# Chamber of Commerce and Industry of WA
# Submission to the Productivity Commission on its Review of the National Gas Access Regime
**September 2003**

## Introduction

The Chamber of Commerce and Industry of WA (CCIWA) is pleased to provide the following submission to the Productivity Commission (PC) on its inquiry into the National Gas Access Regime.

CCIWA is a strong supporter of free enterprise and competitive markets. We regard regulation, including gas access regulation, as a default necessary only in circumstances where the market has failed to deliver the desired efficient outcomes.

Natural monopolies can and will arise in competitive markets and it is the existence of natural monopoly "bottleneck" infrastructure that creates the case for access provisions. This is necessarily an infringement of the owners' property right to sell the service at a price that he or she likes. The challenge for governments is therefore to limit access to those circumstances where the benefits outweigh the costs and ensure that where access is granted it is done so on terms and conditions that are not unduly onerous.

CCI has been an enthusiastic supporter of the application of the generic Part IIIA access framework and the various industry specific regimes, including the gas regime. For example, we have pressed strongly for the introduction of a fair and equitable access regime overseen by an independent regulator to cover access to Western Power's transmission and distribution network.

Ideally, the application of the National Gas Access Regime should produce outcomes that mirror the operation of an effective competitive market. The desired outcome should not be to ratchet down access prices. Rather, the aim should be to set prices at a level that is efficient and maximises welfare for the community as a whole.

In this regard we are mindful of the Productivity Commission's 2001 Review of the National Access Regime". Here it stated:

*"…the national access regime does not do enough to guard against the possibility that investment in essential infrastructure will be deterred. So-called 'regulatory risk' under the regime is greater than it need be. There is a danger that the regime could be applied to projects that should not be regulated at all".*

WA is heavily dependent on gas pipeline infrastructure because of the large distances between WA's gas resources and the sources of demand. The importance of gas as an energy source to industry and the wider community necessitates that it is transported cheaply and reliably. Equally, however, sufficient returns must be provided to gas pipeline owners to ensure that pipeline infrastructure is maintained and that expansion and new development occurs efficiently.

Given the current review of the Code it would also be advisable if the State Government considered undertaking a review of the Gas Pipelines Access Act. CCIWA is not aware

that any review has commenced. As such the comments in this submission should be considered relevant for the purposes of any future review of the WA legislation.

**Recovery of Costs**

In Western Australia the Office of Gas Access Regulation is able to recover the reasonable costs of access regulation from the gas industry. The proposed Economic Regulation Authority (ERA), which will subsume, inter alia, the responsibilities of the gas access regulator, will therefore also continue to be able to recoup the reasonable costs of access regulation from the industry. In addition, the proposed legislation enacting the ERA has specific provisions for the recovery of costs from regulated parties.

It is noted that the Ministerial Council on Energy has agreed to implement institutional arrangements that are funded by industry. Accordingly, comments in relation to WA's regime should be considered relevant when considering whether this is an appropriate model to adopt.

CCIWA has a number of concerns with a regulatory model that permits the regulator to recover its costs from those parties that it regulates. These are detailed below:

1. Giving the regulator power to levy regulated industry to recoup costs creates an incentive structure that obviates the regulator's need to control costs.

   Where a regulator has discretion over the extent of regulation, the way that regulation is enforced and the fees associated with it, there can be no market, budgetary or similar constraints on the regulations and fees imposed. The imposition of regulatory fees on industry has the potential to be unduly onerous and to escalate over time. The incentives structure invites ever-growing regulation and the fees to support it.

   By way of comparison, funding of the regulator's functions from consolidated revenue ensures that the normal budgetary scrutiny prevails. There is a strong incentive by the funding government to ensure that the regulator constrains costs and performs efficiently.

2. Increasingly, within jurisdictions and across jurisdictions there is a move to consolidate access regulation. The new National Energy Regulator is proposed to regulate gas and electricity access across a number of the Eastern States, while in WA the proposed ERA is proposed to be a generic industry regulator responsible for gas, electricity, water and rail.

   Where consolidation of this type occurs, especially in the case of across industry regulation, the presupposed benefits that accrue are spread across the community to a greater extent than under a specific industry regime. In such circumstances, it is appropriate that the body is funded from consolidated State Government revenue to reflect these dispersive benefits.

