



Review of the National Gas Pipelines Access Regime

**Response to MCE's Standing Committee of Officials
Consultation Paper**

September 2005

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Executive Summary

BHP Billiton re-iterates its concerns that the Productivity Commission's review of the Gas Code has been based on an unsubstantiated proposition that investment in the gas industry is being deterred or distorted through 'regulatory error'.

In general, the alternative recommendations made by the MCE's Standing Committee of Officials' (SCO) Consultation Paper are preferred, although the application of specific components of the proposals require strengthening in order to reduce the information asymmetry advantage that would otherwise be provided to pipeline owners with a degree of market power.

The alternative objects clause is supported with a modification

BHP Billiton is not opposed to the adoption of an overarching objects clause to guide regulators in the administration of the Gas Code. BHP Billiton supports the general terminology of the SCO's second alternative objects clause, which incorporates elements of the draft NEL and the National Access Regime, however, with the removal of the word 'promote' in relation to 'economically efficient investment in gas pipeline services'.

BHP Billiton believes that the word 'promote' is superfluous in the context of conditions in which economically efficient investment could take place, and is likely to create confusion with the concept of promoting investment *per se*. Since the promotion of economically efficient investment in up-stream and downstream gas industry operations is not mentioned in the objects clause, neither should it be mentioned in relation to pipelines.

Alignment of coverage with Part IIIA of the TPA requires further analysis

The alignment of coverage criteria to be used by the NCC/Minister in determining coverage under the Gas Code with that applied in Part IIIA of the Trade Practices Act 1974 i.e. the addition of the words 'material increase in competition' into criterion a) instead of 'an increase in competition', cannot be supported by BHP Billiton until further analysis has been undertaken by the SCO to provide an indication of whether the change would have a practical effect on coverage decisions.

Given the difficulty in establishing whether increases in competition in downstream or upstream markets are achieved through coverage, and the costs and benefits of doing so, in BHP Billiton's view the coverage decisions that have been undertaken to date have already been governed by a requirement that there be a strong chance of increases in competition (i.e. that there exists significant market power at the pipeline level) and that the benefits of explicit regulation clearly outweigh the costs. That is, BHP Billiton expects that there will not be a significant practical difference in the outcomes of future coverage decisions based on the alignment in words to include 'material'.

The SCO's alternative monitoring model has positive features but should not be restricted to price monitoring

BHP Billiton is strongly opposed to the price-monitoring model with compulsory arbitration, as proposed by the PC's Final Report. A regime in which service providers are able to dictate the

nature of the arbitration, and where service providers enjoy a significant informational advantage cannot be effective in curtailing market power.

The SCO's alternative proposed monitoring regime is preferred relative to the PC's recommendations, but has certain features that should be modified to strengthen its application. In particular, BHP Billiton is concerned that a monitoring regime in the gas industry should not be modelled on the airport industry, where in general there is no concept of regulated asset value (RAV).

In order for a monitoring regime to be effective where service providers may have some degree of market power, there should be a monitoring requirement that does not limit itself to the disclosure of prices, but also provides disclosure of revenues and costs, and regulatory asset values (RAVs). Without these disclosures it will not be possible to determine whether service providers are earning an excessive rate of return on a consistent basis, and therefore no way of knowing whether market power is being abused. If it were found that addition of the word 'material' to criterion a) would not make a practical difference to coverage decisions, BHP Billiton would be comfortable with mere price monitoring, as suggested by the SCO.

On the issue of a lower bound of physical materiality for monitoring purposes, BHP Billiton recommends that any pipeline system with an annual throughput in excess of 10PJ should be subject to monitoring under the SCO's proposals if it is not covered, and therefore subject to explicit cost-based regulation.

The SCO's proposed review of regulatory guidance is supported

The PC's proposed dismantling of s 8.1 of the Gas Code is based on biased and flawed analysis, and its recommendations are opposed by BHP Billiton. Having said that, BHP Billiton agrees that the creation of a single national regulator for gas and electricity transmission and distribution will reduce the diversity of regulatory approaches. This approach has the potential to reduce regulatory risk facing Australian energy utility owners, although the scope of this risk reduction has been exaggerated in the PC's Final Report.

BHP Billiton supports the SCO's proposal for a review of the rules for rate of return setting and regulatory processes, but recommends that the SCO undertake its own objective analysis, so that an 'appropriate degree of certainty is provided' to pipeline investors. If greater certainty is achieved there should be a lowering of the cost of capital and lower tariffs for users, since the current regulatory arrangements already provide superior rates of return to pipeline owners.

In order to justify changes to regulatory rules and processes, the SCO's analysis should be able to demonstrate that both the service providers and the users will be better off as a result.

