New Zealand Gas Industry Reform Conference
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Ed Willett, Commissioner

Australia possesses very large reserves of natural gas. Known reserves could meet domestic demand for more than 100 years at current consumption levels.

However, while the vast majority of Australia's population is in the south-east, nearly 90 per cent of these gas reserves are located at the exact opposite end of the country in basins off the north-west coast of Western Australia.

These basins are not currently connected to south-east Australia and are instead being developed mostly to supply export markets with liquefied natural gas (LNG).

The gas reserves in south-east Australia that supply the major population centres are modest, but sufficient to meet demand for the next decade.

Reserves in the traditional sources of Gippsland, Cooper-Eromanga and Bowen-Surat basins have been supplemented by recent discoveries in the Otway and Bass basins and exploration is currently underway in a number of other areas.

Gas production is highly concentrated. The three largest gas producers supply 98 per cent of gas to the eastern Australia market. In order to diversify exploration and production risk, gas producers have traditionally set up joint marketing arrangements for the sale of their gas. In addition to the joint marketing arrangements, there is extensive common ownership across gas basins.

It's expected that market concentration will decrease slightly as smaller gas fields are developed in coming years.

In addition to the traditional gas sources, Australia has massive reserves of Coal Seam Methane (CSM). These reserves are 10 times greater than all the conventional natural gas reserves in eastern Australia combined and have the potential to be a substantial source of gas in the future.

While CSM production is more costly and technically difficult than traditional gas production, it has the great advantage of being available close to the major population centres with fields being developed in the NSW and Queensland coal fields. The commercial and technical viability of CSM is yet to be confirmed but will be tested soon by contracts to supply the Townsville power station and Sydney market.

So there appear to be four major options for providing the new gas supplies that will be required to meet demand in south-east Australia beyond 2012:

1. The discovery of new reserves in south-east Australia;
2. The commercial development of coal seam methane;
3. The connection of the massive northern gas reserves to south-eastern Australia via the construction of new pipelines and
4. The proposed PNG pipeline, with expected capacity of around 200PJ per year.

It is unclear at this time which option or options will succeed.

Commercial consideration is being given to each of the four options. Ultimately the market will decide which option (or combination of options) is able to deliver the gas in the most efficient manner.

At this stage extensive government intervention does not seem necessary in order to ensure continued gas supply to the south-east. However, it is important that the underlying policy settings ensure that the option or options that proceed are in the best interests of gas customers.

Why am I making these points?

Investment decisions in the gas sector have long lead times.

Where market growth is constrained a large project's advancement can mean another project's deferral.

That is why intervention to facilitate one option over another needs to be carefully considered.

Australia's relatively low energy and gas prices provide industry with a strong competitive advantage. This has been boosted by increasing competition in the gas market over the past decade, but competition remains immature. Some segments of the gas market will not be subject to effective competition for many years.

So the best approach to maintaining Australia's low energy prices is to continue to facilitate competition where this is feasible. Where competition is not feasible, effective regulation should be applied to restrain monopoly positions and mimic effective competition. This is where the Australian Competition and Consumer Commission comes into the equation.

Role of the ACCC

The Australian Competition and Consumer Commission is somewhat unique as a regulatory body, in part because we have responsibility on both sides of the market – consumer protection and promoting competition.

Crucially we are also responsible for regulation of aspects of the deregulated government monopolies such as gas, electricity and telecommunications.

The opening up of the gas sector to competition flowed from the 1994 Council of Australian Governments agreement on *Free and fair trade in gas.*

The agreement saw a major restructure of the gas industry, with monopolies such as pipelines being separated from more competitive segments of the gas industry, such as production and retailing.

The agreement also removed barriers to inter-state trade in gas and developed a national framework for creating a right of access by gas producers and retailers to Australia's major monopoly gas pipelines.

These reforms recognised that simply privatising or deregulating the gas sector would, on its own, do little to promote competition, because it would in most regions simple turn a state-owned monopoly into a private monopoly.

