

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

Dear Mr Hinton

Thank you for the opportunity to take part in the Productivity Commission's Review of the National Gas Access Regime (NGAR). The Tasmanian Government's initial submission is attached.

As you would be aware, the Tasmanian Government has played an active role facilitating the Tasmanian Natural Gas Project (TNGP). The TNGP has involved the construction, by Duke Energy International, of the Tasmanian Gas Pipeline, from Longford Victoria to Georgetown in northern Tasmania. More recently, the Government has signed the first Development Agreement with Powerco LTD as the preferred developer of the gas distribution network that will supply gas to commercial and domestic customers.

In developing the TNGP to its current stage the Tasmanian Government and industry proponents have encountered numerous difficulties with the NGAR. The Tasmanian Government strongly believes its recent experience is illustrative of the deficiencies in the NGAR, particularly in relation to regulatory arrangements for greenfield gas pipelines.

It is the Tasmanian Government's view that the appropriate purpose of the access regime should be narrowly confined to preventing the abuse of market power in mature or monopoly gas networks for the benefit of consumers. The access regime is not appropriate when attempting to attract significant greenfield gas investment located in mature energy markets.

In this context, the key issues that Tasmania has addressed in this submission are:

- a critical assessment of the need for economic regulation, and more specifically of pricing regulation;

- an explanation of the risks imposed by the NGAR upon greenfield gas developments, with specific reference to coverage application and franchising principles; and
- a discussion of the inadequate regulatory certainty provided to greenfield gas proponents, with specific reference to the Tasmanian Government's failed Code compliant tender process.

Collectively, these issues are contributing to a substantial regulatory burden on gas pipeline developers and/or operators. Generally the current provisions of the Code are too onerous and complex and are open to varied interpretation. This increases the cost of the regulatory regime to both industry, through compliance, and to government, through administration.

Ultimately, these costs are passed on to consumers, and as such, the current regulatory complexity and uncertainty is not in the public interest, and is in fact counter-intuitive to one of the primary arguments for regulatory intervention; that is reducing costs to consumers. To the extent that the regulatory regime has been an impediment to large numbers of Australians being supplied with gas, it has failed as an instrument of economic policy and must be reformed.

In addition to the difficulties caused by the current regulatory regime in the commercial development of the TNGP, the Tasmanian Government experienced difficulties of a political nature. In particular it has been difficult to explain to the public why the current regime was imposing such a significant regulatory burden in view of the substantial benefits generated by the project for the State's sustained economic development.

The Tasmanian Government has had an active and long-standing interest in the National Gas Access Regime and looks forward to the outcome of the Review.

Yours sincerely

Paul Lennon  
**Deputy Premier**  
**Minister for Economic Development, Energy and Resources**

**Submission to the Productivity Commission Review  
of the Gas Access Regime**

**August 2003**

**Tasmanian Government**

## INTRODUCTION

The Tasmanian Government's submission to this Review has been guided by the State's experience of the application of the National Gas Access Regime (NGAR) to the development of the Tasmanian Natural Gas Project (TNGP). The TNGP has involved the construction, by Duke Energy International, of the Tasmanian Gas Pipeline, capable of transporting up to 60 PJ of gas each year from Longford in Victoria to Tasmania. More recently, the Government has signed the first Development Agreement with Powerco Ltd as the preferred developer of the gas distribution network that will deliver gas to commercial and domestic customers. In aggregate, the project represents \$475 million in investment and is a cornerstone of the State's energy reform strategy.

Tasmania believes that the significant difficulties encountered in the development of the TNGP are illustrative of various deficiencies in the NGAR, particularly as it applies to greenfield gas projects. Specifically, the regulatory demands of the NGAR proved to be particularly ill-suited in the context of the small, regional and geographically isolated status of Tasmania's energy market and the truly greenfields nature of the TNGP. Consequently, both the Government and potential industry participants encountered unacceptable regulatory and commercial risks.

