North Australia & PNG Gas Summit

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"The Status of National Gas Reform"

Mr Allan Asher

Deputy Chair

Introduction

I have been asked to speak to you today on the status of national gas reform. I believe this to be an opportune time to speak on this topic, as Australia is at a critical stage in the gas reform process. While gas reform has been underway for some years now, we are really only just starting to implement the reforms, having spent three or four years developing the reform framework – focussed significantly on development of the National Third Party Access Code for Natural Gas Pipeline Systems.

I am interested to see that one of the talking points suggested for me today was to 'answer industry calls for a disassembly of the regulatory framework'. I find this a little puzzling, given that it is by no means assembled yet. The National Gas Code is not even in force in some jurisdictions yet. And in those where it is, very few Access Arrangements have been determined. The Commission, as nominated Regulator for transmission pipelines in all jurisdictions (except Western Australia), has only made final determinations on the Victorian pipelines access arrangements, while the Independent Pricing and Regulatory Tribunal (IPART) in NSW and the Office of the Regulator General (ORG) in Victoria have made determinations with respect to distribution network access arrangements in their states.

Moreover, the Commission has not heard of any calls for the complete disassembly of the regulatory framework. There are pipeline companies that would obviously like to be able to continue to earn the profits they were prior to being regulated – but even there, the complaints have been that the regime is too onerous in terms of its pricing principles or requirements to release information, rather than objections to the entire regime. If anything, the majority of 'complaints' that the Commission has heard voiced are frustration that the regulatory regime is not going far enough or progressing quickly enough.

Once people understood that the gas reform process was about deregulating all the potentially competitive areas of the gas supply industry, while giving access to the services provided by infrastructure for which competition was not feasible, an expectation of growth and flexibility in supply conditions was created. People were led to believe that the days of only one gas supplier who sold on a delivered basis were over. Thus far, however, very little of what was expected has been delivered.

In fact, there are some quite worrying signs. The Australian Financial Review ran an article earlier this month with the headline, "Vic gas prices tipped to rise after deregulation". This claim was made by the Australian Gas Users Group, based on its belief that following privatisation of the Victorian gas retailers, there would only be 'sluggish competition' and that the retailers were now submitting proposed prices that were 6 to 8 per cent higher than before. The claims were rejected by a Victorian Government spokesperson, but what actually happens to gas prices in Victoria will be a real test of the success of the reform process.

Another worrying sign regarding the success of the reform process thus far is the fact that the use of coal as a source of energy is increasing, while natural gas is decreasing as a percentage of all energy consumed.

Regulatory Consistency

I have also been asked to address the importance of consistency between various jurisdiction's regulatory regimes. The Commission has always been a strong advocate for consistency in regulation across jurisdictions – and not just in gas. The Commission has

sought to bring a consistent approach to regulation of a number of industries that it has responsibility for, including electricity, gas, telecommunications, airports and ports.

The Commission, in conjunction with several national and state bodies, has sought to refine its decision making in the areas of gas and electricity reforms via the formation of specialist consultation groups.

The Energy Committee

The Commission has created an Energy Committee to be responsible for its regulatory decision-making on gas and electricity matters. This initiative should also assist in achieving consistent regulatory outcomes. For the time being, the Energy Committee membership will be drawn from (as appropriate for particular decisions) the Chairperson and Deputy Chairperson, Commission full-time members and the State based regulators who are ex officio associate members of the Commission. The additional regulatory experience and expertise of the associate members should assist in achieving consistent approaches at all regulatory levels.

Among other things, the Energy Committee assists in the coordination of Commission decision-making with that of the state regulators. By giving State regulators input at the national level, the Energy Committee ensures that relevant regional considerations are reflected appropriately in Commission decision-making.

The Utility Regulators Forum

The Commission has also established a forum of Australian utility regulators which meets on a regular basis to facilitate effective cooperation and communication between regulators.