   In any event, CCIWA is not convinced that the application of cost recovery in the provision of regulatory services has been driven by governments on the basis of the "users pays" principle. It is much more pragmatic. It is a mechanism to increase revenue from captured industries. CCIWA notes with some concern that

it is becoming the norm in the provision of many regulatory services especially in the environmental area.

3) On general equitable principles it is unfair that a company is forced to bear the operational costs of an agency whose core requirements add to their costs and restrict their commercial freedoms. It effectively penalises them twice.

Depending upon the market conditions a regulated party may not be in a position to pass on the costs of regulation to consumers. To the extent that the regulated party cannot pass on costs it may be appropriate to have explicit provision to recover the actual cost of regulation in access charges. However, care would need to be taken in allowing the regulated party unfettered ability to recover its regulatory costs through access charges, because as with the case of the regulator, there will be little incentive for that party to minimise the costs of regulation.

CCIWA is aware that there have been suggestions that a similar cost-recovery funding formula to that which applies in WA could be applied elsewhere. We would strongly recommend against such a move.

**National Energy Regulator Subsuming Functions of Regulating WA Gas Access**

CCIWA does not on balance support providing the proposed National Energy Regulator with the authority to regulate access to the gas pipeline network in Western Australia.

We acknowledge that there may be advantages from incorporating WA gas regulation within the National Energy Regulator.

First, it would further reduce the possibility of capture and political interference. In recent times in WA, much to the concern of CCIWA, there have been suggestions that the Government should intervene and direct the Gas Access Regulator.

Secondly, it would allow for consistency and transferability of practices between jurisdictions, with businesses having reasonable confidence that activities which are permissible in one state are permissible in all states. This could potentially reduce compliance costs.

Despite these benefits, however, CCIWA's preference is for a generic, state-based regulator.

Although CCIWA is generally highly supportive of the principles and objectives of National Competition Policy, it has long held the reservation that the emphasis on consistency and uniformity of National Competition Policy (and particularly the Hilmer Report) has the potential to inhibit competition[1].

For example, under the old centralised wage system, businesses had little incentive and few opportunities to achieve competitive advantages through innovative human resource management strategies. Businesses are more willing to tolerate onerous or costly regulation if their competitors carry an identical burden. More generally, the concept of *competitive federalism* suggests that inter-state rivalry in regulatory, taxation and

[1] see "Economic Reform and the Hilmer Report: A Discussion Paper". Chamber of Commerce and Industry of WA, May 1994.

spending regimes is a source of efficiency, innovation and improvement in the same way that rivalry between businesses creates these effects.

The principle of *subsidiarity* suggests that the costs and benefits of government action and regulation should, as near as possible, fall within the same community. Nationwide regulation is appropriate either where activities in one sub-national (State or local) jurisdiction have clear and significant costs or benefits in another jurisdiction, or where there is unanimous agreement that uniform regulation is necessary.

This is not merely a concern of abstract political theory; it has considerable relevance for the operation of government policy in practice. It is much easier to gain political capital by 'robbing Peter to pay Paul' when Peter and Paul are not neighbours. While aloofness from the rough and tumble of local politics might make for a better, more dispassionate regulator it can make for worse, less outcome-focussed political decision-making. And in the final analysis it is politicians, not regulators, who decide on the most controversial regulatory decisions.

CCIWA notes that the main driver for the establishment of the National Energy Regulator is the desire to consolidate the functions currently performed by a plethora of regulatory bodies (both state and federal) that regulate aspects of the National Electricity Market. But this is a national market in name only - distance and costs unfortunately preclude WA from participation, and will probably continue to do so for the foreseeable future. The benefits of consolidation would not accrue to WA to the same extent, while the understandable eastern states focus of the new regulatory regime may lead it to impose measures that are not suitable on the separate WA market.

CCIWA also believes that there is a real risk that the removal of the gas access regulatory function from the auspices of the ERA in Western Australia could derail the establishment of the ERA and could reduce its effectiveness and affordability. One of the key advantages of the ERA is that being a consolidated body it will pool the regulatory expertise and be more administratively efficient than several industry specific regulators. These benefits would largely be lost if gas and electricity were removed from its remit.

**Coverage**

Most gas pipelines in WA were automatically covered from the outset under the National Gas Code.

The PC found in relation to the National Access Regime that there is a danger that the regime could be applied to projects that should not be regulated at all.

