NORTHERN TERRITORY TREASURY* SUBMISSION TO THE REVIEW OF THE NATIONAL GAS ACCESS REGIME

Introduction

The Northern Territory Government is a strong proponent of energy reform and the establishment of a comprehensive National Energy Policy. Australia's primary energy consumption is expected to grow by 30% over the next two decades. Gas will play an increasingly important role in the fuel mix, particularly if taxation of greenhouse emissions is implemented. Given the predominance of domestic energy demand in the south-east of Australia and gas reserves in the north of Australia, the importance of gas pipeline access regulation in promoting future pipeline development is paramount.

The Northern Territory is located in close proximity to substantial natural gas resources in the Timor Sea. The future exploitation of these energy resources is likely to provide significant impetus to the economic development of the Territory over the medium to longer term.

Timor Sea gas resources, which are largely undeveloped, are up to 500 kilometres off-shore from Darwin and over 3 000 kilometres away from Australia's major supply centres. As such, the productive development of these resources, in a manner, which fully realises the associated downstream benefits, will be heavily reliant on future investment in gas transmission and distribution infrastructure. Isolation related factors, combined with the Territory's small population and the comparatively early stage of its economic development, result in a relatively unique framework for the development of natural gas resources. Therefore, whilst the Territory's submission canvasses several issues, the primary focus is the impact of the National Gas Access Regime on new investment.

Access Regulation and New Investment

The undeveloped nature of gas resources in the Timor Sea suggests that the application of the Code in the Territory will principally involve new transmission and distribution infrastructure.

Investment in gas infrastructure involves considerable, up front, capital outlays and long asset lives, often with relatively low operating costs. The projects may take some time to breakeven, and the full extent of returns are generally not realised until perhaps many years after the initial investment has occurred. In a relatively undeveloped market, it is likely that risks will be accentuated through there being few sources of gas (without which, gas pipelines characteristically have very low salvage values as there are few alternative uses) and few alternative customers. In the Territory, these commercial risks are also exacerbated by the small local economy and distances between gas reserves and major population centres. Accordingly, new investment in gas infrastructure in the Territory has been, and is likely to be, heavily dependent upon procurement of foundation customers.

Submission drafted in consultation with Office of Territory Development and Northern Territory Department of Business, Industry and Resource Development officials.

It is important to recognise that the Territory's current energy market is so small as to render it difficult, even if all potential foundation customers agree to accept the long term contracts with associated risk acceptance (e.g. through such contract terms as take or pay) to justify the very large capital costs of developing offshore gas fields and piping the gas to those customers.

The current provisions of the Code provide scope for regulators to pursue short term allocative efficiency gains at the expense of dynamic efficiency and the longer term financial interests of pipeline owners, with consequent implications for new investment.

A Territory specific example involves the NT Gas case, where the regulator's initial determination would have resulted in the application of a reference tariff significantly lower than that being paid by the foundation customer, and possibly below unavoidable costs facing NT Gas. This determination cast into doubt the financial viability of the service provider. While the final determination was more favourable to NT Gas, this outcome was achieved at considerable time and expense for all parties involved.

This, and other cases such as the Supreme Court of Western Australia's decision on proposed access arrangements for the Dampier to Bunbury pipeline, suggest that the current Code can be enforced in a manner which could generate a significant degree of regulatory uncertainty for future investors in the Territory. This uncertainty presents a significant disincentive to new pipeline investment as well as distorting pipeline investment decisions. Potential consequences include under-investment in pipeline infrastructure, through the construction of pipelines with only sufficient capacity to meet the needs of foundation customers. An access regime, if successfully applied, should provide pipeliners with incentive to size pipelines with spare free flow capacity at first operation, where there is reasonable prospect for market expansion in the short term. This outcome would be more consistent with an access regime's central objective of promoting economic efficiency through increased competition.

The adoption of pipeline access holidays would provide greater incentives for new investment, particularly in cases where commercial and regulatory risks are significant. However access holidays should only be adopted in cases of demonstrable public benefit. Also, access holidays should be able to be revoked on the basis of material change in circumstances.

The proposed pre-investment determination of access arrangements for greenfield projects, which have been proposed in other forums, also have merit in terms of addressing regulatory uncertainty and therefore warrant further consideration by the Commission.

The concerns with the impact of the Code on new investment could be mitigated by the insertion into the Code of a separate section dealing exclusively with greenfield projects. This section could: clearly enunciate the regulatory objectives for new pipeline infrastructure; focus on the longer term interests of pipeline operators and consumers; recognise the commercial and regulatory risks involved in new investment (particularly in small, isolated markets); and include the above mentioned mechanisms for pre-investment determination of access arrangements.

Finally, we note the recommendation of the recent National Access Regime review regarding declaration exemptions for network infrastructure constructed with government financial contributions and subject to a competitive tendering process. This is of particular relevance for the Territory, where the provision of essential infrastructure, with marginal direct financial benefits but significant economic benefits, is often contingent upon government support. Although, given the potential for adverse economic outcomes, such exemptions should also only apply where in the public interest.