The arduous nature of this experience has led the Tasmanian Government to the conclusion that the NGAR should be reformed. These concerns extend beyond the specific application of the NGAR to the TNGP. Specifically, Tasmania believes that in the absence of significant reform, the current regulatory regime will reduce the likelihood of the expansion of natural gas networks to fulfil the Ministerial Council on Energy's policy objective of increasing the penetration of gas in the Australian energy market.

In this context, the key issues that Tasmania has addressed in this submission are:

- a critical assessment of the need for economic regulation, and more specifically of pricing regulation;
- an explanation of the risks imposed by the NGAR upon greenfield gas developments, with specific reference to coverage application and franchising principles; and
- a discussion of the inadequate degree of regulatory certainty provided to greenfield gas proponents, with specific reference to the Tasmanian Government's failed Code-compliant tender process.

These matters are addressed in greater detail below.

## **1. Justifying the need for economic regulation of greenfield gas markets**

The imposition of economic regulation such as access pricing can only be justified by the incidence, or likely incidence, of clear market failure. In the absence of such failure, regulation of the kind imposed by the coverage provisions contained in Section 1 of the National Third Party Access Code for Natural Gas Pipeline Systems (the Code) is unnecessary and counterproductive.

### ***Pricing Regulation***

The NGAR fails to acknowledge the impact of competition faced by greenfield gas projects from other sources of energy supply within the broader energy market. Competition within this market means that greenfield gas projects are not monopolies but are instead late entrants into a mature market in which they must compete directly with other sources of energy supply. In this environment, regulatory provisions based on the prevention of monopoly behaviour are unnecessary as gas access prices are set competitively within the wider energy market. Furthermore, the complex process of access pricing regulation injects additional expense, uncertainty and delay into gas projects, thus hindering the efficient and effective operation of the wider energy market.

More specifically, the Code does not recognise the downward pricing pressure created by a mature market in which incumbent energy suppliers enjoy sunk capital costs and mode switching price barriers that provide them a strong competitive position. This is particularly so in energy markets such as Tasmania where historically lower rates of economic growth preclude new entrants' reliance upon organic growth in demand for energy. This means that gas projects must attract business away from incumbent energy suppliers to a greater extent than in regions exhibiting higher economic growth.

Similarly, the application of pricing constraints to gas is not justified in a market where electricity has wide coverage and a monopoly on the practically available customer base. Historically, the pricing of electricity has reflected its status as an essential service. This has meant that the development of the electricity supply industry has been substantially underpinned by Government financial support over a lengthy time frame. The NGAR does not currently make any allowance for this history of subsidised and Government supported development of electricity networks, and the competitive disadvantage this creates for the proponents of gas projects.

In aggregate, these issues cast doubt upon the necessity for price regulation when an appropriate market-based outcome may have been achievable without the impost of regulatory intervention. In this context, the Tasmanian Government supports the introduction of economic regulation free periods for gas pipeline infrastructure projects in recognition of the competition they face from incumbent market participants.

## **2. Addressing greenfield gas development risks**

Tasmania's recent experience, and that of other jurisdictions, has highlighted the risks imposed upon gas developments by the heavy-handed approach of the current regulatory framework. However, for a greenfields gas developer, these additional risks are magnified by the nature of the greenfield gas market.

In a greenfield gas market, a developer is required to make a significant up-front investment in the construction of the network with little certainty regarding customer penetration. Revenues that would make such investments viable only begin to accumulate in a significant way after a number of years. Investors will make negative returns and/or less than economic rates of return in the early years of a project, but face the prospect of regulation when they seek to record offsetting higher rates of return in later years. Under the current regulatory regime two specific areas of risk exist which compound the tenuous position of the developer. These are:

### ***Coverage Application***

The Tasmanian Government considers the current coverage application process provides insufficient certainty for developers that elect to operate as uncovered pipelines. Under current arrangements, any party can apply for Code coverage for an uncovered pipeline. This creates the opportunity for vexatious Code coverage applications from competitors or other vested interests, regardless of whether the party has sought access to the pipeline in question.

