice it has received from the Authority on retail pricing matters."

When considered in the context of the preceding statements, it seems difficult to conclude anything other than that the expectation is that the ERA would have the eventual role, even if not from inception, of setting public utility prices and terms of use.

As the ERA is proposed to fall under the responsibility of the State Treasurer and given the need to consider, as alluded to on page 30 of the ERA Consultation Paper, *"the budgetary impact of prices and subsidy issues*" in regard to government owned utility revenue, the independence of advice from the ERA is likely to be strained at best. At the very least, a conflict will exist between the ERA's consumer advocacy function and the need for State revenue.

Perhaps more significant in the long run, where government owned infrastructure is faced by competition from new private enterprise market entrants (as is presently happening in the Electricity Market), budgetary considerations associated with the potential to lose market share, and the principles of access regulation will be in direct conflict.

(5) ERA as Government Policy Adviser

The ERA Consultation Paper attempts to offer the reassurance that, "*[w]hile the Authority would, quite appropriately, not have a formal policy development role, it would be open to it to make any representations to the responsible Minister that it considered appropriate,"* (emphasis added).

It is certainly a sound principle of good governance that the agency tasked with enforcing the law does not have a role in making the laws. This is the principle of "the separation of powers", and is discussed in greater detail in another submission by CMS. The point that must be made here however, is that a distinction must be made between the formal role laid out for the ERA and the informal role which it would in fact fulfil.

The range of issues which the ERA will be required to take into consideration in the determination of its price setting advice to Government (identified in Section 7.5 of the ERA Consultation Paper and cited in this submission at point (4), above) is expansive. The nature of how each issue would be evaluated will be highly policy dependent, as has been shown to be the case under current regulatory implementation practises.

Moreover, the requirement imposed on Government that it should "*have to explain its reasons for departing from the independent advice it has received from the Authority*", as stated on page 31 of the ERA Consultation Paper, provides a strong indication as to the likely weight - formal or otherwise - with which the policy interpretations and directions of the ERA would be endowed.

Summary of Conflicting ERA Roles

Thus we see in summary that the ERA proposal anticipates the following roles, responsibilities and conflicts.

Table 1. Proposed ERA Roles, Responsibilities & Conflicts

	Role	Responsibility	Conflicts
(1)	Consumer Advocate	Reduce prices to consumers	(2), (4)
(2)	Access Regulator	Promote competition and efficient development	(1), (3), (4), (5)
(3)	Government Franchise Administrator	Limit entrants and maintain safe & orderly industrial environment	(2), (5)
(4)	Government Monopoly Price Setter	Consider State budget requirements	(1), (2), (5)
(5)	Government Policy Adviser	Guide policy development	(1), (2), (3), (4)

3. Regulatory Implementation and Sovereign Risk

There exists a considerable body of evidence, analysis, discussion and debate concerning the nature and extent to which regulatory imposition has manifested higher levels of investment risk in Australia as a result of government behaviour. There have also been arguments as to whether or not risks arising from regulation or regulatory implementation should, strictly speaking, be called "sovereign risk". The fact is that as far as investors are concerned, especially international investors, outcomes that derive from the actions of government are viewed as falling within the sovereign risk category.

There is little point in adding to the generality of the sovereign risk debate here, except to commend an analysis of the existing evidence to the Economic Regulator Implementation Committee as a matter of prudence.

In this regard however, it should be noted that what is of significance to considerations of sovereign risk are actual outcomes and not regulatory intentions. It has become obvious that there can be a vast gulf between what is formally required of and defined as the objective of a regulatory regime, and the effect of its implementation. Such a gulf has been demonstrated in Australia in regard to the National Access Regime and the National Gas Code in particular.

The ERA proposal in its present form, appears set to continue this unfortunate situation.

This may not be so obvious at first glance to individuals and companies without regulatory experience in Australia (or perhaps who have enjoyed the relatively scarce and privileged position of having been a short term consumer

beneficiary). The detail of regulatory execution is at times esoteric and the casual or poorly informed observer may not fully appreciate the consequences of what is being described. Additionally, in the broader Australian regulatory context, the evidence would suggest that regulatory authorities address regulatory failures with obfuscation or denial. Compounding this is the fact that some of the assertions made by industry, particularly in regard to the stagnating effects of regulatory implementation on infrastructure investment, are difficult to demonstrate or measure.

However certain basic principles must be obvious, whether or not they are seen to be having an observable and immediate impact. In many cases, by the time the consequences are measurable, the long term damage has been done.

From the preceding specific contents of this submission, it can be seen that implementation of the ERA proposal in its current form is likely to suffer from seriously conflicting objectives and responsibilities. These conflicts will almost inevitably undermine the very regulatory objectives which the ERA will be formally tasked with achieving. Based on the regulatory experience of Service Providers and infrastructure investors throughout Australia, it seems likely that formal regulatory responsibilities will be supplanted by informal pre-existing bureaucratic paradigms.

The ERA proposal does not address this fundamental failing of regulatory implementation, already in evidence in this state and elsewhere in Australia.

Furthermore, it does little for public or investor confidence that this redefining of the workings of the regulatory regime for access to essential infrastructure has been made prior to the imminent release of a very significant review of the National Access Regime by the Productivity Commission, prior to the formal review of the operation of the Gas Access Code in WA required later this year and prior to the outcome of current court proceedings that may significantly alter the way in which regulation is administered in WA.

The ERA proposal is a wholly government inspired initiative. Ostensibly it seeks to produce a government agency which, irrespective of any assertions of independence from government direction, will objectively implement the social and economic objectives of government, for which purpose the various regulations have been written. To repeat an opening sentiment, good regulation requires both good drafting in the first instance, and then good implementation. The success or otherwise with which these objectives are met by the ERA – and the extent of any economic damage which results if the implementation falls short of the stated regulatory objectives – are aspects of sovereign risk which we all (consumers, Service Providers, investors and the wider community) share alike.

The current ERA proposal requires significant additional detail and consultation to inspire confidence. CMS strongly recommends that the State Government and the Economic Regulatory Implementation Committee should

reconsider its implementation timetable, and to also give full and careful consideration to structuring behavioural safeguards into the proposed ERA. This should be done in order to ensure that whatever laudable outcomes have been determined as the objectives of regulation, all are actually achieved by the authority tasked with implementing those regulations.

Current regulatory implementation has many demonstrable failings. The ERA proposal needs to take firm steps to bring regulatory implementation back into line with the objectives for which the originating regulations (and their predecessors, where relevant) were drafted.

Public Submission

CMS confirms that this document is a public submission and looks forward to its early posting on the Department of Treasury and Finance website.

CMS ENERGY
GAS TRANSMISSION AUSTRALIA

Attachment 4 to

Submission to the Productivity Commission

as part of its inquiry into

The National Gas Access Regime

August 2003

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in response to the

ECONOMIC REGULATION AUTHORITY
PUBLIC CONSULTATION PAPER

(5 April 2002)

Purpose of Document

This document is part of a series of submissions by CMS Energy Gas Transmission Australia ("CMS") regarding the establishment and operation of the proposed Economic Regulation Authority ("ERA"). This submission is made in response to the invitation extended by the Government of Western Australia ("the Government") in its document "Economic Regulation Authority: Public Consultation Paper" dated February 2002 ("the ERA Consultation Paper").

Cost Recovery

Introduction and Background

The ERA Consultation Paper puts forward in its Executive Summary (p. iii):

> ***Proposal:***
>
> ***The Authority be provided with the ability to recover costs associated with the provision of regulatory services to industry (eg. gas access and industrial licensing)***

At section 7.6 (p. 31 on), the ERA Consultation puts forward the above proposal and provides the following explanatory text (emphasis added):

> The Government's election commitment included that the costs of regulatory activity would be fully funded by industry. Gas pipeline owners are currently the only parties subject to full-cost recovery (for access regulation). Other bodies are only subject to nominal licence fees that reflect neither administration costs nor the revenue earning capacity from the licence. Other jurisdictions effect at least partial cost recovery through licence fees.
>
> To the extent that Government used the Authority for **expert independent advice**, this would be **funded from the Consolidated Fund**. Government funding would also be required to cover costs associated with **maintaining the Authority's 'core capacity' and expertise (eg. training)**.
>
> Funding for the Authority would be determined in formulating the **2002-03 Budget**. Existing appropriations for the component regulatory functions would be identified and transferred together with any additional **start-up requirements**. Following this, the Government would anticipate the Authority achieves greater cost recovery where appropriate. This is because ultimately **end-users will benefit from economic regulation** and the regulated industry participants are **generally capable of passing through any costs**.

This paper addresses issues raised in the ERA Consultation Paper, and then discusses other, previously unidentified, issues.

Funding of "Expert Independent Advice"

CMS endorses the proposal that the State bears the cost of the regulatory regime proposed. However, CMS is strongly opposed to the proposed ERA providing "expert independent advice" to the Government. This issue is addressed in another paper in the current series.

Funding of Training, etc.

CMS endorses the proposal that the State bears the cost of "maintaining the Authority's 'core capacity' and expertise (eg. training)".

When considering both the training provided to its existing and future staff, and the expertise held by its consultants, CMS suggests that the ERA would be well advised to consider what its 'core capacity and expertise' should comprise.

Salutary lessons flow from the regulation of the gas transport industry in this state over the last three years.

By way of background for the following text, the Western Australian Independent Gas Pipelines Access Regulator ("the Gas Access Regulator") is supported by the Office of Gas Access Regulation ("OffGAR").

CMS respectfully offers the view, with complete respect to the individuals involved, that OffGAR's staff members and the consultants engaged by OffGAR do not always hold the necessary level of 'real world' knowledge and skills in commerce, finance (not to be confused with the discipline of 'economics'), and negotiation that would allow them to effectively deal with the 'real world' issues facing the private sector owners of essential gas transport infrastructure and their stakeholders.

