



Australian Competition & Consumer Commission

Committee for Economic Development of Australia

The ACCC and the Economic Regulation of Gas Infrastructure

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1. Introduction

It is a pleasure being here today to talk to you about the ACCC's role in deregulating one of the most fundamental industries upon which the Australian community relies - that is, the gas industry. Certainly, the importance of having a reliable and constant supply of this essential commodity has been highlighted in the past ten days by the disturbing circumstances which have plagued Victoria since the Longford disaster.

2. The ACCC's Role in Deregulation

Firstly, I would like to start off by saying that economic reform is about changing the way in which firms do business in order to improve resource usage. The traditional view of public utilities such as gas was that they were best supplied by a single operator, and that it was in the interests of the community that they should be owned and operated by government.

The Hilmer report suggested that whilst some assets in a market will be naturally monopolistic, those businesses downstream and upstream of the asset can operate in competitive environments, where there is a regime which enables effective access to the services offered by the natural monopolist.

As a result of the COAG review, the Commission has been given a significant regulatory role in relation to communications, energy and transport. Whilst today's presentation focuses on gas, it is true that the stories in respect of the benefits of deregulation of each sector are the same.

In relation to gas, economic modelling has provided an estimate of the potential benefits that are available from gas industry development. Studies carried out by ABARE for the Industry Commission estimate that the economic returns from new gas pipeline interconnections alone could total \$1 billion (in net present value terms) Australia-wide over 35 years.¹ On the other hand, the Australian Gas Association (AGA) estimates that continued restrictions on interstate trade in gas could result in additional cost to Australian consumers of between \$1.5 billion and \$4 billion in net present value terms by the year 2029-30.² Based on the experience on other countries such as the US and Canada, which undertook significant gas reforms that led to a more competitive market environment, Australian consumers can expect to reap significant benefits from gas industry reform. At the same time, there has been no indication of a loss of security of supply or service reliability.

Thus, the successful introduction of competitive reforms to the gas industry is a key to providing incentives to participants at all functional operating levels to improve the efficiency of their production, resource allocation and investment decisions, and to minimise costs. These benefits are not limited to the gas industry, as gas is an important input into many Australian industries, influencing their ability to compete both domestically and internationally. Certainly, this has been significantly highlighted in the past week by the events in Victoria. Benefits are likely to be distributed broadly throughout the economy, through lower input costs to Australian industry, lower prices

¹ Industry Commission, *Australian Gas Industry and Markets Study*, AGPS Canberra 1995, p.231.

² AGA, *Gas Supply and Demand Study*, 1992.

to final customers, and more efficient use of resources. Hence, regulatory and public policy reform of the gas market is vital to Australia's ability to capitalise upon growing international and domestic demand, and to capture its natural advantage as a low cost energy supplier.

Ensuring that competition can work to yield welfare enhancing results gives rise to two regulatory issues:

i) Access

There is a need to ensure that businesses which operate in upstream or downstream markets are able to access the services offered by the natural monopoly asset. Particular concerns may arise if a monopolist has a downstream arm to its business as it may be in a position to impede competition in the downstream market by denying competitors access to its services, or by selling its services at a favourable price to its downstream arm. Such behaviour could seriously limit the effectiveness of competition in the upstream or downstream markets.

ii) Access Prices

Monopoly status confers significant market power on an asset owner, enabling it to earn monopoly rents by charging prices in excess of competitive levels. Further, a monopolist might restrict supply to increase prices and this could seriously retard growth in downstream industries. To prevent inefficient outcomes, the challenge for the regulator is to ensure that users upstream and downstream of the monopolist are charged prices which reflects the true costs of providing the service. Otherwise, monopoly rents will be passed on to end users and the benefits of reforms in the natural gas industry will not be realised.

Enter Part IIIA of the TPA, which has been designed to facilitate a smoother transition from regulation to deregulation by addressing issues such as imbalances in power between parties negotiating access arrangements.