Federal, state and territory regulators are now facing new regulatory roles and responsibilities in newly competitive and commercially oriented public utility markets which have been subject to structural reform and, in some cases, privatisation. New regulatory policies, principles, methodologies and procedures are being developed in areas where there is limited or no past experience or established methodologies.

The regulators forum provides a mechanism for facilitating the development and adoption by regulators of consistent regulatory principles and methodologies, particularly in relation to interstate regulatory issues, for facilitating the exchange of information and experience and for sharing skills and resources during this important regulatory learning period.

Particularly in the area of access and access pricing, regulators face new challenges in developing appropriate regulatory principles, methodologies and procedures which effectively address issues such as:

- the commercial interests of facility owners and access seekers;
- consequences for competition, economic efficiency and end users;
- asset valuation, cost of capital, depreciation and related costing issues;
- preventing monopoly pricing while encouraging the development of economically efficient rate structures;
- the appropriate application of price cap or rate base direct regulation methodologies versus more flexible negotiation/arbitration models;

- the tension between providing adequate regulatory certainty while retaining sufficient regulatory flexibility; and

- the expertise, analytical, modelling, information and procedural requirements to perform these regulatory functions in practice.

The Utility Regulators Forum should assist regulators to address these issues in a cooperative and consultative way, and in doing so, to identify and deal appropriately with any overlap of jurisdictional powers, while fostering a coordinated and consistent approach to regulation.

The Utility Regulators Forum has recently released a discussion paper on Best Practice Utility Regulation. The Commission and other regulators are committed to achieving best practice regulation, and this paper and the principles it identifies form an important part of that process.

In formulating best practice principles and processes it is worthwhile considering what regulators, utilities and customers need or want from the regulatory system. Having consulted widely, the regulators forum concluded that a key requirement of utilities was for clarity of regulation and well-defined regulatory objectives.

Utilities also want regulators with efficient processes and procedures, industry consultation and to have input into the processes used by a regulator. When decisions to regulate are made, consideration needs to be given to the costs of compliance.

Concerns have been raised about the lack of predictability in regulation and inconsistent treatment of market participants. This leads to confusion and reduced efficiency and effectiveness of compliance. There are also concerns about regulators prejudging issues and lacking objectivity. To address these concerns, regulatory decisions need to treat and be seen to treat utilities openly, consistently and fairly.

Utilities expressed a desire for the regulator to have industry experience, a body of past precedents and be willing to listen to arguments with an open mind. They want regulators to be flexible and supportive, and to be prepared to update decisions or adjust the style of regulation if circumstances change. Finally, utilities want regulators that are accountable for their decisions, and appropriate appeal mechanisms.

Regulators expressed a desire for a regulatory system in which utilities are willing to communicate and consult on proposals that are likely to have regulatory implications. Regulators want utilities to be committed to the regulatory framework and to appreciate that they share common objectives, such as improving customer service standards and the development of the industry. They also wanted utilities to recognise the legitimate role of regulators and to cooperate in providing information on which reliable regulatory decisions can be made.

Consumer representatives desire regulatory systems that provide them with access to their utilities, appropriate levels of consultation and effective complaint resolution mechanisms.

Principles of best practice utility regulation

The cost of all the new regulatory organisations that have been established in each jurisdiction is ultimately borne by the community. This means that it is in our interests to ensure that regulation is as efficient and effective as possible. This prompted the Utility Regulators Forum to develop the Best Practice Utility Regulation discussion paper I referred

to earlier. This paper attempts to identify the behaviours and characteristics that represent best practice in regulation of utilities.

The following principles are characteristic of best practice regulatory behaviour. The principles can serve as a checklist for utilities and regulators for examining current and proposed regulatory tools. They can also serve as the basis for the development of benchmarks by which regulators can monitor and compare their performance with each other. The nine principles identified were:

1. Communication
2. Consultation
3. Consistency
4. Predictability
5. Flexibility
6. Independence
7. Effectiveness and efficiency
8. Accountability
9. Transparency

The principles need to be considered as a 'package', as there must be a degree of balancing some of the principles against others. For example, the principle of flexibility (adapting regulatory approaches and tools over time and to suit circumstances) could be seen as contrary to the principles of consistency and predictability. The objectives of maximising public benefit should be kept in mind when competing priorities are considered.

