

Moomba to Adelaide Pipeline System Revocation of Coverage under the National Gas Code

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Summary

Once meaningful competition is in place, it is generally agreed that regulation should be removed. Determining the nature of meaningful competition has been a contentious issue in the gas supply industry but regulatory appeal body decisions and reports by the Productivity Commission have brought clarification.

Over recent years we have seen two authoritative reviews of regulators' decisions and a policy framework for regulation of these facilities set out by the Productivity Commission's Review of the Gas Access Regime. Together these three reviews establish a strong body of well documented and rigorously argued material that provides a guide to when regulators should revoke regulatory coverage or not seek it in the first place. In the context of gas pipelines, the findings of the reviews are that regulation is not appropriate when there are two pipelines of comparable capacity serving the same market.

Although once considered to epitomise natural monopoly, in less than a decade during which the statutory protection enjoyed by most transmission pipelines has been overturned by national competition policy, some important natural gas transmission pipelines are now in rivalrous supply situations. There are now two sets of pipelines serving Sydney and Adelaide, and Brisbane is also likely to see competitive provision.

Decisions of regulatory appeal bodies have largely eliminated regulatory coverage of the two pipelines serving Sydney. The SEAgas pipeline from Victoria to Adelaide has not sought coverage and at the present time is fully contracted. The SEAgas pipeline is comparably sized to its competitor, the Moomba to Adelaide Pipeline, which is seeking revocation of its own coverage.

In line with the precedence established by regulatory reviews and the informed analysis of such respected bodies as the Productivity Commission, the National Competition Council should agree to the application by Epic Energy to remove coverage of the Moomba to Adelaide Pipeline.

Introductory Comments

Australian gas pipelines, having been considered to be natural monopolies are now increasingly facing competition. This is both for sources of gas (MAPS/MSP) and Gasnet/EGP) but more importantly for customers (EGP/MSP, SEAgas/MAPS)¹. A further competitive injection will take place once the PNG Pipeline to Brisbane is committed.

Hence, of the major pipelines, only the Gasnet system and the Dampier Pipeline in Western Australia will in the near future be likely to have monopolistic market power features. Even with these two pipelines there are significant competitive disciplines. In the case of Gasnet, for example, as well as the opportunity of other pipeliners to build bypass pipelines, there is competition from the Moomba link and from the Otways and the Port Campbell storage facility.

This was not expected by the Hilmer report which offered gas pipelines as an example of a “natural monopoly”. The development of competitive provision calls for the regulatory authorities to adopt a changed conceptual framework in addressing the regulatory arrangements they set for the industry.

Under Part IIIA of the Trade Practices Act, owners of monopoly infrastructure services like gas pipelines were required to grant access to allow third parties to transport their own product over the network. Access to infrastructure facilities can be brought about in three ways.

- First by having “the Designated Minister or any other person” apply to the NCC to have a service “declared”, requiring the owner to allow third parties to use the facility. The terms and conditions of that access can then be negotiated and, in the absence of a negotiated outcome, these are determined by the Australian Competition and Consumer Commission (ACCC).
- Secondly, a provider or intending provider may approach the ACCC and offer an “undertaking” specifying terms and conditions of operations. This grants immunity from legal challenge under the Trade Practices Act.
- Thirdly, by a State based regime that the NCC has recommended is an “effective” access regime to the Commonwealth Treasurer and where the Commonwealth Treasurer has accepted that recommendation. In the Eastern States, State Regulatory authorities are responsible for distribution and the ACCC is the regulator of transmission pipelines.

The ACCC cannot accept an undertaking if the service is already “declared”. Nor may the NCC recommend a service be declared if it is subject to an access undertaking.

The MAPS has sought to become uncovered in the light of its competitive situation changes following the building of the SEAgas pipeline from Victoria. This leaves it no longer dominant as a supplier to Adelaide and the region. MAPS has a capacity of 418 TJ/day almost all of which is presently contracted but most of which will be out of contract during 2006. SEAgas has a capacity of 411 TJ/day. It is jointly owned by

¹ Moomba to Adelaide (MAPS); Moomba to Sydney (MSP); Gasnet (Victorian system); Eastern Gas (EGP); South East Australian (SEA Gas).

