Australian Competition & Consumer Commission	**Australian Competition and Consumer Commission** **Promoting Competition and Fair Trading**

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Thank you for the opportunity to provide the regulator's perspective on Australian Energy Market Regulation.

I'm sorry my colleague Commissioner Ed Willett had to drop out at the last minute. I know he was looking forward to coming to Darwin and speaking here. I can assure you I am certainly very glad to be here, and escape Canberra, where the temperature was minus three last week!

Darwin is an exciting location at the frontier of a new phase in Australia's energy sector development. Similarly, the establishment of the Australian Energy Regulator is placing the Australian Competition and Consumer Commission at the centre of a new era in Australian energy regulation.

Before I talk about the AER I first want to talk about the state of the gas sector in Australia and how competition and careful regulation in part administered by the ACCC is helping to open up this sector to greater competition to the benefit of the industry, and consumers.

Gas production

This conference is focussing on the development of oil and gas reserves in Northern Australia and surrounding areas. As this conference is well aware, most of these reserves are located offshore.

For the moment producers in Northern Australia are seeking markets outside of Australia for their gas.

This export focus requires massive and risky capital investment to build processing and transport facilities. These developments are underpinned by long-term contracts.

No one can be certain if the negotiated terms are too high or too low, but the parties must have felt that they were right when they signed the contract.

These developments are taking place in a highly competitive international environment. Down the track maybe the buyer or maybe the seller will conclude that they got a great deal.
The domestic market is somewhat different.

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 three 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 and
3. The connection of the massive northern gas reserves to south-eastern Australia via the construction of new pipelines.

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

Commercial consideration is being given to each of the three 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.

Once constructed, pipelines ensure that a basin is connected to a market. That said, producers generally won't have another option for delivering their gas to a particular market on reasonable terms. In other words transmission and distribution pipelines are monopoly service providers.

Competition between basins can only restrain monopoly power at the margin. That is:

- Marginal gas projects become uneconomic if transport costs are too high; or
- Wholesales/retailers can seek suppliers using alternate pipeline where they exist

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 ACCC comes into the equation.

Role of the ACCC

The ACCC 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, as far as this audience is concerned, 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 **firstly**, generate adequate returns to the infrastructure owner while enabling access seekers to compete effectively in related markets, and, **secondly**, 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 pleasing.

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 by 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 argumentation of coal fired energy with natural gas is also of course a big plus for the environment.

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 a number of 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 still very successful businesses. An example I can point to is the performance of the ASX Utilities Index. Businesses in this index outperformed the S&P ASX 300 accumulation index over the past four years. Moreover, the market values of these businesses trade at a premium to the value of their regulatory asset bases.

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

However, as many of you are aware, the way gas and electricity are to be administered is about to undergo a significant change with the commencement of the Australian Energy Regulator.

Australian Energy Regulator

In August last year the Ministerial Council on Energy agreed to establish a single new regulator for both gas and electricity - the Australian Energy Regulator or AER.

The AER will be a constituent part of the ACCC but a separate legal entity. This means that the AER will have the power to make decisions on regulatory matters independently of the ACCC.

However it is intended that there will be a single body of staff providing assistance to both the AER and to the ACCC on energy matters to avoid duplication.

The objective in establishing a single energy regulator was to ensure a consistent approach to regulating gas and electricity that did not distort investment decisions and create unnecessary costs.

It was also acknowledged that making the AER a constituent part of the ACCC would ensure the new regulator could draw on the skills and expertise of the Commission.

The AER will initially have responsibility for electricity transmission revenue regulation in the National Electricity Market, though this won't involve substantial changes from the ACCC's existing electricity transmission regulatory functions.

The AER will also be responsible for enforcing the National Electricity Code, with provision made for the Northern Territory and Western Australia to join at a later date.

On, or before July next the AER will regulate gas transmission for all jurisdictions except Western Australia, with provision for Western Australia to join at a later date, possibly 2006.

The AER will become responsible for national regulation of energy distribution and retailing (other than retail pricing) by 2006.

The nature of energy regulation will also be influenced by the response of Federal, State and Territory governments to the Productivity Commission report on the Gas Code.

Productivity Commission Draft Report

The Productivity Commission is currently conducting a review of the Gas Access Regime. The draft report, released last December concluded that the costs of regulation in the gas sector will overtime outweigh the benefits, and recommended a substantial winding back of regulation.

