EMRF

ENERGY MARKETS REFORM FORUM: FURTHER SUBMISSION

TO THE PRODUCTIVITY COMMISSION'S REVIEW OF THE GAS ACCESS REGIME

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The Energy Markets Forum (EMRF) welcomes the opportunity to provide additional comments to the Review of the Gas Access Regime. The EMRF comprises major energy-using and energy infrastructure-using companies operating in most Australian States and its members are drawn from the following entities:- BHP Steel, BHP Billiton, OneSteel, Amcor, Visy Paper, Tomago, Hydro Aluminium Kurri Kurri, Orica, and Boral. This submission provides comments on the amendments considered necessary to improve the effectiveness of the Gas Access Regime.

1. Objects Clause

As previously indicated in the EMRF's initial submission[1], we consider that the Gas Code provides a balance between the competing interests of various parties, as it provides regulators with sufficient flexibility, defined parameters, but with an ability to exercise judgment. In that regard, we consider that the preamble to the Gas Code is appropriate – the critical issue from users' point of view is to prevent the abuse of monopoly power (price and non-price factors) which are so destructive of downstream investments, whilst balancing the interests of users and infrastructure owners.

The EMRF is aware of the Commonwealth Government's response to the Productivity Commission's Part IIIA Review in which it proposed that an objects clause for access regimes includes "economic efficiency" with reference to "competition" and "investments".[2]

In addition, the Australian Competition Tribunal has provided guidance to regulators by clarifying the Gas Code objectives as:-

> "…replicating the outcomes a competitive market…(which)…involve not only prices that reflect efficient costs, but a range of non-price attributes (such as conditions of delivery and innovation) tailored to what customers want".[3]

Against that background, the EMRF would recommend that the Gas Code have a new objects clause inserted, which combines clear economic efficiency objectives with the existing preamble, as set out below:-

> **"The objective of the Gas Code is to establish a framework for third party access to gas pipelines that promotes economically efficient costs and non-price factors by replicating the outcomes of a competitive market and that:-**
>
> **a. facilitates the development and operation of a national market for natural gas;**

[1] Energy Markets Reform Forum: Initial Submission to the Productivity Commission's Review of the Natual Gas Access Regime, 2 September, 2003.
[2] Costello, Peter, Government Response to Productivity Commission Report on the Review of the National Access Regime. 2002
[3] Australian Competition Tribunal. DEI Queensland Pipeline Pty Ltd v Australian Competition and Consumer Commission, A Comp T2, 10 May 2002.

b. **prevents abuse of monopoly power;**
c. **promotes a competitive market for natural gas in which customers may choose suppliers, including producers, retailers and traders;**
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."**

The EMRF also considers that relevant specific clauses which are already incorporated into the detail of the Code and provide clear and specific guidelines (some of which have been interpreted and clarified by the Australian Competition Tribunal and/or the Supreme Court of Western Australia in earlier appeals cases) should be referenced into the general objects clause. Specifically these are Sections 2.24 (factors that regulators must take into account in assessing a proposed Access Arrangement) and 8.1 (specific objectives to be achieved by a reference tariff and a reference tariff policy). We consider that these clauses will link the general objectives of economic efficiency with replicating competitive markets and promoting investments in upstream, mid-stream and downstream sectors.

2. Information Collection Powers

The EMRF's initial submission covers the problems faced by regulators and users in obtaining information from network service providers and detailed specific recommendations.

A problem which has been discussed (ad nauseum) by the National Gas Pipeline Advisory Committee concerns the ambiguity of both the Code and the Law in providing regulators with sufficient information collection powers to enable them to undertake their regulatory tasks. This ambiguity concerns:-

- the inability (or otherwise) to specify the information required to be kept by service providers until a regulatory review commences; and
- the inability (or otherwise) to obtain relevant information (and specify the type of information to be kept) in the face of changing (complex) corporate structures to enable regulators to ascertain that costs data are robust and at 'arms-length'.

Some jurisdictions (e.g. Victoria) have introduced specific clauses in their licensing provisions which provide them with the necessary information collection powers in a format which allows clear and concise analysis by the regulator. Other jurisdictions (e.g. New South Wales) do not have these powers, but the NSW regulator and gas users have preferred to have these powers clearly incorporated as part of the National Gas Access Regime in order that there is national consistency in the application to transmission and distribution pipelines (note that in NSW, the regulator is responsible for 2 trunk pipelines, in addition to the distribution system).