International Power, TXU and Origin Energy, the three major gas users/intermediaries in South Australia.

Recent Reviews of Gas Pipeline Regulatory Arrangements

Three recent reviews of significant regulatory matters concerning the Gas Access regime have been undertaken. These were by the Australian Competition Tribunal regarding coverage of the Duke EGP; the Commonwealth Minister regarding the coverage of the MSP; and the Productivity Commission in several reports the most recent being the Report on the Gas Access Regime. Together these reviews assemble a coherent and authoritative body of evidence regarding the appropriate regulatory arrangements for gas pipelines.

The three reviews base their prescriptions on the conventionally accepted view that a market rather than a regulator is a preferred means of setting price and other conditions of supply. In principle this view is not contested by the NCC or the ACCC.

Recognising that a stylised perfect market is impossible with a gas pipeline system, each of the recent reviews set about trying to define workable conditions whereby the regulatory role can be reduced and declaration can be avoided or rescinded.

The Australian Competition Tribunal Assessment re the Duke (EGP) Pipeline

The NCC in the Final Recommendation on the EGP sought to have the pipeline covered. The NCC argued that the relevant services of a pipeline were the point to point services and not the markets it serves. The former is a definition that is likely to greatly extend regulatory reach.

While the Tribunal took that view as well, it also quoted favourably *Re Queensland Co-Operative Milling Association Ltd* (1976) 25 FLR 169 at 190:

"A market is the area of close competition between firms or, putting it a little differently, the field of rivalry between them (if there is no close competition there is of course a monopolistic market). Within the bounds of a market there is substitution - substitution between one product and another, and between one source of supply and another, in response to changing prices. So a market is the field of actual and potential transactions between buyers and sellers amongst whom there can be strong substitution, at least in the long run, if given a sufficient price incentive. ... Whether such substitution is feasible or likely depends [on a number of factors] ... in determining the outer boundaries of the market we ask a quite simple but fundamental question: If the firm were to 'give less and charge more' would there be, to put the matter colloquially, much of a reaction?"

In that judgement the market rivalry includes rivalry between different sources of supply.

The Tribunal considered separately Criterion (a)² and found “that EGP will not have sufficient market power to hinder competition based on the commercial imperatives it faces, the countervailing power of other market participants, the existence of spare pipeline capacity and the competition it faces from the MSP and the Interconnect.” The Tribunal said that the most important factor behind this reasoning was that EGP does not have market power and, “The arguments advanced by NCC and AGL were largely based upon a contrary assumption as to the existence of market power.”

The important feature of assessing the market power was the nature of the competition and the supply base compared to market demand. The Duke pipeline almost doubled the capacity into the main Sydney market. Though demand is growing, this means that there is considerable rivalry for customers between the two main pipelines.

With regard to Criterion (b)³ the Tribunal agreed that, “it would be uneconomic in a social costs sense to develop the Interconnect to provide the services provided by means of the EGP.”

The Minister's Decision on the MSP

The NCC had declined to revoke coverage of the MSP on four grounds:

- First they argued that the MSP could charge the suppliers monopolistically because, unlike the EGP on which the Minister had decided to overturn the NCC decision, there was no other outlet for their gas other than via that pipeline
 - This interprets the reforms as being in place to protect suppliers, and very substantial suppliers at that, from others within the supply chain.
 - Moreover, it is hardly the case that there are no other outlets for the Moomba gas when there are alternative outlets for gas through established pipelines to Brisbane and Adelaide.
- Secondly, they reported that the price was some 30 per cent above the levels they thought should prevail in the light of the costs
 - The estimates were based on work commissioned by consultants and were based on the costs involved in the pipeline and not the competitive environment in supply; in this respect, the NCC took the view that a 7.5 per cent price reduction on the MSP that had taken place due to the commissioning of the rival EGP facility was inadequate and represented on-going excessive market power.
 - In seeking a reduction of 30 per cent in the MSP, a reduction of a similar magnitude would be forced on the EGP thus undermining the economics of that pipeline and the investment strategy of its owners (and others looking to build such facilities) since it is in direct competition with the MSP. It is difficult for a regulator to say that a pipeline is charging too high a price since the parameters that

² (a): "That access (or increased access) to services provided by means of the Pipeline would promote competition in at least one market (whether or not in Australia), other than the market for the services provided by means of the Pipeline".

