

Fletcher International Exports Pty Ltd

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Light Regulation of Central West Pipeline



Submission

relating to

**The National Competition Council's
Draft Determination**

16 December 2009

1. Background

APT Pipelines Pty Ltd owns and operates the Central West Pipeline (CWP) which conveys gas from the Moomba Sydney Pipeline at Marsden to, amongst other customers, Fletcher International Exports' abattoir at Dubbo.

On 2 October 2009, APT Pipelines (APT) made application to the National Competition Council (NCC) for converting the current full regulation of the covered pipeline to light regulation.

On 30 November 2009, the NCC issued a Draft Determination in which it indicated its intention to grant light regulation status to the CWP and sought to provide reasons for its decision. The NCC invited comments from interested parties which will be considered prior to its handing down its Final Determination in January 2010.

Fletcher International Exports Pty Ltd is a major end-user of the CWP and is pleased to have the opportunity to make this submission. In preparing this submission we have engaged Energy and Management Services Pty Ltd (EMS) to provide assistance. EMS has been Fletcher's energy consultants since 1996 and has been deeply involved in every aspect of our conversion to natural gas and all subsequent contract negotiations.

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Parts of this submission are confidential and are clearly marked as such. We request the NCC to strictly restrict access to such sections to the Council and its Officers only. A public version of this document, with confidential sections removed, will also be submitted to the NCC.

2. Context

As noted in paragraph 2.20 of the Draft Determination, Fletcher International Exports is the largest end-user of the CWP. In fact, our annual gas consumption is in the order of 240TJ, some 20% to 25% of the total current haulage through the CWP.

All production from Fletcher International Exports' Dubbo Abattoir is sold into the international export market. At Dubbo, we employ around 900 workers, and provide a market for many suppliers of livestock from across the eastern States of Australia. Clearly, the foreign income gained from our production provides employment and flow-on social benefits to many rural and regional communities.

Competing, as we do, on the international market means that the cost of inputs such as energy, are critical to our success. If the cost of energy becomes unreasonable, the cost of our products will increase and our market share will suffer with widespread adverse effects. This fact cannot be dismissed lightly.

3. Business Relationship with APT Pipelines

Notwithstanding that Fletcher International Exports is not strictly a direct customer of APT, the magnitude of our share of the CWP's haulage has always dictated that we must negotiate directly with APT on the terms and conditions of their services.

The arrangement is that Fletcher International Exports, with the assistance of EMS, negotiate prices and other terms with APT which are then formalised as a transport agreement. Our contracted gas retailer (which changes from time to time) then writes the terms of the transport agreement into the gas supply contract as a straight pass-through cost. Thus, although the invoicing and payment for CWP services is part of our retail contract and APT is paid by our retailer rather than by us, the terms of the transport agreement are fully determined by our direct negotiations with APT.

Fletcher International Exports experiences the full effects of APT's market behaviour without any screening by the retailer or smoothing over a wider customer base. For the information of the NCC, we provide a brief history of our dealings in relation to the CWP in the Appendix. The material provided in the Appendix is confidential.

4. The Essential Differences between Full and Light Regulation

From our viewpoint, the essential differences between full regulation and light regulation are as follows.

- Under full regulation, fair and just pricing is determined *ex ante* by an independent regulator whereas under light regulation, fair and just pricing is determined *ex post* by means of disputation and arbitration;

- Full regulation ensures that pricing is based on a sound economic determination that covers all cost components (including a reasonable profit margin for the pipeline owner) whereas light regulation provides for pricing that is based simply on what the market will bear and enables the charging of monopoly rents;
- Under full regulation, pricing is constrained by regulatory action whereas under light regulation, pricing is constrained only by the pipeline owner's level of concern about disputation, cost of arbitration and poor publicity (and when a pipeline owner has great market power, their level of concern is minimal);
- Under full regulation, the cost of determining fair and just pricing is met by the pipeline owner in their dealings with the AER whereas under light regulation, the cost of determining fair and just pricing through disputation and arbitration is also carried by the end-user who is already disadvantaged by virtue of the monopoly rents that are the subject of the disputation.

5. The Market Power of the CWP

We commend the NCC for refuting the claims of APT Pipelines and instead recognising that the CWP enjoys, and will continue to enjoy, significant market power.

In their submission, APT Pipelines claims (paragraph 2.47) that "Fletchers has advised that it has alternative fuel options installed including LPG and coal boilers". Whilst this may be true in theory, in reality LPG is three to five times more expensive than natural gas (comparative billing information on natural gas for our Dubbo abattoir and LPG for our Narrikup abattoir can be provided confidentially if required to verify this statement).