Part IIIA has been designed to pursue two main objectives. The primary objective is an economic one. It aims to improve economic efficiency by introducing competitive forces into certain essential facilities which have been monopolised by one, or a very small number, of owners in circumstances where access is required for persons to enable them to compete in upstream or downstream markets. To be successful this will generally require regulation or other incentives to guard against monopoly pricing, artificial constraints on capacity and anti-competitive behaviour.

The subsidiary objective is to establish light handed regulatory procedures. Such procedures should be flexible enough to accommodate individual circumstances, not generate unnecessarily high administrative and compliance costs, but be binding on service providers and users.

3. National Third Party Access Code

The National Third Party Access Code for Natural Gas Pipeline Systems (the Code) aims to provide access to the services provided by monopoly pipeline assets. On 7 November 1997, the Australian Heads of Government agreed to implement the Code. Given that the Code confers powers on Commonwealth bodies such as the ACCC and the NCC, Commonwealth legislation and complementary legislation in each State and Territory is required. The Commonwealth recently passed the *Gas Pipelines Access (Commonwealth) Bill 1998*, while the South Australian, Northern Territory and New South Wales legislation have already been proclaimed and other states are set to follow.

The Code aims to achieve a uniform national framework for third party access to natural gas pipeline systems, and to facilitate the development and operation of a national market for natural gas by providing rights of access to pipelines on fair and reasonable terms. In essence, therefore, it aims to address both of the regulatory problems identified above - it tries to ensure third parties, such as downstream competitors, have access to the services provided by gas pipelines and that the terms and conditions upon which those services are obtained are fair and reasonable.

4. ACCC Role in Gas Industry Reforms

Under the *Gas Pipelines Access Law*, the relevant regulator for gas pipelines differs according to the type of pipeline under consideration. The ACCC is the relevant regulator for access to services provided by transmission networks in all States and Territories except Western Australia. Distribution networks will be regulated by independent State-based regulators, except in the Northern Territory, which has requested the ACCC regulate both its transmission and distribution pipelines.

This new and diverse range of regulatory functions has brought out the importance of State and Federal regulators coordinating their assessment of cross-jurisdictional applications for regulatory approval. To this end, jurisdictional regulators have formed the Utility Regulators' Forum which seeks to coordinate research and regulatory response to a wide range of issues, including information requirements of regulators, ring-fencing of accounting information, monitoring of quality standards, 'best practice' and benchmarking, appeals processes and regulatory data bases. The ACCC also has an Energy Committee on which the heads of State counterpart agencies, who are *ex-officio* members of the ACCC, have input to the ACCC's regulatory decisions and regional considerations can be taken into account.

5. Incentive Regulation and the National Gas Code

Most of the access pricing principles under the National Gas Code are contained within chapter 8 of the Code. The Commission seeks to minimise the regulatory burden on industry (and hence lower the overall cost to consumers) by maximising competition wherever possible. In cases of natural monopoly, where competition is typically neither feasible nor efficient, the Commission generally seeks to create a set of incentives which encourage those in positions of market power to conduct their business in a socially desirable manner without the regulator having to second guess their every move. Facilitation of competitive secondary markets in service provision,

such as pipeline capacity, is an efficient method of reallocation and can provide valuable information for the ongoing regulation of the primary Service Provider.

The theoretical underpinning for incentive regulation is that with the ability to retain cost reductions as profits, the service provider has a strong incentive to be more efficient in the provision of access services and to expand its market share and to contribute to market growth. Higher than expected performance in both these areas will lead to better than initially-expected profits and better utilisation of resources. Generally, users of the services benefit directly only in future periods after regulated prices are subjected to review and the new cost structures are taken into account when re-establishing the regulated prices.

To achieve the potential efficiency gains from competition in upstream and downstream markets, it is important that the prices of access not reflect the exercise of market power by the service provider and that the structure of pricing to various users and between different categories of service be based on the costs involved in providing each service. The price paths for services in question are usually defined at the beginning of a review period to achieve these ends.

