



# **Response to MCE's Proposal for Consultation on the Review of the National Gas Pipelines Access Regime**

**NOVEMBER 2005**

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The Australian Pipeline Industry Association (APIA) welcomes this opportunity to respond to the Ministerial Council on Energy's proposal for consultation, released on 9 November 2005.

This submission is structured as follows: (1) Introduction; (2) Response to MCE's position on key issues; and (3) Expert Panel.

In the forum discussion on 23 November, the issue of ranges in regulatory parameters was raised. Accordingly, although not raised in any detail in the consultation paper, APIA has also provided some comments on this issue in an attachment.

## **1 Introduction**

The MCE's current review processes, and its response to the Productivity Commission (PC) gas review, are undertaken in the context of the new national energy access regulation reforms.

The gas access regime commenced in 1997 with the aim of improving economic efficiency through the development of competitive upstream and downstream gas markets. At the same time, wider reforms were introduced, including privatisation of previously government owned gas businesses. The gas industry is continuing to develop, and is becoming increasingly competitive. However, continued and increased investment in infrastructure is required to ensure the benefits of upstream and downstream competition are fully realised.

Against this background, the primary objectives of the PC's review of the gas access regime were to:

- examine the extent to which current gas access arrangements balance the interests of relevant parties;
- provide a framework that encourages efficient investment in new pipeline and network infrastructure; and
- assist in facilitating a competitive market for natural gas.

APIA believes that the original objectives of the regime and the subsequent PC review should be pre-eminent in the current MCE processes.

#### *Implement the PC recommendations*

There is no doubt that the PC's review of the gas access regime was based on a thorough and comprehensive investigation, with the benefit of extensive consultation with a range of stakeholders. Given the extensive nature of the PC's consideration of the issues, APIA believes that any departure from the PC's recommendations must be carefully considered and justified by reference to some compelling circumstance. In this context, we note that APIA did not support all of the recommendations of the PC, but supports the package as a whole in order to avoid 'cherry picking' and delays in implementation of necessary reforms.

The PC report is a comprehensive reform package and the introduction of this package would not be a difficult process. APIA is therefore concerned that the current MCE process diverges from the PC recommendations and is proposing further review of key issues. This 'clean slate' approach is not warranted and will lead to delays and uncertainty.

#### *Merits review*

APIA would also like reiterate the importance of retaining the existing merits review process as part of the access regime. The existing review framework is an integral part of the gas access regime and APIA submits that the reform to the access regime cannot be undertaken in isolation from the issue of review rights..

#### *Convergence of gas and electricity*

The drive for wholesale standardisation of energy access regimes is a significant concern for APIA as the goal of seamless regulation across gas and electricity transmission and distribution has not been demonstrated to be the most appropriate regulatory design.

Clearly, there are aspects where a consistent approach is relevant and beneficial, in which case consistency may be an appropriate policy goal. However, APIA submits that the MCE must consider and take into account the fact that in some areas of the industries, regulatory differences are required due to the different nature of the assets. There is a risk that an overriding goal of consistency will prevent the best regulatory system being

implemented, with accuracy and optimal outcomes being sacrificed for the sake of standardisation.

APIA is concerned that, to date, there has been little or no consideration or debate regarding this issue. Such an untested matter requires full and careful consideration. The time allowed for this process is clearly going to be inadequate, unless the Expert Panel's review is limited to determining whether the PC's recommendations are appropriate more widely than for gas transmission and distribution (see comments below on Expert Panel).

The nature of the assets and operations in electricity and gas differ in many ways. Areas where the industries do not converge include:

- upstream production processes and economics are very different – for example, in gas, long-term contracts underpin field development;
- long-distance transmission location and economics are different:
  - gas pipeline economics are driven by the distance between naturally occurring gas fields and load centres;
  - unlike electricity transmission, there is no discretion or feedback loop in siting the gas transmission (decisions to site power stations and electricity transmission lines can react to each other. Decisions to site gas pipelines are driven by gas field location);
  - Long-term contracts underpin pipeline development.
- long-distance transmission functions are different – gas pipelines act as storage vessels as well as transmission infrastructure – electricity is instantaneous and acts only as transmission infrastructure;
- markets are driven by long term contracts required to underpin field and pipeline development;
- the gas and electricity industries tend to converge closer to the customers – this is evident in the fact that while most energy retailers retail gas and electricity, most long-distance transmission companies transport either gas or electricity, but not both. Similarly, at the production level, most participants generate electricity or produce gas, but not both.

