



# AGA 2002 Gas Industry Forum

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Sheraton Towers

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Chairman

## **INTRODUCTION**

Thank you for the invitation to speak to you today. This morning I want to provide the ACCC's perspective on regulation in the gas industry and more specifically, concerns relating to regulatory risk. I will cover four main areas:

- The form of regulation in the gas pipeline industry and the use of incentives;
- Upstream gas issues;
- Regulatory treatment of risk for greenfields projects; and
- Regulatory governance for the future.

In the mid 1990s the Council of Australian Governments (COAG) agreed to wide ranging competition reforms. A central reform was the agreement to apply competition laws to all businesses regardless of ownership. Until then the Trade Practices Act did not apply to certain government business enterprises, unincorporated businesses, partnerships and professional bodies. Now everyone is covered by the provisions of Part IV of the Act or the equivalent provisions which apply by virtue of the competition code application legislation in each state and territory.

COAG's competition principles agreement introduced additional competition reforms. These were primarily directed at utilities, many of which were still government owned and in some cases vertically integrated monopolies. The agreement aimed to promote competition where possible through structural reform of public monopolies and legislative reform. It also established a national access regime covering 'essential facilities' (which are not easily duplicated economically). The access regime applies generally and has paved the way for industry specific regulatory measures in the electricity and gas industries.

An Australia-wide integrated gas network was, and I hope remains the shared vision of producers, regulators, and government and potentially will enable inter-basin competition. The reforms have seen the expansion of pipeline infrastructure. Nevertheless the gas transmission sector is likely to remain highly concentrated. Future pipeline investment is likely to be driven by an increase in demand for gas. Such future

market expansion will require access to, and effective price signals from, transmission and distribution sectors to produce efficient economic outcomes in downstream markets.

The in-principle case for addressing market power in the pipeline sector of the gas industry remains as important today as it was at the outset of the reform process in 1995. Regulation seeks to do this by limiting the potential for asset owners to exert market power arising from these bottleneck facilities.

Some benefits from the reforms are now more evident with a growing trend to more efficient gas pricing and substantial new investment in all parts of the energy market. In addition, we are now seeing the emergence of an integrated energy market in which gas competes with electricity and where increasingly electricity is being generated using gas, particularly for peak generation.

Some concerns have been expressed at the reach of regulation in the pipeline sector. However these decisions were made up front by the governments which identified the pipelines to be regulated. For new pipelines the regulatory framework covering gas transmission infrastructure in Australia requires that a number of tests must be satisfied before a pipeline, or prospective pipeline is regulated. The National Competition Council is responsible for making coverage and declaration recommendations. Accordingly, the ACCC only has a role where these tests have been determined to be satisfied.

### ***Regulation – incentive based?***

The ACCC carries out regulation of gas transmission assets under the requirements set out by the gas code. The approach adopted in the code is for an incentive framework that encourages the regulated businesses to outperform the benchmark rate of return established by the ACCC for the forthcoming regulatory period. Returns achieved need not be, and are unlikely to be, the same as regulated returns. Higher returns can be achieved in a number of ways. For example actual operations and maintenance costs may be less than those forecast or service providers can increase actual demand above

the forecast level by developing their market. In both cases higher returns can be earned.

The incentive-based regulatory framework adopted in Australia attempts to overcome the weaknesses of the rate-of-return regulatory approach found in the US. These include, the lack of incentives for the regulated business to reduce costs, the incentives for the businesses to “gold-plate” investment, and the considerable administrative burden it places on businesses and the regulator. Incentive regulation gives discretion to the service provider to operate its business and allows it to benefit from returns greater than those anticipated by the regulator. In providing this opportunity it is expected that the market will grow and new services will be developed to meet the needs of users while operational and capital costs are minimised. The result is intended to be greater productive and allocative efficiencies in the economy.

A key requirement of regulation is the establishment of the underlying efficient costs of the regulated business. A building block approach has been adopted by the ACCC and this is widely followed by state regulators, to determine the revenues required by regulated businesses. I would contend that this approach has been appropriate particularly for the initial round of reviews where the availability of market prices has been limited due to previous government ownership of gas assets.

In Australia price and revenue caps have been used. Increasingly, however the ACCC and other regulators are making greater use of benchmarks to enhance the incentives provided. The ACCC as well as the NSW and Victorian regulators have, through the regulators forum, recently initiated a consultancy to review alternatives to the building block approach and the possible use of efficiency and performance measures in the future.

In making regulatory decisions a balance must be achieved between the needs of service providers and users. The perceived short term gains of reducing prices for infrastructure services and the mitigation of monopoly rents must be balanced with the ongoing viability of the business and the industry as a whole. The regulatory framework must provide the appropriate incentives, and accommodate new efficient

investment in infrastructure. Only then will long term efficiencies arise and benefit the economy.