If regulation adjusts prices to simply allow the service provider to recover costs and achieve a normal rate of return on investment, the service provider will have little incentive to be efficient in the provision of such services; indeed there may be an incentive to reduce efficiency. Hence the need for incentive-based regulatory mechanisms.

Most incentive mechanisms seek to avoid heavy handed revenue control and to divorce the permitted charges for access from the reductions in costs or efficiency gains the service provider is able to achieve over and above those that were expected at the beginning of a review period. Hence above-normal profits are only restrained after the period under review has passed and the regulator looks forward to the next period.

There is a welter of analytical tools available to policy-makers, regulators and stakeholders to shape or check on incentives to achieve a higher level of cost efficiency in the regulated firm. They can also be used to generate incentives for investment at levels that are consistent with allocative and dynamic efficiency in the industry, and a sharing of the benefits of regulation between the firm, the customer and the community.

It is important to remember that although the regulatory control over the earnings of private assets may appear somewhat heavy handed, as natural monopolies they impact on the earnings of the wider community and they perform a public function, for instance, in transmitting telephony messages or electricity over the wires by the path of least resistance. Therefore the public have an interest in the efficiency, safety, cost and other aspects of how that job is done.

The ACCC will not proceed to make determinations without public consultation, which, importantly, includes the asset owner. While investment in infrastructure is essentially an industry decision, the Commission will regulate with the objective that such decisions are not distorted by access conditions being too harsh (e.g., access prices

set too high, leading to either a lessening of competition or wasteful duplication) or too lax (e.g., access prices set too low, leading to inefficient use of existing facilities). The aim is to encourage decision-making consistent with maximising benefits to users and the community.

It is essential that reform outcomes be objectively reviewed from time to time, taking care to distinguish outcomes of reform initiatives from inevitable pricing trends consistent with technological change and to distinguish and have regard both to the level of competition and to the level of enhancement of competitive capacity, which includes such dimensions as research and development, and expenditure on exploration and infrastructure development.

6. ACCC Experience in Implementing the Code

I would now like to consider some of the ACCC's recent experience as transmission regulator in the Victorian gas industry.

In order to expedite its gas reform process, the Victorian government introduced a transitional access Code, which is identical in all material respects to the National Code. The Victorian government nominated the ACCC as transmission regulator and the Office of Regulator General (ORG) as the distribution regulator. The Victorian Government simultaneously submitted its gas access regime and associated access arrangements to the National Competition Council (NCC) for effectiveness certification; the ACCC for approval of their transmission access arrangements; and to ORG for approval of their distribution access arrangements. The access arrangements set out the terms and conditions on which access to transmission services will be made available to third parties in Victoria.

Applications were also submitted for the authorisation of the Victorian Market and System Operations Rules (MSOR) which govern wholesale spot market operation, and provide for systems security, connection to the transmission system, dispatch and metering.

On 28 May 1998, the ACCC released its Draft Decision on the three Victorian Gas Transmission Access Arrangements and its Draft Determination on the MSOR. The preliminary decisions proposed by the ACCC are to approve the access arrangements subject to certain amendments being made and grant conditional authorisation to the MSOR. The ACCC has now released its final determination authorising the MSOR and its final decision on the Access Arrangements was handed down this week.

The most controversial issue arising out of the Draft Decisions was the choice of an appropriate weighted average cost of capital (WACC) for the access arrangements. The WACC is essentially the rate-of-return allowed on the capital base. It is calculated as a weighted average of returns investors could otherwise achieve through various industry-specific debt and equity instruments. The ORG and the ACCC used a similar approach in determining the WACC for both transmission and distribution assets, and calculated a **real pre-tax** figure of 7%. Concerns were expressed within the industry, as well as by potential investors and the Victorian Government that the figure was too low.

The Commission yesterday released its final decision on the Victorian access arrangements, and both the ACCC and the ORG have determined a real pre-tax WACC of 7.75%, which is equivalent to a nominal after tax return on equity of at least 13.2%. A private investor, however, may obtain a higher effective rate than this due to the tax benefits flowing from the operation of Australia's tax system.