Only genuine ‘speculative’ greenfields projects should be provided with a 15 year ‘regulatory holiday’

The key issue associated with the application of a 15 year ‘regulatory holiday’ for greenfield pipeline projects is the definition of what constitutes a ‘greenfield pipeline’ in this context. It is BHP Billiton’s view that only speculative pipelines that are built without the benefit of foundation customers should be able to qualify as ‘greenfield pipelines’ for the purposes of a ‘regulatory holiday’ application. Proposed new pipelines, which are underwritten with foundation contracts that share the risks should not be provided with an up-front binding 15 year regulatory holiday. Such pipelines would be monitored upon completion of the holiday period (if large enough), and subjected to potential applications for coverage.

BHP Billiton is not opposed to genuine ‘speculative’ pipelines being provided with an up-front binding 15 year non-coverage guarantee.

Views on other regulatory matters

The SCO also called for an expression of views on other regulatory matters. BHP Billiton’s views on these matters are as follows:

- The NCC should continue as the administrator of the coverage test for energy businesses, including pipelines.
- With respect to regulatory discretion, the status quo should be maintained for section 8 of the Code, however, if a change were found to be justified by demonstrated net benefits to all parties, then the electricity industry approach should be adopted, whereby the regulator provides its own determination on the basis of a best estimate of cost of capital and other parameters.
- The SCO Consultation Paper’s proposals that the regulator’s information gathering powers should be robust are agreed, and the powers available to regulators in the electricity industry should be applied where they are more robust.
- Merit reviews are supported, but it is recommended that users should have equal access with service providers to initiate a merit review. Full merit reviews with reliance on old papers are also supported.
- Associate contracts between retailers and vertically integrated pipeline owners should continue to be authorised by the regulator. Where a monitoring regime applies, information on associate contracts should be provided to the regulator.

Chapter One

Overview

1.1 Background

In June 2003, the Productivity Commission (PC) was tasked by the Federal Treasurer to review the National Gas Access Regime. To assist in the preparation of its Draft Report, the PC called for submissions from interested parties, and BHP Billiton responded with the following submissions:

- BHP Billiton (2003), *BHP Billiton Initial Submission to the Productivity Commission, Review of the National Gas Code*. (Submission Number 26)
- Allen Consulting Group (2003), *Review of the Gas Code: Commentary on Economic Issues*, Report to BHP Billiton, August. (Attachment to Submission Number 26)

In December 2003, the Productivity Commission released its Draft Report, and made a second call for submissions, to which BHP Billiton responded in March 2004, with a third submission.

- BHP Billiton (2004), *Review of the Gas Code: Response to Productivity Commission's Draft Report*, March. (Submission Number 96)

In June 2004 the PC's Final Report was provided to the Federal Treasurer, and was made available to the public on 10 August 2004. The Council of Australian Governments agreed that the government response to the Productivity Commission's review of the National Gas Access regime will be made by the Ministerial Council on Energy (MCE). In August, 2005, the MCE's Standing Committee of Officials (SCO) issued a Consultation Paper dealing with the PC's recommendations, and invited submissions from interested parties. BHP Billiton's current submission is a response to that invitation.

1.2 BHP Billiton's interests in the gas and gas transportation industry

BHP Billiton has been following the Productivity Commission's review of the Gas Code with considerable interest and concern. It therefore welcomes the MCE's SCO Consultation Paper, and the opportunity that has been provided for further expression of BHP Billiton's views, and a reiteration of previously expressed concerns.

BHP Billiton has very significant interests in the Australian gas and gas transportation industries, both as an up-stream supplier and shipper of natural gas, and as a buyer of gas (and therefore pipeline transportation services). BHP Billiton's major interests are:

- *Gas sales of circa 180PJ p.a.* (equity interest) spread across joint venture interests in the following fields: Bass Strait (Victoria), North West Shelf (Western Australia), Minerva (Victoria), Griffin (Western Australia), Moranbah (Queensland).
- *Gas purchases of circa 70 PJ p.a.* spread across our interests in Alumina, Iron Ore, Nickel, Base Metals and Fertilizer.

1.3 Structure of the report and BHP Billiton responses

The structure of this report mirrors that of the SCO's Consultation Paper, with each chapter responding to major issues raised, as follows:

- Chapter two examines the PC's rationale and proposed 'overarching objects clause', together with alternative proposals put forward by the SCO.
- Chapter three reviews the important issues of the scope of coverage and form of regulation. It is shown that the PC's proposals are based on very little evidence, and that evidence does not in any case support its proposals for light-handed regulation.
- Chapter four deals with the PC's proposals for providing greater certainty for mature networks. It is BHP Billiton's view that if greater certainty is provided, a lower rate of return should be provided to service providers.
- Chapter five deals with the question of greenfields projects. The PC proposes that only genuine 'speculative' new projects should be provided with an upfront ruling on coverage and a 15 year regulatory holiday.
- Chapter six deals with additional regulatory matters, including, administration of the coverage test proposed by the PC, regulatory discretion and information gathering, merit reviews and associate contracts.