In particular, CMS believes, based on the evidence available to it, that OffGAR and its consultants are not always equipped to comprehend and hence cannot adequately assess the commercial realities facing:

- the operators of the state's two major gas transmission pipelines,
- the users of those pipelines' services,
- the ultimate end users of the gas being transported (where different), and

- other stakeholders.

The apparent inability of OffGAR to recognise the consequences of disincentives to investment is a case in point.

A pipeline owner facing an unacceptable rate of return on capital (or, for that matter, any value of return on capital) is not obliged in any way to make any capital expenditure and is completely at liberty, pursuant to the National Third Party Access Code for Natural Gas Pipeline Systems ("the Gas Access Code"), to obtain a 100%, up-front, capital contribution from a (prospective or existing) pipeline User to enable expansion of pipeline capacity. Such a capital contribution is by definition at the cost of capital applicable to that User of pipeline services. In many cases (and particularly in the cases of industries which provide value added downstream processing), this will be higher than that of the pipeline owner. If this is the case, the Gas Access Code's requirement of "economic efficiency" is violated and economic development of the state is stifled.

This example is not a hypothetical one. Both of the state's major gas transmission pipelines, the Goldfields Gas Pipeline ("GGP") and the Dampier to Bunbury Natural Gas Pipeline ("DBNGP"), are currently operating at maximum capacity.

In the cases of both pipelines, if OffGAR had engaged in effective dialogue with the pipeline owners prior to the release of the Draft Decisions for the GGP and DBNGP, it would at least have been better informed regarding the consequences of its actions.

The following brief discussion, founded on recent, direct, experience, provides further insight to this point.

The owners of the DBNGP and (separately) the owners of the GGP have commenced legal action against the Gas Access Regulator regarding his Draft Decisions[20] for the two pipelines. This action bears testament to the inseparable gulf which currently exists between the Gas Access Regulator and OffGAR, and the pipeline owners.

CMS understands that in both cases, the Gas Access Regulator (and hence OffGAR) issued a blanket refusal to engage in any meaningful two-way dialogue prior to the release of his Draft Decision[21]. This was despite concerted efforts by both pipeline owners to engage in dialogue and negotiations.

Appropriate training could, to some extent at least, ameliorate these problems.

[20] Draft Decisions are the first milestone in the regulation of natural gas pipelines and provide firm indications of regulated tariff outcomes. They apply to an "Access Arrangement" or a regulated, 'standard' gas transport contract with a 'standard' tariff (or price) available to all comers.

[21] This position was stated explicitly by the Gas Access Regulator during the Public Forum for the GGP Draft Decision.

At this point it is relevant to note that Access Arrangements for the GGP and the DBNGP were submitted to the Gas Access Regulator in December 1999. The Draft Decision for the GGP was handed down in mid April 2001, and the Draft Decision for the DBNGP followed in mid June 2001 (i.e. respectively 16 months and 18 months later). The Gas Access Code, which comprises Schedule 2 of the Gas Pipelines Access (Western Australia) Act 1998, requires the Gas Access Regulator to complete the entire process of regulatory assessment for a gas pipeline within 6 months. In practice, the process of assessment is currently (April 2002) at approximately the half-way mark, and progress to date has overrun the prescribed duration of the entire process by approaching four times. If the current rate of progress were to be maintained, it would take around four and a half years to approve Access Arrangements whose designated lives are five years.

CMS is fully aware that circumstances in the public sector are different from those in the private sector, and accepts that such differences mitigate (to some extent) the performance of OffGAR and its consultants[22]. However, OffGAR is required to deal with the private sector, and is obliged under the provisions of its enabling Act of Parliament to act in a "fair and reasonable" manner towards the owners of pipeline assets.

CMS therefore proposes that training (in both the 'classroom' and wider context) be given priority and resourced appropriately for both the ERA and for existing regulatory agencies. Some form of private-public sector exchange program may also be useful, so that each side is better able to come to terms with the challenges, issues and operating practices of the other.

State Budget

CMS welcomes the current actual cost of regulation to be specifically identified in the State Budget. This is a necessary step for improving accountability and transparency of process, and in assessing the cost-benefit of regulation.

"Start Up Requirements"

When the current regulatory regime for gas transport was established, the State carried OffGAR's costs in the initial instance.

CMS firmly endorses this principle, and commends both the State for taking such a position in the gas industry and OffGAR for administering the financial aspects of its start-up in a reasonable and pragmatic manner.

[22] The (declining) performance of OffGAR (by its own criteria and by its own measurement) is addressed in another paper in this series. In summary, OffGAR's performance has in recent times deteriorated in all categories.

CMS therefore proposes that a realistic start-up phase be explicitly programmed for the ERA, and that this phase be fully funded by the State. Part of such start-up could include the initial phase of staff training as discussed above.

It is unreasonable to expect the industry to carry the cost of 'de-bugging' the inevitable problems which manifest themselves at the beginning of any project (and CMS contends that the establishment and operation of the ERA should be viewed in precisely this context, given that "regulatory withdrawal" is foreshadowed in the ERA Consultation Paper). It is also unreasonable to expect that industries such as gas transport which are currently funding regulation should fund the start-up of the ERA simply because they are currently being levied.

"End Users Will Benefit"

For the past decade, the Australian public has been subjected to statements by regulators and others to the effect that "end users will benefit as a consequence of economic regulation".

CMS is not aware of any systematic, quantitative studies conducted in Australia in the industries which will be regulated by the ERA which have had the objective and / or outcome of proving, disproving, qualifying, etc. this assertion.

However, this does not mean that such studies may indeed exist.

If such studies do exist[23], then the Economic Regulation Implementation Committee is, in CMS' view, duty bound to:

- identify them;
- place them prominently into the public domain; and
- use them to more fully define its role and form of operation.

If such studies do not exist, then statements regarding the benefits of regulation must be treated as unproven speculation that is potentially misleading the Australian public.

It is insufficient justification to contend that benefit will occur because today's 'orthodox' economic theory[24] predicts it. The development of science to the present day is littered with theories which were at one time held in high regard, sometimes with vehemence and / or for long period of time, only to be

[23] It is quite possible that such studies could exist, given that economic regulation now has an appreciable life-span in Australia and that academic interest in regulation appears to be increasing.
[24] It should be noted that the field of economics contains diverging views, and that positions which challenge the 'orthodoxy' attract considerable following.

subsequently dismissed and consigned to history[25] when empirical evidence revealed their shortcomings.

Hard, empirical evidence is required to properly justify the assertion that "end users will benefit as a consequence of economic regulation".

CMS, as an energy company, has cause to observe the consequences and impacts of economic regulation of the Australian energy sector. As a pragmatic observer, it concludes that economic regulation is not a panacea, but rather has (to date) failed (to varying degrees) to achieve the objectives it specifically seeks. This view is based on events in Australia and abroad.

The regulation of the electricity industry in Australia's eastern states is delivering outcomes which are meeting increasing resistance on a variety of fronts, including those consumers who were to have benefited from the process. The practical operation of the National Electricity Market and the implementation of Full Retail Contestability has resulted in the following outcomes:

- price instability;
- supply instability;
- substantial price increases to end users;
- government subsidy of some end users;
- huge losses (including asset value write-downs of billions of dollars) by infrastructure asset owners[26];
- asymmetric regulation, where demand-side prices are capped, but supply-side prices are not[27];
- progressive withdrawal from the market by many key players[28];
- extremely low rates of 'churn' in the retail sector[29];
- the refusal of some governments to commit to full involvement (on what has been described as pragmatic grounds);

[25] Geocentricity, phlogiston, and the ether are among the best known.
[26] Superficially this is a paradox given price rises to consumers, but it is confirmed by the events of recent history. Also see the discussion of events in California immediately below.
[27] One of the salient features of recent regulation of the Californian electricity industry.
[28] The Australian Financial Review (Friday 22 March 2002) reports the impending wind-up of Pulse Energy and impending sale of Citipower. These current events follow a long trail of asset sales and strategic withdrawals over the past 3 years.
[29] "Churn" is the switching by a customer to another supplier.

- the proposed establishment of new regulatory agencies specifically so that current regulatory problems may be solved.

It should be noted that this is by no means a complete list.

Further afield, the events which rocked the electricity industry in California in comparatively recent times have been widely reported in the press and in the literature. It is interesting to note that both consumers and their suppliers suffered during this difficult period. The (superficial) paradox of consumers facing skyrocketing electricity prices and regular blackouts and their suppliers (of long standing) filing for bankruptcy indicates that what was experienced was regulatory failure on a massive scale.

The Australian gas transport industry is currently facing a regulatory hiatus, with increasing levels of litigation being driven by the now clearly demonstrable trend by regulators to cut tariffs by applying precedent-driven methodology with disregard to the circumstances applying to individual pipelines.

On the basis of the above discussion, it is apparent that the simple statement that "regulation benefits end users" is by itself insufficient justification for implementing cost recovery as proposed.

If an undertaking on the scale of establishing the ERA were to be considered in the private sector, financial justification would, in all but the most unusual of circumstances, be mandatory. As it will be the private sector which will bear much of the proposed cost recovery, it is reasonable that corresponding criteria, scrutiny, and methodology apply.

CMS proposes that the Economic Regulation Implementation Committee produces a Business Plan for the ERA, and offers this for public comment prior to any commitment to the creation of the ERA.

Pass-Through of Costs to End Users

In a situation of complete monopoly, the proposition that regulatory costs can be passed through to the end user carries some weight. Uniform accounting procedures and full knowledge of, and access to, the market served facilitate a simple (and potentially equitable) flow-through of costs (regulatory and otherwise) which can be specifically identified.