Communication

Effective communication assists all stakeholders to understand regulatory initiatives and needs. Effective communication is both educative and informative, and can help to build commitment to regulatory initiatives through better understanding of the regulatory objectives and rationales.

In addressing the principle of communication, regulators should establish processes that provide relevant and comprehensive information that is also accessible, timely and inclusive of all stakeholders.

Consultation

Effective and early consultation between regulators, customers and utilities is an essential component in ensuring appropriate regulatory systems are established. Consultation assists regulators to understand the implications of their regulations on industry participants, and enables stakeholders to discuss the impact of regulation and suggest alternatives and improvements. The canvassing of all the possible alternatives is not the only outcome of consultation – consultation provides the basis to ensure that the quality of regulation is maximised.

Consistency

Consistency of treatment of participants across service sectors, over time and across jurisdictions, was highlighted as a key principle for providing confidence in the regulatory regime. This principle is linked to the provision of consistent and fair rules that do not adversely affect the business performance of a specific participant.

Predictability

The principle of predictability of regulation is an essential requirement for utilities to be able to confidently plan for the future and be assured that their investments will not be generally threatened by unexpected changes in the regulatory environment. The principle is particularly important in the utility sector, which is characterised by major infrastructure works with long investment time horizons.

Regulators need to appreciate the long-term nature of assets and related investment decisions in the utility sector. The implementation schedule of regulations that will affect the cost or price structure of market participants must therefore be taken into account. Similarly there should be predictability in respect to government policies on externalities that are likely to have an impact on utility pricing and investment, such as environment, technical, safety and social welfare policies.

In some circumstances predictability is not possible, that is where there is economic instability or rapid technological or political change, but these circumstances should, as far as possible, be made exceptions. The rule to which regulators should strive is a consistent and predictable regulatory environment.

Key mechanisms for providing predictability in regulation include the establishment of decision-making criteria that are well defined and the provision of clear timetables for the review of standards and regulations.

Flexibility

Flexibility involves the use of a mix of regulatory tools and the ability to evolve and amend the regulatory approach over time as the external environment changes. This assumes that the organisation has knowledge of, keeps up to date with, and is open to alternative regulatory approaches. At times courage may be required to implement new initiatives rather than to recycle approaches which can become a part of the culture within the public sector.

Independence

Regulatory decisions should be free from undue influences that could compromise regulatory outcomes.

A confident, independent regulator will not seek to hide the processes used to reach decisions. Independence, when openly exercised, builds trust and confidence in the regulator.

Independence requires that regulators have the expertise necessary to make judgements without undue influence from, or reliance on, market participants.

Effectiveness and efficiency

Best practice regulation should include an assessment of the cost effectiveness of the proposed regulation, and an assessment of alternative regulatory approaches.

Efficiency takes a number of forms as shown below.

- **Information requirements.** Regulatory bodies must have access to information that relates to the operations of the service provider. In order to achieve efficiency, it is important that the information required should be limited to that required for them to carry out their functions. There needs to be a balance between the disclosure of

information required for regulation and the need for maintenance of confidentiality of commercial information.

- **Time taken to make decisions.** Decision-making processes should be well defined and structured to eliminate unnecessary delays
- **Staff with appropriate levels of technical knowledge.** There needs to be a stock of technical knowledge within the regulatory body to ensure that informed decisions can be made.

  Regulatory authorities should therefore invest in attracting, training and keeping good staff – which requires sufficient funding.

Accountability

Accountability involves regulators taking responsibility for their regulatory actions. This requires regulators to establish clearly defined decision-making processes and provide reasons for decisions. Supporting the decision-making processes should be effective appeal mechanisms and adherence to principles of natural justice and procedural fairness.

