



Submission to the Ministerial Council on Energy regarding: Expert Panel Review of Revenue and Network Pricing across the Energy Market

21 December 2005

The Australian Pipeline Industry Association (APIA) welcomes the opportunity to provide comments in response to the matters raised in the *Energy Market Reform Bulletin No. 56*.

Overview

APIA submits that the objective of ‘convergence’ between gas and electricity should be reflected in common economic principles underpinning the respective access regimes rather than in having identical regimes that do not adequately reflect the differences between the two industries. There are good policy reasons for the retention of a gas access regime tailored to the unique economic and technical features of the gas industry. APIA notes that the current separate gas and electricity regimes have operated successfully in parallel for a number of years and believes there is no reason why this cannot successfully continue based on a suite of common underlying regulatory principles.

In particular, there are certain key elements of the current gas access regime which APIA believes should be carried forward to the new regime notwithstanding the fact that these exact elements may not be included in the electricity regime – namely, the coverage test for the regulation of services (as modified by the PC), use of a propose/respond model, and access to merits review.

APIA considers that the framework elements of the access regime should be included in the National Gas Law (NGL) rather than the Rules. These elements, which include, the tests for coverage and revocation, certain procedural matters and appeal rights are fundamental to protecting the legitimate interests of service providers, and should therefore be included in the overarching legislation.

Distinction and commonality

APIA notes that one of the overarching principles adopted by the Standing Committee of Officials (SCO) in the gas reform process is that, wherever feasible and unless there is a good policy reason to do otherwise, alignment with the new electricity regime should occur.¹

This drive for standardisation of energy access regimes is a significant concern for APIA. In particular, APIA is concerned that sufficient recognition is not being given to the good policy reasons for not aligning gas regulation with the electricity model in a number of important areas, potentially to the considerable detriment of the gas industry.

While there will be elements of the regulatory regime where a consistent approach is relevant and beneficial, APIA submits that the Expert Panel should have due regard to the fact that, in some areas, regulatory differences are required due to the fundamentally different physical and financial operating characteristics of the gas sector.

Further, APIA believes that aspects of the gas regulatory framework that have been tested and proven effective over time should not be altered purely to achieve a goal of standardisation across energy regulation. The operation of merits review in the gas regime is a case in point.

APIA would like to reiterate its strong concern that there is a risk that an overriding goal of consistency would prevent the best regulatory regime being implemented for the gas industry, with accuracy and optimal outcomes being sacrificed for the sake of standardisation.

Differences between gas and electricity

The gas and electricity sectors differ in a number of fundamental ways, due to both technical and economic factors:

- upstream production processes and economics are very different, characterised by a small number of producers with substantial countervailing power;
- long-distance transmission location and economics are different:
 - gas pipeline economics are driven by the distance between naturally occurring gas fields and load centres;
 - unlike electricity transmission, there is no discretion or feedback loop in siting gas transmission facilities (decisions to site power stations and

¹ Standing Committee of Officials of the Ministerial Council on Energy, Statement of Approach, *A New Legislative Framework for Gas*, September 2005, p.7.

electricity transmission lines can react to regulatory incentives. Decisions to site gas pipelines are driven by gas field location);

- long-term bi-lateral contracts underpin pipeline development.
- long-distance physical transmission characteristics are different (gas pipelines serve both as transmission and storage facilities) as electricity transmission is effectively instantaneous and electricity cannot be stored, transmission infrastructure only provides a transport service;
- gas markets are driven by long-term contracts required to underpin gas field and pipeline development;
- to the extent that the gas and electricity industries tend to converge they do so closer to the customer – this is evident in the fact that while most energy retailers retail gas and electricity, most long-distance transmission companies transport either gas or electricity, but not both. Further, electricity acts as a very real substitute for gas in most applications – for example for heating or cooling purposes. While gas can be used to generate electricity it is less able to substitute for the full range of final energy uses that electricity serves.