However, one stated objective of economic regulation (in the gas and electricity industries at least) is to advance competition. Competition means, by definition, weakening (and in the limiting case, elimination) of monopoly market structures. Different firms operate in different ways, serving different segments of the markets, offering different services with different cost structures, etc. Firms of different sizes are affected by fixed cost components of cost recovery. Thus, the assumption of uniformity which (either statedly or

unstatedly) is applied to the consideration of monopoly market structures does not apply.

When cost recovery is to be extended across more than one industry, differences in industry structure which lead to different cost structures for its participants present even greater challenges to achieving "fair and reasonable" outcomes.

Thus, the concept of an apparently simple flow-through of regulatory costs becomes, in practice, more problematical if equity is to be achieved and maintained as industry structures change through natural evolution.

To overcome these difficulties, CMS proposes that regulatory cost recovery be achieved by means of a separately identified component of all regulated tariffs. Conceptually, this could be stated in terms similar to those currently applicable to the Goods and Services Tax (i.e. tariffs could be structured in terms of a 'base' component and a 'regulatory overhead' component in the same way that other prices include a separately identified GST component).

Such an approach would help to "inspire public confidence through a transparent framework", and thus help to realise the stated objective[30] of the Economic Regulation Implementation Committee.

Accountability and Financial Liability

Any cost recovery from third parties carries with it a variety of issues not addressed in the ERA Consultation Paper.

One issue is the responsibility to make prudent imposts only.

CMS considers that operation on a cost recovery basis offers incumbents in a future ERA the potential for inefficient acquisition and utilisation of resources, and in the limiting case, unchecked 'empire building'.

It is a historical fact that between the first quarter of 2000 and the fourth quarter of 2001, the Standing Charge[31] levied by OffGAR increased by over 50%. This is far in excess of increases in the Consumer Price Index, and is paralleled by a decline (by OffGAR's own standards and measures) in its performance[32].

At this point it should further be noted that all Access Arrangements requiring consideration by the Gas Access Regulator had been submitted by the end of 1999, the bulk of the cost of assessing these Access Arrangements was

[30] See ERA Public Consultation Paper Attachment A.
[31] The Standing Charge funds OffGAR's fixed costs, such as office space, staff salaries, etc. but does NOT include variable costs, such as consultants, etc., associated with the assessment of specific regulated 'standard' contracts (i.e. Access Arrangements), etc.
[32] This disturbing phenomenon is discussed in more detail in another paper in the current series.

incurred through the use of (external) consultants, and that these consultants' costs were not (and currently are not) included in the Standing Charge.

CMS sincerely hopes that a future ERA will not incur such cost escalation.

The operators of regulated infrastructure assets have, to varying degrees and at different times, been forced to justify to their regulator that the operating costs they incur are "efficient".

CMS believes that the obligation for such justification rests equally with any regulatory body.

CMS therefore proposes that the Economic Regulation Implementation Committee provides a detailed description of both efficiency standards and the means of monitoring and controlling them.

A second issue relates to unrecoverable costs.

The hearing in the Supreme Court of Western Australia of the action by Epic Energy (the owner of the DBNGP) against the Gas Access Regulator regarding his Draft Decision for that pipeline was completed in late 2001. A decision has not been released at the time of writing (i.e. April 2002).

It is eminently possible that Epic Energy will be successful in its action.

If this is the case, then the Gas Access Regulator may be required to re-draft his Draft Decision for the DBNGP.

Under the "fair and reasonable" criterion, Epic Energy should be able to recover the costs of its legal action from the Gas Access Regulator, recover the cost incurred by the Gas Access Regulator (and paid by Epic Energy) for the preparation of the flawed Draft Decision, and be liable only for the cost of preparation of a valid Draft Decision.

The Gas Access Regulator would, in turn, be forced to obtain the funds payable to Epic Energy from the State, as the "fair and reasonable" criterion would preclude him from recovering such costs from the gas transport industry.

CMS proposes that any cost recovery mechanisms available to a future ERA must, of necessity, incorporate provisions for unrecoverable costs.

Consideration of prudent costs and unrecoverable costs raises a wider, philosophical issue.

If a future ERA is to be operated by independent Commissioners who are beyond the direction of Government, then they are in the position to incur substantial financial liabilities for the State of Western Australia with (in the limiting case, complete) impunity.

If the "OffGAR model" were to be perpetuated, public funds would, in effect, be at the disposal of private individuals against whom no sanctions exist, either at the ballot box (the Commissioners are independent of Government) or in the courts (any action against the Gas Access Regulator is, pursuant to his enabling Act, an action against the State). Hypothetically, a 'rogue' Commissioner could pursue an inappropriate ideological bent to the detriment of the public interest in a manner which could be difficult or impossible to check.

CMS therefore proposes that the Economic Regulation Implementation Committee provides a clear, public, indication of safeguards against this unlikely but unpleasant possibility.

Public Submission

CMS confirms that this document is a public submission and looks forward to its early posting on the Department of Treasury and Finance website.

CMS ENERGY
GAS TRANSMISSION AUSTRALIA

Attachment 5 to

Submission to the Productivity Commission

as part of its inquiry into

The National Gas Access Regime

August 2003

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(5 April 2002)

Purpose of Document

This document is part of a series of submissions by CMS Energy Gas Transmission Australia ("CMS") addressing issues regarding the establishment and operation of the proposed Economic Regulation Authority ("ERA"). This submission is made in response to the invitation extended by the Government of Western Australia ("the Government") in its document "Economic Regulation Authority: Public Consultation Paper" dated February 2002 ("the ERA Consultation Paper").

Note (as at August 2003): Parts of the original submission have been updated for the purpose of providing a more relevant view to the Productivity Commission's inquiry into the National Third Party Access Code for Natural Gas Pipeline Systems.

Concern over Adoption (by implication) of the "OffGAR Model"

Background

The prospect of establishing a centralised "super-regulator" in Western Australia has been a matter of discussion within various state agencies for some time. CMS has been aware that the matter was being given consideration and has on various informal occasions expressed its support in principle for such a move. This support has always been stated as being on the basis that it might result in an administrative economy of scale which would be able to afford to attract resources with a higher degree of technical and commercial expertise than has to date been available to State regulatory decision makers. This is especially pertinent in regard to decisions under the National Third Party Access Code for Natural Gas Pipeline Systems ("the Gas Access Code").

Within the gas transmission industry, it has generally been considered that such a consolidated regulatory agency might also be a significant step towards modifying the "consumer advocate" role adopted by the existing agency responsible for supporting the Independent Gas Pipelines Access Regulator ("the Gas Access Regulator"), the Office of Gas Access Regulation ("OffGAR"), and establishing the balance of interests which is intended under the Gas Access Code but which has been lacking.

There is a strong implication that the new entity will adopt what might be termed the "OffGAR model", if not the actual agency itself. That is to say, it seems that it may be based on an expansion of that State Government agency which currently appears to be most well established in regulatory oversight, it being only incidental that the regulatory regime for which it has oversight is the national Gas Access Code. Superficially, this might seem like a practical enough and even logical choice. However, for the reasons outlined below, it would in reality be a most unfortunate outcome, not only for regulated

industry (both operators and investors), but for the immediate and long term economic well being of the State as well.

The Nature of the Concerns

Performance of the Office of Gas Access Regulation

Besides supporting the Gas Access Regulator, OffGAR is also tasked with supporting the Gas Disputes Arbitrator, and has a role in advising the Appeals Tribunal. Its senior officer also holds an advisory position on the national body responsible for maintaining and, if thought necessary, modifying the Gas Access Code itself, the National Gas Pipelines Advisory Committee (NGPAC).

From an industry perspective (that is industry commentators, Service Providers and infrastructure investors), it is perceived that there is a lack of technical, commercial, and legal expertise within OffGAR. This has led in many cases to unnecessary delays, extensive use of consultants taken from a limited pool of non-conflicting private sector expertise, and high service costs, which are ultimately borne by end users. In many cases, despite playing a strong consumer advocate role, OffGAR has failed to deliver any strong consumer outcomes.

The performance indicators selected and published by OffGAR itself provide some evidence of the standard of performance which has been demonstrated to date. These are presented in Table 1 below. *(Note that Table 1 has been updated to include the last available data as at August 2003).*

Table 1. OffGAR PERFORMANCE INDICATORS
(From Customer Satisfaction Survey of Interested Parties,
reported in the Western Australian Independent Gas Pipelines Access Regulator's Annual Report 2002) – Updated as at August 2003

Effectiveness

Desired outcome	**Percentage of interested parties satisfied or very satisfied that consider the Agency has served to:**	**% 99/2000**	**% 2001/02**	**% 2002/03**
To facilitate a national market for natural gas	Promote national consistency to assist the facilitation of a national market for natural gas	44%	28%	37%
To prevent abuse of monopoly power	Prevent abuse of monopoly power	58%	52%	49%
To promote competition	Promote competition	52%	38%	38%
To provide rights of access to natural gas pipelines	Provide rights of access to natural gas pipelines	64%	46%	42%
To respond to gas access issues appropriately	Respond to gas access issues appropriately	56%	47%	31%
To respond to issues in a timely manner	Respond to issues in a timely manner	43%	15%	17%

It is noteworthy that in all cases above, there is a trend towards declining performance standards, in some cases a very significant decline. However, according to the Regulator's annual report [33];

> *"**Quality** (page 33)*
>
> [...] The decline in satisfaction levels appears to be related to the time taken to approve Access Arrangements, which in part appears to be a more general problem of the national access regime. [...]
>
> ***Timeliness** (page 34)*
>
> The survey of interested parties indicated that the proportion satisfied or very satisfied with the agency responding to issues in a timely manner was 17 per

[33] Western Australian Independent Gas Pipelines Access Regulator Annual Report 2002, Report on Operations.

cent as compared to 15 per cent last year. The proportion of respondents that were dissatisfied or very dissatisfied was 56 per cent.

The survey also indicated that the problem seems to be a universal one for the National Gas Access Regime more generally. This is indicated by only 20 per cent of respondents indicating satisfaction with the National Gas Access Regime making provision for issues to be addressed in a timely manner and 58 per cent considering that it provides for this poorly or very poorly.