The MCE's desire for convergence between gas and electricity regulation is not a justification for delaying implementation of the PC recommendations. The gas access regime has been tested nationally by seven years of experience and a number of reviews. It is substantially more widely and deeply tested than the electricity model. Any need to move gas access regulation to the less tested and (to date) state-based electricity system has not been demonstrated.

Moreover, convergence in regulatory frameworks will not lead to continued and increased investment in infrastructure.

## **2 Response to MCE position on key issues**

### **Objects clause**

APIA notes that the PC recommended a clear and simple change to the objects clause.

However, the MCE has now proposed the adoption of an objects clause for the gas access regime which mirrors that in the electricity regime in the interests of promoting a seamless approach to access across the energy sector.

APIA submits that the objects clause proposed by the PC should be adopted for the gas access regime. Importantly, it contains a single objective of economic efficiency, thereby promoting effective competition in upstream and downstream markets. The PC objects clause is appropriate because it:

- encapsulates all elements of economic efficiency (productive, allocative and dynamic); and
- recognises that promoting effective competition can enhance all these elements of efficiency, thereby promoting the interests of consumers and economy-wide efficiency.

APIA does not support the MCE's proposed objects clause. In our view, it suffers from critical failings. These are that:

- it has lost the connection with the objectives of third-party access. Instead, it places emphasis on consumers, rather than providing access in the interests of enhancing competition in upstream and downstream markets. Clearly an efficient and thriving transmission industry will benefit consumers while an industry hindered by lack of investment would not benefit consumers;
- it will be further removed from the Part IIIA objective, thus creating an artificial and unjustified distinction between access regulation to energy infrastructure and other infrastructure;
- it contains potentially competing objectives. Despite recognition of the need to consider the 'long-term' interests of consumers, its focus on the interests of consumers introduces a potential confusion in objectives of the regime – if nothing else, it wrongly suggests there is a conflict between efficiency and the interests of consumers. APIA submits that this will serve to undermine the goal of the new objects clause, which is to provide certainty to all stakeholders.

The proposed objective moves the regime from being an access regime where pricing is one component of access, to a pricing regime. For pipelines, the objective of access regulation is to facilitate competition in upstream and downstream markets. For example, for pipelines delivering gas to mine sites, power stations etc, regulatory intervention is not justified in order to protect large corporate mining concerns and power generation concerns but to facilitate access which in turn will enhance conditions for increased competition in upstream and downstream markets. An objects clause focusing on the promotion of competition will give a more balanced outcome which recognises the interests of both customers and service providers.

Furthermore, there has been no reason given to diverge from the Trade Practices Act and National Access Regime. In fact, rather than bringing the gas regime in line with the NEL, APIA submits the better question may be whether the NEL objective should be reviewed. This is an aspect of the MCE's response where APIA is concerned that the goal of consistency across the energy sector has been applied to the detriment of optimum regulatory outcomes.

APIA believes it is essential that an objects clause for the gas access regime be linked with promoting competition in upstream and downstream markets. It was in recognition of this objective that the gas industry agreed to the introduction of the Code.

Accordingly, if the MCE insists on departing from the PC's recommended objects clause, APIA believes that any alternative must retain a link to promoting competition. The ENA proposal would be a better alternative in this regard.

On a related matter, the question of whether the guidance to regulators (s.2.24, s.6.15) should be deleted should be considered in the context of the objects clause. Amending the objects clause as proposed by the MCE, rather than as proposed by the PC, but then adopting the PC's recommendation of deleting this guidance to the regulator would remove an important protection of the legitimate business interests of the industry. The questions cannot be considered in isolation.

### **Coverage test and administration**

APIA welcomes the proposed adoption of a coverage test for gas transmission and distribution pipelines that is aligned with the coverage test in Part IIIA. This change is in line with the fact that regulation should be applied to pipelines only where intervention is justified on economic grounds – namely, where it would generate a *material* increase in competition. This should be a fundamental underlying principle of economic regulation.

APIA does not support the proposal for the AEMC to replace the NCC as the coverage recommendation body, or for the decision on coverage to be separated from the decision on the form of regulation.

The separation of “rule making” and policy setting function from rule application and enforcement is a fundamental underpinning of good legislation and regulatory policy.

The proposal to achieve this separation by transferring the criteria and procedure for coverage assessments to the new National Gas Law is not sufficient. Given the AEMC's role as 'rule maker' in the new arrangements, it should not then also have a role that involves being a part of regulatory decision making. APIA considers that these responsibilities should remain separate.