Implications for the regulatory regime

These differences have certain implications for the regulatory regime, specifically; new gas transmission infrastructure is contestable at the development phase and as such is unlikely to exhibit monopoly power. Further, electricity provides a real substitute to gas as a source of energy and therefore mitigates the market power potential of gas in many markets. As such, APIA is strongly of the view that gas access regulation needs to retain a high degree of flexibility to ensure that only those services that truly exhibit monopoly power are subject to intrusive access regulation and that the regulatory regime does not interfere with the currently successful bilateral contracting that occurs with gas transmission infrastructure – an arrangement that allows parties with equal negotiating power to develop market based outcomes that will be far superior to regulatory outcomes.

Therefore, APIA submits that key elements of the existing gas access regime, such as the coverage test (as amended by the PC), the propose/respond model and merits review should be carried forward to the NGL.

Possible Alternatives to Current Regulatory Methodologies

APIA considers that the following are appropriate guiding principles in determining the form and content of the regulatory framework:

- regulatory intervention should be limited to situations where it is economically justified;

- where regulation occurs, it should be light handed (i.e. low cost and least distortionary) and incentives based;
- regulation should be sufficiently flexible and adaptable to an evolving and increasingly competitive market;
- regulation should focus on promoting efficient use of and investment in the network;
- regulation should be sufficiently flexible to accommodate market and technical differences between gas and electricity;
- regulation should provide sufficient guidance to ensure efficient and timely regulatory processes;
- the regulatory framework should include mechanisms to ensure regulator accountability.

APIA considers that these principles are relevant in establishing the overall regulatory framework, as well as in determining the detail of the regulation.

In terms of the particular issues raised for comment by the MCE, APIA submits the following:

Scope of regulation

APIA notes that the scope of regulation is an area of difference currently between electricity and gas regulation. All transmission and distribution networks that form part of the interconnected national electricity market are subject to regulation under the NEL. This is fundamentally different from the gas access regime, where new gas pipelines are only subject to regulation where they have satisfied the coverage test and assets existing at the time the Gas Code was introduced are able to seek (and in many instances, have sought) revocation.

From APIA's perspective, it is essential that the new legislative arrangements for gas reflect the coverage test approach, as recommended by the Productivity Commission (PC).² That is, the body that decides on coverage must be satisfied that coverage would promote a *material* increase in competition (consistent with the proposed changes to the coverage test under Part IIIA). APIA considers that the coverage test as proposed by the PC is a fundamental part of the regulatory framework and, therefore, should be incorporated in the National Gas Law (NGL).

² Productivity Commission, Review of the Gas Access Regime, Inquiry Report no. 31, June 2004, recommendation 6.2

In terms of service quality mechanisms, the legislative framework needs to be flexible enough to allow the service provider to propose service quality arrangements as part of the incentive regulatory framework. This flexibility is inherent in the propose/respond model in the current gas access regime.

Alternatives to building blocks methodology

In line with the principle of having a sufficiently flexible regulatory regime, APIA considers that it is appropriate for the regime to contemplate the use of alternatives to the building block methodology. However, the methodology used should be at the discretion of the service provider, subject to regulator approval. This is consistent with the propose/respond framework that currently operates in the gas access regime. APIA believes that this approach should be carried forward into the new legislative framework for gas.

In this regard, APIA endorses the PC recommendation to amend the Gas Code to provide greater flexibility by allowing a service provider to use another method to calculate total revenue, provided the relevant regulator is satisfied that the proposed method is more likely to meet the overall objective of the gas access regime.³

APIA notes the broad acknowledgement of the difficulties associated with some alternative methodologies, such as total factor productivity (TFP), given the risks that service provider costs could significantly diverge from regulated revenues. Moreover, APIA notes that TFP would have particular issues for gas pipelines and is unlikely to be a viable option. This is because of the high capital costs and relatively low operating costs associated with gas transmission activities and therefore the limited ability to reduce total costs (through productivity improvements) once a project is established.