CCIWA believes that this is a relevant consideration in relation to some of the pipelines that have been covered in WA. The Tubridgi Pipeline is a case in point. CCIWA understands that the costs of regulating this short low-volume pipeline are considerable with respect to the revenue generated.

It thus appears that in some cases in determining coverage an appropriate cost benefit analysis was not conducted. As a result the onus is now on the owners of these pipelines to demonstrate that the pipeline should not be covered. In retrospect we think the onus would have been more appropriately reversed when it is considered that the regulation of a pipeline incurs costs on the owner (in WA's case these are often significant because the regulator's costs are also borne by the owner) and impedes property rights.

Consistent with our view that gas access regulation is the default option that should be applied in cases of natural monopolies and other market failures, we do not believe that such stringent regulation is required in cases where there is demonstrable pipeline on pipeline competition or in cases where a pipeline operator and foundation customers have agreed to construct a pipeline on commercially agreed terms. In the latter case, access regulation should only apply to spare capacity.

CCIWA is aware of suggestions that a "national significance test", similar to that existing in the certification process, should be applied to the criteria that is used to determine coverage in the revocation process. CCIWA would support the PC investigating the merits of such a proposal.

However, if it is adopted it will be necessary to ensure that some mechanism exists that will allow an uncovered pipeline to be covered again in the future. It is always possible that an insignificant pipeline could become of national significance in the future. That said, however, if it is determined that a pipeline is not covered that must apply for a fixed period, unless there has been a demonstrable failure by the asset owner to grant access on commercially reasonable terms.

**Sources of Delay**

There have been significant delays in applying the Gas Access Regime in WA. In the five years since its introduction, access arrangements still have not been put in place for the two main pipelines in this State – the Dampier to Bunbury Natural Gas Pipeline (DBNGP) and the Goldfields Gas Transmission (GGT) pipeline. Having said that though, there are in both instances, regulatory frameworks governing access that currently exists.

Most would agree that the delay in finalising the access arrangements under the Code for these pipelines, and thus resolving the impact which the Code has had, has created uncertainty interfering with and possibly even impeding investment in downstream gas-consuming industries in WA. For example, CCIWA is aware of the affect this uncertainty on some of the tenderers for the supply of power to meet the Government's power procurement process.

However, the delay must be considered in the context of the circumstances that have prevailed in WA. These include the recent privatisation of the DBNGP, the relatively recent construction of the GGT pipeline under a state agreement, and uncertainty as to the correct approach when applying aspects of the Gas Code as evidenced in the WA Supreme Court's decision on the DBNGP.

The Gas Code is still in its infancy and thus it is not surprising that there have been uncertainties and delays associated with its implementation. It is has often been the norm in Australia that when major changes are enacted to affect the way assets are legislated or regulated, especially assets of considerable value, uncertainties and delays have developed that have necessitated ongoing amendments to the initial regime.

We note in this regard that some of the delays and to some extent uncertainties have arisen because of court action and the outcomes of that action. However, our affected members point out that such challenges were commenced in order to protect the property rights of owners and the decisions have favoured their claims.

That said however, CCIWA believes that there is a need to impose stricter timelines and deadlines on the delivery of regulated decisions. If information deficiencies are the cause of these delays, as regulators claim, then better arrangements are needed under the Code. Time limits for both service providers and regulators need to be enforceable. It is CCIWA's experience across the spectrum of government regulation that too open-ended a regime with respect to timelines and deadlines is abused.

CCIWA believes that for practical purposes regulators do need to have the power to grant extensions. However, that power should not be open ended. Aspects of the regulatory process should have ascribed to them expected timelines with the limited potential to grant extensions.

In addition, as far as the operation of the regulator is concerned, a funding model based on cost recovery is not inherently conducive to efficiency and speedy service delivery.

The difficulty is to put in place a system that provides for stricter timelines and deadlines that still provides for natural justice. There must remain avenues for the regulated parties to appeal to the courts.

**Lessons from WA**

***Background***
In December 1999 Epic Energy submitted an access arrangement for the DBNGP to the Regulator for approval under the National Third Party Access Code for Natural Gas Pipeline Systems (the Code). This proposed tariffs of $1.00/GJ and $1.08/GJ (north and south of Kwinana).