Transparency

Transparency requires regulators to be open with stakeholders about their objectives, processes, data and decisions. Regulators should establish visible decision-making processes that are fair to all parties and provide rationales for decisions. Such openness can assist in gaining stakeholders' confidence and acceptance of the regulator's decisions.

Best practice regulation processes

In this context the Commonwealth Government has established a mandatory process for all departments, agencies or statutory authorities that make, review or reform regulations. This process seeks to ensure that regulation is necessary, will produce net benefits to the community and is the most efficient/effective of all available alternatives. It is pursued through the development of a regulatory impact statement which provides a structured framework to guide the activities of organisations that have a regulatory function.

The need for a whole-of-government approach

There is a common argument among stakeholders that it is inefficient to have to deal with the different organisations that make up part of the regulatory jigsaw. This suggests the need for a concerted whole-of-government approach to regulation. A small number of regulatory bodies and consistency in their approaches is desirable. The test for the adequacy of the regulatory regime is the degree to which it imposes cost, delivers benefits and provides flexibility to reflect regional needs while at the same time providing consistent regulation nationally.

Next steps

Two other mechanisms that can support this aim are the use of performance indicators based on the principles and the use of benchmarking to compare the performance of regulators.

In addition to setting performance indicators for regulators, benchmarking would provide a further means of improving regulatory practice. Benchmarking can be a useful mechanism for organisations to measure the performance of key functions against those of counterparts in order to identify gaps and corresponding opportunities for improvement. It can also be

used to identify the practices for the best performers and to develop a strategy for achieving world-class levels of performance.

Just as regulators seek to compare the performance of service providers to improve their performance, benchmarking of regulators can assist them to improve their own performance. The principles of best practice regulation can provide a framework for this process.

Actual Regulatory Practice

Having spent some time going through the principles of best practice regulation, let me now focus your attention on some aspects of actual regulatory practice. Given the importance of consistency in regulation across jurisdictions, it is of concern to note some of the significant differences in approach already apparent.

Victoria

In Victoria, the government has vigorously pursued the separation and privatisation of its gas businesses, including the creation of an independent system operator for the transmission network with a complex set of market rules to govern its behaviour. Given the nature of the market rules, the Victorian Government sought authorisation of them under the Trade Practices Act, which was granted, subject to a number of variations to the original proposal. In the face of a challenge to that authorisation in the Australian Competition Tribunal by BHP Petroleum, the Victorian Government passed legislation to exempt its new market regulation from the operation of competition law entirely.

The arrangements have the ongoing protection of a Commission interim authorisation while they are before the Tribunal. In the Commission's view the exempting legislation introduces scope for inconsistency with the outcome that may be decided by the Tribunal or action of the parties to resolve the proceedings. It now appears that the Victorian Government intends to maintain the statutory exemption even though BHP Petroleum has indicated its intention to withdraw its appeal.

Queensland

In Queensland, the opposite situation is occurring, with a Government owned electricity corporation purchasing a private gas distributor/retailer. What's more, the two previous government owned electricity retailers are reported to be proposing to aggregate all potential future gas demand in the State and commit to 20 year gas purchase contracts with PNG producers for annual volumes close to four times the current Queensland gas demand. One of these retailers, Energex (which purchased Allgas) has applied for authorisation for exclusive dealing in the resale of PNG gas to Queensland gas users. In considering Energex's application for interim authorisation, the Commission received a significant number of submissions expressing concern at the potential for the Queensland government's involvement to create distortions in both electricity and gas markets. Indeed Entenergy's Managing Director was recently reported to state that the most significant reason Entenergy is withdrawing from its position as 50 percent partner in the proposed 900 MW expansion of the Tarong power station is:

> … the market uncertainty created by the (Queensland) Government's potential support of the PNG pipeline project and the associated generation projects that will come along with that have created a large amount of uncertainty regarding the market outlook for power in Queensland.[1]

Given reports that the vast majority of the PNG gas is proposed to be used in electricity generation, it is difficult to imagine exactly who is going to buy all the additional electricity. One conservative estimate translates the reported volumes of PNG gas into around 2700 MW of electricity. This would supposedly come on stream around 2003, when the total installed generating capacity will be around 9000 MW (excluding Milmerran and Kogan Creek – which together would add an additional 1660 MW). NEMMCO expect peak demand for electricity in Queensland to be around 7800 MW in 2003. With electricity demand in Queensland increasing at about 300 MW per year, it will be some time before the excess capacity can be absorbed.

