6 June 2000 **[APIA]**

Mr Luke Berry
Policy Manager
National Competition Council
GPO 250B
Melbourne Vic 3001

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Dear Mr Berry

NCC Draft Recommendation – Application for Coverage of the Eastern Gas Pipeline (EGP)

This submission is made by the Australian Pipeline Industry Association (APIA), whose pipeline members own and operate the majority of high-pressure natural gas transmission pipelines in Australia.

The NCC's deliberations are taking place in an environment where the Access Code cannot be viewed as a vehicle that creates regulatory certainty and promotes pipeline investment. The Code has very little operational basis and regulators have experienced major delays in reaching draft and final decisions. Notwithstanding recent statements by NCC Chairman Graeme Samuels on the "facilitative" nature of the Code, the fact remains that the small number of transmission pipeline Access Arrangements that have been commented on or approved by ACCC do not demonstrate that regulators have much understanding of the commercial drivers and economic issues that confront pipeline owners and proponents of new pipelines. They simply do not have the necessary experience to form judgements on the fine balances to be achieved – including the need to provide genuine "facilitation" to new pipeline development and enhancement of existing systems. APIA reiterates the risks in using North American and European models as the bases for their education – markets in these countries are very different to Australia's and their infrastructure is much more mature.

At the outset, APIA was extremely concerned about the indecisiveness of the NCC's Draft Recommendation in relation to coverage of the EGP. The NCC's pipeline coverage test should provide clear guidance on the Council's views on whether the EGP should be subjected to the onerous provisions of the National Gas Code.

In its Draft Recommendation, the NCC has failed to express a clear view on the fundamental question of whether the entire pipeline should be "covered" or "not covered" by simply putting forward both alternatives, but with the implication that the Council was in favour of coverage. The Draft Recommendation is not framed in a form that could be considered a recommendation to the relevant Minister.

Private sector pipeline developers have every right to expect clear and unambiguous draft decisions from government agencies on major regulatory issues affecting pipelines. This is particularly important for the transmission sector given the large capital investment involved and the fact that the Code gives explicit recognition that a decision to cover a pipeline can have major commercial implications for pipeline companies.

The NCC has been given an important role under the *1997 Natural Gas Pipelines Access Agreement.* The ambiguous nature of NCC's response in the first major coverage assessment assigned to it sends a deplorable signal to the pipeline industry, runs counter to the goal of effective administrative decision making, and has created additional uncertainty in relation to a key aspect of the *1997 Natural Gas Pipelines Access Agreement*.

Turning to the Draft Recommendation, APIA notes that the overall presumption in the NCC's assessment is that transmission pipeline owners will be "rent seekers". The NCC's assessment ignores or downplays a number of key factors relevant to transmission pipeline operations and the specific circumstances faced by the EGP and its competitors. These factors are:

- Transmission haulage is a "wholesale" activity characterised by a relatively small number of informed buyers
- Transmission charges are a small component of the total delivered price of gas in the Sydney market
- The Code was designed for "natural monopoly" pipelines and did not contemplate "competing" transmission pipeline activities
- Firm haulage rates for the competing Moomba-Sydney pipeline have fallen
- Excess transmission pipeline capacity into the NSW market is expected to be long term in nature given projections of gas demand growth in NSW
- The NCC has failed to assess the consequences of a coverage (or partial coverage) decision in terms of costs, the possibility of regulatory error and the prospect of regulatory intervention acting as an impediment in the evolution of new services
- The NCC has failed to substantiate its assertion that the construction of the EGP will render further development of the Interconnect and associated pipelines uneconomic
- The NCC's views on competing energy sources and convergence are contrary to current industry thinking which views convergence of gas and electricity as important factors.

APIA takes the view that it would be inappropriate to make a decision to cover the EGP in the absence of compelling evidence that this intrusive regulatory avenue represents the only available means to "replicate the outcome of a competitive market." The NCC's recommendation will be viewed in a relatively wide context, including future business decisions relevant to greenfields, high risk transmission pipelines. It will also provide damaging market signals to pipeline users in NSW, many of whom have substantial market power in their own right resulting from three competing pipelines and three supply basins. Against this broader background, therefore, any recommendation for coverage (or part coverage) of the EGP would send a clear signal that the NCC's desired approach is to decrease the influence of markets and increase the level of regulatory uncertainty.