BHP Billiton's general responses to the PC's recommendations are provided in Appendix A, which shows the SCO's preliminary views.

Chapter Two

The Objects Clause

2.1 Productivity Commission's rationale for an overarching objects clause

The Productivity Commission's Draft Report proposed that in order to simplify the regulatory framework, and reduce uncertainty of outcomes, a single overarching objects clause should be inserted into the Gas Code. The initial suggestion of the PC was contained in the Draft Report's Recommendation 5.1:

To promote the economically efficient use of, and investment in, the services of transmission pipelines and distribution networks, thereby promoting competition in upstream and downstream markets.

BHP Billiton's submission on the Draft Report did not oppose the idea of an overarching objects clause for the Gas Code. However, it was explained that the PC's wording gives the impression that the Gas Code's purpose is to 'promote investment' in transmission pipelines and distribution networks, but to merely promote competition in upstream and downstream markets. In response, the PC's Final Report adjusted its Recommendation 5.1 as follows:

To promote the economically efficient operation and use of, and economically efficient investment in, the services of transmission pipelines and distribution networks, thereby promoting effective competition in upstream and downstream markets.

BHP Billiton continues to oppose the specific wording of the revised objects clause recommended by the PC. In the Final Report, the PC states that, "the objective [of the Gas Code] is to promote or improve economic efficiency rather than to arrive at an undefinable level of efficiency, which is impractical".¹ This point is agreed, as is the fact that the best way to achieve economic efficiency is through the operation of competitive markets. However, the promotion of economic efficiency does not require the promotion of investment. If the conditions for economic efficiency are present, the appropriate level of investment will occur, and there is no need to refer specifically to investment promotion.

¹ Productivity Commission (2004) *Review of the Gas Access Regime*, p.182.

2.2 SCO's suggested objects clause options

The SCO's Consultation Paper agrees that an overarching objects clause is desirable to clarify the intentions of the regime and provide greater certainty to participants. In the interests of promoting consistency with electricity, the SCO has proposed that as an alternative to the PC's proposed objects clause the clause, contained in the draft NEL could be adapted to the gas industry as follows:

The objective of the gas access regime is to promote efficient investment in, and efficient operation and use of, natural gas pipeline services for the long term interests of consumers of natural gas with respect to price, quality, reliability, safety and security of supply of natural gas.

The SCO sees a number of advantages in adapting the electricity draft objects clause to the gas industry:

- Consistency with the electricity sector:
- Drawing the regulator's attention to important non-price elements valued by customers (e.g. reliability and security of supply): and
- Highlighting to Ministers the importance of ensuring that the regulatory regime delivers benefits to customers.

A second alternative objects clause proposed by the SCO incorporates elements of the draft NEL and the National Access Regime:

The objective of the gas access regime is to promote economically efficient investment in, and economically efficient operation and use of, natural gas pipeline services thereby promoting effective upstream and downstream competition and the long term interests of consumers of natural gas with respect to price, quality, reliability, safety and security of supply of natural gas.

The second alternative is seen by the SCO to enhance consistency with the National Access Regime and the Competition Principles Agreement, and would support certification of the National Gas Access Regime.

The SCO also agreed with the PC's Recommendation 5.3, which recommended the removal of a number of objectives in the existing Gas Code, such as the objective of 'facilitating the development and operation of a national market for natural gas'.

2.3 BHP Billiton's response on the objects clause

As was expressed in our response to the PC's Draft Report, BHP Billiton agrees that an overarching objects clause should be introduced into the Gas Code in order to simplify and clarify the objectives of the Code, reduce risk and provide guidance to regulators.

Even though they are both concerned with energy transmission and distribution, the gas and electricity markets have different fundamentals and there is no overriding logic that supports one system being mirrored by the other. There may be aspects of both the electricity and gas markets that require different treatment, and others that are superior for both, and would ideally require identical treatment in both. Therefore, BHP Billiton does not agree that a perfect alignment of the two is necessarily desirable.

Regulation should not be used as a mechanism to promote the interests of investors, but should be founded on the primacy of the customer, whose demand results in business investment. In an unfettered competitive market, the forces of demand and supply will result in appropriate returns for investors given the risks undertaken, and appropriate levels of investment being made in the pursuit of profit.