The expressed concern over the timeliness of the activities of OffGAR is a major concern, but there is increasing evidence around Australia that regulating access to infrastructure is much more difficult than originally envisaged. It is also apparent that it would be inappropriate to issue decisions without sufficient consideration and public consultation.

This impacts on timeliness, posing a challenge to regulators to balance requirements and responses more effectively.

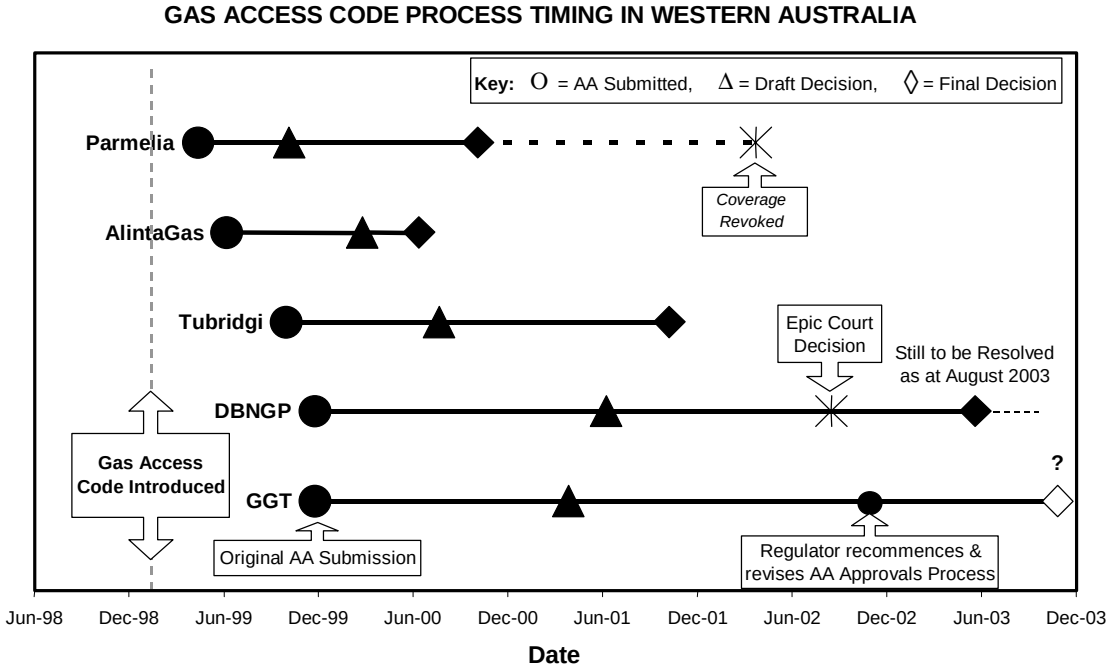
Satisfaction Survey *(page 45)*

[...] The key finding was that interested parties were generally dissatisfied with OffGAR's performance in addressing issues in a timely manner. However, this finding reflected attitudes towards the National Gas Access Regime and not OffGAR's performance alone. [...]"

Clearly, the Regulator sees certain deficiencies in the Gas Access Code which absolve his office of a large part of the responsibility for the manner of its implementation. Nevertheless, the performance graphs, which are attached to the Regulator's Annual Report, appear to apportion reasonably equal shares of public dissatisfaction to both OffGAR and the Code itself. These graphs have been reproduced as Appendix C to this submission.

Furthermore, the execution of regulatory performance in regard to timeliness is more clearly illustrated in Figure 1, below. It can be seen that with the notable exception of the AlintaGas Distribution Network (which was in the process of being privatised by the State Government while its proposed Access Arrangement was under consideration by OffGAR), the trend is for increasingly poorer timeliness. Durations should be viewed in the context that the Gas Access Code contemplates the completion of the entire process within six months.

Figure 1.



Tariff Outcomes and their Impacts

Figure 1 illustrates the relative timing of regulatory outcomes under the Gas Access Code as it has been implemented in Western Australia.

It is instructive to further consider the treatment by the Gas Access Regulator of Western Australian gas transport infrastructure which was subject to formalised Open Access regimes prior to the introduction of the Gas Access Code.

These pipelines / distribution systems and their associated Open Access regimes are:

- The Dampier to Bunbury Natural Gas Pipeline ("DBNGP"): the Gas Transmission Regulations, and later the Access Manual. Both have been superseded by the Gas Access Code. The previous regimes were promulgated by the Government of Western Australia.

- AlintaGas Mid West and South West Distribution Systems: the Gas Distribution Regulations. These have been superseded by the Gas Access Code. This regime was promulgated by the Government of Western Australia.

- Goldfields Gas Pipeline: the Goldfields Gas Pipeline Agreement Act 1994 (in force before and after the introduction of the Gas Access Code). This regime is the product of negotiation between the original owners of

the Goldfields Gas Pipeline and the Government of Western Australia. The latter formally approved these Open Access arrangements in January 1995.

The comparison below emphasises the stark contrast in tariff outcomes delivered by the Gas Access Regulator.

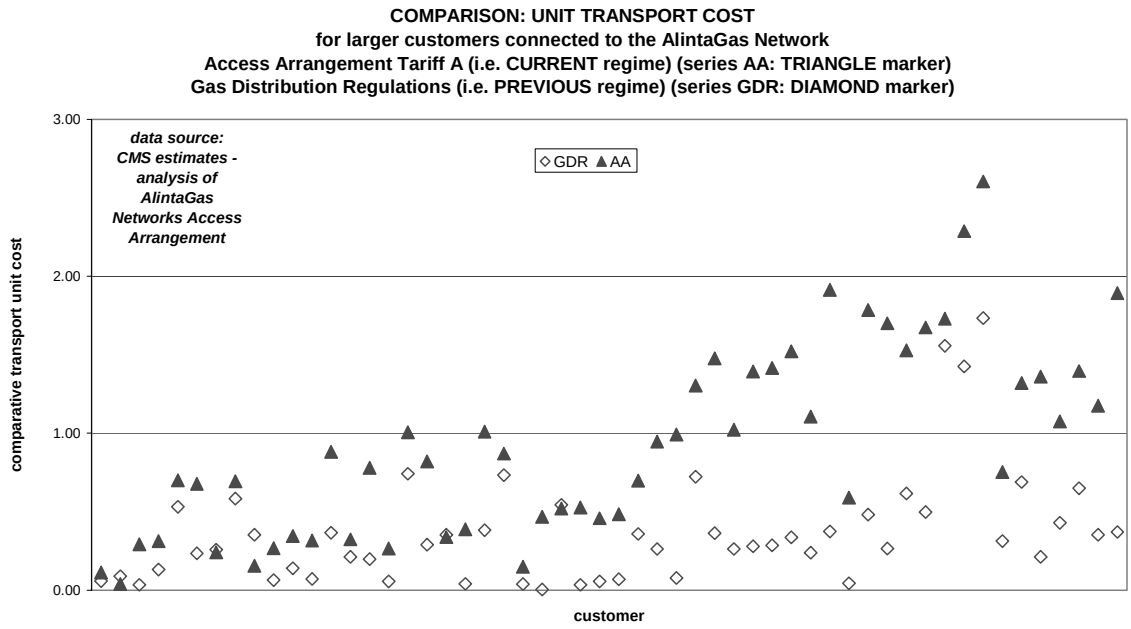
For the Parmelia Pipeline (a pipeline which has always been privately owned and operated along commercial lines, and which has been in competition with the much larger DBNGP since 1994), the Regulator mandated a tariff reduction of 33%. The Parmelia Pipeline, which had experienced no benefit from the Code but was continuing to incur regulatory costs, subsequently sought revocation. It was removed from the Code on the basis that it criteria (a), (b) and (d) were not satisfied. It is reasonable to surmise that, had it been evaluated rather than merely included arbitrarily on the list of covered pipelines, it would never have been covered in the first place. The fact that such a tariff reduction should have been calculated (based entirely on academic theory) for a pipeline which should never have been covered in the first place, is damning evidence of the functioning of the Gas Access Code regime.

Under the Gas Access Regulator's Draft Decisions for the DBNGP and the Goldfields Gas Pipeline, substantial tariff cuts are proposed for those pipelines. Compared to current (April 2002) tariffs, the Gas Access Regulator recommended a 25% (approximately) reduction for the DBNGP, and a 47% (approximately) decrease for the Goldfields Gas Pipeline.

It should be noted that subsequent to writing this original submission, the Regulator has issued a Final Decision for the DBNGP in which he appears (it is unclear from the material he has made available) to have moderated his view such that the cut now represents perhaps around 15%.

However, in the case of AlintaGas, despite claiming a "headline" tariff reduction of 5%, the Gas Access Regulator's assessment of its Access Arrangement resulted in tariffs for the transport of gas by AlintaGas Networks increasing dramatically. The extent of these increases is presented graphically immediately below for a number of larger end consumers of natural gas supplied by the AlintaGas South West Distribution System. Unit transport costs shown have been calculated for individual customers using the two relevant published tariffs. Such larger customers are likely to be the subject of very strong competition between the incumbent AlintaGas and new market entrants.

Figure 2.



Note: To compare the impact of the AA and GDR tariffs for a particular customer, compare the position of the solid triangle (AA) with the position of the hollow diamond (GDR) vertically below it (or, in very few cases, above it).

It is readily apparent that the Gas Access Regulator approved tariffs for AlintaGas under the Gas Access Code which are integer multiples of those in effect prior to the introduction of the current regulatory regime.

It is a historical fact that the assessment of the AlintaGas Access Arrangement was finalised immediately prior to privatisation of the AlintaGas Distribution System, while the Draft Decision for the DBNGP was handed down after that asset was sold by the State Government to the private sector. The Goldfields Gas Pipeline was originally, and remains to the present day, a private sector project which operates under a State Agreement Act (the Goldfields Gas Pipeline Agreement Act 1994).