These reforms were furthered through the 1997 *Natural gas pipelines access intergovernmental agreement,* which sets down the current legislative and regulatory framework for the gas industry.

The Gas Code, as it is known, aims to:

- facilitate the development and operation of a national market for gas
- prevent abuse of monopoly power
- promote a competitive market for gas in which customers may choose suppliers, including producers, retailers and traders
- provide a right of access to gas pipelines on fair and reasonable terms for both pipeline owners and those seeking access, and
- provide for resolution of access disputes

The Commission's aim when administering the Gas Code is to achieve the same sort of outcome in terms of access prices and quality of service that would occur in a competitive market.

Accordingly, the Commission determines benchmark tariffs at levels that generate adequate returns to the infrastructure owner while enabling access seekers to compete effectively in related markets, and, provide for maintenance and improvement of facilities while not compensating for inefficient operations.

Gas Code regulation outcomes

So what has been the record so far?

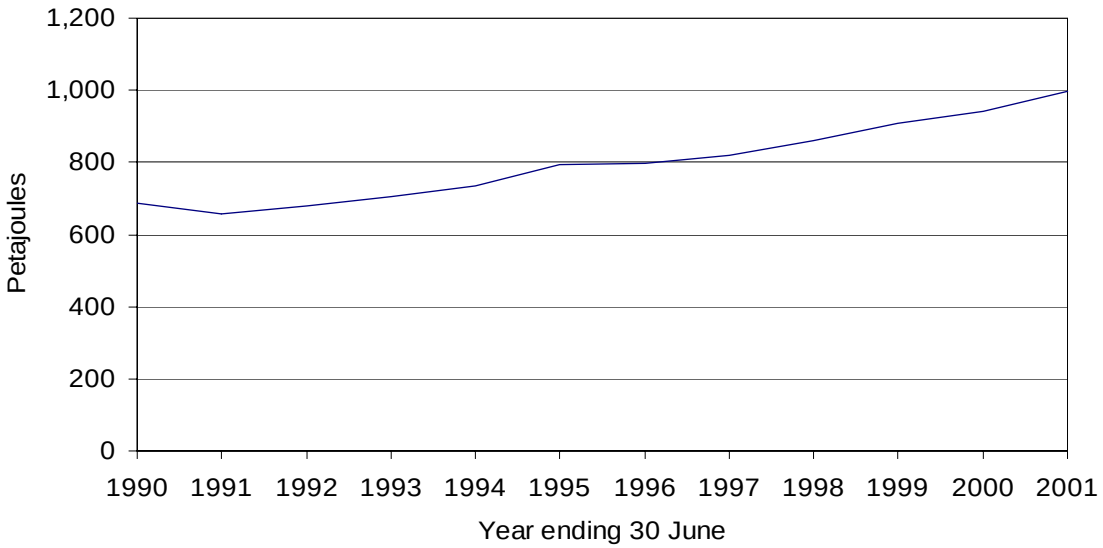
We believe the evidence is very positive.

The gas industry has ended the bad old days when local authorities took gas supplies from monopoly producers under long term contracts that left little room for an injection of competition from third parties.

Regulation has gone from legislating intra-state monopolies to promoting competitive markets through structural reform and facilitating access to monopoly infrastructure on terms that still encourage further investment.

Gas consumption has grown at an accelerating rate since the mid-1990s, averaging four per cent since 1995, while gas has increased as a proportion of Australia's energy mix from 12 per cent in 1980/81 to 20 percent in 2000. The augmentation of coal fired energy with natural gas is also of course a big plus for the environment.

Gas consumption in Australia 1990-2001



According to the Pipeline Industry Association, 14,000 km in new transmission pipelines have been laid in Australia since 1997. This amounts to a doubling in the length of transmission pipelines to 28,000 km in just seven years.

