!8 September 2003

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

Sent by email to: **gas@pc.gov.au**

Dear Commissioner

Productivity Commission's Review of the
Gas Access Regime

Please find enclosed the combined submission to the Productivity Commission's Review of the Gas Access Regime from the Energy Users Coalition of Victoria (EUCV) and the Electricity Consumers Coalition of South Australia (ECCSA).

In our submission we have made reference to a number of other documents which support our contentions. We commend these documents for your review, but should you require copies of the referenced documents we will be pleased to provide them to you.

Should you wish greater clarification of the issues raised we would be pleased to amplify on the points made.

Yours sincerely

John Pike
Chairman, EUCV

Rod Davidson
Chairman, ECCSA

Submission

to the

Productivity Commission review

of the

National Gas Access Regime

by

Electricity Consumers Coalition of SA

and

Energy Users Coalition of Victoria

September 2003

Introduction

The Electricity Consumers Coalition of South Australia (ECCSA) and the Energy Users Coalition of Victoria (EUCV) wish to provide their views to the Productivity Commission as it carries out its review of the National Gas Access regime. The ECCSA and EUCV in include amongst there members Adelaide Brighton Cement, Kimberly Clark, Holden, Toyota, Ford, Mitsubishi, Pasminco, BHP steel, and OneSteel.

As major gas users the member companies have seen the national gas access regime deliver significant benefits to Australian industry and to all energy consumers. As a result Australia's international competitiveness has improved remarkably. The reform to both the electricity and gas markets have contributed significantly to the productivity growth the Australian economy has seen over the past decade.

It should be remembered that the introduction of the energy reform programs were carried out in conjunction with other industry, banking and tax reforms, all of which were designed to make Australian industry more globally competitive. To therefore review and modify one element of the reforms in isolation is neither appropriate nor equitable. We are therefore very concerned that the review of the Gas Code is being undertaken without fully appreciating the impact changes will have on energy consumers.

In particular we have a great concern that the Productivity Commission's review has been instigated at the request of vested interests (pipeline companies) with the unstated aim of minimizing the benefits realized by the reforms to date and to enhance the ability of the relatively few pipeline companies to levy monopoly rents on the many consumers, and so disadvantage Australian industry reducing the international competitiveness so hard won.

In carrying out its review the Productivity Commission must not listen closely just to the claims of the vested interests of the pipeline lobby assuming that as they are intimately involved they therefore are the most knowledgeable source of information about the Gas Code and its shortcomings. The Commission should recognize that the impact of allowing such vested interests to lead the debate on the gas access regime will potentially allow them to extract monopoly benefit to the detriment of Australia’s competitive industry it. Not only will investment in both upstream and downstream industries be affected as a result of declining competitiveness in the gas transport industry but ultimately this will also lead to a reduction in investment in linking Australia's infrastructure projects.

Many well qualified commentators have recognized the importance of strengthening competition policy, including Professor Michael Porter in his recent paper on national competitiveness[1]. In this paper he avers that there is a need to maintain

> "continued efforts to enhance competition policy"

and raise

> "regulatory standards that enable rather than constrain competition".

The ECCSA and EUCV would request that the Productivity Commission should bear in mind that the review being undertaken is not a one-sided affair and that any decisions the Commission reaches must encompass the realization that the review of the Gas Code is about ensuring there is balance between the desires of the pipeline industry to increase their profits, and that there is a driving need for Australia's competitive industry to maintain or improve its ranking in the international market.

About monopolies

It has been suggested that monopolies do not really exist, *but if they do there is a benefit to consumers but it is impracticable (impossible) to quantify the benefit.*

Do monopolies really exist?
In the Productivity Commission review of National Access Regime arguments were put to the Commission that a monopoly does not really exist because there is always some competition, for example, between electricity and gas. This argument is quite fallacious as once a major infrastructure project is completed and there is no ability for a parallel project to be built alongside the existing facility as no investor nor bank would countenance putting money into a venture with such a risk profile.

Further whilst there is a need to accept that there can be some limited competition between gas and electricity, analysis of the actual usage of these forms of energy by consumers clearly identifies that there are many areas where the two can never be in serious competition such as where such a change by the consumer becomes too expensive, the cost structure makes one prohibitively more expensive, or the form of energy cannot be readily converted to the needs of the consumer such as in the provision of lighting or powering computers where the energy source is exclusively the province of electricity.