Proposals to clarify the 'ambiguity' of information collection powers in NGPAC have not made progress despite lengthy debate and discussion.

Information disclosures are critical to regulators and users and the 'ambiguity' inherent in the information collection powers detailed in the Code needs to be removed. The EMRF points to the problems engendered and directly observed as a result of experiencing regulatory gaming in NSW and elsewhere all add, and to the more significant problems likely to be encountered in the period ahead, where pipeline owners can use complex corporate restructuring, the creation of ‘trust’ vehicles, and complex corporate transactions arrangements to avoid having to provide the information necessary to properly carryout the regulatory functions..

Corporate restructuring and other arrangements with related and non-related entities can have significant implications for competition. This has been recognized by the National Competition Councils’ lengthy review of the coverage revocation application by the Moomba Sydney Pipeline Systems[4]. Unless regulators can obtain relevant information in a timely fashion, extended delays will be encountered in access reviews, and regulatory outcomes more likely to be inefficient and ineffective in the absence of the availability of data.

The EMRF recommends that the ambiguity in the information collection powers of regulators be removed and clear provisions inserted in the Code to ensure that:-

- **regulators may prescribe the type and format of information to be maintained between regulatory reviews;**
- **regulators have the right access to the relevant information between regulatory reviews; and**
- **regulators may have access to the relevant information, and are able to penetrate corporate structures and other corporate arrangements, in order to ascertain that costs are robust and at ‘arms-length’.**

3. Greenfields Pipeline Projects

It is important for the Productivity Commission to consider carefully the views of the pipelines industry with respect to its assertion that access regulation has deterred new investments. Invariably, the weaknesses of the current access regime are always cited as the reason for pipeline projects not going ahead, rather then the economic and commercial viability of the projects concerned. And whilst information is provided on the number of Greenfield projects that have been cancelled, deterred or delayed during the period of the gas access regime[5], little is provided in the public domain explaining that in most cases such projects have not proceeded due to commercial drivers. In this regard the very public saga of the PNG pipeline is a case in point demonstrating that commercial drivers are fundamental to such projects proceeding, rather than the ostensible reason so often given, of blaming the regulatory environment. As a counterpoint, and intriguingly so, the reasons given by the pipeliners as to why new pipelines have proceeded[6], supposedly, despite the regulatory environment, even though many of the pipelines were originally developed under the regime, but subsequently had coverage revoked for sensible reasons after an appropriate regulatory review.

Despite the so-called negative regulatory environment the number of Greenfield projects that have been approved or constructed easily exceeds those which have not proceeded due to commercial reasons. To provide a more balanced view of the investment situation, the EMRF

[4] Moomba to Sydney Pipeline System: Revocation Application Under The National Gas Code. Final Recommendations. November 2002.

[5] Australian Gas Association, Submission to the Review of the Gas Access Regime, September 2003, page 61.

[6] Ibid, page 63

provides the following information on new distribution pipeline investments in New South Wales in recent years:-

AGLGN

Year	Kms of network	Cost ($Mil.)	New areas reticulated
97/98	623	45.9	Blue Mountains; commencement of Central West Project
98/99	782	60.3	Blue Mountains; Central West and commencement of South West Slopes
99/00	685	63.8	Central West, South West Slopes, Temora
TOTAL	2,090	170	

Source: Various AGL Annual Reports

We also understand that AGLGN also had plans to construct a $96million Central Ranges project to Tamworth once based-load contracts are established. Press articles have also suggested that AGLGN plans to reticulate to the Upper Hunter (i.e. a $3million low pressure pipeline from Rutherford to the Upper Hunter. A second high pressure pipeline also appears to be under consideration for the Upper Hunter).

GSN

In December 1999, GSE contracted with AGLGN to construct at a cost of $5million a natural gas network in Cooma. Gas has started flowing to 600 customers in Cooma.

Integal Energy

In October 1999, Integral announced that it was spending $4million to reticulate natural gas in Nowra. Integral has approximately 2,000 natural gas customers.

