

WORSLEY ALUMINA PTY LTD

Submission to the Productivity Commission Review of the Gas Access Regime

Submission on Draft Report

29 MARCH 2004

Background

1. Worsley Alumina Pty Ltd (Worsley) is a joint venture of Billiton Aluminium (a subsidiary of BHP-Billiton), Japan Alumina Associates (Australia) and Nissho Iwai Alumina and operates a bauxite mine and alumina refinery near Collie, approximately 200 km south of Perth.
2. Worsley's operations have traditionally required a large quantity of natural gas for use in the alumina refinery.
3. Worsley was constructed in 1980-83 at a cost of \$1B and commenced operation in 1984 at a 1Mt/yr operating rate. It has undergone several expansions since then at a similar cost and is today operating above 3Mt/yr. Worsley is planning three more stages of expansion, again at a similar cost, to an operating rate in excess of 4Mt/yr.
4. All of the gas utilised by Worsley is transported from the Carnarvon Basin via the DBNGP.
5. Worsley's planned future expansions give rise to a requirement for additional gas transport capacity through the DBNGP. To date, Worsley has been unable to obtain the developable capacity it requires through its negotiations with Epic Energy, the owners of the DBNGP.
6. Worsley considers that the difficulties it encountered in relation to its expansion requirements were largely due to the continuing operation of the earlier regime. The Gas Access Regime (GAR) has only applied in full to the DBNGP since January 2004.
7. Worsley generally considers that the GAR operates effectively and delivers economic benefit through its regulation of pipeline businesses, which without third party access regulation, would be able to charge excessively for use of its strategic assets.
8. Worsley considers that whilst there is room for improvement in the GAR, there is no need to completely re-model the regulatory process.

Submissions:

9. Worsley make a number of submissions to the Productivity Commission in light of its review of the GAR:
 - (a) first, the current regime should be maintained as users require the assistance of regulation to secure competitive access to gas transmission pipelines as users lack bargaining power in their negotiations with service providers;
 - (b) second, a lighter-handed regulatory approach is not required as the threshold tests for coverage are demonstrably capable of accommodating any market changes which may result in regulation no longer being required; and
 - (c) third, the GAR should be strengthened in favour of users where expansions are sought, with the onus shifting to service providers to demonstrate that expansion is uneconomic.

Chapter 2 – Australian gas industry

Draft Finding 2.1

10. The GAR was introduced to, among other things, improve the level of competition and economic efficiency in both upstream and downstream markets where gas transmission pipeline service providers are able to wield market power.
11. Worsley submits that, in Western Australia, the characteristics of the gas transmission sector have not changed in any material way since the time at which the GAR was introduced. Without an effective third party access regime, service providers remain in the position of being able to wield market power. Accordingly, the GAR is still required to redress the power imbalance between users and service providers.
12. A single pipeline, the DBNGP, connects the major gas basin in Western Australia with users in the South-West of Western Australia. Accordingly, almost every user requiring natural gas in South-West Western Australia must utilise the DBNGP to transport that gas.
13. In a gas transmission industry without third party access regulation, in order to access key pipelines, users would have no choice but to pay the whatever charge is demanded by service providers (up to bypass cost or substitution cost, if applicable). Worsley agrees with the Productivity Commissions finding that:

“The bargaining power of users and owners of transmission pipelines rests on their ability to threaten not to deal with the other party. The balance of power depends on the credibility and effectiveness of each party’s threat. It also reflects which party would incur the highest cost if the transaction did not take place.”¹
14. In the present environment, the user will incur the highest cost if it is unable to secure gas transmission capacity. In Western Australia, users lack any real ability to credibly make a threat to the owners of the DBNGP that users will cease contracting to access gas transmission services as users’ bargaining power is severely constrained by a number of factors.
15. For example, users’ bargaining power in negotiations with service providers is constrained by the following factors:
 - (a) lack of alternative transmission pipelines;
 - (b) the extensive sunk costs in infrastructure that that can only be fuelled by natural gas, for example gas turbines;
 - (c) a very limited ability to substitute alternative fuels for natural gas, especially in industrial applications where product quality considerations may require the use of natural gas, for example in calcination in alumina refineries; and
 - (d) environmental agreements..
16. Due to the operation of each of these factors, Worsley cannot make a credible threat to Epic that Worsley will switch to an alternative transmission pipeline should Epic’s prices and other terms and conditions be unacceptable.