Clearly there is an important role for government in the reform process, particularly in the identification and independent regulation of those industry sectors for which competition is not feasible. Indeed, the 1980's and 90's have been different to the 1960's and 70's because governments, on the whole, have been getting out of markets and leaving the competitive sectors of industry to industry players.

One concerned industry participant recently used the experience of the initial arrangements that led to development of the North West Shelf as a warning of what can result from excessive government intervention in a major resource development. To facilitate the North West Shelf development, the WA Government entered into long term take or pay contracts with the producers for volumes significantly in excess of the existing WA market requirements. The market did not expand rapidly in the way required to utilise all the gas contracted for and the WA Government was making significant losses. Eventually, the Commonwealth Government had to come to WA's assistance by passing legislation with the effect that it would forego significant royalty revenues on domestic gas sales from the North West Shelf until 2005.

Getting back to gas reform more generally, Queensland passed the Gas Pipelines Access Law around 12 months ago, but is yet to proclaim it. In signing the intergovernmental agreement to implement the national gas code, Queensland agreed on the basis of significant derogations. These derogations principally relate to preventing any review by the regulator of the tariff and tariff related matters for the four main existing Queensland pipelines as part of their access arrangement approval process under the Code. The owners of those four pipelines would still be obliged to bring in an access arrangement to the Commission for approval, but the reference tariffs will be those taken from the existing access principles. These will not be subject to public or ACCC scrutiny until the nominated review date expressed in the individual access arrangements. The review dates vary from around 10 years through to over 20 years.

Given the significance of these derogations, in March of this year the NCC asked the ACCC to provide advice as to whether the Queensland Gas Pipeline Access Regime is broadly consistent with National Access Code. The NCC is considering an application by the Queensland Government for certification of the 'effectiveness' of the Queensland regime under Part IIIA of the Trade Practices Act. The Commission has only just received information from the Queensland Government to allow it to commence this review.

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[1] *US giant pulls out of $1b power proposal*, The Canberra Times, Wednesday 8 September 1999, p.17.

South Australia

Another significant barrier to effective gas reform is the existence of provisions in gas supply or transportation contracts that act to impede access and growth of a gas trading market.

In South Australia, the lead legislator for the Gas Pipelines Access Law, a great deal of effort was put into the introduction of a regulatory framework for third-party access to pipelines. However, provisions in gas haulage contracts that would maintain the *status quo* for some years after the introduction of retail contestability are a potential barrier to effective gas reform.

The Commission recently released its issues paper seeking submissions on Epic Energy's proposed access arrangement for the Moomba to Adelaide Pipeline System. The issues paper raises for industry comment the limitations on third-party access arising from the reservation of the pipeline system's firm capacity and provisions of the existing haulage agreements.

Putting aside terms and conditions of service, the main issues are whether there is demand for firm and interruptible services from other users and whether firm and interruptible services can be made available without the need to construct new delivery points and laterals where that is operationally unnecessary. Consistent with Code principles at section 2.24, the Commission wishes to establish whether:

- investment in new facilities to overcome current contractual restrictions limiting third party access to the system would be efficient investment; and

- negotiation of access by prospective entrants with the two present users of the system is a satisfactory means for them to obtain access in the period until 2006, given that the retail contestability timetable is 5-6 years ahead of that timeframe.