If there is market failure, and companies own essential facilities that are capable of exercising market power, regulation is required to achieve conditions that protect captive consumers, and provide conditions, including appropriate investment returns, which result in economically efficient investment. BHP Billiton's submission on the PC's Draft Report displayed the principal objectives underpinning gas industry regulatory arrangements in the much less highly concentrated US gas pipeline industry. The main theme in the US 'objectives' was found to be the promotion of an efficient competitive market that would mitigate market power and protect captive customers.²

BHP Billiton remains concerned that the PC's Recommendation 5.1 and both the alternatives presented by the SCO retain the word 'promote' in connection with 'investment'. Whilst use of the word 'promote' would achieve consistency with electricity, may be meant to connote 'facilitation', and is qualified by the words 'economically efficient', it is BHP Billiton's view that the word is open to misinterpretation, and is therefore best left out. Thus, BHP Billiton is in favour of the MCE's second alternative objects clause, by dropping the word 'promote' in connection with 'economically efficient investment'. That is:

The objective of the gas access regime is economically efficient investment in, and economically efficient operation and use of, natural gas pipeline services thereby promoting effective upstream and downstream competition and the long term interests of consumers of natural gas with respect to price, quality, reliability, safety and security of supply of natural gas.

In BHP Billiton's submission on the Draft Decision it was submitted that fewer and simplified supplementary objectives should be retained. These included:

- Prevents abuse of market power;
- Provides for rights of access that are fair and reasonable; and
- Provides for the resolution of disputes.

BHP Billiton believes that the SCO's second alternative objects clause, as amended above, captures the essence of most of these points. Therefore, such an objects clause would be appropriate in the context of the removal of the related objectives, as proposed in the PC's Recommendation 5.3.

² See Box 5.1 in BHP Billiton (2004), p.35.

2.4 Conclusion

BHP Billiton is not opposed to the adoption of an overarching objects clause to guide regulators in the administration of the Gas Code. BHP Billiton supports the general terminology of the SCO's second alternative objects clause, which incorporates elements of the draft NEL and the National Access Regime, however, with the removal of the word 'promote' in relation to 'economically efficient investment in gas pipeline services'. BHP Billiton believes that the word 'promote' is superfluous in the context of conditions in which economically efficient investment could take place, and is likely to create confusion with the concept of promoting investment *per se*. Since the promotion of economically efficient investment in up-stream and downstream gas industry operations is not mentioned in the objects clause, neither should it be mentioned in relation to pipelines.

Chapter Three

Scope of Coverage and Form of Regulation

3.1 Introduction

The Productivity Commission's Draft Report and Final Report have recommended substantial changes to the Gas Code with respect to the scope of coverage and form of regulation. These changes have been grounded in a perception that investment in gas pipelines is being deterred or distorted by the application of the current Code. No substantial evidence or thoroughly argued case studies of regulatory error with respect to coverage and the operation of the Gas Code were provided by the PC.

The Ministerial Council's Standing Committee of Officials has reviewed and modified the PC's recommendations in an effort to make them workable in practice. BHP Billiton rejects the approach suggested by the Productivity Commission, and continues to have concerns about the modified approach put forward by the SCO.

3.2 The PC's proposals for coverage were based on unsubstantiated assertions of regulatory error

The Productivity Commission's Draft Report was based on its assessment that 'regulatory error' is prevalent in the gas industry with respect to:

- *Coverage decisions* – The PC maintained that a significant proportion of gas industry assets that have been covered by the National Competition Council (NCC), are in fact a case of regulatory error.
- *The terms of regulated third party access* – The PC held that there is a high potential for regulated prices to incorporate regulatory errors that distort or hinder investment in pipelines and gas networks.

BHP Billiton's previous submission on the Draft Report noted that the careful analysis that is a hallmark of the Productivity Commission's general approach was missing from its Draft Report on the Gas Code. It was noted that the PC had provided no evidence in the Draft Report to support its assertions about regulatory error.

In its Final Report, under a heading of "evidence of regulatory risk" the PC included a sub-heading relating to 'coverage risk'. This section reviewed several alternative views of coverage risk as expressed by regulators (e.g. ACCC) and gas businesses (e.g. Envestra). The PC concluded that, "the regime subjects most, if not all, new pipelines to coverage risk".³ However, the PC continued to provide no evidence that 'regulatory error' had resulted in inappropriate coverage decisions.

³ PC (2004), p.111.

In the same section on ‘evidence of regulatory risk’ the PC included a sub-section on ‘parameter risk’. The PC argued that the flexibility provided to regulators results in parameter risk, since investors cannot be certain about what parameters will be applied over time. An example of parameter risk was quoted from GasNet’s submission, which noted:

...the ACCC shifted the GasNet equity beta from 1.2 to 1.0 between 1998 and 2003.