Energy Ministers will be considering their response to the Final Report over the next six months.

The ACCC believes the draft report placed too much weight on the views of the service providers and not enough on service users. In our assessment, these recommendations, if implemented, could put the gains that have been won from the current regime at risk.

Now I would be the first to acknowledge that the gas sector has already undergone significant reform. But its origins - state based providers with government ownership - still exerts an influence on the emerging national energy market.

The gas market is characterised by limited supply sources and competition in the overall market remains underdeveloped. The market is not national in scope.
The combination of high market concentration and the critical importance of energy for domestic and industry users mean the sector still needs to be subject to more regulation than other parts of the economy.

The January 2004 Moomba Plant failure has also been used by some in the industry to push for the scrapping or winding back of gas regulation in order to promote system expansion. Others have portrayed the incident at Moomba as demonstrating a need for central planning. The ACCC views both of these positions as wrong.

It’s worth noting at this point that twenty four pipelines totalling more than 5000 kilometres have been constructed since 1997, adding to the security of supply and further increasing competition.

But complete security of supply would require the construction of spare capacity that is only likely to be used in emergency circumstances, something unlikely to ever happen on a purely commercial basis. As such, the construction of uneconomic spare capacity pipelines would only ever proceed with either direct government support (perhaps through a subsidy) or the imposition of higher prices on users under normal operating conditions.

The Gas Code already permits new investment to be added to the regulatory asset base used in determining tariffs where the new investment generates ‘system-wide benefits’ or is necessary to maintain the safety, integrity or contracted capacity of services.

Some in the pipeline industry have suggested that, if regulation is removed, higher profits would be channelled into the production of further capacity. With the greatest respect, this seems highly unlikely. When faced with a choice between returning higher profits to shareholders or undertaking additional non-commercial investment it would be surprising indeed if shareholders missed out.

While there are numerous plans mooted for the construction of new transmission pipelines in Australia, there does not appear to have been any significant shortfall in investment under the gas access regime. The ACIL Tasman report for example demonstrates that the existing network already possesses significant reserve capacity.

ACIL Tasman’s modelling of the Australian gas market indicates that over the next 10 years only limited capital expenditure on greenfield transmission pipelines will be required as most of the major demand centres already have significant reserve pipeline capacity.

It identifies only one case where additional investment is required immediately – the expansion of the Dampier to Bunbury Natural Gas Pipeline which has been delayed due to Epic’s unique circumstances.

And finally, there was this conclusion from the Allen Consulting Group on the impact of regulation on investment:

> *In summary, there is no evidence to suggest that Australia's regulatory framework is deterring investment in regulated utilities. On the contrary, the regulated utilities sector has relatively strong investment fundamentals, whether compared to the Australian market or internationally.*

In fact, there is a strong argument that a relaxation of the current regime could actually reduce investment levels. Should pipeline operators be given greater scope to exercise their market power this must lead to higher gas prices, which in turn would make it harder for producers and users to develop their businesses.

Given that under the gas access regime there has been an unprecedented level of investment in pipeline capacity, it's hard to see how its removal would promote further investment.

Conclusion

Over the past decade, the opening up of the gas sector has improved competition, security of supply, returns to the industry, and given better services and prices to industry and consumers.

The growth in gas consumption has also been positive for the environment, with gas increasing as a proportion of Australia's energy mix from 12 per cent in 1980/81 to 20 percent in 2000, augmenting coal fired energy.

This has not occurred by chance. Government policy settings and the careful application of that regulation by the ACCC has played its part.

Over the next decade some big decisions are going to have to be made about how to best ensure the continuity of supply to Australia's major gas markets in the south-east. This decision could have major ramifications for Darwin and the development of the gas industry in northern Australia.

It is not the ACCC's role to promote or protect any particular gas project or pipeline, or even to promote gas over any other power source. Our role is only to intervene where markets can't operate properly due to a monopoly or a lack of competition, and ensure that if a project does or does not proceed, it is entirely due to the relative merits of that project and is in the best interests of both industry and consumers.

We believe the experience of the past decade has shown that as far as gas is concerned, the ACCC's application of effective and careful regulation has been a success, and should continue for the benefit of the industry and the wider Australian public.