The nature and commercial impact of these outcomes reflects heavily upon the manner in which regulatory discretion permitted under the Gas Access Code, along with interpretive latitude, has been applied. Clearly there is little evidence of any uniform consideration of the "balance of interests" required under the Gas Pipelines Access Law. Were this to also be the approach adopted by the ERA, it would extend these ongoing adverse ramifications into all other areas of regulated industry in Western Australia.

The Gas Access Code seeks to promote the development of competitive markets in order to facilitate economic growth. The mandate which OffGAR appears to have assumed is that of a consumer advocate. This is not only evidenced in the outcomes illustrated in Figures 1 and 2, it is made clear by

various public statements made by OffGAR staff, both verbally and in numerous places throughout various official regulatory Decisions. A selection of these appear at Appendix A.

However, it is apparent that the agency has not actually fulfilled its own apparently self-imposed goal of reducing prices for consumers. OffGAR officials (and in this matter, the Gas Access Regulator himself) have been forthright in stating that they have no interest in whether or not price reductions are passed through to final end-use customers, and it is not a matter of consequence if Australian consumers who have invested their own money (via superannuation funds or other investment vehicles) lose substantial proportions of their investment as a direct result of asset write-offs necessitated by regulatory decisions. Tangible evidence of this position appears in dialogue during the Public Forum for the DBNGP Draft Decision, cited in Appendix A to this submission
It also needs to be considered whether the means adopted by OffGAR are effective in serving what appears to many to be the department's own self-appointed objective of lowering gas consumer prices. As the National Competition Council (NCC) has recently pointed out in its Decisions regarding the Application for Revocation of Coverage of the Parmelia Pipeline, the evidence indicates that the price of delivered gas in Perth is highly inelastic in respect to transmission costs.[34] The transmission (as distinct from distribution) component of the total delivered price of gas in Perth is too small to have any significant effect on prices.

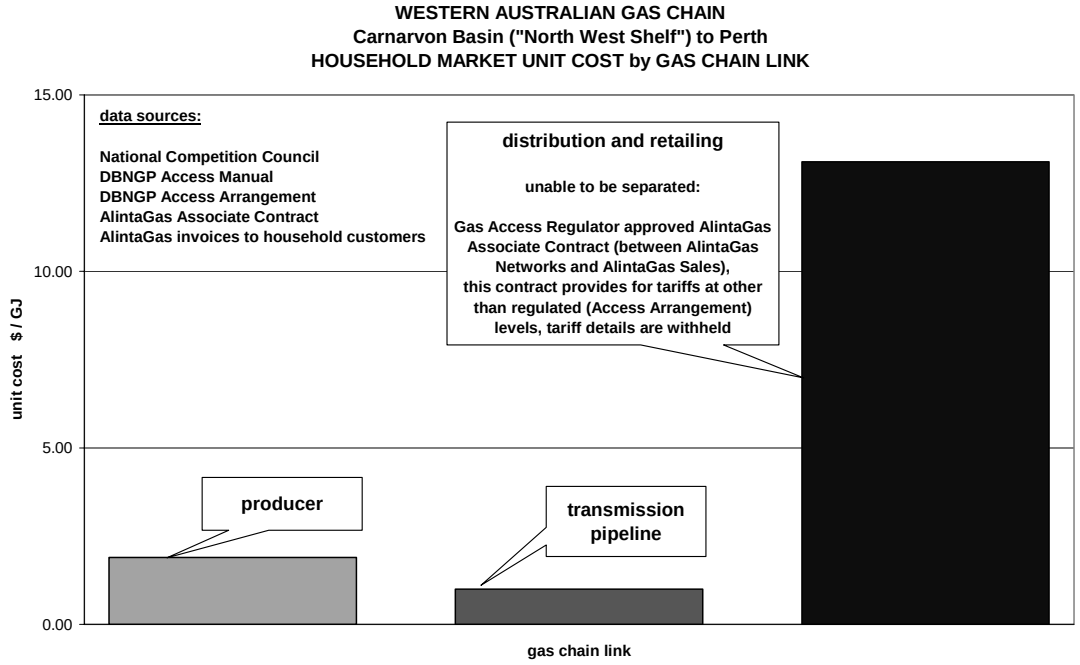
This means that for the DBNGP, the Gas Access Regulator's action in prescribing tariff reductions of around 25% in his Draft Decision, would have had, if implemented, the effect of delivering insignificant benefits to end consumers of gas while severely damaging the financial viability of an infrastructure asset which is critical in satisfying the present and future energy needs of the bulk of the population of Western Australia.

(As noted previously, the Regulator has subsequently issued a Final Decision for the DBNGP in which it appears he has moderated the required tariff reduction to (perhaps) around 15%. While the effect on the Service Provider may be somewhat less damaging – that is yet to be seen in the specific circumstances – this reinforces the triviality of the effect for consumers).

To put this into perspective, the following graphic quantifies the gas value chain from a producer in the Carnarvon Basin (i.e. the "North West Shelf") to a household end user in the Perth metropolitan area:

[34] Refer Final Recommendation: Application for Revocation of Coverage of the Parmelia Pipeline under the National Gas Access Regime, February 2002, NCC, pages 33 & 58.

Figure 3.



It is apparent that:

- transmission pipeline transport costs are around half of the gas purchase price,

- both gas purchase price and transmission pipeline transport cost are small compared to distribution and retailing costs.

When relating this industry cost structure to outcomes delivered by the Gas Access Regulator, it is further apparent that cuts in tariffs have been applied to the least significant cost link in the gas chain (i.e. transmission pipelines), and tariff increases have been granted to the most significant cost link (i.e. distribution and retailing).

For the household consumer of gas in Perth, receipt of the full 25 cents per gigajoule reduction intended in the Gas Access Regulator's Draft Decision would result in the delivered price of gas moving from around $16 per gigajoule to around $15.75 per gigajoule, a reduction of around 1.6%. However, for the owners of the DBNGP, the potential 25% reduction in tariffs and hence revenue represents an impact which:

- has (already) caused fund managers to write down the value of their equity in the DBNGP to zero,

- has (already) caused small Australian investors to suffer consequential damage, and

- continues to threaten the financial viability of an essential infrastructure asset.

The situation for the Goldfields Gas Pipeline is similar to that for the DBNGP.

If the tariff reduction prescribed in the Gas Access Regulator's Draft Decision for the Goldfields Gas Pipeline were to flow through to a major (and recently highly publicised) mining and minerals processing project in the Goldfields, it would lead to a reduction in reported operating costs of at best a few percent.

If these are the likely cost-benefits to be delivered to the West Australian community through creation of the ERA, then the latter needs to be very carefully re-considered.

The Gas Access Regulator is fully cognizant of the fact that his Decisions impact the financial viability of the infrastructure assets he regulates. In his Draft Decision for the AlintaGas Access Arrangement, he gives considerable attention (at section 5.3.4 of part B) to the impact of his Decision on the ability of AlintaGas to meet its financial objectives and obligations. However, he does not extend the same consideration to the pipeline owners in his Draft Decisions for the DBNGP and Goldfields Gas Pipeline. CMS considers this to be a serious omission and one that leads many in industry to believe that a proscriptive, interventionist agenda is in operation.

It is not possible to perform meaningful analysis for the AlintaGas Distribution System. This is because the details of gas transport costs incurred by AlintaGas Sales in transporting its gas via the Distribution System owned and operated by AlintaGas Networks are not known.

The gas transportation contract between AlintaGas Networks (the "Service Provider") and AlintaGas Sales (the "User") has been subjected to scrutiny and subsequent approval by the Gas Access Regulator pursuant to the provisions of the Gas Access Code. As part of this process, most of the content of this contract was released into the public domain. However, the tariffs applicable to transport in the Distribution System were withheld, with the approval of the Gas Access Regulator. Such a lack of transparency is, in CMS' view, contrary to the public interest, particularly given the current efforts by the Government of Western Australia to implement Full Retail Contestability in the gas market.

With regard to the above examples, CMS suggests that the expenditure of time, money and resources by OffGAR is not only misguided, it is also largely self-contradictory and hence all the more wasteful. This is because, on the basis of current regulatory behaviour, consumers seem likely to face either future higher prices associated with increased Distribution tariffs and / or a lack of transmission pipeline infrastructure investment, or be required to put up their own funds for the up-front financing of any future required increments

of transmission pipeline capacity.[35] This latter impact is significantly compounded as infrastructure investors have traditionally been able to borrow money at lower cost and have investment rate of return thresholds which are generally lower than those applicable to many other investment sectors (particularly those involved in downstream regional or minerals processing). Hence, gas consumers will pay even more when, as the actions arising from the current regulatory predisposition being demonstrated in regard to the Gas Access Code seem bound to ensure, such outcomes eventuate.

Stakeholder Assessments

From a review of the public submissions that have been made in response to the highly controversial DBNGP Draft Decision, it is clear that many consumers are beginning to object to these current regulatory attitudes. A summary of the responses which were elicited by the release of that decision and in the aftermath of the public forum conducted by OffGAR in which the agency's logic was described and defended, is given below in Table 2.

Table 2.