[1] DTI Economics Paper No.3, UK Competitiveness: Moving To the Next Stage, May 2003 for the UK Department of Trade and Industry.

If monopolies do exist, then do they benefit the community?

Another argument put to the Productivity Commission during the review of the National Access Regime was that if a monopoly did exist then this is to the benefit to the society as a whole. A number of submissions from consumers such as from Dwyer and Lim[2] clearly highlight the falsity of this argument. The only analogous argument to this allegation is the right of patent granted by the Crown. The reason a patent is granted is to allow the inventor to recover the costs of developing the invention[3]. In the case of pipeline infrastructure development there is little sunk investment requiring such recovery, as has been seen in the recent construction of the Tasmanian gas pipeline (linking a known gas supply – Longford, to a new market – Tasmania) and the SEAGas pipeline (linking a new gas supply – Otway Basin, to an existing market – South Australia).

Even if monopolies do extract a monopoly rent, how can it be quantified?

A further argument put to the Productivity Commission during the National Access Regime review was that monopoly rents cannot be distinguished from what might otherwise be termed “entrepreneurial profits”. The argument then proceeded along the lines that “light handed regulation” is seen to be essential to ensure that no disincentive is created to regulated monopolies leading to a reduction in future infrastructure investment.

To consumers this argument is the fundamental cause of all of the lobbying by the pipeline industry. Essentially what is being claimed is that if a pipeline owner does not get a profit at a level that it considers acceptable then the direct result will be a reduction of future investment in what is considered by all to be essential infrastructure. Consumers do not contest this principle. What is contested is, at what level is it determined that a monopoly enterprise is receiving a reasonable level of profit, commensurate with the risk they have. The Gas Code provides for regulated pipeline owners to get a firm revenue stream, not subject to the vagaries of the international markets.

It is in this context that the Gas Code must be and be seen to be equitable to both the service provider and the gas consumer who ultimately pays for the costs involved in the gas transport.

Light handed regulation

The gas transport companies aver that light handed regulation is the solution to their needs.

[2] Terry Dwyer and RKH Lim, Some observations on economic arguments advanced on behalf of infrastructure owners in relation to the Productivity Commission inquiry into access regime, 2001

[3] Even allowing for this right granted by the patent, many inventors are wary of registering patents as there is a thriving trade in reverse engineering new products, backed up by legal teams arguing the follow on product being sufficiently different to the original work.

However the definition of what is light handed regulation would appear to depend on whether it is the pipeline owner or consumer who is assessing the degree of light handedness. The pipeline lobby declares that the level of “light handedness” should allow the infrastructure provider to be able to carry out its desired course of action (with maximum profit) and minimum interference from regulatory oversight. The risk in this approach is that monopoly rents are very likely to be levied.

From a consumer's viewpoint light handedness requires the regulator to ensure that only reasonable returns are awarded on the investment, sufficient only to ensure that needed future infrastructure is provided but that only appropriate investment in new infrastructure is carried out. To permit anything more allows the monopoly provider to use its unique position to the detriment of the consumer. Throughout the development of the Gas Code the fundamental issue was that there always had to be a balance between the interests of the service provider and the interests of the end user.

US researchers Carpenter and Lapuerta examined the concept of light handed regulation in the UK[4], specifically examining the monopoly gas service provider British Gas. They concluded that although the principle of light handed regulation is attractive in theory, the implementation suffers many problems. In particular they noted that light handed regulation has

- not worked to avoid lengthy regulatory proceedings
- unintentionally created inefficient incentives for regulated companies
- not successfully constrained the monopoly power of incumbents.

The ECCSA and EUCV commend this report to the Productivity Commission and highlight the fact that light handed regulation in other jurisdictions has equally suffered such similar drawbacks, to the extent that such an approach has been discontinued as it has been seen that the monopoly providers use the system to maximize their profits to the detriment of consumers. It is of interest that in many other jurisdictions there has been a decision to not change existing regulatory approaches, even though these may have the detriments of what monopoly providers state are extraordinarily intrusive regulatory systems, such as apply in the US.