The Commission is disinclined to accept the existing agreements as binding the regulator's decision on approval of the access arrangement without further inquiry, given that the agreements are relatively recent, having been executed in late June 1995 as part of the PASA privatisation. The Regulator must be satisfied that agreements made after March 1995 do not contain exclusivity rights. I also note that June 1995 was well into the COAG reform era.

Concerns have been raised with the Commission that if the capacity reservation provisions in existing contracts are not addressed, South Australia may end up with an access regime that is sterile.

NSW

NSW was quick to embrace the concept of gas reform – passing legislation to introduce a NSW Gas Code significantly prior to the introduction of the National Code. The NSW Code was heavily based on the latest draft of the National Code at the time. The intention of the NSW Government was to amend its gas law to substitute the National Gas Code for the NSW Code as soon as it was agreed to. NSW expected the National Code to take some time to be finalised, which turned out to be true, and did not want to wait that long.

Unfortunately, the first regulatory decision by the NSW regulator was delayed significantly due to a number of reasons, not the least of which was the reluctant provision of information by the distribution network owner. There were a number of potential new market entrants lining up to access the greater Sydney market for the first time, but when the decision was finally released, the reference tariffs were generally held to be so high that new entrants could

not economically compete with the incumbent. Some potential entrants also had difficulties contracting for gas supplies out of central Australia because Santos insisted that it would only deliver gas contracted for supply in South Australia to the inlet to the Moomba-Adelaide pipeline and not the Moomba-Sydney pipeline. As a result, the potential benefits from competition in gas supply in NSW were not realised.

The interconnect pipeline that joined the Moomba-Sydney pipeline system with the Victorian transmission system has allowed interbasin competition in Victoria and NSW for the first time, but the restricted volumes, the Longford-related supply constraints and existing sales contracts have meant that it has had little overall effect on either market.

So much so that a bypass pipeline is being built from Longford in Victoria to Sydney. Duke, who will own and operate the pipeline, is now duplicating the AGL trunk lines from Wollongong to Wilton (the location of the end of the Moomba-Sydney pipeline in the outskirts of Sydney) and from Wilton to Horsley Park, to take gas to one of their major customers. The fact that it is more economic for Duke to bypass such an extensive section of the existing regulated pipeline system than pay the reference tariffs is a clear sign of either ongoing market power by the incumbent or regulatory failure - or both. I understand that IPART is soon to release its second decision on reference tariffs for the AGL gas network. Hopefully the entry of a new pipeline into the NSW market and revised reference tariffs on the distribution network will finally bring some competition into gas supply in NSW.

Northern Territory

With regard to the status of gas reform in the Northern Territory, the Commission is currently in court concerning allegedly anti-competitive provisions of an NT Government owned corporation's gas purchase contract – so I can't really comment on that. The Commission is in the early stages of considering the proposed Amadeus Basin to Darwin pipeline access arrangement. The NT has nominated the ACCC as both its transmission and distribution pipeline regulator.

There is certainly the danger that differences in approach by the various jursidictions and regulators may impede interstate trade in natural gas and impose unnecessary compliance costs on gas entities that operate in a number of jurisdictions. Mr Len Gill, the General Manager, Wholesale, for Eastern Energy, was quoted in a feature article in the September '99 Issue of the Australian Gas Journal as saying:

> We've got the 1900s rail gauge problem in gas, with different market rules in each state. And it took decades to resolve the rail gauge issue.

Upstream reform

I was also asked to speak on ways to protect the benefits of competition reform to date. In many ways, as I have described, the task before us is more to ensure that we do achieve the benefits of gas reform, rather than protecting benefits already achieved. One crucially important aspect of gas reform that requires attention is achieving greater competition in the production and supply of natural gas.

Until recently, Eastern Australia typically had one joint venture monopolist selling gas into each jurisdiction. Supply competition in Eastern Australia is still severely limited, with only two joint ventures now selling gas into NSW and Victoria, and even there they have only penetrated each other's market to a limited extent.