Moreover, as the NCC is the advisory body for coverage/declaration decisions for all other types of infrastructure, it is not apparent, and nor has a case been made, as to why energy access should be treated differently and subject to a separate process. This distinction may in itself lead to perverse and inconsistent regulatory outcomes between infrastructure industries. Retention of the NCC as the advisory body is also more likely to result in timely and cost effective consideration of applications given the NCC, rather than the AEMC, will have the resources and expertise involved in considering applications.

APIA also believes that the expertise regarding coverage assessment and decisions currently lies with the NCC. No case has yet been made to justify this change and it is inconsistent with the PC.

### **Light-handed form of regulation**

APIA endorses the MCE's proposal to introduce the option of a 'light-handed' form of regulation. As an industry, APIA supported this aspect of the PC's report and it is therefore pleasing to see this taken up in general by the MCE. This proposal is consistent with APIA's view that there is no economic justification for access regulation where it would have no material impact on competition.

In this regard, APIA also notes that MCE has rejected the notion of any form of monitoring for uncovered pipelines. As the introduction of a monitoring regime to uncovered pipelines would be, in effect, a broadening or extension of regulation, we urge that it not be reconsidered in the current negotiations.

Generally speaking, including a new option of monitoring, with recourse to dispute resolution, is likely to help ensure that where regulatory intervention does occur, it is imposed in a manner that is justified in terms of the net economic benefits of that regulation, including not imposing undue costs on industry. The key issue from APIA's perspective is to ensure that regulation in any form will only apply to pipelines meeting the new coverage test. In terms of which form of regulation should apply, the current, 'heavy-handed' option should only apply where it is justified in terms of an assessment of the costs and benefits.

That said, there are aspects of the MCE's model that are of some concern.

### *Decision on form of regulation*

APIA supports the MCE's price monitoring proposal, with the NCC, rather than the AER as the body undertaking the assessment. APIA supports the NCC as the relevant body to undertake such an assessment as it is appropriate to link this test with the decision on the type of regulation to apply to the pipeline. This will make it a simpler decision path as the issues are connected.

In addition, it can be expected that the AER – as a permanent regulatory authority – will face an unavoidable conflict in considering whether to approve a pipeline to move from ongoing regulation by the AER to price monitoring.

APIA also supports the use of clear decision criteria to support the decision making on the level of regulation. The development of such criteria is not overly complex and APIA proposes the following criteria could be used in the assessment of the form of regulation to apply:

- if a covered pipeline has been through two building block price reviews there should be a presumption that price monitoring could apply given that their efficient costs would be substantially known;
- the nature of demand for commodities and services of end users of gas;
- the degree of countervailing power in the market (eg large and well-resourced customers; amount of spare capacity in pipelines serving that market);
- the degree of horizontal and vertical integration in the market;
- the level of competition from other pipelines or sources of energy; and
- the nature and extent of any entry barriers to the market.

If a pipeline passes the first test they should only have to meet one other test to be price monitored.

APIA notes that the first criterion has been supported by the Productivity Commission:

*“In the position paper the Commission recognised on the complexities of moving to productivity-based approaches and, in particular, the issue of how to establish starting cost bases. However, it noted that as a result of past building block exercises, cost bases have already been established for most essential infrastructure in Australia.”<sup>1</sup>*

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<sup>1</sup> *Productivity Commission. Review of the National Access Regime, Inquiry report No. 17, 28 September 2001, p. 346.*

The other criteria are from the PC Gas Review and are based on the ACCC merger guidelines.

As noted above, there are considerable linkages between the assessments to be made in regard to coverage and form of regulation which make it appropriate for these decisions to be assessed at the same time and by the same advisory body. This is not only efficient in an administrative sense, but minimises the chance of such decisions being inconsistent due to creating an artificial separation. The potential disconnect in this decision process is not avoided by the fact that the Minister remains the actual decision maker as the advisory body plays a critical role in the decision-making process.

APIA reiterates that the decision on the form of regulation should be made at the same time as the coverage decision.

### *Guidelines*

APIA believes that guidelines governing what form of regulation should apply should be determined now by the MCE. In particular, APIA is concerned to ensure that the PC recommendation that the full reference tariff regulation option only be used where the benefits ‘markedly’ outweigh costs is preserved. There is a risk that key elements of the PC recommendations will be diluted or set aside if left to the future discretion of the AEMC. This is a high-level policy issue that should be in the National Gas Law and is not appropriate for the AEMC to determine.