A separate, but related, issue is the potential application of the access provisions of the Trade Practices Act (TPA) to be applied to pipelines by the Australian Competition and Consumer Commission (ACCC). This opportunity exists regardless of whether the relevant pipeline meets the coverage criteria under Section 1 of the Code. The uncertainty generated by the operation of the Code and the prevailing application of the TPA exacerbates the financial risk associated with gas pipeline developments.

### ***Franchising Principles***

Annex E of the National Gas Pipelines Access Agreement (NGPAA), Franchising Principles, is another aspect of the access regime that does not take into account the specific risks of a greenfield gas project. Tasmania has consistently argued this position since 1996, when the Gas Reform Task Force was responsible for developing the national gas access regulatory framework and market structure.

At the time, the Tasmanian Government argued, with industry support, that future franchising arrangements would be necessary to ensure comprehensive gas network roll-outs in greenfield areas and that this should be reflected in the NGPAA. While Tasmania was successful in having franchising provisions included in the NGPAA, this outcome was achieved in the face of considerable resistance from the Commonwealth Government and most other jurisdictions, despite the fact that most gas markets in Australia had been developed under franchise arrangements.

During these negotiations, the Tasmanian Government expressed concerns that the franchising principles of the NGPAA were inadequate in terms of their scope and duration and lacked sufficient flexibility. However, faced with strong resistance, the final content on Annex E reflected the best outcome that Tasmania was able to negotiate with the Commonwealth and other jurisdictions.

Tasmania's long-standing position on the inadequacy of the NGPAA franchising principles has now been supported by the difficulties encountered in the TNGP, and the difficulties that have been faced by both the Victorian and New South Wales Governments in promoting greenfield gas network extensions. The failure of the State's Code compliant tender process to attract adequate bids to secure the non-renewable, short-term franchises for gas distribution and retailing that were available in Tasmania under the terms of the NGPAA, illustrates the shortcomings of the current franchising principles. In a greenfield site with mature energy markets, such as Tasmania, the heightened commercial risks that are present mean developers need longer franchise periods, in order to achieve the market penetration and growth required to provide a sufficient return on their investment.

Based on recent experience, the Tasmanian Government believes that the Code, and the NGAR, should be reformed to explicitly address the specific risks associated with greenfield gas developments, and to remove the impediments that they currently create for regions attempting to facilitate the development of gas infrastructure.

### **3. Increasing regulatory certainty**

The NGAR imposes considerable uncertainty upon gas project developers. In the case of a greenfield gas developer entering the energy market, the impact of this regulatory risk is magnified, due to strong incumbent competition and potential additional costs imposed by regulation. The regulatory environment would be significantly improved were it to provide some capacity for a developer to secure long-term regulatory certainty for a greenfield gas network development in advance of project commencement.

Such a mechanism would allow a developer to make a more accurate and comprehensive assessment of commercial risk that could be balanced against the returns expected from the significant infrastructure investment.

Under the Code, the only means by which a developer can currently obtain regulatory certainty, prior to investing in network construction, is to be selected via a Code-compliant tender process. As the Tasmanian experience has shown, the market dynamics of a greenfield site do not always lend themselves to the prevailing Code conditions, preventing a successful tender outcome.

By way of illustration, the Tasmanian Government sought to conduct a Code-compliant competitive tender to award non-renewable gas distribution and retail franchises in the State. The franchise approach was deemed most consistent with encouraging the development of the State's greenfields gas market within the context of the maturity of the State's wider energy markets. Additionally, this approach was consistent with that which has been applied in broadly similar circumstances for the emergence of new markets elsewhere. The Government was also mindful of its National Competition Policy obligations with regard to establishing a gas market in Tasmania.