Having a competitive upstream sector is crucial to gas reform being successful. In the gas market of the US, for example, it was a highly diverse gas supply industry that really drove competitive reform of the entire industry. Once third party access to essential facilities was provided (critically to pipelines and distribution networks, as processing facilities are typically run as independently of gas exploration and production businesses), producers began vigorously competing to sell their gas and prices fell significantly and services improved. Brokers appeared, who had no physical assets, but provided an aggregation service. They group customers' demand to allow significant bulk discounts to be achieved or buy up cheap small production quantities and combine sufficient quantities to create marketable parcels of gas.

I believe that until Australia develops a more competitive upstream gas sector, many of the potential benefits from gas reform will either not be realised or be captured by the upstream industry.

The need for upstream reform in Australia has been examined most recently by the Upstream Issues Working Group (UIWG) – a sub-group of the Gas Reform Implementation Group (GRIG), which comprises representatives from all jurisdictions, relevant industry bodies and regulators. The UIWG issued a final report to Government in December 1998, which made recommendations in three key areas: acreage management; marketing arrangements; and access to upstream facilities.

Acreage management

The UIWG considered that while the offshore acreage management regime was working effectively, there was a clear need to make some onshore regimes similarly transparent. Jurisdictions, on the whole, have accepted this recommendation and are implementing it through changes to legislation. Ideally, prospective tenements will be smaller than those granted in the past, and the process will be more transparent – including publishing the selection criteria beforehand and the winning bids after the allocation.

Marketing arrangements

The UIWG report concluded that while some Australian gas markets may currently be considered as immature, markets are evolving in ways that will eventually support separate marketing by individual joint venture participants. The UIWG recommended that the ACCC and State governments should encourage separate marketing whenever and as soon as it is feasible to do so.

There are a number of authorisations before the Commission that have yet to be finally determined that relate to joint production and co-ordinated marketing of gas. When resources become available after the current batch of access arrangements are processed, the Commission intends to turn its attention to these applications and to the potentially significantly changed circumstances since they were last examined.

Access to upstream facilities

The UIWG endorsed industry's view that ideally, third party access to upstream facilities should be determined through commercial negotiations. There was a strong concern, however, that without some established framework for such negotiations, new entrants may not be confident of their ability to gain access on reasonable terms and conditions.

The UIWG report therefore recommended that the Australian Petroleum Production and Exploration Association (APPEA) should develop a set of best practice principles for access

to upstream facilities. These principles would then be considered by UIWG before being brought to Ministers for their endorsement. Ministers agreed to this approach.

A draft of the principles was considered by the UIWG in May, after which APPEA was asked to amend the draft to make the principles more positive and to include as a minimum:

- firm timelines within which negotiations should take place over the terms and conditions of access;
- a principle that access tariffs should be cost reflective; and
- a process of dispute resolution or mediation in case negotiations break down.

A second draft of APPEA's principles was produced which the Association told UIWG was its final document which it intended to distribute to member companies. Unfortunately, this second draft did not address any of the three critical issues listed above. This meant that the UIWG was unable to recommend that Ministers endorse the principles. In the view of the majority of UIWG members, they do not represent best practice and are unlikely to provide sufficient confidence to potential new entrants that they can gain access to existing facilities on reasonable terms.

It is now left to jurisdictions to legislate as they see fit to provide third party access to upstream facilities. It is fundamental that potential new entrants are not discouraged from bidding for acreage by uncertainty as to whether they could negotiate access on commercial terms to existing processing facilities. Failure to achieve access on reasonable terms makes only the large finds economic, since the explorer has then to construct its own processing facilities, and this acts as a disincentive for new players to explore.

The Commission believes that this is a significant issue and needs to be addressed to ensure that new entrants are not discouraged, so that eventually we can develop a more competitive upstream sector.

Central West Pipeline Access Arrangement – draft decision

Finally, let me address a concern commonly raised by the pipeline industry that regulation under the National Gas Code may stifle investment or be too inflexible to deal with the needs of marginal greenfields projects. I will address this concern by describing the Commission's recent draft decision on the Central West Pipeline in NSW.