¹ Productivity Commission 2003, Review of the Gas Access Regime, Draft Report, Canberra, p. 26

17. As stated in paragraph 2 - 5 Worsley has invested significant funds in the establishment, maintenance and expansion of its operations. It would be financially disastrous for Worsley to abandon use of its extensive gas-fired facilities. Further, Worsley is unable in the short to medium term to adapt its gas-fired facilities to allow operation by alternative fuels. Worsley's negotiating position is therefore constrained by its high level of sunk costs in terms of its investment in plant and equipment.
18. Worsley agrees with the Productivity Commission's finding that "the ability of users to substitute to alternative fuels or energy sources is limited in the short term if they have plants built to run only on natural gas (a purpose built gas-fired electricity generator)."² This is precisely the position that Worsley finds itself in.
19. Worsley submits that there are few or no alternative fuel sources available, and that financial, technical and environmental factors operate to effectively exclude the use of other fuels (as discussed above at paragraphs 15 - 18) and accordingly there are really is no appropriate substitute.
20. Service providers tend to be aware of the factors discussed in paragraphs 15 - 19 and accordingly are in an overwhelmingly strong position when it comes to access contract negotiations. In the absence of an effective third party access regime it is extremely difficult for a user to negotiate access and prices at efficient, commercial levels.
21. In the case of the DBNGP, the service provider's bargaining power is increased further by the fact that there are many users, competing for the same limited capacity in the pipeline.
22. The Australian Competition Tribunal's (ACT's) decisions in the Duke Eastern Pipeline (DEP) case³ and the AGL Cooper Basin Supply Arrangements (AGL) case⁴ are of particular relevance.
23. The Productivity Commission appears to have failed to give any weight at all to these decisions, finding as it did in Draft Finding 2.1, that "the market power of transmission pipeline owners is constrained by a number of factors, particularly the availability of substitutes...that is alternative fuel and energy sources".
24. The ACT decided in the AGL case that the relevant market was one for "natural gas, extending at the margin to encompass, at times, alternative and complementary energy sources, principally electricity."⁵
25. The ACT cited the finding in the DEP case that "the product of concern is mainly gas as there is little competition between energy sources at this time."⁶
26. It is of significance that the ACT made these findings regarding the lack of substitutability of natural gas in respect of eastern States gas pipelines, where there is arguably more competition between energy sources than there is in Western Australia, and where, in any event, natural gas comprises a significantly smaller share of the primary energy market.⁷

² Productivity Commission 2003, Review of the Gas Access Regime, Draft Report, Canberra, p. 36

³ Duke Eastern Gas Pipeline Pty Ltd (2001) ATPR 41-821

⁴ Re AGL Cooper Basin Natural Gas Supply Arrangements (1997) ATPR 41-593

⁵ Re AGL Cooper Basin Natural Gas Supply Arrangements (1997) ATPR 41-593 at 44,210-44,211.

⁶ Duke Eastern Gas Pipeline Pty Ltd (2001) ATPR 41-821, 43,061

⁷ Productivity Commission 2003, Review of the Gas Access Regime, Draft Report, Canberra, p. 17.

27. The Australian Competition and Consumer Commission's (ACCC's) analysis of the ACT summarises the position:

“There is an argument that the gas supply chain (including the pipeline sector) is constrained from exercising market power owing to competition from other energy sources. This argument raises the prospect that the relevant product market may include other energy sources rather than being a gas specific market.

However, in the past the [ACT] has consistently found that gas prices are not effectively constrained by alternative energy sources and has found the product market to be a gas specific market.”⁸

28. In addition, Worsley is committed to a reduction in greenhouse gas emissions. Worsley's operations are heavily regulated by legislation and environmental agreements which have been written on the assumption that Worsley is able to use natural gas. Legislative requirements and environmental agreements cannot be readily changed or circumvented.
29. Therefore, it is clear that there is at best only a very limited potential for substitution of alternative fuels for natural gas. Accordingly, Worsley submits that the Productivity Commission's Draft Finding 2.1, stating that “the market power of transmission pipeline owners is constrained by a number of factors, particularly the availability of substitutes...that is alternative fuel and energy sources”, is fundamentally misconceived, particularly in relation to the Western Australian market.

Draft Finding 2.3

30. The Productivity Commission stated in its Draft Report:

“When the GAR was developed, there was limited interconnectivity between gas fields and markets. However, over the past several years, there has been significant and rapid change in the market, with deepening interconnectivity.”⁹

31. The Productivity Commission cited various submissions in support of the above statement, including the Australian Petroleum Production and Exploration Association, which submitted that:

“new pipelines have been built, new inter-linkages have been made. Its no longer one pipeline into Sydney. For example, its no longer one pipeline into Melbourne. It will, in the very short term, no longer be one pipeline to Adelaide. I think the whole nature of the Eastern Sea Board Market has changed quite dramatically¹⁰.

32. Worsley does not disagree with the comments of the Productivity Commission or the Australian Petroleum Production and Exploration Association as stated in paragraph 32 above. However, Worsley must emphasise that these comments are made **only** in relation to the Eastern Sea Board Market. These comments cannot be made in respect of the Western Australian market, which has made little progress in terms of competition in the gas transmission sector since the GAR was introduced.
33. As discussed above in paragraph 12, in the Western Australian gas transmission market there is only a single pipeline, the DBNGP, connecting the major gas basin to the majority of industry operating in the South West of Western Australia. There is no trend

⁸ Productivity Commission 2003, Review of the Gas Access Regime, Draft Report, Canberra, p. 35.