³ (b): "That it would be uneconomic for anyone to develop another Pipeline to provide the Services provided by means of the Pipeline"

determine the “fair” price are so uncertain and, in that particular case, different regulators came to different views of what the “fair” price actually should be.

- Thirdly, AGL’s rights to a “most favoured nation” price under its Gas Transportation Deed impeded the incentive of MSP to offer competitive prices
 - Overturning this would entail an inability of any business to sign foundation contracts with a pipeline in the expectation that these would not be undermined by future price discounts to competitive retailers. It would destroy the basis on which pipeline capacity was sold and seriously reduce the capability of pipeliners to finance a new facility.
- Fourthly, the vertical linkages between MSP and AGL (which has a 30 per cent shareholding) would create incentives to distort competition
 - This claim represents a serious misunderstanding of the way that businesses operate. AGL retailers operate as profit centres whether or not they are ring fenced and, as evidenced by the activities of electricity retailers, will measure the value of offers from their host businesses against those from outside businesses. This has led to the complete divorce of some businesses from their supply sources as well as some reintegration based on risk defrayment
 - Irrespective of these commercial considerations, the imputation demonstrates a lack of awareness of the legal framework within which Directors control businesses. With only 30 per cent of the ownership, AGL would be unable to dictate policy that led to a benefit to itself that was greater than its shareholding. Directors who permitted this to occur would be acting unlawfully and be liable to punishment including imprisonment. This aside, the remaining 70 per cent shareholding includes one major shareholder who would be expected to take particularly vigorous steps to ensure the 30 per cent minority owners were not receiving benefits over and above that level.

The Minister⁴ based his decision to overturn the NCC judgement with regard to Criterion (b). He was critical of the NCC’s judgements that the “Eastern Gas Pipeline (EGP) to Sydney, should be excluded from this consideration because they do not accommodate the physical transport of gas between Moomba and Sydney (6.16).” He pointed out that in considering the Duke EGP case, the Australian Competition Tribunal (‘the Tribunal’) found that:

there is no logic in excluding existing pipelines from consideration in determining whether criterion (b) is satisfied’.

He argued,

“24. A Moomba to Sydney gas transmission service in future may be contracted for via the Moomba to Adelaide System (MAPS) and SEAGas pipelines and either of the Interconnect or the EGP pipelines. It is therefore no

⁴ Macfarlane I. (Minister for Industry, Tourism and Resources) 2003, *Applications for Revocation of Coverage of Certain Portions of the Moomba to Sydney Pipeline System: Statement of Reasons*, www.industry.gov.au/content/itrinternet/cmscontent.cfm?objectid=F14AF2D8-0F2F-FF46-E371BA8885EA4888&indexPages=/content/whatsnew.cfm&CFID=30998&CFTOKEN=24724739.

longer appropriate to think in terms of gas transportation as being only from a single well- head or processing plant along a single transmission pipeline to a single off- take point. Yet this is largely the characterisation adopted by the Council for its consideration of the Moomba to Sydney Gas Pipeline System (3.3 and 6.15)."

He further said

"Insistence upon 'point-to-point' transportation along a single pipeline, or an associated requirement for physical duplication of an existing pipeline, is not justified in the context of a gas pipeline network. This does not provide a sufficient justification for the Council's conclusion that 'no other pipelines currently provide the point-to-point transport services' of the MSP Mainline (6.15). It would be unduly restrictive to conclude that a single transmission pipeline must provide the same point-to-point service as the MSP Mainline to be considered relevant to Criterion B."