Submissions on Regulator's DBNGP Draft Decision		
Supports Draft Decision ?	Total	Pct
Submissions from Epic (ie. proponent)	9	-
Late Releases (ie. pre-dating Draft Decision)	3	-
Opposed to Draft Decision	62	68%
Qualified Opposition	5	5%
Queried or Expressed Concern about Impact	16	18%
Qualified Support	4	4%
Support	4	4%
	91	100%
Total Number Submissions Released post-DD	103	-

(as at 22 Jan 2002)

It can be seen that after discounting the proponent's own submissions and other submissions which were released following the release of the Draft Decision but which in reality predated it, 92% of the public submissions made on the matter, oppose or express some concern about the outcome. In fact the only quarter from which OffGAR currently enjoys little criticism comes from those parties who believe that they stand to gain financially in the short term from reduced costs and hence higher (windfall) profit margins. These are primarily entities whose current perspective appears to be short term, but for whom the windfall gains in the short term may be substantial. Such

[35] This is specifically acknowledged by the agency. To quote OffGAR's Dr Ray Challen, "*So, yes, you are correct that new users may indeed pay a price greater than the reference tariff simply by meeting some of the capital cost for extensions or expansions*." (DBNGP Public Forum, Draft Decision on Proposed Access Arrangement, Transcript of Proceedings, August 2001, OffGAR, page 17).

considerations are hardly likely to be aligned with the public interest and the objectives of the Gas Access Code.

In CMS' view, this opposition reflects on both the content of the Gas Access Regulator's Draft Decision for the DBNGP and the process by which he formulated it. He is on the public record[36] as stating that he refused to engage in dialogue with at least one pipeline operator regarding his Draft Decision for that pipeline prior to the release of that Decision. CMS considers this position to be both inappropriate and counter-productive to achieving reasonable and timely outcomes.

From the perspective of a pipeline operator (or infrastructure investor), the predictability, bias, and administrative intransigence characterising the manner in which gas access regulation has been implemented in Western Australia only serves to engender an increasing exposure to sovereign risk, both in terms of wasted time (and hence cost) as well as the negative revenue impact of the apparently inevitable tariff outcome. It is important to also be aware of the fact that regulatory cost figures published by OffGAR and borne by industry[37], are only a small fraction of the full cost of regulatory compliance.

This paper has attempted to quantify and illustrate the measurable impacts which the attitude embodied in the present "OffGAR model" of regulatory implementation has wrought. However what can not be so clearly illustrated in a graph is the stagnating effect this regulatory behaviour, affecting as it does such a vital sector of the Western Australian economy, is having on immediate business activity or on longer term economic development. While industry proponents have been presenting their views on these issues for some considerable time now, it is acknowledged that the only real evidence that counts is empirical by nature. New business or investment can be simply measured - business or investment that does not occur cannot be either simply or accurately measured.

However what can be simply appreciated is that the regulatory outcomes experienced in the gas transmission industry in Western Australia, and the costs borne to date by Service Providers both in terms of regulatory expenditure, reduced revenue, and wasted resources, have failed to result in any <u>new</u> business, other than (inevitable) organic growth of the household and small commercial sector. To the best of CMS' knowledge, the only new Reference Service contracts entered into in Western Australia have been in regard to accessing the AlintaGas metropolitan distribution monopoly and that this business would have proceeded just as well under the Gas Distribution

[36] Public Forum for the Goldfields Gas Pipeline Draft Decision.

[37] Much has been made of the provisions in the Gas Access Code which provide for Service Providers to pass on to their customers the costs of regulatory compliance by way of factoring these costs into the determination of tariff, however as Figure 1 illustrates, this increased cost burden must be accommodated within and recouped only as part of a reduced revenue stream. Even were this not to be the case, the extent to which Service Providers may or may not be able to pass on all or part of these costs to end-use customers depends upon the extent and nature of the competition that they face and their pre-existing contractual arrangements.

Regulations (GDR) which prevailed prior to the introduction of the Gas Access Code.

It should be noted that subsequent to the original drafting of this submission, it has been announced that a small diameter gas pipeline will be constructed to extend from the end of the Goldfields Gas Pipeline, via the Kambalda lateral to Esperance. However, CMS notes that this pipeline is being built in the expectation that it will not be covered under the Code, and that the associated contracts for gas transmission down existing pipelines owed nothing to the Code. The Goldfields Gas Pipeline presently operates under a State Agreement and neither it, nor the Kambalda Lateral Pipeline, have Access Arrangements in place under the Code.

Without the ensuing regulatory uncertainty, the limited growth which has occurred may have progressed earlier. In CMS' assessment, it would have actually proceeded at a lower cost under the earlier GDR.

The Gas Access Code emphasises the creation of circumstances which provide a positive basis for future market development. There is little evidence to date that supports the view that the approach which has been adopted by the agency which determines exactly how the Gas Access Code will be implemented in Western Australia is contributing to that objective. In fact the contrary is true.

In summary, it is CMS' view that adoption of the "OffGAR model" as implied in the ERA proposal, without some other steps being introduced to avoid it, would embrace and perpetuate the following characteristics:

(1) Insufficient and inappropriate technical and commercial expertise, resulting in considerable reiteration and duplication of effort between Service Providers and the regulatory agency and reflected in regulatory Decisions which continue to manifest flawed logic.

(2) One way and highly selective communications. This point is based on the experience of those representatives of infrastructure owners who have had dealings with OffGAR, and is confirmed by public statements by the Gas Access Regulator.

(3) Adversarial, pro-litigation attitudes towards to Service Providers, as evidenced by the fact that with only three major gas infrastructure assets being covered under the Gas Access Code in Western Australia (another one having been revoked and the remaining two others being effectively only single user lateral lines), two – the DBNGP and Goldfields Gas Pipeline - are the subject of expensive and probably lengthy legal action. The third – AlintaGas – made (to the best of CMS' knowledge) strong legal representations to the Gas Access Regulator during its own regulatory approvals process.

(4) Lack of formal departmental independence compromising the independence of the Gas Access Regulator, for while the Gas Access Regulator's independence is enshrined in the laws which enact the national Gas Access Code in Western Australia, no such requirement is prescribed for the government agency which supports him. The manner in which the Gas Access Code was interpreted in regard to the various Access Arrangements discussed above and the AlintaGas Associate Haulage Contract and the outcomes which ensued provide grounds for questioning the bases upon which the subsequent decisions were delivered.

(5) Preconceived interpretation of the Gas Access Code with a disregard for the long-term, and a propensity to "reverse engineer" outcomes[38] which are in fact adverse to the stated objectives of the Gas Access Code, as demonstrated in selected citations provided in Appendix A.

(6) An apparent bias towards being a consumer advocate in terms of price. Such a position is, however, likely to be ineffective, as downstream prices are unlikely to be significantly affected by transmission cost reductions. This point is exemplified by the widespread public concern expressed over the likelihood of delivered gas prices increasing as a result of regulatory decisions, combined with an expressed lack of interest by the Gas Access Regulator in such outcomes.

(7) Demonstrated failure to hold the longer term economic interests of the State at heart, favouring academic interpretations and dogma.

Conclusion

The present "OffGAR model" of regulatory implementation in Western Australia has shown itself to be flawed and a liability which compromises both the very objectives of the Gas Access Code which it is tasked to champion, but also the position of the Gas Access Regulator. The evidence for the case against the adoption of the "OffGAR model" is in the regulatory outcomes demonstrated to date. The evidence thus provided stands in stark conflict with the OECD's "Guiding Principles for Best Practice Regulation" referred to in the Section 3.2 of the ERA Discussion Paper.

Western Australia should stand to benefit from the establishment of a centralised regulatory agency. However the proposed ERA certainly should not be based on a model that has demonstrated itself to be flawed.

In this regard the ERA proposal and especially its implication that the "OffGAR model" should be adopted, is particularly untimely given that a major review of the Gas Access Code and its implementation at both state and national levels is imminent.

[38] The determination of the Initial Capital Base and hence regulated tariffs for the Parmelia Pipeline's Access Arrangement is one of the most obvious of these. See also Appendix A first page.

More immediately, the whole of Australia is awaiting the public release of the report into the effectiveness of National Access Regimes recently completed by the Productivity Commission and whose dissemination must surely be imminent after months of internal review by state governments and Australia-wide regulatory agencies. To make large scale changes to the State's regulatory framework prior to this report being made publicly available hardly augers well for either public confidence or transparency of process.

The fact that the Gas Access Regulator is currently the subject of two, separate legal actions regarding Draft Decisions handed down by him means that his current position should, in the interests of positive public perception and confidence, be preserved until these processes have run to their final conclusion.

Finally, the ERA proposal as it stands, offers no remedy for the problems currently being experienced in the highly significant gas transmission sector. In fact, the implication of the adoption of the "OffGAR model" appears likely to substantially compound these problems and extend poor regulatory practices into other critical infrastructure sectors.

Based on its track record, the resources employed in the regulatory oversight of the Gas Access Code in Western Australia are clearly not the much needed source of "scarce regulatory expertise" referred to in the ERA proposal. Moreover, the extension of the approach embodied in the "OffGAR model" to regulatory implementation seems likely to cost the State of Western Australia dearly - directly and indirectly, and in the short and long term. An extension of the adverse longer term outcomes which are already being evidenced today, is likely take many years to reverse and rectify.

The problems associated with the need for appropriate statutory guidance of regulation were highlighted in a recent paper dealing with the broader aspects of infrastructure regulation presented by the Chairman of the Productivity Commission. The paper is highly relevant to the ERA proposal and is attached to this submission as Appendix B. Nonetheless it is useful to repeat the following comments made by Mr. Banks in that paper (emphasis added).

> *"Ultimately, a large element of judgment is unavoidable in deciding whether and how to intervene, and this raises the prospect of regulatory error. As already argued, where long-lived investments in essential infrastructure are involved, the costs of regulatory error can be substantial. In addition, regulatory interventions risk dampening incentives for cost saving, innovation and entrepreneurship in regulated firms, or those depending on them"*[39]
>
> *"...regulatory error can also have more systemic origins, reflecting the susceptibility of regulators to various forms of 'capture'. Their significance will depend on how regulatory frameworks are designed, including the*

[39] Competition regulation of infrastructure: getting the balance right, 14 March 2002, Gary Banks, Chairman, Productivity Commission, page 10.

independence and degree of discretion afforded regulators and how their objectives are specified and their performance monitored.