National Access Regime Objectives

While the Code prescribes the principles and stakeholder interests to be considered by regulators in making access determinations, the Code provides no direction with regards to the weighting to be afforded to, the sometimes conflicting, interests of investors and consumers. This is a necessary aspect of access regimes as some degree of regulatory discretion is necessary for determining access conditions for individual pipelines in the public interest.

However, we contend that the uncertainty generated by regulatory flexibility has the potential to create disincentives for new pipeline investment. Making explicit provision in the Code for pre-investment determination of access arrangements will mitigate uncertainty to some degree. However, these concerns could be reduced further through the inclusion of an overarching objects clause in gas pipeline access legislation in order to provide a degree of guidance for potential investors in formulating investment decisions and for regulators in weighing up the public benefit.

There would also appear to be scope to amend Section 2 of the Code to unambiguously require regulators to justify weightings used in balancing commercial and consumer interests when making determinations on access arrangements (particularly for projects involving the transport of gas to a market not already supplied).

Institutional Arrangements and Processes

The current institutional arrangements, established under the regime, appear to involve a significant degree of overlap between regulator and policy maker responsibilities. Accordingly, we urge the Commission to examine the institutional arrangements under the regime in order to ensure an appropriate delineation between policy setting and regulatory functions under the national framework.

The processes for initiating and implementing Code changes also appears administratively burdensome, particularly against the context of evolving market conditions and technological change.

We consider that these aspects of the framework require further examination by the Commission. Reference to the institutional framework currently applying under the National Electricity Code, and that proposed for the national energy regulator, may provide some guidance for the Commission in this area.

Pricing Principles

As noted, the Section 8 pricing principles provide a significant degree of discretion to regulators in setting reference tariffs. The associated uncertainty can be exacerbated by the interpretation and application of the principles by various State-based regulators.

There would appear to be significant scope to both simplify and clarify the Code's pricing principles making it explicit that tariffs would be set to recover the long run efficient costs of operating the infrastructure and to provide a return on investment commensurate with commercial and regulatory risks involved.

The establishment of a single energy regulator would more than likely reduce the current levels of uncertainty associated with the application of pricing principles under the Code. However, given the differences in the structure and performance of electricity and gas markets, it would be important to ensure that separate access codes for electricity and gas network infrastructure are retained.

Market Based Tariffs

It would appear that regulatory and compliance costs could be significantly reduced in cases where there is more than one transmission line and/or energy source supplying a single demand centre.

In such circumstances, it seems prudent from an economic efficiency perspective to provide for the use of market based tariffs as opposed to prescriptive regulation. This would need to be accompanied by price disclosure provisions to be effective. Also, the use of market based tariffs would need to be contingent upon the implementation of an appropriate ring fencing regime for vertically integrated operators.

Alternative Regulatory Approaches and Efficiency Incentives

The cost based approach to regulating transmission and distribution tariffs involve significant compliance and administrative costs for pipeliners and regulators. These costs are ultimately borne by consumers and tax payers.

The adoption of more "light handed" regulatory approaches could reduce the associated costs with minimal impact on the objectives of the access regime. This could be achieved through the use of price cap regulation, whereby tariffs levied at the beginning of the access period are increased annually in line with CPI minus an efficiency or productivity benchmark.

Such an approach also encourages improved operating performance and dynamic efficiencies, as operators that outperform industry productivity benchmarks are rewarded, while those that don't are penalised.

Other proposals mentioned in the Commission's issues paper (information disclosure/prices monitoring) are also worthy of consideration. However, these

alternatives would seem more appropriate for relatively mature and dense gas markets where competitive forces provide a barrier against abuse of market power by pipeline operators.

Compliance Costs

Pipeline operators in the Territory have incurred significant costs in complying with the provisions of the Access Regime. In cases where the Regime has applied to relatively small distribution networks and transmission lines, these costs have been significantly higher than the benefits generated through providing access arrangements.

In 2001, the Palm Valley to Alice Springs transmission line and the Alice Springs urban distribution system were revoked from coverage under the Code. In making its application for revocation to the National Competition Council, Envestra noted that the costs of complying with the Code nationally were between $150 000 to $250 000 per pipeline. In the case of the Alice Springs pipelines, this amounted to between $230 and $390 per customer. These costs primarily involved data collection, tariff design financial analysis and engaging consultants to provide advice on legal, economic and technical matters. The Council accepted Envestra's assertion that the compliance costs, and associated regulatory costs, outweighed any potential benefits to consumers from having the Alice Springs transmission and distribution pipelines covered under the Code.

Significant costs were also incurred in the NT Gas Distribution Pty Ltd application for revocation of the City Gate to Berrimah pipeline. This pipeline transports gas from the Amadeus Basin to Darwin transmission line to an industrial estate on the outskirts of Darwin. Whilst the pipeline was never officially covered (requirements to submit an access arrangements under the Code were deferred on a number of occasions prior to being revoked), it is understood that NT Gas Distribution incurred around $40 000 in applying for revocation.

Another related matter to the costs of compliance is the issue of the same Code rules currently applying uniformly to both transmission pipelines and distribution networks. This presents a particular compliance difficulty for small distribution networks (and possibly all distribution networks irrespective of size). As such, consideration should be given amending the Code to provide for alternative, less prescriptive, regulatory approaches for distribution networks.