In conclusion, the dominant principle to be adopted by the NCC in its final decision must be to create the best environment in which to promote competitive outcomes wherever possible. In the case of the EGP the only appropriate decision is to recommend against coverage, including part-coverage of the pipeline.

The NCC should adopt a "wait and see" approach to regulation of the EGP under the Code. This will minimise the risk of error, allowing the Council to monitor the behaviour of pipeline owners serving the NSW/ACT markets and obtain information about market operation and shippers' reactions. APIA recommends that a period of three to five years will allow market participants to develop responses to pipeline-on-pipeline and basin-on-basin competition in the market. Access Code based regulation will only impede the development of the vigorous market conditions that are now beginning to emerge.

Yours sincerely

Allen Beasley
Executive Director

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DRAFT RECOMMENDATION BY NATIONAL COMPETITION COUNCIL ON APPLICATION FOR COVERAGE OF THE EASTERN GAS PIPELINE

SUBMISSSION BY THE AUSTRALIAN PIPELINE INDUSTRY ASSOCIATION

Introduction

The role of the National Competition Council (NCC) in relation to pipeline coverage is described in the *1997 Natural Gas Pipelines Access Agreement* agreed by the Council of Australian Governments.

The Code outlines in Schedule A those pipelines which are to be covered from the date of commencement of the Code. The Code also sets out three approaches to coverage of new pipelines under the Code, viz.:

- A case by case approach under which the NCC would use criteria specified in the Code

- The ability of service providers to request Coverage by submission of an Access Arrangement

- Use of a competitive tender arrangement, resulting in coverage from the time the Regulator approves the outcome of the competitive tender.

In addition, parties have the ability to avail themselves of provisions of Division 6 of Part IIIA of the Trade Practices Act through submission of an Undertaking to the ACCC.

The Code also includes a process to revoke the coverage of pipelines, including those listed in Schedule A and any other pipelines that may become covered under the Code.

The Code gives explicit recognition that a decision to Cover a Pipeline or to Revoke Coverage can have major commercial implications for service providers and prospective users; hence a mechanism was provided for review of the decision by the relevant appeals body.

The overlying attractiveness to customers of coverage under the Code is that it is expected to "replicate the outcome of a competitive market" and lead to lower prices.

A key concern of the Code to service providers is its prescriptive nature, the regulatory risk inherent in the role given to the regulator, the cost of service approach implied in the pricing principles (and borne out in practice in Access Arrangements) and the disincentive/regulatory impediments to innovative pricing and rewards for the development of new services in a rapidly changing energy market environment.

The challenge for the NCC, therefore, is to consider and make the most appropriate and informed recommendation to the Minister on the finely balanced interests of the service provider and customers/potential customers. The recommendation must also be viewed in a much wider context - it will provide signals to the pipeline industry which will influence business decisions on investment in greenfields, high risk transmission pipelines. It will also provide signals to pipeline users in NSW, many of whom have recognised that they have market power where three pipelines (EAPL, EGP and the Interconnect) and three supply basins (Cooper, Gippsland and Otway) are competing. A recommendation for coverage of EGP will signal that the Governments of Australia (through the agency of the NCC) wish to decrease the influence of markets and increase uncertainty.

However, the dominant principle must be to create the best environment in which to promote competitive outcomes whenever possible (as outlined in the NCC's mission statement). If NCC chooses to recommend coverage under the Code as the only available means to "replicate the outcome of a competitive market" it has not properly assessed the facts of this case.

Background to Code

The entire National Gas Pipelines Agreement is based on the assumption that transmission represents a natural monopoly and that there is no scope for competition in "natural monopoly" parts of the gas market serviced by the Code, ie transmission and distribution.

More generally, the Code approach assumes that transmission operators will be "rent seekers" by virtue of their natural monopoly position.

In this respect, the NCC's overall analysis on coverage ignores an important difference between distribution and transmission activities. Transmission haulage is a "wholesale" activity characterised by a relatively small number of large customers (retailers and major users); distribution on the other hand has a very large number of customers large and small (industrial, commercial and residential). Transmission owners deal with a small number of informed buyers who are in an excellent position to negotiate price of haulage services (particularly given that they have a number of competing supply routes and haulage options to meet their anticipated needs).