It is interesting to note that British regulators have found that the determination of what is reasonable pricing, without in-depth examination of the costs has been found not to be possible. They have observed that regulated companies use their information advantage (the well known Information asymmetry issue) to the disadvantage of both regulator and consumer, and that monopoly companies consistently continue to exercise the market power they undoubtedly have.

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[4] Paul Carpenter and Carlos Lapuerta, ‘A Critique of Light-Handed Regulation’, Northwestern Journal of International Law & Business, February 1999

Regulatory games played by providers

There are many examples of where the regulated businesses have used their unique position and the light handed regulatory environment used in Australia to the great disadvantage of consumers.

One submission giving a clear example of how the “regulatory game” is played by regulated businesses was made in a detailed submission to the Productivity Commission by the Energy Markets Reform Forum about the AGL gas networks application[5] during the late 1990’s and refers to the regulatory game played by AGLGN when IPART the gas access regime in New South Wales. We commend this report to the Productivity Commission review as a case study demonstrating the way regulated businesses operate in the current regulatory environment.

However this should not be seen as an isolated incident. Exactly the same issues occurred during the review of gas distribution business in South Australia where the South Australian Independent Pricing and Access Regulator needed nearly four years to reach agreement on a new tariff structure with the South Australian gas distribution network owner Envestra. During this review SAIPAR was continually confounded by lack of information, by confusing operating agreements and by an interwoven ownership structure. The final result of the review leaves a number of concerning issues between consumers and the regulator, while at the same time allowing Envestra to collect enhanced revenues.

In both of these cases the regulators themselves have referred in their decisions to the difficulties they have faced in getting sufficient information in order to set the allowed revenue. Consumers would point out that to be confident the regulator has set an equitable revenue stream requires confidence in the quality and quantity of information disclosure.

The current Gas Code has worked to the benefit of all concerned

There is no doubt that the Gas Code has provided significant benefits to all parties involved.

- Consumers have seen a reduction in gas transportation prices
- There has been an increase in the exploration and development of new gas supplies

[5] Energy Markets Reform Forum, “The Regulation Game”, Third Party Access To AGL Gas Networks – A Case Study Of Regulatory Gaming, December 2000. Submission to the Productivity Commission Review into the National Access Regime

- Pipeline owners themselves have benefited through certainty of revenue and the ability to enhance profits through incentives granted by the regulators.

With this general benefit to all parties involved in the production, transport and usage of gas it is of great concern that one of the three groups involved appears to be carrying out a determined program to enhance its revenue stream and in doing so, may well impact negatively on both upstream and downstream parties involved.

It is a matter of record that members of the gas transmission pipeline industry have appealed the majority of decisions made by regulators regarding transmission pipelines, including those of OffGAR (WA), ACCC and NCC. This indicates that either the pipeline industry is seeking excessive returns or regulators as a group are working in concert to affect a minimal return on pipeline owners.

The very fact that shares of listed regulated businesses have generally risen shortly after regulatory decisions, would indicate that the share market as a whole, and investors in particular, see that the decisions of regulators are equitable, perhaps favorable to the pipeliner, casting severe doubt as to the validity of the pipeline industry contentions that they have been awarded inappropriately low revenues by the regulators. A review of the returns granted to pipeliners in overseas jurisdictions indicates that Australian regulators consistently grant higher returns in favour of the regulated businesses.

It is not only the economic regulators who have been supposedly disadvantaging the pipeline industry. Adverse decisions by the National Competition Council are also consistently being appealed. The claims regarding pipeline coverage by the owner of the Eastern Gas Pipeline and the Moomba to Sydney gas pipeline owner have also gone to appeal. The final recommendation by the National Competition Council in November 2002[6] regarding its recommendation on the Moomba to Sydney pipelines provides interesting reading, and provides an insightful assessment of the issues surrounding this gas pipeline.

Particularly clause 7.430 of their report is telling.

> "This information from major gas users in the electricity generation and fertiliser industries suggests that removing monopoly rents in gas transmission (as identified by the ACCC) would result in a material increase in demand for delivered gas by major consumers – and hence, for commodity gas, gas haulage and gas retail services. In particular, a price change of this magnitude could impact on whether a major customer

[6] National Competition Council's Final Recommendation (November 2002) in relation to the revocation application for the Moomba to Sydney Pipeline

> enters or exits the market. This would stimulate competition between gas producers to supply the load, and hence, would enhance entry incentives in upstream and downstream markets".