The assessment of the rate of return requires the regulator to determine a rate which is fair to both the utility owner and customers. In other words, a rate that restricts monopoly profits yet still provides a reasonable return on the investment. In addition, the intent of the reform process at both the national and state levels is to encourage the provision of competitive inputs for Australia's existing and prospective energy intensive industries and to encourage the delivery of competitively priced gas to consumers.

7. Upstream Reform

The development of effective competition in both downstream and upstream gas markets in Australia is of vital concern to the ACCC. The reforms implemented to provide pipeline access should drive greater competition in the downstream gas retail markets. However, the benefits of these reforms may be severely limited or not eventuate if there is a lack of competition upstream.

The primary objective of gas reform is to remove any barriers that may inhibit free and fair trade in gas, to encourage a competitive gas supply industry. The greater the number of participants competing in the supply of gas, the better for users and the community as a whole, which benefits at least indirectly as a result of the lower production costs faced by power generators and manufacturers.

Aggregation of production interests and coordinated marketing arrangements of gas production joint ventures in the main Australian gas basins are potential obstacles to the development of a competitive interconnected, multi-state Australian gas market. The Commission is aware that the achievement of a more competitive market structure in the upstream gas production sector will be a difficult task, particularly in basins where gas production and use is project-focused and associated with members of the joint venture contracting on common terms with customers for large, long-term quantities of gas.

Given local market characteristics, Australia is unlikely to match the level of competitive activity in the USA and Canada in the near term. However, the prospective development of a secondary market trading in gas and pipeline capacity, the interconnection of pipelines and the development of gas swap opportunities and gas storage will encourage market entry and growth and an environment sustaining greater competition between producers, if complemented by upstream reform initiatives in relation to acreage management, flexibility of delivery points, replacement of take-or-pay by more efficient two-part tariffs, and third-party access to gas gathering and processing facilities.

8. Victorian Gas Crisis

The explosion that extensively damaged and temporarily shut down Victoria's main gas processing plant at Longford, crippling the State's gas supplies, highlights the vulnerability of Victoria to the dominant gas supplier, Esso-BHP. That dominance is the result of State policies of thirty years ago, when reserves were being proved for development. Contractual arrangements, a prohibition at the time on interstate sales and State revenue-raising arrangements brought about an interdependence between the producers and the local State market, which has had continuing effects to this day. The upshot of all of this is that Victoria has no real alternative sources of gas supply, and that the lack of competition has wreaked havoc on the State both economically and socially.

The circumstances are similar in other States.

That situation has explained in part the past reluctance in Victoria to bring on new production areas. Provided the economics of production support them, new areas would introduce supply options beyond that of the dominant producer, giving a measure of greater production security.

Whether greater security in processing can be fostered by stand-alone processing by new producers depends very much on the economics of processing. In some cases (such as near Moomba in the Cooper Basin), studies suggest that tolling arrangements would be more economic for the new entrant. In those cases security of processing comes down to plant design and operations.

Earlier this year a \$50 million interconnection between the New South Wales and Victorian systems was completed, allowing gas from the Cooper Basin to flow into the Victorian network. This pipeline was fostered by national competition policy reform involving an agreement signed by the States to implement free and fair trade in gas.

I have seen comments suggesting that the solution to the Victorian crisis is greater interconnection. While that argument has merit, it will only be with the liberalisation of supply markets that utilities and users will have greater choice of supply arrangements tailored to their price and risk requirements. If that liberalisation is to occur, States must foster the development of competition between gas production areas and between companies operating in production basins, as far as possible.

9. Conclusion

In conclusion, the reform process underway in Australia's gas industry holds huge promise for growth both within the industry itself and flowing through to many other industries. The Commission recognises that market reform, privatisation and deregulation can result in risks and costs for users of public utilities as well as efficiency, price and service quality gains. It will continue to follow progress in the reform agenda to identify the potential for adverse effects on competition and consumer interests and will work to promote the objectives of the Act in market reforms.