Against that background, it is somewhat surprising that the following assertion has been made:-

> "Given the wide variety of circumstances underpinning a range of new investments since1997, it is an unsustainable and misleading observation that the operation of the gas access regime has promoted or encouraged new investment in network or pipeline infrastructure".[7]

What the pipeline industry fails to advise is that many of the projects it lists as being prevented by the regulatory environment have been assessed by the Victorian authorities as being not commercially viable – ie that the revenue stream from the newly connected consumers will not service the costs associated with the pipelines.

The EMRF and its member companies have participated in the debate in recent years on the issue of whether the Code can deal with Greenfield pipeline projects. Whilst maintaining that

[7] Australian Gas Association, op. cit, page 64.

the Code can accommodate Greenfields pipelines, the EMRF has, on the other hand, supported the ACCC's development of regulatory guidelines for Greenfields pipelines.

Thus, for example, the EMRF would support the following conclusions from a submission by Visy Paper to the ACCC on its draft Greenfields Pipelines Guidelines[8]:-

> "The draft guidelines are seen as a good start to clarifying the regulatory approach to greenfields pipelines under the Gas Code (or Part IIIA of the Trade Practices Act) to improve and understand how the ACCC would apply the Codes, and so meet the request by the pipeline industry for regulatory certainty. However, we are of the view that in providing this certainty, the ACCC has overlooked a number of features of pipeline development which can used by developers to greatly improve the expected returns arising from the construction of this monopoly asset.
>
> - It is clear that the National Gas Code is to apply to both new and existing pipelines. The Code has already been adequately applied to new pipelines and there has been significant investment in new pipelines since its introduction. There would appear to be no fundamental reason for there to be a change.
> - There is clearly no lack of investment in new pipelines where the demand has been identified. In fact there has been competition between competing pipelines development for essentially the same service.
> - Claim by pipeline investors that the Gas Code does not permit them to acquire adequate returns for providing surplus capacity over the needs of the foundation shippers is difficult to sustain. The ACCC must require the pipeline industry to provide its quantification of the costs to provide surplus capacity, and the contribution to the revenue from foundation shippers.
> - Analysis of the way
>   - surplus capacity can be added;
>   - the costs associated with its provision;
>   - the capital outlaid by the pipeline owners;
>   - the revenue contributed by foundation shippers; and
>   - the revenue that the National Gas Code would provide under tariffs set by the Code;
>
>   all indicate that there is more than adequate return for the risk for providing surplus capacity without providing access holidays or extended uncontrolled regulatory periods.
> - The Gas Code provides risk mitigation features to pipeline owners arising from inaccurate forecasting (K-factor) and basing tariffs on actual gas flows rather than on capacity, both of which minimize the downside risk faced by pipeline owners. Such features need to be assessed as part of any assessment of the apparent loss of "blue sky" upside returns.
> - There is no apparent reason for the Code to be changed (or for regulators to permit) the granting of access holidays, or to permit uncontrolled extended regulatory periods.

[8] Response to ACCC request for comments on Draft Greenfields Guideline for Natural Gas Transmission Pipelines. Visy Paper, February 2003.

- Access holidays are inappropriate for the Australian regulatory environment. Third party access must be made available under regulator oversight.
- If regulators do consider granting extended regulatory periods they must consider that such action may impinge on the mitigation provisions foundation customer(s) may (and are able to) have inserted in their contracts to minimize the risks they face. Thus, any review for changing the National Gas Code or the way the regulator may intend to act under it, must consider the rights foundation shipper(s) have within their contracts in order to manage their risks."

In addition, the EMRF agrees with the following sentiments on the real risk/reward equation:-