It is significant that an independent organization such as the National Competition Council so clearly highlights that the extraction of monopoly rents by infrastructure providers can and does have a major impact on downstream industry survival or growth.

The cost of regulation is not a barrier

The pipeline industry consistently maintains that the cost of regulation adds a major and avoidable impost onto the gas transportation industry. This clearly overlooks the fact that most of the obligatory imposts are carried by consumers, and not by the pipeline industry. What is consistently avoided by the pipeline industry is that the cost of providing the regulatory oversight is borne by governments (tax payers who are also consumers) or directly by consumers via a levy. Similarly the costs incurred by pipeline companies in carrying out their regulatory functions are accepted by the regulators to be legitimate business expenses and so are recoverable under the revenue determination. Consumers carry their own costs of participating in regulatory reviews.

In this regard we refer the Commission to the costs actually involved in regulatory reviews which was provided by BHP Petroleum in its submission to the National Access Regime review[7].

Clearly the costs involved in regulatory oversight are much smaller than implied by the pipeline industry and in the main are borne by gas consumers. As consumers accrue the benefit of increased economic growth and clearly if they are of the view that they benefit from the Gas Code as currently written, then surely it is not up to the pipeline industry to decide how the consumers might wish to conduct their affairs.

It would seem that the pipeline industry could be seen to be acting more in its own interests rather than for any altruistic reason. As a counterpoint to this "altruism" we have seen the pipeline industry cause significantly increased costs due to their unreasonable delays in access reviews, in their attempts to foil access causing unnecessary duplication of infrastructure, and confounding effective implementation of accepted regulatory approaches.

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[7] BHP Petroleum, Case Study 11, The Costs and Benefits of Natural Gas Pipeline Open Access Regulation, in What Price Access? February 2001. Submission to the Productivity Commission Review of the National Access Regime

Improvements to the Gas Code

Whilst consumers generally accept the Gas Code as currently crafted, there number of improvements and enhancements that could be made which would bring more balance into the regulatory process. These changes would bring

- Increased powers of the regulators to obtain information in an acceptable time frame
- The ability of regulators to access information regarding pipeline costs held by related or contracted parties
- Penalties to service providers for failing to comply with Gas Code provisions, including ring-fencing and associated contracts
- Rights of consumers and end users to appeal against a regulator's final decision

The preamble to the Code and the explanatory introductions to each section add value to the Code and clearly assist in its interpretation – regulators frequently quote from these as part of their explanations of their conclusions. However we do see there is a benefit in expanding the opening preamble of the Gas Code to include a statement which clearly annunciates that the Gas Code is to provide a framework which promotes efficient costs and non-price factors by replicating the outcomes of a competitive market and that it is designed to

- Facilitate the development and operation of a national market for natural gas
- Prevent the abuse of monopoly power
- Promote a competitive market for natural gas in which customers may choose suppliers, including producers, retailers and traders
- Provide rights of access to natural gas pipelines on conditions that are fair and reasonable for both service providers and users
- Provide for rapid and equitable resolution of disputes

The high degree of flexibility granted by the Gas Code to regulators with its moderate prescription (compared for example to the Electricity Code) already results in a degree of uncertainty. This uncertainty will be even further increased if the pleas by the pipeline industry for even less prescription are heeded. Certainly consumers do not wish to see any removal or dilution of any of the Gas Code provisions, as they see it provides a reasonable balance between the competing interests of the upstream, downstream and the "midstream" gas transport businesses.

Information disclosure

Earlier in our submission we alluded to the issue of information disclosure. There is regularly and clearly reported by all regulators a major problem confronting regulatory oversight with regard to the provision of information. Sufficient and accurate information is essential if a regulator is to carry out its tasks competently. As all the information is held by the pipeline companies it is in their responsibility to collate and release only that information which they consider best serves their interests. It is the task of the regulator to define and request what information they do not have and what they consider essential for them to prepare a competent regulatory decision. This asymmetry of access to information and the ability of the regulated business to minimize the extent of any disclosure, is a major drawback to any regulatory review.

The Gas Code as currently written includes for specific information to be released to the regulator by the regulated business. Some jurisdictions have introduced specific clauses into their licensing provisions which grant the jurisdictional regulator the necessary powers to collect all of the information which they deem necessary, and in a form which readily allows rapid interpretation of the information provided. Other jurisdictions rely purely on the Code provisions as written.