This is not evidence that investment is deterred by regulation. What matters to continued investment is that the expected return is greater than or equal to the cost of capital. The UBS Australia Infrastructure and Utilities Index series shows that in the three years to 30 June 2005, GasNet earned a 21.7% annualised total rate of return, compared with only 14.7% for the ASX200, and this was in the period affected by the ACCC’s revision of GasNet’s beta from 1.2 to 1.0. This is *prima facie* evidence that the previous beta parameter of 1.2 was erring too far in favour of GasNet compared with GasNet’s customers.⁴ The fact that GasNet was able to perform so strongly, even with the lower beta of unity, is also evidence that future investment by GasNet in its regulated activities is not being deterred by regulation.

In the course of its review of the Gas Code, the PC chose to ignore the ample evidence provided to it that showed gas sector companies have been out-performing general market indexes and that the Enterprise Value (debt plus market value of equity) of these companies is significantly greater than the Regulated Asset Value (RAV). This evidence is consistent with the view that regulators are generally erring in favour of asset owners, and thereby providing ample incentives for investment. Such evidence is also indicative that regulators already do take account of the regulatory and commercial risks inherent in regulated gas transmission and distribution activities.

The question is not whether regulatory risk exists, but rather:

- Whether regulatory risk is being adequately compensated for in the *ex ante* returns provided by regulators; and,
- Prices to consumers in the long run are lower, and investment is higher, than would have been the case in the absence of regulation.

The PC provided no credible evidence on either of these two points. The PC’s Final Report pointed to two appeal decisions that have ‘identified errors made by regulators in setting reference tariffs’.⁵ These two cases were *Application by Epic Energy South Australia Pty Ltd (2003) ACompT 5*, and *Application by GasNet Australia (Operations) Pty Ltd (2003) ACompT 6*. These cases demonstrate is that the Code provides a mechanism to address any regulatory errors that might arise. They do not demonstrate that errors are of such a magnitude that appropriate *ex ante* return expectations are not provided to investors, or that there are no compensating errors and/or regulatory conservatism in favour of pipeline investors, that have not been appealed by market participants. The returns evidence referred to above supports the proposition that regulators have been over-compensating investors for risks (including regulatory risk).

⁴ It should also be noted that GasNet appealed against various aspects of the ACCC’s decision, and maintained that an equity beta of 1.16 was appropriate under the requirements of the Code, but decided not to appeal this matter to the Australian Competition Tribunal. See *Application by GasNet Australia (Operations) Pty Ltd (2003) ACompT 6*, p.16.

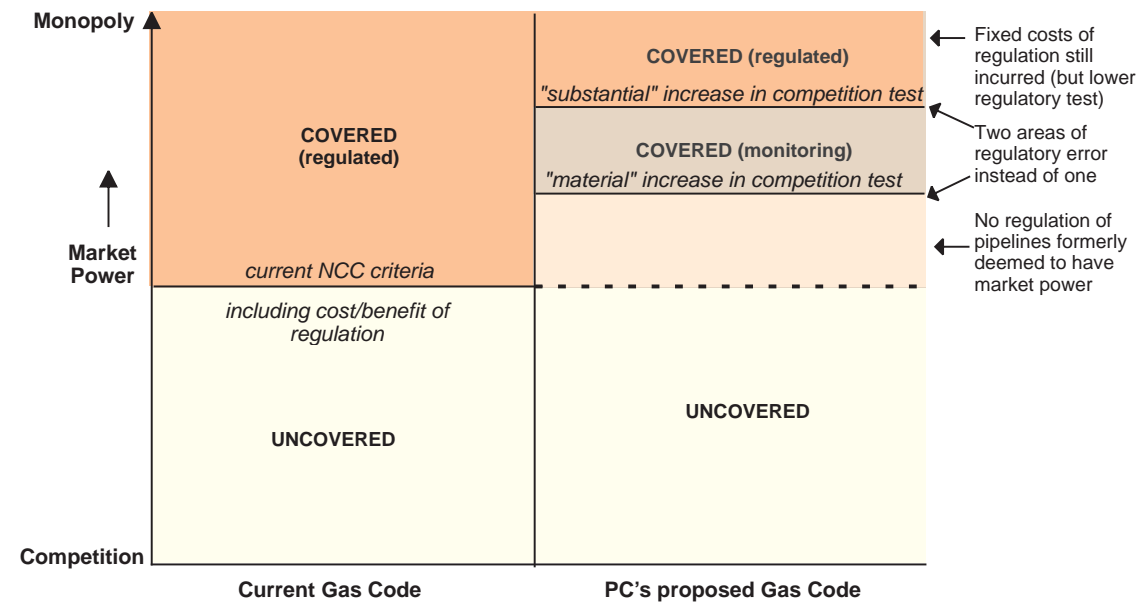
⁵ PC (2004), p.110.