> "It has been generally (wrongly) assumed and accepted that surplus pipeline capacity is built at a high cost and the "blue-sky" surplus capacity is therefore provided at high risk. Pipeliners aver that if the future demand above the foundation shipper demand is weaker than forecast there is not the ability to increase tariffs to retain the expected cash flow enhancement. Conversely, if the future demand exceeds expectations, the pipeliners are concerned that regulations will cap cash flows, thus creating asymmetry of risk. This argument has weight if, and only if, the increased investment to create the surplus capacity is symmetrical with the overall cost of the pipeline.
>
> Assessment of the draft guideline implies that the ACCC assumes that the cost to surplus capacity equation has a high degree of symmetry. As the foundation shippers underwrite well over 80% of the cost of the facility, the cost to provide significant additional capacity can be included in the original design for very little additional exposure to the developer (as demonstrated earlier).
>
> The bulk of the pipeline's risk is borne by the foundation shipper(s) who effectively have to fund a return of most of the debt in a period much less than the depreciation period assumed for regulatory purposes.
>
> To further increase the transfer of risk away from the pipeline owner, the Australian Government has instituted a mechanism to benefit infrastructure development by the use of accelerated depreciation for taxation reasons, which serves to significantly increase the cash flow to the pipeline owner in the higher risk early years of the new pipeline.
>
> The revenue arising from the regulated tariff for the surplus capacity is significantly higher than the marginal costs involved with providing the surplus capacity. Thus, in reality the cost to surplus capacity equation is heavily biased in favour of the developer, as is the revenue arising from a regulated tariff which applies to this surplus capacity." (Page 13 & 14)
>
> Another key element in assessing the risks faced by pipeline developers for providing capacity above that underwritten by foundation customers, is the estimate of costs for providing any additional (surplus) capacity.

In its draft of the greenfields pipeline guidelines, the ACCC goes to significant lengths to establish the costs which might be attributable to surplus capacity, and how this might be treated within the regulatory environment. However, the analysis by the ACCC is, in part, flawed due its costing assumptions for constructing increased capacity.

When a new pipeline is being developed the basic model is to provide for the initial demand in an uncompressed state, with future augmentations relying on increasing compression on the pipeline. The basic example used in Appendix 1 indicates that the cost to increase capacity by 50% for an uncompressed pipeline is of the order of 20%.

However, this increase in costs is assessed as being too high, and does not replicate the costs of construction. To identify the real cost increase, it is necessary to examine what is different in the construction costs between two pipelines of marginally different sizes. As most of the cost of a pipeline is related to the pipe and the laying of it, a close look at the actual differences between the building of the smaller and the larger pipelines will provide a guide.

As an example, increasing the cost of a 350 mm pipeline to 450 mm pipeline, increases the uncompressed capacity by 65%. The differences between supplying and laying the two pipeline sizes are:-

1. <u>Amount of steel increase is 30%, with a cost increase of about 20%</u>.
2. <u>Pipeline coating increases by 30%, with a cost increase of about 15%</u>.
3. Survey costs and easement acquisition costs are identical.
4. Site preparation costs are identical.
5. Trenching needs to be only 100 mm wider in a trench width of at least 1 m. Costs are much the same as slightly wider excavation equipment is used.
6. Pipe delivery costs will be identical as in this case trucking capacity is determined by volume, rather than weight.
7. Pipeline handling and laying costs (equipment and time) are identical.
8. Set up and aligning time is identical.
9. <u>Welding time increases by 30%</u>.
10. Time used and cost for protective wrapping are identical.
11. Pipeline padding (cost and time to lay) is identical.
12. Backfill time is identical.
13. Site reinstatement costs are identical.

As can be seen from the above illustration the increased construction costs to change to a pipeline with 65% increased capacity affect only a few of the elements of construction and therefore would only require an increase in cost of no more than 5% as distinct from the increase of 20% used in the Appendix 1 example. It should be noted that as the diameter of the pipeline increases, the percentage cost increase for providing additional capacity reduces below that shown for the example above.

Operating costs of both sizes of pipelines will be similar for the same volume of gas pumped, with perhaps less power needed for the larger pipeline due to lower friction losses." (Page10, 11 &12)

The purpose in referring to the above is to underline the EMRF's concerns that the pipeline owners (and to an extent regulators) have tended to over-play the risks involved in Greenfields pipeline projects, and in so doing, seek support for:-

- Access holidays;
- Price monitoring; and
- Ex-ante regulatory compacts.

In the final analysis, the real agenda of the pipeline developer is for high commercial returns. The EMRF strongly considers that the ultimate test for their validity (i.e. access holidays, etc) is whether pipeline companies have been able to demonstrate that they have been provided with inadequate financial returns in regulatory decisions. Unless that is demonstrated (i.e. what are the facts?) the EMRF would urge caution in any general acceptance of "access holidays", "price monitoring" and "ex-ante regulatory pacts" which, whilst superficially attractive, it must be recognized that the real and underlying agenda is to obtain and protect franchises and the licence to tax via monopoly rents.