The Draft Decision on the Central West Pipeline Access Arrangement, if confirmed, means that gas users will pay lower charges than originally proposed by AGL Pipelines NSW (AGLP), but it also accommodates AGLP's desire to reduce the financial risks associated with the pipeline. I believe it demonstrates the flexibility inherent in the Gas Code and the willingness of the Commission to consider regulatory approaches quite different to the traditional 'cost of service' methodology.

A major issue for the Commission in assessing the access arrangement has been that the Central West Pipeline was only recently constructed, without significant foundation contracts. The Commission acknowledges the uncertainty that can arise in the early phase of such a project, in particular that take-up targets may not be achieved on time.

AGLP had proposed a number of financial risk-minimisation measures for the pipeline. The most important measure was a regulatory framework designed to protect AGLP from the

impact of early under-performance when gas throughput volumes are expected to be low and revenues would not cover total capital and non-capital costs.

The mechanism allows losses to be capitalised into the asset base. Consequently the asset base would increase substantially during the first phase of the life of the pipeline. Once gas demand grows in the region, AGLP would be able to recover the losses, including a return on capital derived from the regulated rate of return and the size of the asset base. Effectively, this means that the income lost in the early years can be recovered in later years, depending on the actual volume of sales achieved.

Other important measures in the proposal are that AGLP would retain any benefits of above expected volume performance during the first regulatory period, and the pricing structure is to be based on throughput only with no capacity charge in this period.

Consequently, AGLP will have a major incentive to increase volumes and decrease costs. The acceptance by the ACCC of a single price from Marsden to Dubbo irrespective of the actual distance involved also helps to underpin the early viability of the project.

In its assessment the Commission has considered the proposed access arrangement and the submissions from interested parties. The Commission has decided to accept all of the mechanisms proposed by AGLP to reduce its exposure to the risks associated with a newly established pipeline. However, in addition to the risk-averting measures, AGLP sought a high rate of return.

In light of the mechanisms in the regulatory framework to reduce risk, the ACCC concluded that the appropriate post-tax nominal cost of equity for AGLP is 14 per cent. To make this figure comparable with AGLP's proposal, the ACCC has used cash-flow analysis to calculate a post-tax nominal Weighted Average Cost of Capital (WACC) of 7.0 per cent and a pre-tax real WACC of 7.5 per cent. This is in contrast to the 10% real return sought by AGLP.

The Commission identified a number of aspects of the access arrangement that do not fully meet the requirements of the Code. Accordingly, the ACCC's draft decision is that it proposes not to approve the access arrangement in its current form. The Commission has specified a series of amendments to the access arrangement. If a revised access arrangement incorporating those amendments is submitted, the Commission proposes to approve it.

The ACCC's draft decision is subject to further public consultation prior to the release of the final decision. Submissions are requested from interested parties, to be received by 8 October 1999.

In addition to seeking written submissions from interested parties, the ACCC intends to visit the Central West region and speak directly to major users and other interested parties. This will provide an opportunity for users and interested parties to discuss with ACCC representatives the impact of the ACCC's draft decision.

Conclusion

There are a number of potential new sources of gas supply for eastern Australia in the next few years – PNG, Timor Sea, coal seam methane. It is an exciting time with the potential to radically change the whole gas supply industry.

Third party access to transmission pipelines and distribution networks is a crucial element in Australia being able to realise the full potential of these possibilities. We need to minimise

the cost of this regulation and the compliance burden on the owners of the infrastructure, but the benefits of providing access on reasonable terms should far outweigh these costs.

Governments in Australia need to recapture the vision of gas reform and work together to ensure that the appropriate legislation and regulations are in place. It is important that as these new projects are developed, an appropriate balance is struck between mitigating risk through long term, large volume contracts and leaving sufficient flexibility to allow markets to develop.

We need to recognise that Australia is still only just beginning to implement the agreed gas reforms and to work together to achieve the benefits this process can bring.