⁹ Productivity Commission 2003, Review of the Gas Access Regime, Draft Report, Canberra, p. 45.

¹⁰ Productivity Commission 2003, Review of the Gas Access Regime, Draft Report, Canberra, p. 46

of emerging competition in this market that can justify a retreat from the approach taken in the GAR.

34. Worsley strongly submits that any wholesale changes to the GAR based on instances of emerging competition, which are not reflected nationwide, would seriously compromise the efficiency and even viability of users in the downstream markets where a service provider retains the ability to wield market power.

Chapter 4 – Is the Gas Access Regime working?

Draft Finding 4.3

35. The Productivity Commission in Draft Finding 4.3 states that:
- “The gas access regime deters and distorts investment, possibly altering the nature and timing of pipeline projects. Pipeline construction might be delayed, for example, or pipelines might be built “fit for purpose”. Such alterations can delay the emergence of competition in upstream and downstream markets.”¹¹
36. Worsley questions this finding, particularly in circumstances where the Commission has also stated that it “faces difficulties in trying to draw conclusions about the effect of the Gas Access Regime on investment based on the information provided by inquiry participants.”¹²
37. There is no evidence that the GAR delays and distorts investment, as is made clear from the Productivity Commission’s survey of available studies on the matter set out in pages 85-112 of the Draft Report. For each piece of evidence that tends to suggest that investment might be delayed or distorted by the GAR, there is a piece of evidence that demonstrates that the GAR has had no effect on investment or that it has in fact led to increased investment.
38. In the end, if only rhetoric and anecdotal evidence can be relied on to make Draft Finding 4.3, the finding should not be made.
39. Worsley disputes AGL’s comments that “the only certain outcome for society and the economy from a continuation of the current approach will be the knowledge that monopoly rents have been avoided. In the absence of adequate incentives and rewards, the most likely result of continuing with current practice will be under investment, leading to reduced service and unmatched demand in the longer term.”¹³
40. Whilst Worsley does not deny that there may be a number of potential risks to pipeline investment under the GAR, Worsley does not accept that these risks are unacceptable compared with the known risks of non-regulation.
41. In any event, these risks are understood by regulators to arise and may be adequately addressed under the GAR where it is appropriate to do so. In some cases, it will be inappropriate for a regulator to attempt to ameliorate a risk faced by the service provider and the service provider will simply have to bear the risk as part of running its business.
42. Worsley submits that the fact that the GAR may lead to monopoly rents being avoided should not be minimised. The avoidance of monopoly rents delivers the promotion of competition in upstream and downstream markets in accordance with the Competition Principles Agreement, and can ensure a more efficient allocation of investment economy-wide. Worsley would argue further that in the case of a monopoly utility it is in the economy’s interest that not just monopoly rents are avoided but that economic rents are eliminated. This will lead to the most efficient allocation of investment economy-wide.

¹¹ Productivity Commission 2003, Review of the Gas Access Regime, Draft Report, Canberra, p. 109

¹² Productivity Commission 2003, Review of the Gas Access Regime, Draft Report, Canberra, p. 109

¹³ The Australian Gas Light Company, Submission to the Productivity Commission, (September 2003), (Available: <http://www.pc.gov.au>, accessed 11 March 2004), 5

43. Further, it must be understood that investment in assets with monopoly characteristics is very likely to be distorted when compared with the efficient level, as without third party access regulation, service providers are able to achieve unnaturally high returns on investment by exercising their market power to realise excess returns for access to pipelines. If there is in fact a reduction in investment caused by the Gas Access Regime, it may partly be due to a more efficient allocation of investment in the economy as a whole because the Gas Access Regime is operating as intended.
44. Worsley agrees with the Energy Markets Review Forums comment that “Invariably, the weaknesses of the current access regime are always cited as the reason for pipeline projects not going ahead, rather than the economic and commercial viability of the projects concerned.”¹⁴ In light of these comments and without clear empirical evidence demonstrating otherwise, Worsley submits that the true distortion is not necessarily in investment itself, but in the number of instances in which the GAR is cited as the reason for deferral of investment.
45. Worsley also notes an apparent inconsistency between the Commission’s finding that there is emerging competition in the gas transmission sector (ie eastern seaboard) and it’s finding that the GAR is negatively impacting on investment. It would seem that an increase in competition in a market is unlikely to be achieved without significant investment.
46. Worsley agrees with the ACCC when they state “there have been criticisms of the Gas Code as chilling investment in gas pipelines. We think that that criticism, by and large, has focused on rhetoric. There has been very little evidence to date put forward to substantiate those claims and, indeed, we think that the evidence is quite the opposite, that there is substantial evidence of increase investment in gas pipelines in Australia since the Code was put in place and we don’t think its merely a coincidence. There can be a debate about the causal relationship between those two things but what is not in doubt is that that increase in investment in gas pipelines in Australia has occurred, as the Parer Committee recognised has occurred, in the context of the Gas Code being in place.”¹⁵
47. Where any deferral or distortion is actually proven to exist, it may well be that such distortion is transitory in nature. Introduction of any regulatory regime is likely to have a significant impact on all aspects of a market, however, once stability and certainty are achieved in that market and the market ceases to undergo unsettling change, investment will likely resume.
48. Worsley endorses the comments of the Commission where it states that:

“First, we do not know the “no regulation” scenario and therefore cannot assess if postponed investments would have proceeded were the Gas Access Regime not in place. Second, the impact of other structural reforms which have taken place in the natural gas sector cannot be easily separated from the impact of the Gas Access Regime.”¹⁶

Draft Finding 4.4

49. Allgas Energy is quoted at page 110 of the Draft Report as stating “the focus has typically been on maintaining existing service levels at low “competitive” prices, in order to curb or eliminate inefficient monopoly rent. Such a heavy-handed top down approach

¹⁴ Energy Markets Review Forum, Further Submission to the Productivity Commissions Review of the Gas Access Regime (September 2003), (Available: <http://www.pc.gov.au>, accessed 11 March 2004), 5.

¹⁵ ACCC cited in Productivity Commission 2003, Review of Gas Access Regime, Canberra, p. 100.

¹⁶ Productivity Commission 2003, Review of the Gas Access Regime, Draft Report, Canberra, p. 108.

is intrusive and potentially distorting. With its demonstrated chilling effect on innovation and technology, quality and service offerings.”¹⁷

50. In Worsley’s opinion there is insufficient data to actually demonstrate that a chilling effect on innovation and technology quality and service offerings has occurred.
51. Further, Worsley considers that the reliance by a service provider on a reference service or services is solely at the choice of the service provider and user. The Gas Access Regime allows for negotiations for non-reference services between the service providers and users. The GAR contemplates the need for non-reference services to be provided and proposed access arrangements must refer to non-reference services. For example a number of non-reference services were listed in Epic Energy’s proposed access arrangement, such as:
 - (a) Park and Loan Service;
 - (b) Peaking Service;
 - (c) Metering Information Service;
 - (d) Secondary Market Service; and
 - (e) Pressure and Temperature Control Service.
52. Worsley submits that these provisions allow room for innovation whilst at the same time providing users with the reassurance that at the very least they will be able to access the reference service at the reference tariff.
53. Worsley also submits that in many cases, a perceived lack of innovation may be a result of many factors in operation, not solely the influence of the GAR, for example, there may be business or tactical reasons why a service provider provides only reference services and does not negotiate non-reference services.
54. Importantly, Worsley considers that the unique situation in Western Australia has meant that market participants have not had the opportunity to determine whether innovation has or will be stifled under the GAR, and more time under the current regime is required before substantiated comments can be made either way.

Draft Finding 4.5

55. The Productivity Commission has found that “that regulation involving access arrangements with a reference tariff should be considered only where service providers have substantial market power...[because]...where market power is not strong, such as where there is emerging competition in the gas industry, the long run of costs regulatory intravenation are likely to outweigh the cost of the market failure that regulation attempts to correct.”
56. Worsley submits that in the early transitional years during implementation of the GAR it is to be expected that costs will be at their highest and most keenly noticed.
57. Whilst high costs associated with regulation are undesirable, Worsley considers that the West Australian gas transmission market has not sufficiently evolved to justify moving

¹⁷ Allgas Energy submission 25, page 82 quoted at Draft Report page 110.

towards a lighter handed regime, which, whilst it may result in lower costs, will certainly diminish the rights of users.

58. The light-handed regime assumes that users have significantly more bargaining power in their negotiations with service providers than that which existed at the time the GAR was implemented. In Western Australia this is simply not the case.
59. Worsley also submits that it would be inappropriate to consider amendments to the GAR which would effect all covered pipelines, where the justification for those amendments are market changes that have only incurred on the Eastern Seaboard and not nationwide.

Draft Finding 4.7

60. Principally Worsley submits that the Gas Access Regime operates relatively effectively and does deliver economic improvements for pipelines that are covered under the regime.
61. Nonetheless, Worsley agrees with the Productivity Commission's draft finding 4.7 that the regime has deficiencies and improvements are possible.
62. Worsley emphasises that amendments that could bring about improvement in the Gas Access Regime should be directed at fine-tuning of the current regime and not a wholesale abandonment of the regulatory process that exists at present. Worsley further submits that any amendments made to the GAR should be focused on redressing the continuing imbalance in favour of the service provider.
63. Worsley stated in its previous submission, and reiterates, that the current regime favours pipeline owners over users, particularly in the area of expansion of developable capacity. The DBNGP is an extreme example of a capacity constrained pipeline, where demand far outweighs supply. However, despite numerous requests, no expansion of the pipeline has occurred since the introduction of the regime. The regime has to date been ineffective against Epic and its refusal to develop capacity in the DBNGP.
64. However, Worsley does understand that its experience in Western Australia has been largely due to the intersection of privatisation and the regime as well as the financial pressures that Epic have been facing since its purchase of the DBNGP.