In addition to the requirements of the regulator, it is essential that sufficient information is disclosed to interested parties so that they can contribute meaningful input to the regulatory review. The lack of a standard methodology for identifying the necessary information to be provided and the format in which the information is to be produced, is a major failing of the current code. As a result of this information asymmetry we would recommend that the code be modified to allow

- Regulators to prescribe the type and extent of the information to be maintained between regulatory reviews
- The format that such information is to be maintained
- Regulators to have the right of access to relevant information between reviews
- Regulators to be permitted to penetrate corporate structures and other corporate and contractual arrangements, in order to ascertain that claimed costs are appropriate.

Greenfield pipelines

Consistently the pipeline industry has complained that new and needed gas pipelines have not been constructed due to the constraints inherent in the Gas Code.

In an attempt to overcome any detriments the Gas Code may have with regard to greenfields pipelines the ACCC instituted a review of the regulatory controls affecting new pipelines, with the aim of preparing a set of regulatory principles with regard to greenfields pipelines. This approach by the ACCC should not be seen as a failing of the Gas Code but in fact one which demonstrates the Code's flexibility. By providing such regulatory principles this gives an increased level of regulatory certainty to pipeline developers. The ACCC is still to formally produce its regulatory principles for greenfields pipelines.

Despite the alleged adverse regulatory environment applying to the gas pipeline industry, the number of greenfields projects that have been constructed easily exceeds those which have not proceeded – those that were not built most probably failed to proceed due to commercial reasons. Consistently the pipeline industry points to a number of pipelines which have not proceeded, alleging it is the regulatory environment that has prevented the pipeline construction. They consistently fail to point out that perhaps the reason for the pipeline not proceeding can be attributed to a lack of a sound business case.

The pipeline which has had the most public of attention with regard to its commitment to proceed must be the PNG pipeline. It has not been the regulatory environment which has prevented this pipeline from being constructed rather it was the lack of that most basic of commercial needs – the commitment of foundation customers on which to underwrite the bulk of the construction costs.

The failure of a number of regional distribution pipelines in Victoria to gain commitment is also often highlighted as being caused by the regulatory environment as detailed in the Gas Code. It takes only a brief discussion with the Victorian government to reveal that it is commercial viability and a lack of demand volume which has prevented this growth of the Victorian gas distribution network to areas where there is a relatively small community demand.

The views of consumers in relation to greenfields pipelines have been well presented in a submission by Visy Paper to the ACCC[8] as part of the development of regulatory guidelines for greenfields pipelines. This submission provides extensive analysis to demonstrate that the risk a pipeline developer is often grossly overstated, and shows that the bulk of the risk for the pipeline is carried by foundation shippers and customers.

Therefore claims by pipeline developers that they should have the right to risk mitigation benefits such as

- access holidays
- price monitoring and
- ex ante Regulatory compacts

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

is clearly not supported by the facts. In particular pipeline businesses have still not yet to proven that the returns they have awarded by regulators are indeed inadequate.

On this basis it is quite clear that to grant pipeline developers any unearned benefit at the expense of consumers is inappropriate and can be really considered an underhand method of extracting monopoly rents.

At what level are returns adequate?

Returns awarded by Australian regulators exceed those awarded in overseas jurisdictions, as the following research work by Pareto Associates on returns for regulated local and overseas businesses demonstrates. Pareto identified that there was consistency in the cost of debt awarded between jurisdictions, but as there was a distinct divergence on the cost of equity awarded, with gearing (d/e) of 60/40, this drives up the overall awarded returns.