One of the most frequently expressed criticisms of the regulatory framework for gas transmission concerns the impact of regulation on new investment. The evidence to date suggests that based on a number of key indicators such as returns in the stock market and similar decisions by regulators elsewhere the regulatory provisions have helped to deliver efficient prices. The evidence also suggests that the current regulatory provisions and their application provide a solid base for future investment in gas transmission and provide earnings opportunities comparable to those elsewhere on the Australian share market.

### *Upstream issues*

Let me turn to some upstream issues. In contrast to transmission and distribution services, the upstream sector has not been subject to direct reform but rather indirectly through reviews under the competition principles agreement. There has been considerable dissatisfaction expressed by some industry participants regarding the competitiveness of the upstream sector and an acknowledgment that the structure of upstream activities does not facilitate competitive outcomes. However, it is considered that reform in this sector will be better achieved through the promotion of new upstream entrants, further pipeline interconnections and a move towards greater flexibility in the length of contracts.

Since the commencement of the reform process, Australian's gas sector has undergone transformation from a series of state-based monopolies and is moving towards a national industry. Where the industry was previously characterised by restrictions on inter-state gas sales and limited physical connections, it is now possible for gas to be traded and transported between jurisdictions through a developing network. This network includes: the interconnect (from Culcairn to Barnawatha) which links the Victorian and NSW pipeline systems; and the Eastern Gas Pipeline both of which allow gas to be transported between Victoria and New South Wales; and the currently under-construction Tasmanian pipeline which will extend from Victoria to Tasmania. Further

pipeline proposals will potentially enable gas to flow from Victoria to South Australia and projects which involve gas from the Timor Sea or PNG to supply eastern Australia in the future are being discussed.

An expanded and more interconnected network is likely to promote the development of new gas production ventures within existing and new exploration areas. For example, should the Seagas proposal from Port Campbell in Victoria to Adelaide proceed, it will complete the loop interconnecting gas markets in south east Australia and facilitate the entry of new gas production ventures out of the Yolla and Minerva fields in Victoria. The development of an expanded network will assist in providing for greater competition in the upstream gas sector.

Joint marketing of natural gas and the ACCC's role in assessing applications for authorisation for these arrangements will undoubtedly continue to be an area for debate. Authorisation can only be granted by the ACCC where it is satisfied that the joint marketing arrangements will result in a benefit to the public and that benefit will outweigh any detriment resulting from any lessening of competition. The ACCC considers that separate marketing, where possible, is the preferred method of gas supply contracting. However, where evidence indicates that the prohibition of joint marketing of gas might dissuade new investment in gas production, then authorisation of joint gas marketing is likely to be in the public interest.

The ACCC's north west shelf authorisation determination in July 1998 involved a thorough assessment of the market and competition issues in Western Australia. Based on the information available at the time, the ACCC concluded that the market had not evolved sufficiently to enable separate marketing. However authorisation was limited to a period of seven years to enable review of the arrangements in light of subsequent market developments and reforms.

The ACCC will continue to assess each application on a case-by-case basis and use the authorisation process to ensure that anti-competitive aspects of coordinated marketing are minimised.

In developing a competitive, interconnected network system the ACCC sees its primary role, in addition to its authorisation functions, as administering the current regulatory

regime for transmission to ensure that price signals drive efficient investment and consumption decisions and provide an environment for the market to develop. Competitively priced gas will be a key factor in determining its uptake with end-users and, in-turn, the benefits that will flow into the economy. This is particularly important for the ongoing expansion of the gas transmission network through greenfields developments.

### ***The draft greenfields guideline***

Despite the substantial investment in new infrastructure in the energy sectors, there has been some debate as to whether the regulatory provisions adequately address the specific needs of new or “greenfields” investment.

While each pipeline throughout Australia is likely to face unique and differing levels of risk, greenfields pipeline projects are generally acknowledged to face greater uncertainties than established pipelines. For example, a new pipeline without significant foundation contracts proposing to supply gas to a new or immature market, faces greater uncertainty regarding future demand than a 20-year old pipeline that is fully contracted and supplying to a well established customer base. The growth in future demand for a new pipeline can often be dependent upon a number of factors, including other new projects securing funding and remaining operational (for example a fertiliser production plant, gas fired generator) and the rate at which users convert from other fuels to natural gas.

The ACCC recognises these issues and has identified its approach to regulation in these cases to participants. However to make its approach transparent we have decided to issue a guideline for the regulation of greenfield transmission projects.