Chapter 5 – Objectives and objects clause

Draft Recommendation 5.1

65. Worsley agrees that the over-arching objects clause recommended by the Commission should be inserted in to the GAR.
66. Worsley has previously identified in its submission to the Commission in July 2003 that there are sets of objectives within the Code that may be in conflict. Accordingly, Worsley agrees with the Commission’s comment that:
- “the objectives of the GAR are not well specified in the enabling documentation. In particular, there are too many objectives, some potentially in conflict with insufficient guidance to regulators on how to weigh up the tradeoffs.”¹⁸

Draft Recommendation 5.2

67. As stated above, Worsley has previously identified in its submission to the Commission in July 2003 the conflict between the various sets of objectives contained within the Code.
68. Worsley does not oppose the deletion of the objectives in Draft Recommendation 5.2.

Draft Recommendation 5.3

69. Worsley agrees that the elements of section 2.24 set out in recommendation 5.3 should be deleted from the Gas Code to eliminate conflict between the various objectives.

Chapter 6 – Coverage issues

Draft Finding 6.4

70. Worsley considers that the continued monopolistic nature of the gas transmission market, particularly in Western Australia, does not warrant in the adoption of a test that sets a higher threshold for coverage, such as the proposed test in draft finding 6.4.
71. Worsley is concerned with the proposed introduction of “substantial” and “material” as qualifying terms within the Code. Worsley considers that such terms are highly discretionary, difficult to use and may serve to introduce further unnecessary potential for conflict and dispute between parties under the Code.

Draft Recommendation 6.1

72. Worsley repeats its concerns raised in paragraphs 70 and 71.
73. Worsley is also mindful of clause 6(3)(ii) of the Competition Principles Agreement (CPA) and questions whether compliance with the CPA is achieved in circumstances where coverage is restricted to only those occasions where increased access results in a “substantial” increase in competition. Obviously this would have significant implications in respect of certification of the regime as effective and therefore excluding Part IIIA of the TPA.
74. Worsley considers that the coverage criteria are sufficiently high and requiring quantification of the likely increase in competition as “material” or “substantial” is only likely to complicate the coverage test unnecessarily. Further, Worsley submits that “material” is often used synonymously with “substantial”, and accordingly does not necessarily represent an appreciably lower threshold. Worsley submits that a lower threshold for coverage is not required, as service providers have effectively applied for revocation of coverage where the pipeline no longer satisfies the current coverage criteria, see paragraph 80 below.
75. In any event, where the other coverage criteria are satisfied, it is difficult to contemplate a situation where increased access is likely to have the effect of increasing competition to a material degree, but warrants only the flimsy protection of the monitoring regime rather than the current regime.
76. Worsley is concerned that the monitoring regime offers very little by way of constraint on service providers. This renders the regime unsuitable for widespread application in the current market.
77. The GAR was introduced with the objective of negating the harmful economic effects on both upstream and downstream competition, in markets where the owners of essential infrastructure (pipelines) are able to wield market power in respect of their operation of a pipeline. Worsley submits that the characteristics of the market, such as the pipeline owners being able to wield market power, still exist, particularly in Western Australia. Accordingly, any third party access regime must strengthen the position of users sufficiently to negate the imbalance of power between users and service providers.
78. The monitoring regime seems to be significant retreat from the current regime and assumes a level of constraint already operating on service providers that is simply not the case in Western Australia see paragraphs 10 - 29 above.

79. A five-year period during which a user is effectively trapped without recourse in commercial negotiations with the service provider may actually operate to protect a service provider's market power during that period rather than promote commercial negotiations between the parties.
80. Worsley submits that the GAR is at present drafted to enable revocation of coverage where pipelines no longer meet the requirements for coverage. Pipeline owners are empowered under the GAR to apply for revocation of coverage, which is arguably sufficient protection. A significant number of revocations of coverage have occurred since the introduction of the GAR, which demonstrates in Worsley's view that the revocation provisions operate effectively. This demonstrated and effective ability to apply for revocation of coverage is more than adequate to reduce the likelihood of regulation occurring where it is not required.
81. Worsley is also concerned that the monitoring option does not provide for binding dispute resolution. A user who has been unable to achieve a satisfactory outcome in negotiations with a service provider has no avenue through which they can pursue access in the face of a refusal to grant access by the service provider.
82. This is a serious compromise of users' rights which does not seem to be off-set by corresponding constraints on service providers:

Draft Recommendation 6.2

83. Worsley does not oppose the adoption of some form of guidance on matters to consider in assessing the 'promotion of competition' test in coverage decisions. However, Worsley is unsure whether this guidance is strictly necessary as it considers that coverage decisions under the GAR have generally been satisfactory.