3.3 The PC’s initial and amended coverage proposals

The PC’s Draft Report proposed that due to the costs of regulation, and the scope for coverage error, a two-tiered approach should be applied with respect to coverage. Relying on the logic of its 2001 Review of the National Access Regime, the PC felt that full cost-based regulation should be applied only where “declaration would have to promote a substantial increase in competition in another market, rather than simply promoting competition in another market”.⁶

As shown in the accompanying Figure 3.1, the PC Draft’s view was that the NCC’s criterion a) for coverage should be raised to requiring a ‘substantial’ increase in competition to justify cost-based regulation, and a ‘material’ increase in competition test should be introduced, that would be best dealt with under a monitoring regime. The PC felt that this would be a higher test than that currently applied by the NCC under criterion a).

FIGURE 3.1: PRODUCTIVITY COMMISSION’S DRAFT REPORT GAS CODE PROPOSALS



BHP Billiton and other commentators expressed concern at the likelihood that the NCC, as the relevant regulatory body, could not accurately distinguish between material and substantial increases in competition. As a result, it was predicted that the approach suggested by the PC was unworkable, and likely to increase the scope for regulatory error, by requiring two decisions about the nature of regulation.

The PC’s Final Report responded to the concerns raised by its Draft Decision by recommending that:

⁶ PC (2001), *Review of the National Access Regime: Inquiry Report*, Report No. 17, 28 September, pp. xxiii-xxiv.

- The NCC’s criterion a) should be amended so that coverage for reference tariff regulation should only be imposed when access would promote a **material increase** in competition in at least one market. (Recommendation 6.2).
- With coverage, the NCC should simultaneously recommend the form of regulation to apply, access arrangements (reference tariffs) or monitoring. (Recommendation 6.3)
- Access arrangements with reference tariffs should only apply when the net benefits are **markedly greater** than the net benefits expected under the monitoring option. (Recommendation 6.4)
- The matters to be considered by the NCC when determining the form of regulation should include those provided as guidance under s.50 of the Trade Practices Act. (Recommendation 6.5).
- The monitoring regime would include provision for binding arbitration in the event of dispute over access and public disclosure of specified information (but well sort of ‘access arrangement information’ currently required). (Recommendation 8.2).

The PC’s move to provision for binding arbitration under the monitoring regime in the Final Report represented a significant shift from the position in its Draft Report.

3.3 SCO’s views and alternative Price Monitoring Model

The Consultation Paper agrees with the PC’s fundamental proposition that the current approach, which either subjects pipeline owners to full access arrangement regulation, or no regulation, is unlikely to provide conditions in which the emergence of competition in formerly monopoly services can be fostered. However, the SCO’s paper expresses reservations about the model of regulation proposed by the PC.

The SCO’s paper believes that the PC’s requirement that the NCC undertake a simultaneous analysis of the form of appropriate regulation, and whether or not coverage is justified would introduce a level of complication that is unwarranted and likely to distract from the main task, which is to determine whether a material increase in competition would be achieved through coverage.

The SCO’s paper also believes that if a material increase in competition would result through coverage of the assets in question, it is highly likely that the assets in question have material market power, and that a monitoring arrangement is not suitable. Furthermore, if the approach is backed by binding arbitration, it is questionable that it represents a truly ‘light-handed’ regime.

Hence, the SCO Consultation Paper suggests an alternative approach that would be based on the following key characteristics:

- **Default Price Monitoring Regime** - Introducing a new default ‘price monitoring’ regime for all gas pipelines and networks above a certain threshold.
 - This form of ‘true light-handed regulation’ would follow the approach used to monitor airport charges in Australia.
 - It would apply to all but the smallest pipeline assets (the threshold was not identified).

- There would be no recourse to arbitration, but rather a threat of formal price control regulation being introduced.
- Greenfield pipelines with immunity from coverage would not be subject to monitoring.
- **Coverage Test** - Retaining the current coverage test used by the NCC (including the word ‘material’ in criterion a)) to establish whether companies have sufficient market power to warrant formal price control.

The SCO paper argues that the scope for regulatory error will reduce under the revised approach, and that at the margin the likelihood for pipelines to pass the coverage criterion will be reduced. It is held that the existence of a price monitoring option would also mean that pipelines with emerging competition would have more chance of a revocation of coverage.

3.4 BHP Billiton’s responses

The Consultation Paper requested responses from parties on a number of issues, which are set out in turn below.

Alignment of coverage test with Part IIIA of the Trade Practices Act

BHP Billiton agrees that there should be an alignment of the coverage test applied under the Gas Code with that applied under Part IIIA of the Trade Practices Act, 1974. There should be no opportunity for ‘forum shopping’ in order to achieve coverage or revocation of coverage. However, it is not apparent that the introduction of the words “material increase in competition” into criterion a), instead of “an increase in competition” will have a significant practical effect on coverage decisions in the future. BHP Billiton is not comfortable with the inclusion of the word ‘material’ until a thorough analysis of its likely practical effects has been undertaken.