### *Other issues*

APIA supports the retention of arbitration in the event of a dispute, including reliance on the current Gas Code dispute resolution provisions, which are tested. In terms of the other elements of the MCE’s light-handed regulatory option (namely, the continuation of ringfencing obligations, the requirement not to hinder access and the provisions related to contracts with associates), APIA supports these to the extent they are consistent with the PC’s recommendations.

In regard to the proposal to allow disclosure requirements to be tailored to the specific circumstances of each pipeline, APIA notes that, while it is not clear exactly what this proposal will entail, to the extent it offers greater flexibility and minimises regulatory compliance costs, APIA supports this initiative. Nevertheless, APIA believes that information disclosure requirements under the light-handed option should be developed now, and not be left to the AEMC’s future discretion.

APIA would also suggest that, for an already covered pipeline, the Rules should state that the body deciding on the form of regulation should, prior to the expiry of an access arrangement, nominate whether price monitoring should apply.

## **Regulatory certainty for greenfields**

APIA strongly supports the need for reforms that improve the incentives and environment for investment in greenfields capacity. In light of this, APIA supports the additional measures proposed by the MCE in terms of the option for new pipeline proponents to seek a binding no-coverage ruling or a price regulation holiday.<sup>2</sup>

### *Criteria*

APIA also supports the development of criteria for identifying a greenfields pipeline. As this can be complex, it is important that the criteria are clear. The proposed criteria seem generally appropriate for the achievement of the underlying policy objective. The only matter on which APIA wishes to particularly comment is the proposed restriction on ownership.

This restriction would appear to be an artificial constraint that is not required for achievement of the underlying policy objective. For example:

- access regulation is about promoting competition in upstream and downstream markets, not about competition between pipeline proponents;
- in the case of greenfields pipeline proposals for the same market, each proponent faces similar risks and, as such, it is not clear why one should be eligible for a price regulation holiday and the other not;
- the proposed ownership restriction may also create unproductive or artificial incentives as proponents seek to work around this obstacle;
- the proposal does not recognise the effect of coverage of the existing pipeline. If there is an existing covered pipeline to a load centre, then there should be no concerns about market power, since there is open access to the existing pipeline, even if it is owned by the builder of the new pipelines. If the existing pipeline is not covered, concerns about potential lack of competition are allayed by the fact that the existing pipeline faces the threat of coverage. The key point is that coverage of a pipeline is “as good as” independent ownership, and ensures that outcomes consistent with competition are available;
- this restriction may also be impractical in a number of circumstances:
  - a new pipeline is being built by the current pipeline owner because fields supplying the existing pipeline are depleting;
  - the new pipeline is awarded via a competitive tender process;

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<sup>2</sup> However, APIA remind SCO that industry sought a regulation holiday of 20 years rather than 15 and our acceptance of the PC recommendations is a compromise.

APIA considers that this criterion is unnecessary. If it is considered necessary to specifically address the issue, APIA submits that alternative measures, such as ringfencing, could be implemented.

The treatment of capacity expansions should also be reconsidered, or at the least clarified. APIA supports the inclusion of capacity expansions in the definition of greenfields. Constructing a pipeline parallel to an existing pipeline could be treated as a greenfields pipeline if undertaken by a third party, but if a pipeline owner loops their own existing pipeline this is a capacity expansion. This has the potential to provide perverse behaviours at the margin, where it may encourage greenfields bypass rather than the more efficient capacity expansion.

### **Expert Panel**

APIA is concerned with the breadth of the Terms of Reference provided for the Expert Panel, particularly in light of the short time within which the Panel is to report. Proper consideration of such an extensive range of issues, which have already been considered in full by the PC, could see the process extended even further.

APIA submits that the PC's recommendations should be implemented, avoiding the uncertainty and delay which will be invariably caused by waiting for the common rules for the energy market to be developed (even if there were a demonstrated need for common rules). In view of the extensive nature of the PC's review, the 'clean slate' approach is unwarranted and unnecessary. The Expert Panel process as proposed by the MCE could lose the benefit of the PC's review of key provisions of the gas access regime with no countervailing benefit.

Nevertheless, APIA would like to offer the following comments:

- the key issue is to ensure the integrity of the PC recommendations is retained and that a full response to all recommendations is made;
- given the broad scope of matters referred to the expert panel and the timeframes suggested, APIA questions whether the terms of reference for the expert panel need to be reworked to simply identify which of the PC's recommendations may not be applicable to electricity transmission and distribution; and
- stakeholders must have an opportunity to comment on any proposals.