Draft Recommendation 6.4

84. Again, Worsley repeat its concerns regarding the adoption of quantitative terms within the Code such as "substantially", "significantly" or "materially" as these terms will almost certainly introduce further and unnecessary uncertainty and potential for dispute between parties under the Code.

Draft Recommendation 6.5

85. Worsley repeats its comments in paragraphs 70 and 71.

Draft Recommendation 6.6

86. Worsley is opposed to the introduction of a monitoring regime as set out in paragraphs 73 - 85 and 87 - 88.

Draft Recommendation 6.7

87. The Commission posits that potential resort to a higher level of regulation would operate as a credible threat to service providers to refrain from exercising market power. Worsley does not agree that this is the case, nor does Worsley agree that imposing a five-year period during which no upgrade of coverage can be applied for is likely to promote commercial negotiations between parties.

88. A user would be forced to accept whatever deal it could get during the five-year period because the only alternative is not to enter into any contract for the transmission of gas, which in light of the lack of substitutes, is clearly no alternative at all.

Draft Recommendation 6.8

89. Worsley agrees with recommendation 6.8 and submits that this is likely to promote efficient management of applications.

Chapter 7 – Access Arrangements

Draft finding 7.1

90. Worsley prefers the building block approach and is generally satisfied in the way that it has operated in the GAR.

Draft recommendation 7.1

91. Generally, Worsley supports the pricing principles contained in draft recommendation 7.1.
92. Worsley does not agree with the Draft Report's comment that the Gas Access Regime's building block approach necessarily inhibits commercial negotiations or that "the regime tends to operate as a form of price-cap regulation."¹⁹ Rather than inhibiting commercial negotiations, Worsley believe that the regime provides for a more even-handed negotiation between users and service providers as it addresses the imbalance of information and power between service providers and users. Worsley believes that this will facilitate more productive commercial negotiations.
93. Worsley does not agree with the Draft Report's comment that the regime is operating as a form of price cap regulation with services and prices restricted to those approved by regulators.²⁰ The needs of users are unlikely to be completely captured by reference services and they will negotiate with service providers for services that satisfy their specific needs. A service provider is expressly required to offer customised services at non-reference prices under sections 3.2(b) and 3.2(c) of the Gas Code. This recognises the fact that users have different requirements.
94. Worsley is not aware of any evidence that the GAR has stifled negotiations between users and service providers in an environment where the imbalance between users and services providers is partially addressed. Worsley believes, however that it is naive to believe that a retreat to the monitoring option or removal of third party access altogether would offer a more satisfactory outcome.
95. As to the proposed pricing principles, Worsley considers that the principle in 8.1(a)(i) should be a target, not an upper or lower limit on the price. A service provider should be able to achieve greater revenue where its sales are higher than those initially contemplated or where it is able to reduce its costs below the forecast level.
96. As to proposed pricing principle 8.1(a)(ii), Worsley is concerned that the words "regulatory and commercial" in pricing principle 8.1(a)(ii) lend themselves to a restrictive interpretation of the risks of a service provider. There are a number of risks operating on a service provider, not just commercial or regulatory risks. Accordingly, the pricing principle should simply refer to the return being commensurate with the risks involved.

Draft finding 7.2

97. Worsley accepts that there is disagreement among experts concerning WACC which clearly "illustrates inevitable imprecision and subjectivity that occurs when regulators are

¹⁹ Productivity Commission 2003, Review of the Gas Access Regime, Draft Report, Canberra, p. 202.

²⁰ Productivity Commission 2003, Review of the Gas Access Regime, Draft Report, Canberra, p. 202.

required to approve reference tariffs.²¹ However, Worsley's wider concern is that the whole CAPM model is of questionable application for the same reasons, as illustrated by the fact that investors routinely pay 1.4 – 1.6 times DORC for regulated assets. The application of CAPM at all is dubious at best and understandably leads to conflict between parties because of its inherent imprecision. Worsley accepts, nonetheless, the continued use of the WACC/CAPM approach in the absence of a better alternative. Worsley's reservations in the use of this approach are with respect to the benchmarking. For example, the debt:equity ratio used in determining WACC and the β_p parameter used in CAPM calculations are derived from benchmarking. In the case of the DBNGP the project returns are based on long-term contracts with a small number of blue-chip customers. This is a fundamentally different risk profile to that of many other pipelines, particularly in the USA, which are used in benchmarking studies. There is intrinsic difficulty in finding appropriate benchmarks consistent with the commercial risk environment in which the DBNGP operates.

Draft finding 7.3

98. Worsley does not object to the expansion of a regulator's powers to enable information to be obtained between access arrangement reviews. However, Worsley cautions that high levels of interaction between service providers and regulators brings ever nearer the prospect of regulatory capture, which must be monitored and stringently guarded against.