With regard to Criterion A, the Minister pointed out that,

"Pipeline investors who perceive that access regulation has not taken proper account of commercial and market risks and has prevented them from earning reasonable returns on their investment, will either not develop an existing pipeline or only build a new pipeline fit for purpose. Such outcomes would do little to assist in promoting competition in downstream gas markets longer term." (para 148)

He argued that the NCC was incorrect to say that coverage would bring lower tariffs at the same time as ensuring new entry. He said, on the contrary, that coverage which brings lower regulated prices will deter competition in the form of entry by new suppliers. He refused to accept,

"the Council's view that revocation of part or parts of the MSP Mainline would be at odds with the policy intent of all Australian governments in 1997 in applying coverage under Schedule A of the National Gas Code (7.448). The purpose of the Code is to regulate gas transmission pipelines that may otherwise be capable of exerting market power, not to establish an immutable regulatory framework for gas access in its own right. The fact that market structures have changed significantly over a period of five years does not invalidate the original decision to apply coverage to the MSP Mainline. A fundamental policy objective of Australian governments has been to encourage a competitive national market for natural gas, including encouraging investment in the transportation of natural gas." (para 152)

The Productivity Commission

The PC⁵ review was one of a series that has addressed infrastructure regulation. While its analysis of the issues was exemplary, its recommendations tended to be less

⁵ Review of the Gas Access Regime, Productivity Commission, Report No. 31, 2004.

forceful than they might have been in promoting the market-based approaches that the report favours.

Deregulation of Existing Pipelines

The PC recognised that the existing Gas Access Regime as applied by the NCC and ACCC is likely to be distorting investment as firms seek ways to escape oversight.

The PC noted that,

“The Gas Access Regime’s coverage test sets too low a threshold for cost-based price regulation. That is, coverage decisions could involve the regulatory error of applying cost-based price regulation when its costs outweigh its benefits, including with respect to investment⁶.”

It also notes

The Gas Access Regime is likely to be distorting investment in favour of less risky projects, including altering the nature and timing of pipeline investments. Pipeline construction might be delayed, for example, and there might be greater emphasis on building capacity that is essentially fully contracted prior to construction. Such alterations can inhibit the emergence of competition in upstream and downstream markets and generate inefficiencies.

FINDING 4.3

And it adds

Generally, cost-based price regulation should be considered only if service providers have substantial market power. Where market power is not strong, such as where there is emerging competition, in the long run the costs of regulated prices are likely to outweigh the cost of the market failure that such regulation attempts to correct. FINDING 4.5

Unfortunately, the PC missed an opportunity to provide unambiguous clarification of the way forward, along the lines that there is an onus on the regulator to exit regulatory control once more than one pipeline of a significant size was serving a particular market, whether or not there was duplication of the pipelines. This might have offered firm guidance about when regulatory agencies ought not to be routinely involved in price setting and access conditions. Even so, the PC clearly took the view that the coverage criteria the regulatory authorities were applying was based on an unreasonably stringent view of monopolistic market power.

As it is, neither the NCC nor the ACCC has shown any indication of having learned from these important authorities.

Indeed, in an address in Sydney⁷, the energy Commissioner, Ed Willett, argued that the evidence of pipeline building, “rather put the lie to the industry’s claim that ACCC regulation has, in the words of one major player “had a chilling effect” on

⁶ P.107

⁷ Ed Willett, *Energy Market Access and Regulation*, address to the Australian Energy & Utility Summit, 22 July 2004.

<http://www.accc.gov.au/content/item.phtml?itemId=525766&nodeId=file4116b3b6bfb6d&fn=2004-07-22%20energy%20utility%20summit.pdf>

investment⁸.” The ACCC position remains one of unreconstructed faith in itself as an institution outperforming competition in creating efficiency.

Greenfield Sites

In its Inquiry into Part IIIA and the Energy Market Review the PC flagged a regulatory moratorium as a regulatory approach. In the Gas Access Review, it recommended that the Minister should be able to offer a binding no-coverage ruling for 15 years with the pipeline remaining uncovered thereafter unless a successful coverage application finds otherwise.

However, that regulatory approach might be interpreted as a step back from that envisaged by the Energy Market Review which argued that it would be difficult to foresee a case for regulating new transmission pipelines and that regulatory strictures should be developed accordingly. This may be aggravated by leaving the Gas Access review's recommendation that the decision on coverage be left with the Minister rather than setting a standard on which the NCC might recommend a deregulatory approach.