The EMRF would agree to improvements in the current competitive tendering provisions. For example, the avoidance of undue delays and/or avoid duplication of processes (e.g. tendering and public subsidy) would be a distinct benefit to all concerned. However, there are strong concerns with any moves to revise:-

> **"the Code's unbalanced focus on the lowest sustainable tariff as a core criteria for bid assessment (Section 3.28 (f)(i))".[9]**

Again, this is another plea for government – sanctioned franchises and a licence to tax via monopoly rents. As most of the gas pipelines are owned by private corporations the benefit of such taxes and monopoly rents do not benefit the nation but provide for enhanced returns to local and off shore shareholders. We consider such an approach is contrary to the benefits that should accrue from the implementation of the Gas Access Regime to facilitate competition in upstream and downstream markets.

With regard to access holidays, the EMRF agrees with Dwyer and Lim who assessed that[10]:-

> **"The suggestion that infrastructure investment should be encouraged through access holidays is fundamentally flawed in several respects.**
>
> **First, an access holiday would allow an infrastructure owner free rein to extract monopoly rents through the period of the access holiday and would allow him an agreed real rate of return later on when the infrastructure came under the access regime. This would amount to a form of double dipping. If an access holiday is granted on the basis that the infrastructure will be able to recoup his investment within the period, then at the end of the period, the invested capital should be regarded as fully recouped and infrastructure priced at socially optimal short run marginal cost. We note that the patent**

[9] Australian Gas Association, op. cit, page 67.
[10] Productivity Commission Inquiry into the National Access Regime. Does Access Regulation Deter Investments? Dr T Dwyer and RKH Lim. July 2001. Page 12 and 13.

analogy has been urged. When a patent expires, no payment is thereafter made for the costs of developing the invention: if the patent analogy is to be followed properly, infrastructure users should only be charged marginal cost operating expenditures after an access holiday.

Second, an access holiday necessarily involves allowing monopoly rents and the creation of excess burdens, discouraging investment downstream and upstream as well as in potentially linking infrastructure facilities.

Third, an access holiday would necessarily be project dependent. No arbitrary time period would be correct in any given case except by accident – investment costs including hurdle rates of return would be either under recovered or over recovered. Instead of a time-defined access holiday, it would make more sense (in this very sub-optimal scenario) to allow an access holiday only for the period until all capital costs had been recouped with a hurdle rate of return, in a manner analogous to a resource rent tax computation.

Fourth, access holidays are like tax holidays - and distortionary in a like manner. In both cases, there is an inherent incentive to close down the factory or the pipeline at the end of the holiday and to build a new (untaxed or unregulated) one - a wasteful premature scrapping of capital investment".

4. Other Issues

Time constraints prevent us from extensive elaboration of a range of other issues considered important to the EMRF. Accordingly, we provide below brief comments on several issues, which we would be happy to further elaborate at the scheduled public hearings:-

- **National Gas Pipelines Advisory Committee (NGPAC):**
  The EMRF strongly supports the need for an effective NGPAC to recommend Code change proposals. The main recommendation is for stronger policy support from jurisdictions (than hitherto) to strengthen the work of NGPAC and for improved resourcing.

- **Users Appeals Rights:**
  Users have access to merits appeals on administrative grounds, but have no rights of appeals against regulatory decisions. Moreover, individual users have insufficient resources to engage in appeals (even if they are permitted as appellants) letalone appearing as an interested party in current appeal cases. The main recommendation is for users to be provided with appeal rights, and for partial assistance with resourcing appeals.

- **Ring-fencing Arrangements:**
  The EMRF considers that ring-fencing provisions should be strengthened in light of experience with breaches of Code provisions with respect to ring-fencing and associate contracts (e.g. charts of accounts). Whilst there are

some penalties for breaches of ring-fencing requirements, the costs for any individual, letalone any individual regulator to take court action can be prohibitive. **The EMRF recommends that stronger penalties need to be introduced; regulators need to be more vigilant in monitoring compliance and be required to pay restitution in the event of any failure to take reported actions; and strengthening the ability of regulators to collect relevant information, especially with respect to transactions involving related parties.**

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