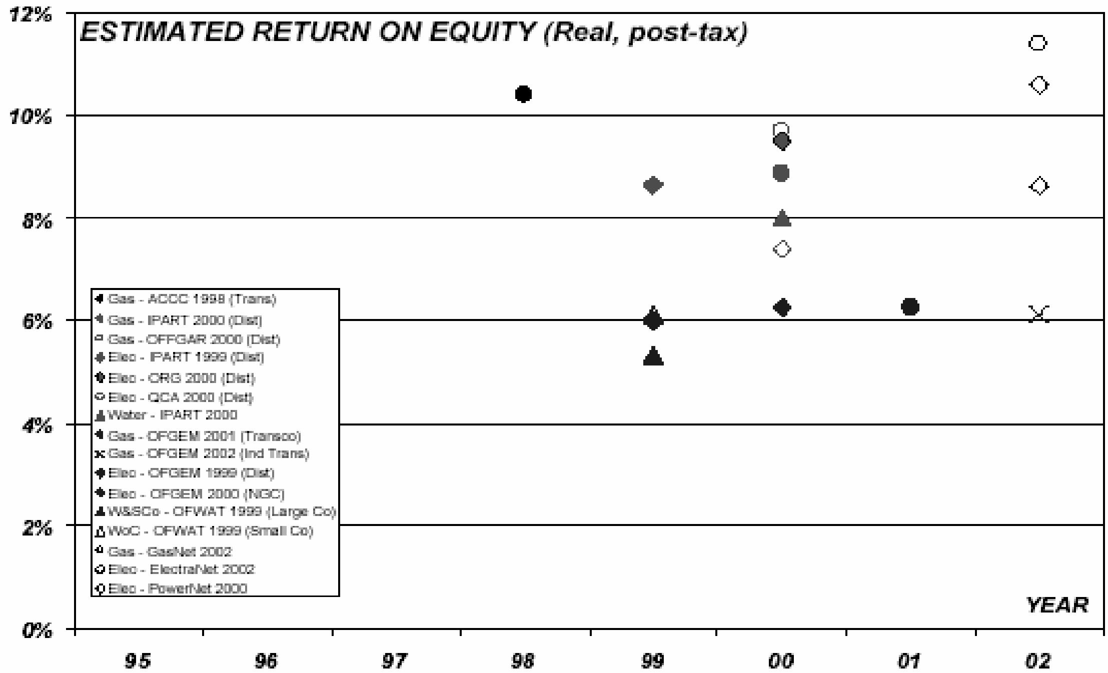

Figure 2 Comparison of estimated cost of equity from UK and Australian regulators' decisions.

It is important to note that even with the lower returns in the UK, investment in needed infrastructure is still proceeding.

Consumers are very concerned that pipeline companies seem to believe that regulators are focused on granting the lowest possible sustainable tariffs. We believe that the appropriate return for an investment with a very low risk revenue stream is one where the actuality of future investment is being precluded by the ability of the pipeline company to invest in areas granting a sustainable higher return with a similar risk profile. For a monopoly business to be able to learn a return higher than the minimum level required for ensuring the needed future investment is totally inappropriate. The risk for consumers is that if inappropriate higher returns are granted, this encourages uneconomic investment by the regulated business – often referred to as the "risk of gold-plating".

If it is accepted that the point where future investment ceases is the appropriate level for returns, it is quite clear that this level has not yet been reached in the gas pipeline industry. A review of the investments (both for new and existing pipelines) in gas transport services undertaken by transmission and distribution pipeline companies indicates quite clearly that pipeline companies believe they will get a better return for their investment money by building new pipelines, pipeline augmentation and pipeline refurbishment, rather than finding alternative investments with a similar risk profile. In its Issues Paper discussing greenfields pipelines, the ACCC clearly points out that there is still massive investment being carried out by pipeline companies.

Thus the Productivity Commission should be wary of claims for benefits by the pipeline industry which will return to pipeline developers any enhanced returns.

Conclusions

The Gas Code was developed in a cooperative environment by a cross jurisdictional group which also included representatives of producers, transmission companies, distribution and gas retail companies, consumers and regulators. Overall the Gas Code has performed generally well to meet the needs of all parties involved in the production, delivery and consumption elements of the natural gas market.

Gas transport companies are attempting to enhance their profits at the expense of producers and consumers by utilizing their monopoly status and alleging the regulatory environment is not conducive to augmenting existing and providing new needed gas pipelines. They allege that the returns awarded by regulators are too low and that other incentives are required to ensure needed investment.

The facts do not support their contentions.

- Returns in Australia are higher than overseas, and despite lower returns investment does occur in overseas jurisdictions
- There has been extensive investment carried out in the gas transport industry (and more planned) under the existing Gas Code
- Regulated gas businesses use the Gas Code to thwart the activities of the regulators by gaming the system
- There are a number of aspects of the Gas Code which discriminate against consumers