As is well known, the traditional concern based on the American experience was of capture of regulatory agencies by industry incumbents, who have more incentive than anyone else to find ways of influencing how regulators interpret the rules in their particular cases. But, depending on the institutional settings, quite different forms of influence can operate. These include favouring the interests of current consumers (and electoral constituents) over the interests of future consumers; which could lead to new entrants being favoured over incumbents.[40]

Regulators may also feel constrained by the precedents set by their own past decisions. Apart from a natural reluctance to admit error (that we all share!) the regulator must consider the potential for subsequent litigation where past errors have imposed substantial costs on particular businesses. To avoid this risk any correction in regulatory behaviour is likely to be incremental and defended in terms of new circumstances.

Finally, regulators may have a risk-averse attitude to the possibility of firms earning high profits because these may be associated, in the public mind, with failure by the regulator to control the excesses of market power.

Regulatory discretion cannot be eliminated, and indeed, some discretion is desirable. However, to reduce the risk of regulatory error, statutes need to be clear about three things: the objectives of regulation; the behaviour at which intervention should be targeted, and the principles governing the type of intervention.

These basic requirements are not often met. For example, the Productivity Commission found that the National Access Regime was deficient in all three respects. It proposed the inclusion of an objects clause and pricing principles in the national regime and a change to the regime's 'declaration' criteria to reduce the possibility that services will be subjected to access arrangements without the prospect of a significant economic payoff.

Given the manifold uncertainties and information difficulties, there are limits to what regulators can be expected to achieve. Rather than aiming for an ideal but unattainable outcome, the public policy goal should be a set of regulatory arrangements that will improve efficiency through time, while minimising the scope for regulatory errors. A framework is needed in which regulators are encouraged to intervene only when significant improvements in efficiency are in prospect and not to be too ambitious in fine tuning the prices they regulate."[41]

[40] In Western Australia, the outcome relating to the DBNGP decision appears to provide an example of the reverse to this being also true.
[41] ibid.

In conclusion, CMS proposes that the ERA proposal be considered in light of this paper and that the form of the centralised regulatory agency be designed only after the findings of the Productivity Commission and the state and national reviews of the Gas Access Code are made public, and full recognition is accorded to them.

The magnitude of the ramifications of "regulatory error" for Western Australia are far greater than any short term imperative to consolidate government agencies.

Public Submission

CMS confirms that this document is a public submission and looks forward to its early posting on the Department of Treasury and Finance website.

APPENDIX A
PUBLIC RECORD REFERENCES:

Parmelia Draft Decision page B80 (emphasis added):

> The Regulator's estimates of Reference Tariffs that would result from different valuations of the Initial Capital Base are described in section 7.8 of this Draft Decision. An indicative Reference Tariff of $0.57/GJ would arise from the maximum value of the Initial Capital Base ($65.8 million) and allowing for an increase in throughput to 60 TJ/day by the end of the Access Arrangement Period. **The Regulator considers this tariff to be unacceptable as it is greater than the current average tariff for the Pipeline**. To determine an acceptable value of the Initial Capital Base, the Regulator calculated the value that would return a Reference Tariff of $0.55/GJ under the same assumptions of increasing throughput.

Parmelia Draft Decision page B127 footnote (emphasis added):

> The tariff calculated for the Initial Capital Base Value of $36.6 million is higher than the **tariff value of $0.55/GJ that was used to calculate the value of the Initial Capital Base**. This difference is due to a distortion inherent in the financial model used for calculating the tariff. This distortion arises from calculation of a tariff for the five year Access Arrangement Period, rather than the 42 year period considered in calculation of the Initial Capital Base value.

CMS Note: The two paragraphs above demonstrate "reverse engineering" of tariff outcomes by the Gas Access Regulator. In this case, regulated tariffs for the Parmelia Pipeline were determined through the following process:

i. a tariff (of $0.55 / GJ) was assumed;

ii. this value of tariff was used to value the asset (using conventional NPV methodology);

iii. the Initial Capital Base was set equal to the asset value obtained immediately above;

iv. regulated tariffs were calculated using the value of Initial Capital Base obtained immediately above.

(It should be noted that in the Regulator's Final Decision for the DBNGP, he has used a similar reverse engineering approach to determining the regulatory Capital Base (refer to paragraphs 512 and 513 on page 122).

Parmelia Final Decision page B59 (emphasis added):

Reference Tariff not Exceeding Current Transmission Charges

> In considering the value to be established for the Initial Capital Base, the Regulator considered the interests and expectations of both the Service Provider and Users. It was considered that Users could reasonably expect that the Initial Capital Base would not be attributed a value that, in conjunction with other aspects of the setting of Reference Tariffs, **would not result in an increase in charges for gas transmission**. This expectation of Users was taken into account in ascribing a value to the Initial Capital Base by allowing a value that is greater than would be justified on the basis of current levels of asset utilisation, but which is **not so high as to result in Reference Tariffs that are higher than the average charge for gas transmission at the time of the Draft Decision**.
>
> The determination of an Initial Capital Base for an existing pipeline (and particularly one of the age of the Parmelia Pipeline) requires the **Regulator to exercise judgment**, taking account of the matters prescribed in section 8.10 of the Code. These matters include the reasonable expectations of the Service Provider and Users. The Regulator maintains that, in the context of the Parmelia Pipeline, the criterion that **Users should not face higher charges** as a result of a pipeline being bought under the Code is an appropriate application of these factors, and results in a reasonable balance of interests between the relevant parties.

Tubridgi Draft Decision part B section 5.3.4 page B81 (emphasis added):

> Regulatory decisions have most commonly derived Capital Base values through a methodology whereby initial DORC values are reduced in accordance with criteria based on a balancing of interests of the Service Provider and Users. For the most part, the criteria for a balance of interests has been that **regulated tariffs should not exceed existing tariffs**.

AlintaGas Draft Decision part B section 4.6.4 page B53 (emphasis added):

> The role of a Queuing Policy is to provide a rule for the allocation of scarce capacity amongst competing parties. Such a rule is necessary as the price regulation being applied to the AlintaGas distribution business **precludes prices from rising above the Reference Tariff** to ration capacity.

AlintaGas Draft Decision part B section 5.3.4 page B99 (emphasis added):

> In determining the most appropriate Initial Capital Base for the AlintaGas distribution systems, the Regulator has considered a balance of interests between AlintaGas, Users and Prospective Users. In accordance with the

proposal by AlintaGas, the Regulator has contemplated a criterion for a balance of interests as the Initial Capital Base being consistent with **not giving rise to increases in retail gas prices**, consistent with a premise of maintaining the current and projected levels of revenue for the distribution business.

Tubridgi Public Forum transcript page 22 on (emphasis added):

MS TASNADY: Suzy Tasnady again from CMS Energy. On page 81 of section B of the Draft Decision, there's a comment that is made under the discussion of the advantages and disadvantages between DAC and DORC. The statement is, "The criteria for a balance of interest has been that regulated tariffs should not exceed existing tariffs." I wonder if you would care to comment. On what is that criteria based and, secondly, how does this reflect the balance of interest, because the balance in this case is talking about the interest between both the Service Provider and the users.

DR MICHAEL: Ray?

DR CHALLEN: In looking at a balance of interests, obviously it's in the interests of the Service Provider to have as high a value of the initial capital base as can be achieved. Obviously then that is reflected in their depreciation allowances and their return on capital.

In considering the interests of users though, I guess the **criterion** that has been adopted, **certainly in Western Australia** but also in the Eastern States, is that by and large **the advent of regulation should not result in an increase in tariffs to the users of the pipeline service**. I suppose it's a reasonable expectation of users that with the advent of regulation, tariffs would be less than or equal to what they are at present, so that is where in effect that criterion arises from.

DBNGP Public Forum transcript page 16 on (emphasis added):

MR DAY: Thank you. John Day, member of state parliament and opposition spokesperson on energy. What I'm actually seeking from the panel is in relation to some of the material that has been provided in Epic Energy's material that has been distributed where it says in effect that it's only those customers who are currently being serviced by the pipeline or at least those who can be serviced within the existing capacity of the pipeline that would be covered by the proposed tariffs, and that any new customers for which greater capacity would need to be created would need to pay a substantially higher tariff.

If that is correct, obviously it would have a substantial impact on the ability of new players in the energy game, whether it be electricity generation or anything else, to compete I guess. So I am just seeking a comment from the panel as to whether they agree with that assertion, and secondly I state simply

to place on the record that the opposition has expressed a view that we would be supportive of higher tariffs being arrived at, taking into account the overall public interest so as to ensure that a sustainable outcome is arrived at and to ensure that adequate expansion can be provided for in the interests of further developing industry in the state. So that is simply for the record, but what I would like a comment on if possible is that subject that I just raised.

THE CHAIRMAN: Thanks, John, and in relation to your second point, I appreciate you have made a submission on that basis and I thank you for it, and I thank you for the position you do have. I think on the first one, I guess, Ray, you might like to comment on that.

DR CHALLEN: Firstly on that point, there is, to the regulator's understanding, still some excess capacity on the pipeline. So there is some provision with the Dampier to Bunbury Pipeline for not only existing or existing users if it should apply, but certainly for new users to access capacity in that pipeline at whatever reference tariff is arrived at in the final access arrangement.

In regard to users that may wish to transport gas in excess of available capacity on the pipeline, the code certainly does provide for, if extensions or expansions to the pipeline are necessary, for new users to meet some of the capital costs of those extensions or expansions. So, yes, **you are correct that new users may indeed pay a price greater than the reference tariff simply by meeting some of the capital cost for extensions or expansions**.

However, if new users are paying more for capacity, that also lifts the value of capacity that is held under existing contracts and which new users may also purchase through trading of capacity between users. So in effect the existing users who now own capacity of greater value face exactly the same opportunity cost for use of that capacity as new users. So in effect the economic cost of capacity in that pipeline is actually the same for all users regardless of the nominal tariff that they may be paying.