Draft recommendation 7.3

99. Worsley supports draft recommendation 7.3.
100. Worsley submits that, to avoid unnecessary duplication, the Regulator's powers to obtain information and documents under the Gas Pipelines Access Law (GPA Law), which places the restriction on disclosure under sections 42 and 43 of the GPA Law, should be consistent with the restriction on disclosure under section 7.12 of the Gas Code.
101. Worsley agrees with the Productivity Commission's view that there seems to be limited scope under a building block approach for a service provider's information requirements to be reduced²². It is essential that the Regulator is able to obtain the necessary information that is required to properly assess the proposed access arrangements. Establishing a standardised system of maintaining of information will enable the Regulator to verify a service provider's assertions and will assist in redressing the information and commercial bargaining power imbalance between users and service providers.

Draft finding 7.4

102. Worsley agrees with this draft recommendation. Further, Worsley believes that this should be further reinforced by:
- (a) expanding the Trading Policy required under sections 3.9 to 3.11 of the Code to require service providers to include a capacity trading regime in its access arrangement;
 - (b) obliging the service provider to facilitate capacity trading by operating an Unutilised Capacity Trading Clearing House as a service.

²¹ Productivity Commission 2003, Review of the Gas Access Regime, Draft Report, Canberra, p. 237.

²² Productivity Commission 2003, Review of the Gas Access Regime, Draft Report, Canberra, p. 245.

103. Precedent for this can be found in Epic Energy’s “Secondary Market” provisions in its proposed access arrangement for the DBNGP. Worsley supports this initiative. However, it believes that short-term capacity trading may be better regulated in the Gas Code to prevent a service provider exploiting its market power in the “Secondary market”. Worsley submits that short-term trading capacity should be regulated as a reference service so that the service provider is not able to exploit its market power. Whilst Worsley accepts that setting reference tariffs for an unpredictable service such as short-term trading capacity is difficult, Worsley submits that it is not a justification for wholesale abandonment of regulation over such a service.

Draft recommendation 7.4

104. Worsley supports draft recommendation 7.4.
105. Worsley submits that any expansion of a covered pipeline should always be treated as part of the covered pipeline, regardless of the service provider’s nomination or preference to the contrary. Allowing nomination of an expansion to fall outside coverage runs counter to the concept that a pipeline is covered because it is judged to have market power and in all likelihood, market power would exist in relation to any capacity created as a result of an expansion.

Draft finding 7.5

106. Worsley agrees that there is certainly the potential for regulatory error in determining reference tariffs and this is largely due to a regulators inability to predict future market circumstances. However, there is no conceivable alternative, as abandoning all attempts at regulation is to embrace the known danger of inefficiency and to accept the negative impact that abuse of market power ultimately delivers.
107. It is also inevitable that in seeking to make the most informed decision possible regulators will seek information that is not always necessary. However, hasty decision-making without resort to information that may be of assistance should not be encouraged, as the impacts of what may be a preventable error are likely to be extremely far reaching.

Draft finding 7.6

108. Worsley disagrees with Draft finding 7.6, whilst the regulatory approach certainly has flaws and shortcomings that need to be addressed, it does not justify a wholesale abandonment of the current regime in favour of an “alternative less costly approach” which, most likely, will ultimately prejudice users and have negative flow on effects into the wider economy. Worsley is of the view that an “alternative less costly approach” is, at best ‘less costly’ in a micro sense – the cost of regulation – but not in a macro sense – the economic cost of a sub-optimal allocation of resources.

Chapter 8 – Lighter- handed regulation

Draft Recommendation 8.1

109. Worsley disagrees with Draft Recommendation 8.1. Worsley does not consider it appropriate that regulation with access arrangements only be implemented in the most extreme circumstances. Worsley submits that the current approach should be implemented wherever all the criteria for coverage are satisfied, this test is sufficiently high and pipelines falling outside coverage are unlikely to require strict regulation.
110. Worsley considers that where a pipeline falls outside the test for coverage, but one or more of the criteria are satisfied, in such circumstances, a light-handed approach to regulation may then be suitable in some cases.
111. The monitoring option, in order to be a valid and realistic option for regulation must be sufficiently intrusive to offset any imbalance of power between users and service providers, irrespective of the cost.
112. Worsley repeats its comments in paragraphs 70 - 89.

Draft Recommendation 8.2

113. Worsley is opposed to the adoption of the monitoring regime for the reasons set out in paragraphs 70 - 89, accordingly, Worsley does not agree with Draft Recommendation 8.2.

Draft Recommendation 8.3

114. Worsley disagrees with Draft Recommendation 8.3 for the reasons set out in paragraphs 70 - 89.
115. Further, Worsley considers that the proposed information requirements fall far short of the information that would be required to achieve the objects of the Code.