Capital expenditure on new pipelines has increased substantially with major new pipelines to have been constructed in recent years including:

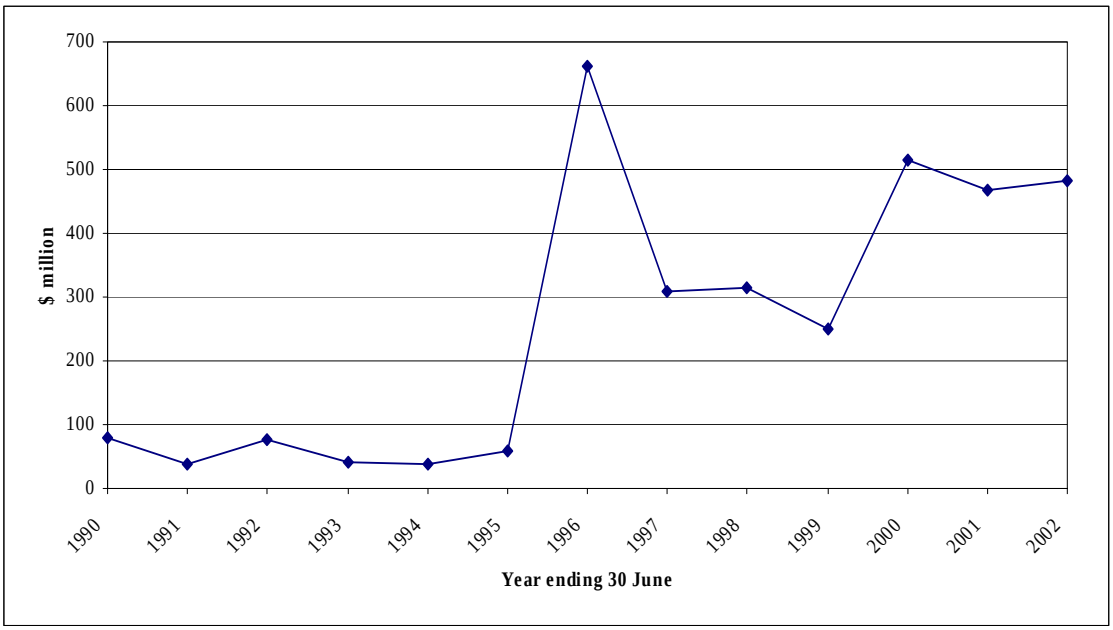
- Eastern Gas Pipeline: Longford (Vic) to Sydney
- Tasmanian Gas Pipeline: Longford (Vic) to Tasmania
- Roma to Brisbane Pipeline looping
- SEA Gas Pipeline: Port Campbell (Vic) to Adelaide
- North Queensland Gas Pipeline: Moranbah to Townsville
- Telfer Gas Pipeline: Port Hedland to Telfer (WA)

In addition, two new pipelines are currently under advanced stages of planning and development:

- Central Ranges Pipeline: Dubbo to Tamworth
- PNG Gas Pipeline: Papua New Guinea to South East Queensland (including a lateral to Gove in the Northern Territory)

This growth in pipeline construction has connected areas whose markets were once discrete.

Transmission Pipeline Capital Expenditure 1990-2002



Source: Australian Gas Association, Gas Statistics Australia, various editions.

The development of an effective access regime over the past decade also means niche players can now invest in gas exploration and development, confident they can access transmission and distribution systems on reasonable terms.

This opens up the possibility of gas fields being developed without long-term contracts being in place.

Now, with access to pipelines and other infrastructure available we are seeing new developments in places like the Otway Basin and the coal seam methane developments in New South Wales and Queensland.

This is in turn increasing investment, diversity in ownership and reducing concentration of ownership in the upstream.

And it's not just the industry which is benefiting. Material prepared by consultants ACIL Tasman for the ACCC's submission to the Productivity Commission estimates the benefits of gas and electricity access regulation to the economy at $2.2 billion to $11 billion over a 15 year period, and the costs at just $185 million.

Consumers have also benefited. The price of delivered gas would have been higher without regulation. ACIL Tasman estimates that without access regulation the price for transmission and distribution services could have been 25 per cent higher.