Guidance on the form of the control over prices

APIA submits that the PC recommendations regarding decisions on the form of regulation should be implemented. That is, a decision on the form of regulation should be based on an assessment of the net benefits to the economy of each option, with access arrangements with reference tariffs only applying where the net benefits of its application are *markedly greater* than the net benefits of the monitoring option.⁴

APIA also supports the use of clear decision criteria to support the decision making on the level of regulation. As stated in a previous submission to the MCE, APIA proposes the following criteria could be used in the assessment of the form of regulation to apply:

- if a covered pipeline has been through two building block price reviews there should be a presumption that price monitoring could apply given that efficient costs would be substantially known;

³ PC recommendation 7.5

⁴ PC recommendation 6.4

- the nature of demand for commodities and services of end users of gas;
- the degree of countervailing power in the market (eg large and well-resourced customers; amount of spare capacity in pipelines serving that market);
- the degree of horizontal and vertical integration in the market;
- the level of competition from other pipelines or sources of energy; and
- the nature and extent of any entry barriers to the market.

If a pipeline passes the first test they should only have to meet one other test to be price monitored.

APIA also supports the implementation of the PC's recommended pricing principles as these reflect appropriate guidance to the regulator in the case where reference tariff regulation is to apply.⁵ These pricing principles are also consistent with the National Access Regime. APIA urges the Expert Panel to include these principles in the NGL.

APIA considers that these guiding principles are a fundamental aspect of the regulatory framework which should be included in the NGL, and not left to the future discretion of the AEMC. In this regard, APIA supports the inclusion of guidelines governing the decision on the form of regulation being included in the NGL as it is a high level policy issue.

Relevant economic principles

APIA submits that the principles outlined above are relevant to the Expert Panel's consideration of these matters. In essence, a well designed regulatory regime should result in regulation only where it is economically justified (including taking into account the costs of regulation). Where it is justified, it should be light-handed and incentive based, it should promote efficiency, be flexible and have adequate regulator accountability.

In terms of the implications of these principles for the gas industry, APIA submits that these principles are reflected in the package of reforms that were recommended by the PC. As noted previously, APIA supports the implementation of the PC package of reforms and therefore urges the Expert Panel to reflect these in its recommendations.

Regulatory Discretion

APIA considers that there is an element of judgment, and therefore discretion, that must be applied by the regulator in making its determinations under an access regime. This

⁵ PC recommendation 7.1

discretion will (and should) be constrained by elements of the regulatory framework, namely the requirement that the regulator have regard to the objects clause in making its determination and the pricing principles to apply in setting reference tariffs. APIA also supports the adoption of the PC recommendation that, in determining the rate of return (where applicable), the regulator's role is to assess whether the service provider's proposed method and values lie within a plausible range.⁶

However, even with this guidance to the regulator, a degree of regulatory discretion will remain. It is therefore essential that this discretion is balanced by adequate regulator accountability in the form of access by regulated businesses to merits review.

As a general principle, APIA considers that those aspects of the current legislation and Gas Code that establish the framework for the gas access regime should be included in the new NGL. This is important to ensure that the principles underpinning the access regime are not undermined over time by 'regulatory creep', which may occur when key issues are left to the future discretion of the AER or AEMC. This is all the more important given the fact that it will be relatively easier to amend the Rules compared to the NGL. APIA considers that the key elements to be included in the NGL include:

- the tests for coverage and revocation of coverage;
- the guidelines for deciding what form of regulation should apply for a covered pipeline;
- the information collection powers of regulators;
- certain procedural issues associated with the regulatory approvals process, including:
 - the need for a draft and final decision;
 - the requirement for the regulator to consider submissions made during a prescribed public consultation period;
 - the requirement for a minimum amount of public consultation before the regulator can proceed with the next step in the regulatory approvals process; and
 - retention of such provisions as section 2.47 of the Gas Code;
- the right to appeal certain decisions of regulators; and
- the ring fencing requirements of section 4 of the Gas Code.

⁶ PC recommendation 7.9

Conclusion

APIA submits that, while the gas and electricity access regimes should be based on the same underlying economic principles, they should also reflect the fundamental differences between the two industries. In that sense, APIA considers that it is appropriate to have distinct gas and electricity access regimes within a common regulatory framework. APIA considers that the gas access regime should reflect the package of reforms recommended by the PC.

In terms of what elements of the regime should be in the NGL and the Rules, APIA submits that the key elements of the regime which establish the regulatory framework and which have an impact on the legitimate business interests of service providers should be established in the NGL.