With regard to coal, our Dubbo abattoir had one coal fired boiler prior to the CWP coming on line. The boiler could be retro-converted to coal if needs be. The associated infrastructure (coal handling, bag filters, ash disposal, etc) could also be re-established. From a purely commercial viewpoint, in the event that APT raised their prices to an unacceptable level, we would determine the economic payback of reinstating the coal infrastructure and make the decision in accordance with our normal commercial hurdle rates.

However, in our view, the environmental issues are far more critical than pure economics. Coal consumption creates many environmental liabilities including excessive greenhouse gas emissions from the boilers as well as the thousands of truck movements that would be required each year to haul the coal from the Hunter to Dubbo.

The additional cost on coal that is likely to be introduced as part of the Carbon Pollution Reduction Scheme (CPRS) legislation will increase the cost of coal consumption by an amount which is unknown at this stage.

It follows that if APT was not constrained by a full regulation pricing regime in which the cost of their services is determined properly by an independent regulator, then APT will instead

charge whatever the market will bear. That is, they will raise their prices until the retail cost of natural gas approaches the retail cost of alternatives. The difference between the properly determined regulated price and the actual price would be a clear monopoly rent, and if the actual price is determined by comparison to coal, then the monopoly rent is further inflated by the amount of CPRS tax that coal consumption incurs.

The monopoly rent forced upon APT's customers would be financed by means of hardship and damage inflicted upon rural economies.

6. Effectiveness of Regulatory Alternatives

We note the NCC's clear statement that the determination of whether or not to apply light regulation to the CWP turns on a comparison of the effectiveness and costs of the two forms of regulation (paragraph 3.2). Accordingly, in this section we address questions of effectiveness. Questions of cost will be addressed in the next section.

6.1 We commend the NCC for refuting APT's risible argument that its inability under the present Access Arrangement to exercise its market power means that it will similarly be unable to exercise its market power under light regulation (paragraphs 3.9 and 3.13). It is patently clear that APT Pipelines' aim in applying for light regulation is to establish a regulatory environment in which it can exercise its market power subject only to the threat of disputes.

6.2 With regard to the proposed shift to a two-tiered (capacity and quantity) pricing structure, we understand that APT Pipelines have submitted a proposal which is revenue-neutral in comparison to the current single-tiered (quantity only) structure. We have some concerns:

- Firstly, has the AER verified the claim of revenue neutrality or is the NCC accepting APT's statement without investigation?
- Secondly, we presume that the revenue neutrality applies to APT and not to each of its customers. Has the NCC or the AER investigated the extent to which the costs faced by each individual end-user will be altered by the introduction of the proposed two-tiered structure?
- Thirdly and most importantly, we submit that while the initial starting point for the two-tiered structure may be revenue-neutral, under light regulation the initial pricing will very quickly be increased. Revenue neutrality will vanish as soon as a decision in favour of light regulation is made.

6.3 It is unfortunate that the NCC has upheld APT Pipelines' request for confidentiality over its proposed two-tiered pricing structure. As end-users, we have a strong and relevant interest in the details.

In the absence of better information, we are concerned about the implication that seems to underlie paragraph 3.19 of the Draft Determination. The discussion indicates that the capacity charge component of the two-tiered tariff will be determined by allocating the fixed costs as a proportion of total utilisation rather than as a proportion of total capacity.

It is our strong contention that the capacity share of each end-user should be that user's share of the total capacity of the pipeline, not its utilisation at any particular point in time. The risk of under-utilisation should be carried by the pipeline owner for that is their core-business. End-users must not be expected to carry the volume-risk of the pipeline owner.

- 6.4 In the process of arbitration (that is, the *ex post* disputation-based method of determining fair and just pricing under light regulation), the ability of an end user to construct a case will depend greatly upon access to relevant economic and operational information about the pipeline in question and in this regard, the NCC recognises that under light regulation such information will be difficult to procure. However, in the matter of the CWP, the NCC finds comfort in the fact that historical information on the CWP is currently available and "will retain much of its relevance" (paragraph 3.24).

We find no such comfort. Firstly, as described in the Appendix, currently available information is scant and mostly unhelpful. Possibly more information has been made available to the NCC than is generally available to end-users. The NCC should not presume that such information is, or will be, publicly available.

Secondly, the process of arbitration is virtually untested (because the only other lightly regulated pipeline has such a large customer base that the effects of monopoly rents are spread broadly – this will not be the case with the CWP). In the event that a dispute goes before arbitration, an end-user's reliance on historical information (such as is available) is sure to be tested by the pipeline owner with the argument that the information is no longer relevant and possibly non-admissible. It is inevitable that a huge asymmetry of information will exist in the pipeline owner's favour. Similarly, unless an end-user engages a range of specialist consultants at its own cost, a huge asymmetry of resources will also exist.