I am pleased to announce that today the ACCC is releasing its *draft greenfields guideline for natural gas transmission pipelines*. The draft guideline has been developed to assist industry to address the uncertainties associated with greenfield gas developments in access arrangement applications. It explains the alternatives available under the regulatory frameworks provided by the *national third party access code for natural gas pipeline systems* (the gas code) and part IIIA of the Trade Practices Act.

In preparing this draft guideline the ACCC consulted with industry. Following the input received from discussions, the ACCC sought the expert views on a number of issues. These include:

- Macquarie bank, on the issues relevant to debt and equity providers;
- Professor Kevin Davis and Mr John Handley from the University of Melbourne, on the appropriate cost of capital; and
- Economic consultants NERA, on the role of foundation contracts and related terms and conditions relevant to greenfields natural gas pipeline projects.

The key findings of these consultancies are summarised in the draft guideline and are available on the ACCC website.

This guideline is a draft. We are seeking industry input and we propose to hold an open forum where issues raised can be publicly debated.

It is intended that this draft guideline will help achieve greater certainty through greater transparency and resolve some of the reasonable concerns that have been raised about the difficulties of developing new pipelines. Specifically, the draft guideline has been produced to:

- Address perceptions of regulatory risk with regard to the application of the regulatory framework and the ACCC's approach to the regulation of greenfields projects;
- Demonstrate the flexibility of the regulatory framework and the various approaches available for the structure of an access arrangement or access undertaking;
- Indicate methods for dealing with project specific risks; and
- Assist prospective service providers to evaluate the likely regulatory outcomes for potential or proposed greenfields projects.



The draft guideline is not intended to be exhaustive and the ACCC is receptive to considering alternative methods, provided that any proposed approach is consistent with the principles of the gas code or, in the case of an access undertaking, Part IIIA.

Despite some criticism of the gas code, it is useful to note that it was designed—with industry input—to facilitate a fair degree of flexibility for service providers in formulating an access arrangement for regulatory consideration. This flexibility provides a range of options for prospective service providers to deal with the unique risks associated with greenfields investments.

The ACCC's perception is that the gas code offers a degree of flexibility that is yet to be fully realised by the pipeline industry. While prescribing a range of matters that the regulator is required to consider, the gas code also provides a number of provisions and options for prospective regulated greenfield pipelines that can address any uncertainty regarding the application of the regulatory regime.

The gas code recognises that to encourage investment a prospective service provider should be given the opportunity to reap some of the returns that exceed the expected level where those returns are attributable to the efforts of the service provider. Often referred to as the 'blue sky' potential of the pipeline, such an approach requires regulatory certainty about the treatment of any greater than normal returns, if realised, in the initial regulatory period/s. The inclusion of an incentive mechanism in an access arrangement (or access undertaking) is an important component of a service provider's regulatory framework. The ACCC encourages service providers to develop mechanisms that will best suit their particular needs.

Prospective service providers are encouraged to consult with the ACCC when developing an access proposal. However, it is ultimately the service provider's responsibility to design an access proposal that best meets its unique needs and circumstances, while complying with the principles of the national access regime. The ACCC can assist prospective service providers with a preliminary non-binding view on a proposed access arrangement or undertaking; however, for it to provide a well considered response, a sufficient amount of relevant and useful information will be necessary.

Without constraining the intentions of the gas code in this regard, the challenge for regulators is to assess access regime proposals to ensure that they establish fair and reasonable conditions of access for both service providers and users in a manner that preserves the service provider's economic incentives to fully utilise its assets and develop its business.

### **Regulatory options for addressing new investment risks**

A criticism levelled at regulators by prospective investors is that perceptions of regulatory risk in a regulated industry act as a disincentive to investment. These perceptions are based on the assumption that a regulated entity is exposed to downside risk whereas the opportunity to make higher profits or 'blue sky' are capped. These fears are exacerbated by the potential for regulators to claw back or otherwise limit the blue sky potential of a new investment at the next regulatory review.

These views fail to recognise the provisions of the gas code that mitigate these risks while ensuring compliance with the code's objectives of providing a reasonable return to service providers and benefit sharing with users.

Within the regulatory framework a prospective service provider has a substantial amount of flexibility when formulating an access proposal. The onus remains with the prospective service provider to submit an access arrangement to the ACCC for assessment that complies with the objectives of the gas code or an access undertaking, depending on the regulatory option sought.

A number of options are available to prospective service providers when formulating an access proposal that can provide certainty as to the limits on blue sky opportunities. Service providers can, if they wish, discuss possible options with the ACCC prior to lodgement. An example of three of the possible options available within the regulatory framework are discussed below.

#### ***Term of the regulatory period***

The gas code allows the regulator to consider an access arrangement period of any length. However, where the access arrangement period is greater than five years it

requires the regulator to consider whether mechanisms should be included in the access arrangement to address the risk of forecasts, on which the terms of an access arrangements were based and approved, proving incorrect.