Even with this price restraint there has been considerable pipeline investment. Gas transmission companies are very successful businesses. An example I can point to is the UBS Utilities Index. In the decade to June 2005, the (Australian) UBS Utilities Index has generated a compound annual return of 22.9% compared to the S&P/ASX 200 Accumulation Index return of 12.2%.

So that is the record so far under the Gas Code regulations administered by the ACCC.

However, as many of you are aware, the regulation of gas and electricity has undergone a significant change with the commencement of the Australian Energy Regulator.

Australian Energy Regulator

In December 2003 the Ministerial Council on Energy delivered its Report to the Council of Australian Governments, entitled 'Reform of Energy Markets.' Ministers made two key recommendations for reform to:

1. Strengthen the quality, timeliness and national character of government of the energy markets, to improve the climate for investment; and
2. Streamline and improve the quality of economic regulation across energy markets, to lower the cost and complexity of regulation facing investors, enhance regulatory certainty and lower barriers to competition.

Ministers agreed in-principle to the development of a national approach to energy access, covering electricity and gas transmission under the *Trade Practices Act 1974*. This emphasis on a national approach was crystallised in the Australian Energy Market Agreement, finalised on 30 June 2004, which established two new statutory commissions:

- The Australian Energy Market Commission (AEMC), with responsibility for rule-making and market development; and
- The Australian Energy Regulator (AER), with responsibility for market regulation and enforcement.

The key principle behind the establishment of the Australian Energy Regulator was that the choice between gas and electricity should be determined by market disciplines and not regulatory distortion.

Different approaches to regulating utilities across industries distort investment decisions and create unnecessary costs and barriers for utilities operating in more than one industry.

A single consistent and independent regulator will reduce regulatory costs to business and barriers to entry and allow both gas and electricity to develop in a way that encourages competition within, and between the two, to the benefit of industry, consumers, and ultimately the nation.

The AER was initially given responsibility for electricity wholesale and transmission in the connected (NEM) jurisdictions, extended in 2005 to include gas transmission for all other than WA.

- ***Roles of AER and ACCC***

So how will this all work in practice?

The AER commenced operations on 1 July 2005 with staff located in Canberra, Melbourne, Sydney and Adelaide. The AER Board, which meets in Melbourne, is comprised of three statutorily appointed members: a full-time Chairperson (Steve Edwell) and two part-time members, one of whom is also required to be an ACCC Commissioner, and a State/Territory member (Geoff Swier).

There is now a single body of staff providing assistance to both the AER, and to the ACCC on energy matters.

This allows both to draw on the same substantial body of specialist skills and knowledge while avoiding costly, and potentially time-consuming, duplication.

The ACCC will continue to be responsible for approving mergers, access codes and undertakings, granting authorisations and for investigating and, where necessary, prosecuting possible contraventions of the *Trade Practices Act.*

However, the AER will now assume the ACCC's current electricity transmission revenue regulation functions, with gas transmission regulation functions to follow in the future. The AER will also assume NECA's current electricity regulatory functions, including monitoring the electricity spot market and ensuring compliance with the National Electricity Code. The AER will also be responsible for enforcement of the National Gas Code.

During 2006, the AER is scheduled to become responsible for the regulation of electricity distribution and retailing, other than retail pricing. Jurisdictions may also transfer responsibility for regulation of retail prices to the AER by agreement with the Commonwealth.

The Australian Energy Market Commission, AER and ACCC will be empowered to share information that they obtain with each other where that information is relevant.

Any information provided on a confidential basis to one regulatory body, including information provided on a "commercial-in-confidence" basis, may be provided to the other regulatory body and conditions may be imposed on the use of the information. The receiving body must protect that information from unauthorised use or disclosure.

However I should stress that despite these close links between the two, the AER will be responsible for making decisions on regulatory matters independently of the ACCC.

At all times when performing its electricity economic regulatory functions the AER will be required to act in a manner that is likely to contribute to the achievement of the national electricity market objective.