Given the difficulty of establishing whether increases in competition in downstream or upstream markets are achievable through coverage (criterion a)), and that the benefits of regulation will outweigh the costs (criterion d)), it is probable that the practical application of the current criterion a) by the NCC errs in favour of caution, and a decision to cover is undertaken only when the expected increase in competition is material.

Analysis of whether the addition of the word ‘material’ into criterion a) will make a significant practical difference to the nature of the NCC’s deliberations can only be undertaken through a number of detailed case studies that would retrace past coverage decisions made by the NCC. Such an analysis would take the available information at the time, and apply the criteria with and without the word “material” in criterion a). It would then be observed whether any of the decisions could possibly have been concluded differently. The PC did not undertake any analysis of this kind, and is therefore not able to conclude that a practical difference would have arisen. This is something that the SCO could now do.

Alternatively, the previous decisions of the NCC could be examined by the SCO to see if the objective or measurable characteristics of the covered pipelines differs markedly from the uncovered pipelines. If a large gap between these decisions is found, it is likely that a change in criterion a) to include ‘material’ could not be expected to lead to a change in the decision. If it

were found that there is a continuum of characteristics, there might be some cause to expect a practical difference. BHP Billiton will not be comfortable with Recommendation 6.2 until some analysis of the kind described above has been undertaken by the SCO.

Monitoring model recommended by the Productivity Commission

The PC's Final Report continued the theme that regulatory error under a cost-based regulatory approach would distort or deter investment, and that a lighter-handed approach to regulation could reduce the degree of regulatory error, particularly if characteristics of 'emerging competition' could be shown. In order to validate the applicability of a lighter-handed approach, such as price monitoring, the PC's Final Report provided a set of 'case studies' to illustrate 'lighter handed gas regulation in other countries':⁷

There have been several overseas initiatives to either implement or consider lighter handed regulation of gas pipelines, with varying degrees of success... Box 8.2 summarises the lighter handed approaches to gas pipeline regulation in some countries. The case studies, like many of the frameworks identified above, reveal the importance of institutional arrangements and rules governing the application of lighter handed regulation.

Three 'case studies' of light handed regimes in the gas pipelines sector were provided in Box 8.2, New Zealand, The United States, and the European Union. As outlined below, the New Zealand and US case studies do not provide any support for the notion that a monitoring option would be appropriate for Australian gas pipelines.

The New Zealand Case Study

In relation to New Zealand, the PC noted that pipeline regulation was light-handed, that the regime was undergoing a review by the New Zealand Commerce Commission (CC), and that the CC released a draft report in May 2004. What the Productivity Commission failed to report, was the main findings of the CC's Draft Report, which was that in relation to NGC Transmission, NGCT Distribution, Powerco, Vector and Wanganui Gas, the preliminary view of the CC was that they "should be controlled", i.e. subject to price regulation and not monitoring.⁸

In the subsequent, Final Report of the Commerce Commission, it was again recommended that the gas pipeline companies of New Zealand be price regulated. The analysis undertaken by the New Zealand Commerce Commission aimed at quantifying to the extent possible the benefits of control, including the scope for control to reduce excess returns, allocative inefficiency, productive inefficiency and dynamic inefficiency. Against these benefits, the CC examined direct and indirect costs of control. The level of analysis applied by the New Zealand Commerce Commission was considerably more detailed than that applied by the Australian Productivity Commission in its review of the Gas Code.

The United States Case Study

The second example provided by the PC in Box 8.2 was the United States, where it noted that all pipelines in the US are subjected to cost-based price regulation, but that in recent years the Federal Energy Regulatory Commission (FERC) had proposed ways of enhancing market efficiency. The

⁷ PC (2004), p.341.

⁸ Commerce Commission (2004), *Gas Control Inquiry, Draft Report*, Public Version, 12 May, pp. xxi-xiii.

PC cited a year 2000 FERC report proposing a ‘two-track model of regulation’, in which non-captive customers would face market prices and captive customers would be able to obtain service at regulated rates.

However, the PC’s analysis ignored developments in the US gas pipelines industry since 2000, when this ‘two-track’ model was implemented through FERC Order 637. Under Order 637 US pipelines can make a submission to FERC, and if they demonstrate that their market has sufficient competitive pressures, they are able to negotiate market transmission rates. The PC’s Final Report didn’t mention FERC Order 637, and the US experience over the first four years of its operation, even though this information was provided to the PC in BHP Billiton’s submission to the Draft Report.⁹ Some distinguishing features of the US approach are:

- A competitive market structure needs to be demonstrated, with a Herfindahl-Hirschman Index of greater than 1800 (calculated on non-contracted market share) indicating that market power is likely to be present.
- If applied, the market rates would initially be set for 2 years, with a subsequent review by FERC.
- Information requirements of companies setting market rates would be strengthened rather than reduced.