In short, we find that the NCC's reliance on the untested disputation process as a means of ensuring fair and just pricing, is heavily biased in favour of the pipeline owner.

- 6.5 To conclude this review of matters relating to the effectiveness of regulatory alternatives, we provide a summary of APT's arguments and the NCC's findings in the table below.

| APT Pipelines' Argument | NCC's Finding |
|---|---|
| That under light regulation CWP's market power is low. | Disagree. |
| That APT will be unable to use its market power under light regulation. | Disagree. |
| That ASX reporting will address end users' need for information in a dispute. | Disagree. |
| That APT may publish certain information that may assist end-users in the event of a dispute. | It is unlikely that APT will publish such information and the regulator cannot force its publication. |
| That historical information will remain available and relevant. | Agree. |
| That CWP prices would have been the same had light regulation been applied since the commencement of the CWP. | Sceptical. |
| That a two-tiered pricing structure is more appropriate than a single-tiered structure. | Agree but irrelevant to the question of light regulation as a two-tiered structure is likely to be included in the next AA in any case. |

It is noted that on every point but two, the NCC's finding is negative and of the two points of agreement, only one is relevant.

The single relevant point of agreement concerns the availability and relevance of historical information. On this point, Fletcher International Exports argues, as discussed above, that it remains untested whether the scant amount of currently available information will be useful or even admissible in an arbitration hearing.

Given that the NCC has found against all but one of APT Pipeline's arguments, and the sole point of agreement relates to a matter which has no precedent, no demonstration and no certainty, we are astounded by the NCC's conclusion that "the light regulation regime is likely to be similarly effective as full regulation in protecting users and other parties that are dependent on access to the pipeline" (paragraph 3.24).

In our view, based on the NCC's own findings, the light regulation regime will have seriously adverse effects upon end-users and accordingly we respectfully request the Council to reconsider its conclusion.

7. Costs of Regulatory Alternatives

- 7.1 APT Pipelines have suggested that the cost of preparing an Access Arrangement submission will be in the order of \$400,000 for themselves and a further \$400,000 for the AER. The NCC does not appear to have verified APT Pipelines' mooted costs or

provided an opinion on whether they are reasonable. It appears that NCC accepts APT Pipelines' figures without question (behaviour which they hope end-users will emulate when APT Pipelines advise their prices under light regulation, should it eventuate). We would expect that a discussion of costs should be predicated on a review of whether the mooted costs are reasonable. It is noted that the AER cannot identify any likely cost savings (paragraph 3.30).

- 7.2 The NCC concludes, without any form of quantification, that "a shift to light regulation is likely to result in modest but significant cost savings" (paragraph 3.33). Since the dictionary defines 'modest' as "moderate or limited in size or quantity" and 'significant' as "fairly large in amount or quantity", we are at a loss to understand the meaning of the NCC's conclusion.

If the savings are modest, then there is no reason to change from the existing full regulatory regime. If the savings are significant, then the value of the savings must be verified, quantified and clearly stated, which as discussed above, the NCC has failed to do.

- 7.3 The NCC admits that it is concerned only about savings accruing to the pipeline owner (paragraph 3.33). Any costs that may be incurred on other parties are ignored.

- 7.4 The NCC's conclusion on costs (paragraph 3.39) is that "where light regulation is similarly effective to full regulation but involves a lesser cost across all relevant parties it is the most suitable form of regulation and a light regulation determination is consistent with the national gas objective".

We dispute this conclusion on the following grounds:

- By virtue of the NCC's own findings as summarised in the Table above, light regulation of the CWP is clearly not similarly effective to full regulation;
- The cost savings have not been demonstrated:
 - APT Pipelines' claimed savings have not been verified;
 - APT Pipelines' assertion regarding the AER's savings have been denied by the AER;
 - The savings which the NCC believe exist have not been verified, explained or quantified but merely asserted by an unsubstantiated, inconclusive and essentially meaningless statement that "modest but significant" savings may result;
- Even if the savings are significant, it cannot be claimed that they involve "a lesser cost across all relevant parties" as the NCC, by its own admission, has addressed only one party – the pipeline owner. The cost effect on all other relevant parties has been ignored.

8. Conclusion

It is our view that the NCC's conclusions on issues of effectiveness conflict with its own findings and its conclusions on issues of cost are completely unsubstantiated. No grounds have been demonstrated to justify any change from the current regulatory arrangements.

9. Appendix - History of CWP Dealings

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