The Code is based on the assumption that the same conditions of "market power" and "natural monopoly" apply to both transmission and distribution in all circumstances. Neither the Code nor the Agreement accommodates the possibility of "competing" transmission pipelines and the means by which this should be treated under the regulatory framework. Had such issues been considered it would be reasonable to assume that the Code include appropriate guidance (eg as currently applies to coverage of pipelines under tender arrangements). Further evidence that such issues were not considered is provided by the fact that government policy makers are only now turning their attention to issues surrounding competing pipelines under the activities of the National Gas Pipelines Advisory Committee (the body set up by governments to advise on the Code and its implementation).

The Market

In its draft recommendation the NCC has adopted a very narrow interpretation of its role under the Code. The apparent intention of the NCC appears to be to develop an argument for coverage under the Code, rather than conduct an objective assessment on whether coverage is justified on the facts of the matter.

There is some evidence that the NCC may view its role as one of securing lower prices for customers. As recently as 31 May 2000 the Minister for Financial Services and Regulation, the Hon Joe Hockey, issued a press release (including an officer from the NCC as a contact person) under the heading "West Australians to Get Cheaper Gas". (The Media Release makes a direct link between the NCC's approval of WA's Third Party Access Regime as an effective regime and the expectation of lower gas prices flowing from the decision). It is evident that the NCC does not consider the wider context of the development of Australia through a regulatory regime that allows companies to manage risk and add value to the community by encouraging growth.

History confirms that governments have at best a very ordinary record at picking winners, so new infrastructure developments are best left to companies who have the risk management skills. Companies have to operate under the threat of retaliation by shareholders if they fail in their management of risk. Governments also have a role in that they can provide the threat of heavy regulation if the behaviour of companies is inappropriate.

In these circumstances, the NCC can make a very "safe" decision by recommending no coverage and observe the way in which the market participants behave. If there is clear evidence of the exercise of market power, the first to complain will be disaffected users, who will seek a review of the coverage decision in the light of new information. This is "behaviour regulation" followed by the threat of onerous regulation. The effectiveness of the Trade Practices Act gives strong support to this approach.

The NCC Draft Recommendation

APIA has previously expressed its concerns about the nature of the NCC's so called draft recommendation on coverage of the EGP. It simply does not reach any substantive draft recommendation in relation to coverage of the pipeline that could be put to the Minister.

Against the background of perceptions that are being created in the minds of the general public about the NCC's role, APIA is therefore very concerned that the Council's assessment has either ignored or discounted outcomes emerging in the NSW energy and gas markets, including those resulting directly from EGP's prospective entry into the Sydney region:

- *Firm haulage rates for the Moomba-Sydney Pipeline have fallen*

Other pipelines competing into the NSW market (MSP, Interconnect) have signaled their intention to compete with EGP in the provision of transmission pipeline haulage services.

The NCC's assessment of the state of competition in NSW does not even refer to this outcome and the implications this may have for coverage (or non-coverage) of the pipelines in question under criterion (a).

This is an important factor which must be addressed by the NCC in its "promotion of competition test" under which "the Council compares the market conditions which would prevail if the pipeline were not covered under the National Code with those that would prevail if it were covered under the National Code."

- *With the entry of the EGP, and on current demand projections in NSW, the NSW market will have excess pipeline capacity until beyond 2010. The Moomba-Sydney pipeline, when fully compressed and operating at 100 percent load factor, has sufficient capacity to serve the entire NSW market beyond 2020. With the addition of the EGP, demand as a proportion of capacity may reach only 61 percent by 2020*

Against this background the NCC reaches the absurd conclusion that the EGP is likely to have market power in the gas sales market and that it is likely to be able to use that market power by restricting throughput in the pipeline and, as a consequence, charging higher prices than would otherwise be the case. The NCC also concludes that the market power, and the possibility of profitable exploitation, is likely to increase as surplus gas transmission capacity is dissipated by market growth.