CMS Note: This last statement does not address the fact that pipeline capacity is contracted for fixed durations (in the cases at hand, typically to 2005) which locks in (lower) tariffs for those periods, while new entrants must pay the "going rate". It also ignores the fact that pipeline Shippers are themselves committed to various degrees (depending on the availability of alternative sources of energy) to utilising their capacity, and are thus unable to realise any change in "value".

THE CHAIRMAN: John, does that address - thank you. At the back and then - just one moment, Max. Peter, did you have something to say?

MR KOLF: Yes, I think I could probably add to what Ray indicated there. In the event that a new user is faced with a requirement to pay a higher tariff or is asked to pay a higher tariff, this is nonetheless subject to the provisions of

the legislation, and there are circumstances there in which the arbitrator may be called upon to ensure that any tariff that is higher than what would be available under the pipeline generally would return the required rate of return that is provided for within the legislation. So that is just one additional item that I thought would be useful to mention.

DBNGP Public Forum transcript page 23 on (emphasis added):

MR PETRIG: Rudi Petrig, CMS Energy. Ken, I have got a question in relation to the extent that OffGAR has considered the broader gas industry and in particular Perth Basin producers, the new gas traders wanting to enter into the market and also end-user customers. There's some particular categories there such as very large customers, very large users, business customers and also mums and dads. If I can give a couple of examples of what has happened in recent times and whether that might be an indicator of what might happen in the future.

In terms of the DBNGP tariff, it used to be $1.25. It's now sitting at a dollar. At the same time the mums and dads out there are now paying 50 per cent [*should read, "50 cents"]* more. So we have had a reduction of 25 cents, and yet mums and dads are paying 50 per cent [*should read, "50 cents*"] more - 50 cents, sorry, more. Also if you look at - and I have had occasion to look at what happens to small businesses - not very small businesses, but typical businesses, and one in particular that comes to mind - I won't mention the name, but looking at the cost associated with getting gas to that customer which then affects the customer's price again **whilst the DBNGP tariff has come down 25 cents, that customer now is facing or whoever supplies that customer is facing a cost increase of over a dollar to what it used to be**. Can you comment on that?

THE CHAIRMAN: I will certainly pass that over. I am certainly not in a position to comment.

MR KOLF: I guess if I may respond to that, Ken.

THE CHAIRMAN: Yes, certainly, Peter.

MR KOLF: I think that the reality is that OffGAR or the regulator does not have an explicit responsibility in relation to retail pricing. These matters are matters for the minister at this point in time, and it really isn't terribly appropriate in that situation for us to comment on retail pricing. **This agency and this regulator is concerned with the pricing of access to covered pipelines, and I think that's about where it's at**.

CMS Note: This response indicates that OffGAR confines the consideration of the consequences of regulatory decisions to a narrow ambit. Such confinement has the strong potential to be contrary to the interests of direct stakeholders and the wider public interest. It is

certainly at odds with the intentions underlying Code coverage criteria (a) and (d).

THE CHAIRMAN: Well, of course with the single economic regulator coming, as of next year some time, of course that does provide that opportunity where they may get closer than they are at the moment. As I said before, the regulatory process we use is very clear as far as the process is concerned, and it relates - I think the reason for that is it relates specifically to access itself. So I really can't comment on retail.

DBNGP Public Forum transcript page 38 (emphasis added):

MR WILKINSON: Andy Wilkinson, CMS. I guess the question is the purchase price for the DBNGP was in the order of two and a half billion dollars. My understanding - and I'm happy to be corrected on this - is that about **30 per cent of that money came from Australian superannuation funds**. I'm just wondering to what extent in considering the public good that that sort of factor is taken into account in coming to your decision and coming out of the valuation that sees basically half of that investment written off.

THE CHAIRMAN: Do you want to comment, Ray?

DR CHALLEN: The source of whatever funds - - -

THE CHAIRMAN: Not the issue.

DR CHALLEN: - - - that Epic may have financed their purchase of the DBNGP from, is information that was not provided to the regulator and **was not - and nor necessarily should be - taken into account in the draft decision**.

NCC Draft Recommendation for Revocation of Parmelia Pipeline page 57 (emphasis added):

In 1998-99 Western Australian transmission charges represented approximately around 6.8 per cent of the final price of gas for residential users, and 13.1 per cent for commercial and smaller industrial users.(*see comment on footnote)

The composition of the final price of gas for large and small users in Western Australia is important in determining the effect that lower or higher transmission charges will have on the final price. Based on the above figures, **a ten per cent rise or fall in transmission tariffs will change final prices (all other charges remaining constant) for residential users by 0.68 per cent and for commercial users by 1.31 per cent**.

* NCC Draft Recommendation for Revocation of Parmelia Pipeline page 57 footnote:

> Assumes an average transmission tariff on Western Australian pipelines of $1/GJ (Australian Gas Association 2001, p77) and final delivered prices of $14.78/GJ for residential users, $7.64/GJ for commercial and industrial users (Australian Gas Association 2001, p77).

CMS Note: the figures used in this footnote are a mix of 1997 and 1998 numbers - current (2002) residential gas price is approximately $ 16 / GJ.

APPENDIX B

Competition regulation of infrastructure: getting the balance right *

Gary Banks

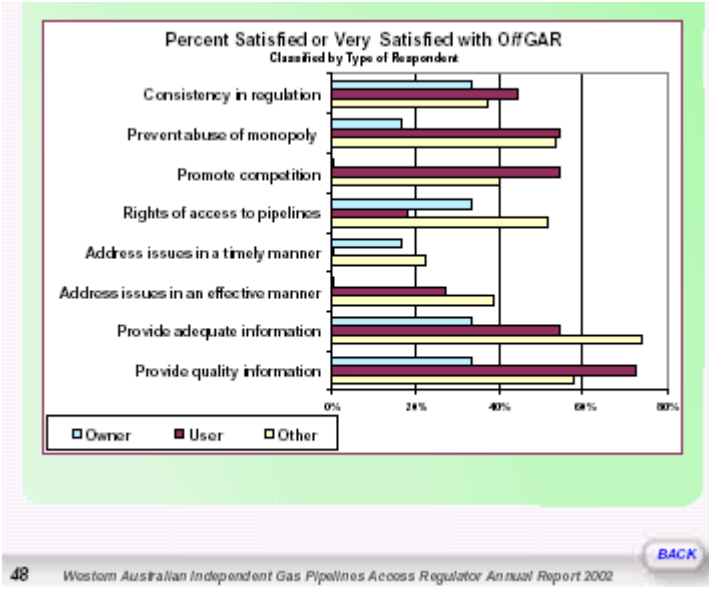
Chairman, Productivity Commission

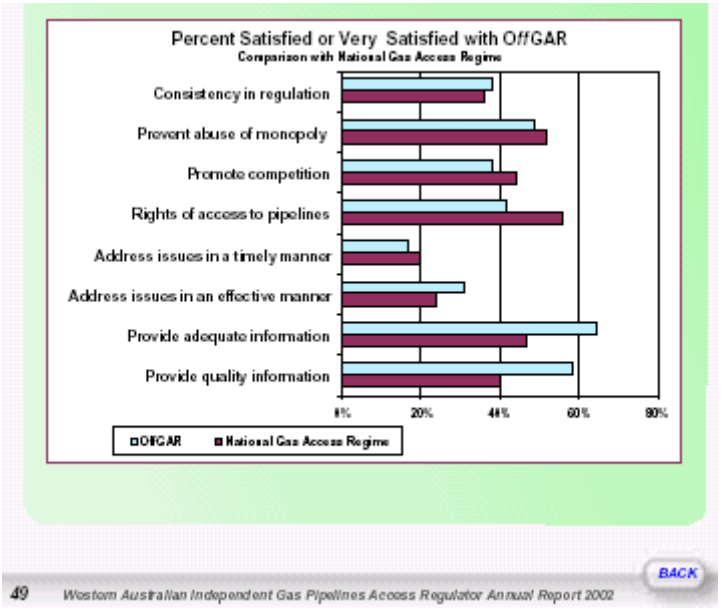
- *Attached to Original CMS Submission on ERA –*

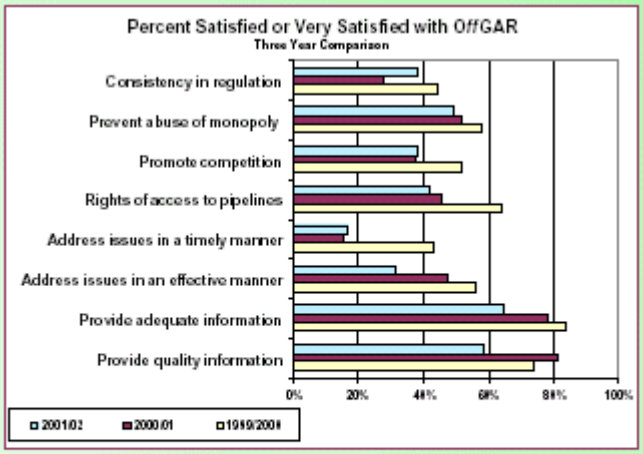
* Presentation to the IIR Conference, *National Competition Policy Seven Years On*, Eden on the Park, Melbourne, 14 March 2002. The presentation draws on the policy discussion in the Commission's annual report for 2000-01 which was tabled in Parliament in February 2002.

APPENDIX C
OffGAR Performance Graphs

Source: Western Australian Independent Gas Pipelines Access Regulator Annual Report 2002






Percent Satisfied or Very Satisfied with OffGAR
Three Year Comparison
Consistency in regulation
Prevent a buse of monopoly
Promote competition
Rights of access to pipelines
Address issues in a timely manner
Address issues in an effective manner
Provide adequate information
Provide quality information
0%
20%
40%
60%
80%
100%
2001/02
2000/01
1999/2000

BACK