In June 2001 the Regulator issued a draft decision not to approve the draft access arrangement. It calculated an alternative tariff, based on an inflation-adjusted Depreciated Optimised Replacement Cost estimated value of the asset of $1,234 million. After various adjustments it proposed an average reference tariff of $0.75/GJ and $0.85/GJ (north and south of Kwinana) from 1 January 2000.

Epic Energy applied to the Supreme Court to set aside the Draft Decision. In August 2002, the Court requested the Regulator to reconsider its decision.

In May 2003 the Regulator's final decision was announced. It found that the price paid by Epic Energy did not reflect a reasonable commercial judgement, and rejected the purchase price as an appropriate benchmark for setting the asset value to determine regulated tariffs. Rather the Reference Tariff was revised to reflect the following two parameters:

- an initial capital base of $1,550 million as at 31 December 1999;
- a present value of total revenue (with a discount rate equal to real pre-tax rate of return of 7.4%) of $768.53 million in dollar values as at 31 December 1999.

On this basis the Regulator calculated an average tariff of $0.95/GJ, from January 2000 and $1.01/GJ, from January 2003 for locations downstream from Compressor Station 9 and including Perth, Kwinana and Bunbury.

This is not the same tariff structure that was proposed by Epic Energy in its Access Arrangement. Furthermore, CCI has been informed that the Regulator defined a reference service that was different from the existing service.

***Implications***

CCIWA has no comment to make on what an appropriate tariff or asset value should be for this pipeline. However, we have serious concerns about the method by which it was determined, and in particular the implications of the Supreme Court's ruling and the Regulator's response for the methodology for determining appropriate tariffs.

CCIWA's view is that the fundamental role of regulation is not to determine a reasonable and acceptable balance between the competing interests of contracting parties. Rather, regulation's objective is to serve the interests of the entire community by diminishing the harm caused by market failure and promoting efficient markets, even if this appears to damage the interests of the users or the infrastructure owner.

There are a number of major problems with an approach that is premised on balancing the competing interests of contracting parties. These are:

- Most fundamentally, it is looking after the wrong interests. The aim of regulation should be to promote the welfare of the whole community, not regulated businesses and their clients. Of course, it is not in the interests of the community that providing essential infrastructure services is unprofitable, as providers would eventually vacate the industry. Nor should prices to be too low to discourage appropriate innovation and investment, with the relatively high risk attendant on these activities compared to operating and existing pipeline. But prices should be the lowest possible commensurate with the long-term financial viability of the regulated asset which includes allowance for maintenance and expansion.
- It provides perverse incentives, as regulated firms are reassured that the regulator will adjust the pricing regime to accommodate mismanagement, inefficiency or simple commercial bad calls.
- It provides the regulator with a wide degree of discretion in applying regulations. The weight given to competing objectives and interests must necessarily be determined by subjective judgement rather than objective calculation.
- As a result of this discretion, the system is highly opaque – businesses cannot easily predict what prices will be prior to the determination of the regulated terms and conditions which as we have evidenced can take some time. Once in place there is further uncertainty as to the rationale the regulator has used to reach the final outcome.
- A related point is that the process of setting prices is complex and ambiguous and consequently hard to defend.
- This in turn will encourage costly and time-consuming recourse to the courts.
- Finally, it can lock in bad decisions that over time could be extremely costly for the community.

***CCIWA's View***

Third party access to essential infrastructure facilities (eg. gas pipelines) is one example where economic regulation is necessary to ensure that the abuse of monopoly power is curtailed and efficient access prices are charged. The precise form of regulation should be the minimum necessary to achieve these ends, but at the same time not significantly distorting for other commercial decisions in the market.

This is best achieved by an independent regulator which has no direct or indirect interest in the outcomes of the regulatory process and has the responsibility for making regulatory decisions based on factual information.

It is important that the independent regulator must operate transparently and within a tightly defined framework, so that service providers and their clients know the rules of the game and clearly understand the basis of any decisions made.

The Epic Energy case has demonstrated that the Code is in need of reform. The Regulator has exercised more discretion in a non-transparent manner than is appropriate in framing the final decision, a position to which it was perhaps pushed by the Supreme Court's decision. While highly descriptive in detailing the factors taken into consideration when framing this decision, it does not outline defensible methodologies and assumptions underpinning the calculation of the initial capital base and final tariff.

There is also a concern that regulators are prone to being selective in how they use their discretion. The unpredictable nature to which the use of that discretion is put can mean that the Code adds uncertainty.