However, the NCC has failed to conduct any objective assessment to substantiate any evidence it may have to support the arguments it presents in relation to "market power". Rather it simply raises the possibility "...the prospect that the Eastern Gas Pipeline will behave in a competitive manner ….especially in the short to medium term", and fails to reach any draft recommendation on the issue of coverage or non-coverage of the entire pipeline.

- *The NCC asserts that transport costs normally represent a significant proportion of total delivered costs, but fails to provide any analysis of the situation as it relates to transmission in NSW*

According to the most recent published information on gas prices to customers (AGA, Gas Industry Statistics 1999), the transmission component of haulage (derived from Port Jackson's report for the BCA "Australia's Energy Reform: An Incomplete Journey" and before the prospect of the EGP and opportunities for pipeline-on-pipeline competition) represents less than 6 percent of the total price paid by residential customers and less than 15 percent of the price paid by commercial/industrial customers. The NCC assertion is flawed because it fails to present the fact that, for pipelines in the south east of Australia, the transmission tariff is a very small component of the total delivered price of gas.

- *The NCC has failed to assess the consequences of a coverage decision in terms of costs, the possibility of regulatory error and the prospect of regulatory intervention acting as an impediment in the dynamic evolution of new services.*

The NCC concludes that access (or increased access) - under the Code - to the services provided by means of the pipeline would not be contrary to the public interest (criterion (d)). However, assessment under this criterion is dependent on the Council's ultimate approach to partial or full coverage of the pipeline.

If a recommendation were made in support of coverage only to the Canberra offtake, the NCC should be required to include in its recommendation a full assessment of the costs and expected benefits and alternative approaches to achieve equivalent customer protection (recognising that only a very small number of customers would be involved, gas volumes to the markets in question are small and the pipeline owner has indicated that pricing policies for the regional markets will be referenced to the major Sydney market**).**

The most appropriate means of addressing this issue is to require the NCC to issue a Regulatory Impact Statement (including costs and benefits) in relation to criterion (d) as an attachment to its recommendation to the Minister.

- *The NCC concludes that "with the construction of the Eastern Gas Pipeline, it would not be economic to further develop the Interconnect and associated pipelines to provide the services of the Eastern Gas Pipeline."*

This is a remarkable conclusion given the current state of evolution of gas and electricity markets in southeast Australia. It suggests that the NCC has a thorough understanding of the nature of competitive forces in both the gas and electricity sectors, the location of possible future natural gas discoveries, the markets they may serve and a comprehensive understanding of the issues that will impact on the future development of the interconnect once the EGP is operational.

The NCC must either provide detailed substantiation in support of its arguments (which appear to be based on elementary, general assertions regarding surplus/developable capacity in the EGP and perceptions of capacity constraints either side of the interconnect), or withdraw the statement and revise its assessment under criterion (b).

- *The NCC states that "While energy sources, such as electricity, provide some competitive discipline on the sale of natural gas, the field of rivalry between these energy products is not so close as to integrate the markets."*

Given the moves towards convergence of electricity and gas in Australia (and overseas) the NCC should detail its reasoning in reaching this conclusion, since it is in conflict with the experience of the North American and European energy markets. Australia is rapidly moving along a path towards convergence. Already electricity generators and gas producers are using inputs from both sectors to determine pricing and development opportunities

The NCC's view is contrary to current industry thinking which views convergence of gas and electricity as an important factor (and one that is recognised as such by jurisdictions).

Power generation is expected to be a major source of increased demand for gas. Given the development of the National Electricity Market, including separate transmission arrangements, it will be open for generators to locate in one state and sell energy in another. Generators will have a range of options in siting their plants, based on an integrated assessment of market demand projects, electricity transmission charges and haulage charges along gas transmission pipelines. In effect, gas pipeline haulage is in direct competition with electricity transmission charges, a factor that the NCC does not appear to have considered in its assessment of the market under criterion (a).

Conclusion

APIA and its constituency are very concerned about the absence of full analysis of the facts of this case and strongly recommend that the NCC engage the industry and large users to carry out a proper economic and commercial analysis of the situation. This analysis would need to take into account all the aspects of the development of energy markets. APIA believes that the NCC must substantiate fully its assertions to support its case for the implementation of heavy-handed regulation which, based on the industry's and users' analyses, will not be in the public interest.