During the tender process, it became apparent that satisfying the requirements of the Code was highly unlikely. In particular, section 8.1 of the Code, detailing general principles for establishing reference tariffs, was very difficult to satisfy, and proved to be open to subjective interpretation by the local regulator. Furthermore, the requirements of Section 8.1, together with other parts of the Code, such as Section 3.28(f)(i) and Section 3.33(c), constrained the flexibility in pricing considered necessary to stimulate the market development required to provide an economic return on infrastructure investment over the project life. As discussed above, the Code's franchising principles were too restrictive in duration and did not sufficiently account for the commercial risks associated with greenfield gas developments in mature energy markets.

These regulatory requirements created a circumstance in which bidders were asked to invest enormous amounts of capital in infrastructure within a market dominated by an alternative fuel source (electricity), on the basis of a limited period in which to achieve a financial return. Most potential investors declined to participate in the tender. In the end, no complying bids were received and the few non-complying bids were considered unacceptable. Specifically, all bids required very significant Government assistance and the transfer of significant project risk to the State.

Given the access pricing arrangements available to competitors after the limited franchise period and their ability to cherry pick key customers from the incumbent, it was no surprise that no successful bids were received. As a consequence, the Tasmanian Government terminated the tender process, and proceeded to negotiate with identified parties in order to overcome the limitations imposed by the Code.

In summary, the Tasmanian Government's experience with the failed Code tender demonstrated that it is a complex, time and resource intensive, and ultimately wasteful process for both Government and industry. The requirement under the Code for the developer to be selected *primarily* on the basis of the lowest sustainable tariff (section 3.38(f)(i)), becomes academic when the market being entered leads developers to make negative Net Present Value (NPV) assessments of their proposed infrastructure investments. Under these circumstances, network coverage and timing of the network roll-out become more important assessment/selection criteria than network tariffs. The Tasmanian experience also highlights the Code's failure to recognise the complex trade-offs that exist between the coverage, speed of roll-out and access prices.

The Productivity Commission's recent Review of the National Access Regime and the Council of Australian Government's (COAG) Independent Review of Energy Market Directions have both highlighted the need for reform of the NGAR. Tasmania believes that the proposals (set out below) arising from these Reviews represent a sensible starting point on which the current review can build to address the identified deficiencies in the NGAR:

- the provision of immunity from declaration under the Trade Practices Act (TPA) following a competitive tender for a government-sponsored essential infrastructure project;
- the capacity for proponents to seek binding rulings on declaration under the TPA;
- the capacity to seek binding up-front coverage rulings under the National Third Party Access Code for Natural Gas Pipeline Systems (the Code);
- the provision of 15 year economic regulation free periods for transmission pipelines under the Code; and
- providing for up-front regulatory agreements under the Code.

## **Conclusion**

Collectively, the issues identified above are contributing to a substantial regulatory burden on gas pipeline developers and/or operators. Generally, the current provisions of the Code are too onerous and complex and are open to varied interpretation. This increases the cost of the regulatory regime to both industry, through compliance, and to Government, through administration. Ultimately, these costs are passed on to consumers.

The degree of regulatory complexity and uncertainty inherent in the NGAR is contrary to the public interest, and is, in fact, counter-intuitive to one of the primary arguments for regulatory intervention; that is reducing costs to consumers. Consequently, the NGAR has been an impediment to large numbers of Australians having access to natural gas. It has failed as an instrument of economic policy and must be reformed.

This matter has been a point of concern for Tasmania for some time. In 1996, the Tasmanian Government raised similar concerns to many of those contained in this submission with the Gas Reform Task Force. These same concerns were reiterated in the Tasmanian Government's contributions to COAG's Independent Review of Energy Market Directions. Furthermore, similar issues have been raised by other jurisdictions and industry participants, highlighting the inadequacies in the current access regime.

It is the Tasmanian Government's view that the appropriate purpose of the access regime should be narrowly confined to preventing the abuse of market power in mature or monopoly gas networks. The access regime is not appropriate when attempting to attract significant greenfield gas investment located in mature energy markets.

In light of these concerns, the Tasmanian Government believes that the issues highlighted in this submission should be a critical focus of any recommendations arising from this Review.