A more transparent exposition of the methodologies and economic rationale for the use of certain calculations and assumptions underpinning the estimates of the initial capital base is important in order to ensure that adequate consideration is given to certain issues (eg. the legitimate business interests of Epic Energy). It would also provide service providers with an opportunity to review the methodology and calculations in responding to the Regulator's decisions.

**Incentive Mechanisms**

CCIWA is aware that Section 8.4 of the Gas Code was changed in 2001 to increase the scope for the application of incentive mechanisms.

From CCIWA's reading of the amended section it is apparent that there has been considerable flexibility given to the design of an incentive mechanism. There is no mandated mechanism. The application, for example, of multi-period incentive mechanisms appears to be authorised under this section.

CCIWA believes that multi-period incentive mechanisms have the potential to encourage pipeline expansion, improve efficiency and still ensure that only prudent amounts are spent by the operator on capital and operations.

The controversial aspects of any incentive regime are determining the size of the efficiencies and the proportion that is distributed to the users. The two are of course linked and to some extent trade off. We would caution against the instigation of arrangements which allow too excessive share of benefit to the users as it will mean at some stage their absolute amount of efficiency benefits will be lower as the incentive for the service provider to be efficient is so diminished. The challenge from a public policy perspective is to find that level of efficiency share that maximises efficiency and the share of those benefits to users.

**Light-Handed, Flexible Regulation**

In principle, CCIWA supports light-handed regulation, where the parties themselves are encouraged by the regulatory regime into negotiated outcomes.

In practice, however, we note the difficulty in attaining this from other regulatory experiences. The most notable in this regard is the WA electricity experience, where light-handed access regulation undertaken by the WA Office of Energy and Western Power has been ineffectual. Likewise, we note the New Zealand experience where the Government moved to stiffen a self- proclaimed light-handed approach to the regulation of electricity access.

We recognise that the Western Power example, particularly, might be to some degree an inappropriate analogy with respect to the WA gas industry. Western Power is vertically integrated and is overwhelmingly the dominant player in those parts of its business that are open to competition. Nevertheless, it does serve to highlight the dangers of too light-handed regulation in certain circumstances. There is also a reactionary risk that too light-handed regulation will be replaced by overly onerous and prescriptive regulation.

We would encourage the Commission to investigate light-handed regulation. We believe that this is particularly relevant in those cases where there is pipeline-on-pipeline competition and in cases where a new pipeline is constructed on commercial arrangements with foundation customers. In these cases there may be no need for regulation at all.

One potential mechanism that has been suggested is a tariff ceiling and floor regime. Under such a regime the regulator would set a tariff that would correspond approximately with marginal cost of providing the service and ceiling tariff that would correspond approximately to the average cost. The parties would then be at liberty to negotiate their own tariff within this range. CCIWA understands that this would be similar to the approach adopted under the WA rail access regime.

Some of our members in industries that use gas or rail or both have expressed apprehension with such an approach. Notwithstanding that many of them are large companies, they believe that they will have little negotiating power vis a vis the service provider because of their dependence on gas, and the service provider's knowledge of this dependence. There is often little scope for an industrial gas customer to switch away from gas as a source of energy because they have large sunk costs invested in gas infrastructure and production process have been set up to work only on gas.

**Objectives**

In the PC's Issues Paper, the question is asked whether there are any improvements required in order to ensure uniform third party access arrangements are implemented and applied on a consistent, national basis.

While there is a need for general consistency across jurisdictions, CCIWA would be wary of supporting a convergence of access arrangements. While such a move could lead to greater clarity and potential transparency, we do not believe that it could produce better outcomes and in fact would probably impose an inflexible model that could be inappropriate in many ways. It is reasonable that the terms and conditions of third party access might vary from pipeline to pipeline – eg between distribution and transmission pipelines.

**Implementation of Intent of Productivity Commissions Recommendations**

CCIWA recommends that the PC should propose some form of mechanism that allows it to ensure the effect of the recommendations as implemented conform with the intent of the recommendations that were proposed and accepted by Federal Government.

**Conclusion**

CCIWA submits that an independently regulated gas access regime is the most appropriate method to address market failure in the gas transmission and distribution market. The current regime should not be abolished, but amended to enhance its operation, and thus address deficiencies that have become apparent since it was first enacted.