This is especially unfortunate in view of the expressed wish of the NCC to see all new pipelines regulated unless the pipelines offered competitive provision to the supply area as well as the market and unless they could be assured that the parallel pipes would operate non-collusively. This very strict test of market power would never see a deregulated transmission system

Concluding Comments

The price on the SEAgas pipeline to Adelaide has been quoted at 63 cents per GJ. The Moomba price at the present time is quoted at 49 cents per GJ. In the light of the surplus capacity in serving the market, these prices are likely to soften. However, supply prices do not simply ramp down to marginal costs. If they did newspapers would be free, Foxtel would be \$5, airline seats between Sydney and Melbourne would be \$50 return and motor cars would be half their present price. After all in most of these cases there is surplus capacity and there are high fixed costs.

Markets do not follow some naive theoretical economics approach and revert to marginal costing as soon as a surplus supply is in evidence. If they did so nobody would invest in the first place.

Market imperfection is the norm in Australia. The airline duopoly of first Qantas-Ansett then Qantas-Virgin has delivered vast price and efficiency gains once the parties were freed to compete openly and obligated not to collude. Other markets with monopolistic features like telecoms, steel and cement also work efficiently.

The danger is that regulators will be dazzled by the prospect of free gains to consumers and will require prices and access that undermine the on-going viability of

⁸ In the same address on later occasions, the ACCC has cited the work of ACiLTasman in suggesting the benefit of the ACCC's regulation (of electricity plus gas) was somewhere between \$2-11 billion. That analysis was discredited at the ACCC's annual regulatory conference (30 July 2004) and also is heavily criticised in the PC Gas Access Review.

a supply by strangling its incentive to invest anew. The three reviews addressed in this submission were mindful of these considerations, while the NCC (and in public fora the ACCC) have been in ignorance of them.

The Tribunal carefully examined the issue of supply to the main market by a second pipeline which the NCC had said should be regulated because the two pipelines may otherwise collude in increasing price and because in any event, competition required parallel pipelines. It found that reasoning deficient in the light of the new competition from the EGP. It accepted, as is commonplace, that rivalrous markets were better determinants of price and market supplies than regulatory decisions that try to shadow a genuine market. It also recognised a disincentive to entrepreneurship if pipelines were to be regulated and their prices kept down to a level that is not commensurate with their costs and risks. The Minister adopted a similar set of reasonings as has the Productivity Commission.

Both the Tribunal and the Minister were exercising their lawful responsibility to reject a decision of the NCC if they consider it to be ill-founded. Both they and the Productivity Commission raised issues concerning the analysis and understanding of the NCC regarding the competition laws they are charged to uphold. The Tribunal, for example, chided the NCC for using an improper interpretation of the Gas Pipeline Code in maintaining that one of its goals was to prevent inefficient duplication when such measures are not within the Code and the decisions are best left to the pipeline owners in search of private gain rather than a public body (para 64)

The NCC Issues Paper contrives to make itself consistent with the Tribunal's decision on EGP by regarding the latter's decision in adopting a point to point approach as binding authority. But the Tribunal accepts that as being an obvious definition of a pipeline but irrelevant as to whether its coverage is necessary to promote competition. The Tribunal concluded that Duke does not have and will not have market power and, accordingly, dismissed the arguments of the NCC (and AGL). Those same issues are directly analogous in the MAPS case

The reasoning used by the Minister cannot be lightly dismissed, as they are in the Issues Paper, as "different views" (Para 5.10). The Minister's decision was not a mere political override of a legal decision. In fact it was a carefully assessed judgement, clearly assembled with the assistance of expert supporting advisers. The Minister's judgements in terms of the legal and economic considerations clearly showed greater comprehension of the issues and better expertise than that demonstrated by the officials who comprise the NCC. To dismiss this legal argumentation as mere political boondoggling is unfortunate in both treating this argumentation with contempt and an exercise of unwarranted hubris on behalf of the Council. The NCC comprises an appointed body of officials. It is not a High Court that can claim a certain infallibility in its decision making but it is, rather, a body charged with making judgements that are reviewable by higher authorities.

Those authorities' decisions must be considered to be precedent for other public bodies.