Draft Recommendation 8.4

116. Worsley is opposed to the monitoring regime, see paragraphs 70 - 89.

Chapter 9 – Investment and access arrangements

Draft Recommendation 9.1

117. Worsley does not object to the National Competition Council having the power to make a binding ruling on coverage on request from a potential pipeline investor. However, Worsley is concerned that there is proposed to be an express and lengthy period during which the binding ruling would apply.
118. A pipeline will only be covered where the service provider is in a position to exert market power in such a way that competition upstream and downstream is adversely affected. Economic efficiency will not be achieved if coverage is ruled out for a fixed period of time. The fact that coverage can be altered if the information provided to the NCC was false or misleading does little to achieve the objects of the GAR if circumstances simply change.
119. Worsley believes that it is only appropriate to make amendments to the GAR that have a potential to be damaging if there is clear and precise evidence that investment is actually being adversely affected by the GAR.
120. Worsley submits that it would be inappropriate to conclude that the GAR has had a profound impact on investment in Western Australia and repeats its comments at paragraphs 32 - 47.
121. In Western Australia, the DBNGP was purchased by Epic for \$2.4 billion, Worsley considers that this over capitalisation is likely to have had a significantly greater impact on investment than the introduction of the GAR. In an unregulated gas transmission market, or even one where a light-handed approach is adopted, Epic would be able to charge a far higher price for transmission.²³ Clearly an increase in the tariff for gas transmission, of the magnitude necessary to recover Epic's purchase price, would have an adverse affect on users in the market and an adverse affect on upstream and downstream competition.

²³ \$1.41 - \$1.62 per GJ according to Epic's original Access Arrangement Information dated 20 December 1999, para 2.5, p 11.

Chapter 10 – Ring fencing and associate contracts

Draft Finding 10.1

122. Worsley agrees with draft finding 10.1.

Draft Recommendation 10.1

123. Worsley understands that requiring authorisation of associate contracts may place a service provider and their associate at some competitive disadvantage. Generally, Worsley considers that the risk of potential abuse outweighs the costs of the regulation. However, Worsley agrees that where a service provider is entering an associate contract for the supply of services at the reference tariff, authorisation should not be required and notification may be appropriate.
124. Worsley notes that if this recommendation is implemented, it would require further amendments to the Code, particularly, that the service provider must be obliged to notify the regulator of the precise terms of the contract to ensure that the regulator is properly informed. In addition, the regulator must have the power to disallow or vary the associate contract if they form the view “that the contract would have the effect, or would be likely to that the effect, of substantially lessening, preventing or hindering competition in a market.”²⁴

²⁴ Gas Access Code, s7.1

Chapter 11 – Administrative and appeal processes

Draft finding 11.1

125. Worsley supports this finding. Worsley has witnessed first hand in the relation to the DBNGP access arrangement decisions, the significant delay that can occur under the GAR.
126. The approval of an access arrangement for the DBNGP took almost four years and is currently being appealed to the Gas Review Board. Accordingly, in Western Australia, there is still considerable uncertainty surrounding access to a major pipeline some four years after the introduction of the regime.
127. Whilst Worsley considers that improvements to eliminate delay are certainly possible in the GAR, it accepts that the situation in Western Australia was complicated by the intersection of privatisation with the regime and may not be a typical case.

Draft recommendation 11.1

128. Worsley supports part one of draft recommendation 11.1, that the regulator would be able to extend the period for approval of an access arrangement by two months only once, but makes the following comments:
 - (a) allowing a Regulator to extend the period of time for approval only once may help reduce delays in the approval process, but the effectiveness of this limitation may be undermined by a service provider's delay in providing information, or provision of inadequate information;
 - (b) the access arrangement approval process is a complex one and it should not be compromised by time pressures as this is likely only to lead to error in decision making and lengthy appeals.
129. Worsley supports the second part of draft recommendation 11.1 (giving the Regulator discretionary power to backdate tariffs). However, Worsley notes the following concerns:
 - (a) that there are likely to be inherent difficulties with implementation (as noted by the Productivity Commission.²⁵);
 - (b) it creates a new potential source of conflict and litigation. Parties may seek to challenge the discretionary exercise of the Regulator's power, with regard to both the decision to exercise and the manner of its exercise.

Draft recommendation 11.3

130. Worsley supports draft recommendation 11.3 as it considers that one draft decision should be sufficient to provide for feedback and amendments.²⁶

Draft recommendation 11.4

131. Worsley supports draft recommendation 11.4.

²⁵ Productivity Commission 2003, Review of the Gas Access Regime, Draft Report, Canberra, pp 344-45.

²⁶ Productivity Commission 2003, Review of the Gas Access Regime, Draft Report, Canberra, p. 346.

Draft recommendation 11.5

132. Worsley supports draft recommendation 11.5.
133. Worsley submits that judicial review under the Code should be limited only to natural justice grounds, other appeals such as those on the grounds of ultra vires, error of law on the face of the record or jurisdictional error should be heard by the Gas Review Board rather than in the Supreme Court.

Draft recommendation 11.6

134. Worsley supports draft recommendation 11.6