The ACCC's final decision for the central west pipeline provided for an access arrangement period of approximately 10 years. The extended access arrangement period was included to provide the service provider with an additional incentive to develop the natural gas market in the central west region. In effect, the business has the potential to earn, and retain for an extended period, a rate of return higher than the benchmark determined by the ACCC.

### ***Determining the initial capital base***

For existing pipelines, the regulator must determine the initial capital base with regard to methodologies such as depreciated actual cost and depreciated optimised replacement cost. However in the case of new pipelines, the gas code requires that the initial capital base will be determined by the **actual capital cost** of the assets at the time they first enter service. In other words the regulator cannot optimise or otherwise reduce the actual capital costs incurred in building the asset. It must take as given the costs of a new asset in formulating the regulated asset base.

The ACCC is aware that the costs of a greenfields pipeline may not be known with precision until some time after it commences operation and that initial reference tariffs would need to be determined based on forecast capital and non-capital costs. As outlined in the draft guideline, a company has the option of forecasting its initial capital base when determining the initial reference tariff and can make an adjustment when the actual capital cost is known with certainty.

### ***Downside risk mitigation***

The gas code provides that the service provider may seek revisions to its access arrangement at any time. In contrast, the ACCC cannot initiate an early review. Similar provisions apply to an access undertaking under Part IIIA. These provisions afford protection to a prospective service provider in the event that unforeseen factors impact on it and constrain its ability to earn a reasonable return.

Thus, service provider initiated, unscheduled revisions to an access arrangement can assist a service provider who finds actual demand much lower than forecast. Further, where demand is expected to grow gradually over time, a depreciation profile may be chosen that allows the opportunity for expected early under recoveries to be recouped in later years.

### ***Regulatory governance***

I would like to also touch on the question of regulatory governance. Based on the Hilmer recommendations, the current approach in Australia has been for the administration of competition law and economic regulatory functions at the national level to be combined within the one organisation, the ACCC. By combining these roles, regulatory functions are administered with reference to on-going competition issues. In its regulatory functions, the ACCC always keeps uppermost in its mind the implications for competition and maintains the objective of seeking competitive outcomes where possible. In gas, these national regulatory functions apply only to transmission pipelines (with the exception of WA). Under the federal system, the regulatory oversight of distribution networks is performed by state based regulatory agencies.

Concerns have been raised that the present arrangements allow for forum shopping among the different regulatory agencies and that uncertainty and complexity is created by regulators interpreting the regulatory regime differently, particularly for companies operating in more than one jurisdiction.

A number of options have been floated in response to these concerns. One option has been the creation of a single national energy regulator to ensure consistency in energy decision making. Other options may include formal or informal cooperation between regulators to ensure greater consistency.

In looking at this issue it is difficult to talk about gas in isolation because there are specific electricity issues as well that need to be considered.

A single energy regulator appears a simple option at first glance. I fear it may in practice be quite complex and could lead to greater regulatory fragmentation rather than regulatory consistency.

First would such a body undertake the role of state regulators? State regulators are involved in activities other than energy. Without state cooperation it would be possible to end up with a national regulator and state bodies. If such a national regulator were not to continue to be linked with the ACCC it is very likely that the result could be a national regulator applying the national competition laws which must be applied uniformly throughout the economy, **plus** a national energy regulator applying pricing and access regulation **plus** state regulators involved at the local level. As there is significant overlap between these matters regulatory overlap could become quite serious.

This is not to say that the issues raised about regulatory consistency are not important and should be ignored.

The ACCC has tried to address this issue in a number of ways. We have established the regulators forum in participation with the other regulators so that we can discuss our approach to regulation and encourage consistency. This meets regularly and is undertaking work on further regulatory development.

We have also established an energy committee in which a number of state regulators participate and have input into the ACCC's decision making in energy.

These mechanisms are not perfect but they do provide a starting point for perhaps more formal arrangements. It is possible working within these arrangements to achieve greater consistency and a national regulatory approach which is also consistent with the application of competition laws.

### ***Conclusion***

To conclude let me thank the AGA and its chief executive Mr Bill Nagle for the invitation to speak to you. I am hopeful the draft guideline will assist all parties involved in the development of new pipelines to have a better understanding of the

flexibility provided by the current regulatory regime and how the regulatory regime will apply to their pipeline.

Prior to finalising the draft guideline the ACCC will hold a public forum at which interested parties can raise any issues or make comments on the guideline. Details of the public forum will be publicised in the major daily press. The draft guideline is available on the ACCC's website.

I look forward to an informed debate about the regulatory options and the way forward for the gas energy sectors and indeed all the utility sectors.

Thank you.