### **Ranges Approach**

At the SCO Forum of 23 November, the issue of the "ranges approach" was raised in the context of the PC's recommendations on the scope of the regulator's decision, including

whether a legal bias should exist in favour of the regulator accepting a proposal. APIA's detailed comments on this are attached.

### **Summary**

In concluding, APIA would like to reiterate its view that the best outcome would be for the full set of PC recommendations to be implemented immediately. There are no obstacles to the prompt introduction of the PC's recommendations. This would represent a balanced outcome for all stakeholders. The alternative is ongoing further reviews which will only result in unnecessary delays and uncertainty.

**Response to the MCE Standing Committee of Officials Request for Comments on the Issue of the PC Recommendation on the “Regulatory Ranges”**

**Introduction**

At the SCO Forum the issue was raised as to whether the “ranges approach”, coupled with an obligation on the regulator to accept a service provider’s proposal, will permit a business to propose and receive high or excessive rates of return. It was suggested that this could result in the business exercising market power. However, APIA believes this concern is unwarranted as discussed below.

**What is the “Ranges Approach”?**

In Australian energy regulation, the Capital Asset Pricing Model (CAPM) has to date been used to establish the allowed weighted average cost of capital (WACC). A key limitation of CAPM in the context of pricing regulation is that it requires estimates of a number of inputs, some of which are unobservable in the market.

The result of this is that CAPM gives a range of values for the WACC, rather than a single correct value. The “ranges approach” is a recognition of this, whereby the role of the regulator is to determine whether the service provider’s proposed WACC falls within the reasonable range of possible values; this is in contrast to earlier approaches whereby the regulator’s role was seen as being to determine the single “correct” WACC.

The “ranges approach” was held to be the correct approach by the Competition Tribunal in the *GasNet* decision, and the PC recommended the continuation of this approach.

Regulators operating under the “ranges” approach have indicated that they have faced no difficulties in implementing the approach. For example, the Economic Regulation Authority in WA has made three recent decisions applying the approach. Similarly, early decisions under the Gas Code involved the determination by the regulators of a reasonable range for the service provider’s WACC.

It is an integral part of the “ranges approach” that the regulator must be satisfied that the proposed WACC is within the range of values which the regulator considers to be reasonable. If it is not, then the regulator can disallow the proposed WACC and specify a WACC which is within the range which the regulator considers to be reasonable.

**What is the “Propose/Respond” Model?**

Under this approach, the role of the regulator is to determine whether the service provider’s proposed Access Arrangement complies with the Code – if it does, then the regulator must approve the Access Arrangement; if not, then the regulator can require

amendments necessary to ensure compliance. This is fundamentally the current position under the Gas Code.

It is incorrect to regard this as requiring that the regulator must approve the service provider's proposal and that it therefore creates some form of "bias" (whether legal or otherwise). The approach simply means that if the proposal meets the requirements of the Code, then the regulator must approve the proposed Access Arrangement rather than being able to substitute an Access Arrangement which the regulator would prefer. It would be unusual to describe an obligation on a decision maker to approve a complying document as demonstrating "bias".

As with the "ranges approach", an integral part of this model is that the regulator only approves the proposed Access Arrangement if the regulator is satisfied that the proposal complies with the Code. If the regulator is not satisfied, then the regulator can specify amendments required to ensure that the Access Arrangement does comply.

### **Does this permit exercise of 'market power'?**

The ranges approach, and the obligation on the regulator to approve a proposed Access Arrangement if it complies with the Code will not permit recovery of excessive rates of return or exercise of market power. The simple reason for this is that in both cases, the service provider must satisfy the regulator that the proposal is reasonable – if it is not, then the regulator can specify amendments or a WACC which the regulator considers reasonable. This is clearly demonstrated by recent decisions in Western Australia where the ERA was not satisfied that proposed rates of return were within a reasonable range and imposed lower WACCs on the service providers.

In addition, an important consideration in assessing the potential costs and benefits of the PC's proposed approach is the finding on the asymmetric consequences of regulatory error. The PC's finding in the review of the gas access regime was that the key risk facing infrastructure regulation was that access prices could be set too low.<sup>3</sup>

The PC recommended that the costs of access prices being set too low far outweighed the costs of access prices being set too high.<sup>4</sup>

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<sup>3</sup> Productivity Commission Media Release, Better Regulation of Infrastructure Needed, 14 February 2002

<sup>4</sup> Productivity Commission, Review of the National Access Regime – Draft Report, March 2001, p.128