This means the AER has to look to the long term and promote greater investment, interconnection, efficiency and security of supply, and not just cheaper short term prices for end users.

The AER is therefore required, before setting revenue caps, to inform regulated transmission system operators of its considerations and allow them a reasonable opportunity to make submissions before any determination is made.

It must also provide a reasonable opportunity for the transmission or distribution system operator to recover the efficient costs in complying with various regulatory obligations.

And importantly, it must provide effective incentives to the operator to promote the efficient provision of regulated services, including the making of efficient investments.

A particularly important aspect of the new regime will be the arrangements between all three bodies which enable the AEMC, AER and ACCC to consult and co-operate on the code change and authorisation processes to avoid any duplication.

The AEMC will have specific obligations to consult in developing or considering any code changes and any person, including industry and end-users, may make comments on proposed code changes.

And, as I have mentioned, there is already an agreement in-principle to the development of a national approach to energy access under the Trade Practices Act, covering electricity and gas transmission and distribution.

This 'convergence' of regulatory functions in electricity and gas transmission and distribution reflects the recommendations contained in the MCE's 2003 Report, supporting the establishment of a national legislative framework for the Australian energy market. Key issues arising from the new national framework include:

1. The harmonisation of regulation between fuel sources and between jurisdictions to encourage cross-market competition and remove inconsistencies; and
2. The operation and regulatory oversight of an emerging multi-product industry in a state of transformation.

- ***Authorisations***

As I mentioned before, the establishment of the AER does not spell the end of the ACCC's involvement in gas regulation.

The AER remains a constituent part of the ACCC.

Even beyond this, the ACCC will continue to have responsibility for mergers and authorisations and we have continued to be active in this area in recent months.

In July last year the ACCC authorised REMCo, the Retail Market Administrator for the gas markets of South Australia and Western Australia, to engage in certain forms of anti-competitive conduct arising from the Retail Market Rules in those two states.

This had the potential to result in breaches of the *Trade Practices Act* prohibition on price-fixing and exclusive dealing.

However, taking into account the substantial public benefits arising from REMCo's proposed conduct - the passing on of the benefits of a more efficient upstream gas market being the key factor in this instance - the Commission granted immunity to REMCo to engage in certain forms of anti-competitive conduct for a period of five years.

With the launch of retail markets in Australia, such as those administered in WA and SA by REMCo, the majority of gas users in Australia now have the opportunity to choose gas suppliers, while retailers can enter any market that attracts them. This is made possible through the physical interconnection of the gas markets in South East Australia, with multiple transmission pipelines bringing gas from more than one field.

Similarly, the ACCC has also granted authorisation for certain forms of anti-competitive conduct by VENCorp, a Victorian Government statutory authority with responsibility for operating Victoria's gas transmission network and its wholesale gas 'spot' market.

VENCorp's Market and System Operating Rules were originally authorised by the ACCC in 1998. The ACCC is also involved in granting approval for amendments to the access arrangement currently in place for VENCorp.

Further, as I have already mentioned, the ACCC is currently involved in the authorisation process for the PNG pipeline.

Conclusion

In less than fifteen years, Australia's entire gas sector has undergone a radical transformation which has benefited the gas sector, consumers, and the nation as a whole.

From the original integrated monopoly supply companies and single transmission pipeline delivery of the early 1990s, business and consumers now enjoy the benefits of diversified supply sources, new infrastructure and competition.

Simultaneously, the institutional framework for economic regulation of gas and electricity in Australia has converged at a national level, delivering a co-ordinated approach to supply security, fuel mix and prices.

Consumers enjoy more reliable and cheaper gas supplies, gas exploration has increased dramatically, new gas fields have been developed, pipeline infrastructure has doubled in just seven years and gas pipeline companies have enjoyed returns which outstrip the stock market average.

In short, the benefits of this national approach to energy regulation are myriad and substantial, delivering long-term advantages for investors and end users alike.