In the event, as was presented in BHP Billiton’s previous submission to the PC, only four market based pricing requests were put forward to FERC between 2000 and 2004, and all of these were rejected. This is a very significant point, given that there are 130 pipeline companies in the US market, with much more numerous pipelines, including many parallel lines, than in Australia. Given this record, it would be inconceivable for FERC to allow market-based pricing and monitoring of any of the major Australian pipelines.

The monitoring model proposed by the Productivity Commission is subject to a number of flaws. BHP Billiton’s main concerns are as follows:

a) Low-cost monitoring of businesses with market power is a flawed concept

If businesses have a degree of market power, it will not be possible adequately to monitor whether that power is being abused, unless full information is obtained and a comprehensive analysis is performed. The PC’s monitoring model is based on the presumption that direct regulatory costs can be minimised by light handed monitoring. This presumption is not justified.

In the US case under FERC Order 637, which was not investigated by the PC, it is apparent that under monitoring, the level of information provided by the company is required to be increased relative to the regulated rate situation. In these circumstances, if there are complaints from users, or the regulatory monitor notices that rates appear to be consistently and significantly above competitive benchmarks, action can be taken. Under the US regulatory framework, with the level of disclosure required under the monitoring option, it would be possible for the regulator to check if an excess rate of return is consistently being earned.

In Australia, it would be difficult for a monitoring regulatory authority to judge whether prices are above competitive levels unless the Authority has an appreciation of what the Regulated Asset Value (RAV) is. Hence, the idea that low cost monitoring can impose an actual constraint on

⁹ BHP Billiton (2004), *Review of the Gas Code: Response to Productivity Commission’s Draft Report*, March, pp. 30-31.

behaviour when the asset owner has market power, is not supportable. The New Zealand and US evidence cited above would suggest otherwise.

b) The PC's arbitration model is a concern to users, and is rejected by BHP Billiton

In a previous submission to the PC prior to the publication of its Draft Report, BHP Billiton outlined reservations with respect to the negotiate-arbitrate model. In the presence of some market power, and information asymmetries, there is a likelihood that such a model will generally fall to an arbitration, and that the arbitrator will err to the benefit of the pipeline owner. Moreover, the cost of delays and information costs of such a process may turn out to be as high, and possibly higher than under tariff regulation.

With respect to arbitrations, two particular concerns of BHP Billiton's are that:

- ***A service provider should not be able to write the arbitration rules.***

That is, a service provider should not be in a position to give guidance to the arbitrator on the matter that is put before it. The outcome of an arbitrated situation is crucially dependent on the definition of:

- What is being arbitrated.
- What a 'fair and reasonable' position means.
- The information sources that can be used in the arbitration.
- The time period over which the arbitration is undertaken.

Hence, any arbitration framework must be established in an unbiased manner, and if the service provider is able to set these parameters, the outcome of the arbitration will be pre-determined in its favour.

- ***Arbitration inevitably results in accumulated information asymmetry to the benefit of the service provider.***

Since arbitrations are private, and there is no public release of information, the transparency that accompanies access arrangements or court cases is missing. As a result, the service provider gathers information and arbitration experience over time that is not available to the user groups that it is negotiating with.

Thus, if an access dispute goes to arbitration, the service provider will have benefited from the accumulated knowledge of previous arbitrations what the arbitrator has found to be a compelling case and what is not. The user has no such opportunity, and is thereby placed at a disadvantage.

Given the inefficiency, potentially ill-defined rules, costs and non-transparent nature of arbitration processes, BHP Billiton is opposed to this aspect of the PC's proposals.

Alternative monitoring model proposed by the SCO

The alternative option put forward in the SCO's Consultation Paper suggests that a price monitoring regime could be applied to pipelines that have some market power, but not necessarily

sufficient to pass the new test for coverage (i.e. including ‘material’ in criterion a)) under the regime. There would be no recourse to binding arbitration, and the monitoring regime would be the default for pipelines over a certain physical materiality. BHP Billiton is supportive of the SCO’s rejection of binding arbitration, as this approach is likely to result in sub-optimal outcomes, and is in any case not a light-handed regulatory approach.

Although BHP Billiton does not support the insertion of the word ‘material’ in criterion a) of the NCC’s coverage criteria, if it were found that under the new test pipelines that are currently covered would become un-covered:

- BHP Billiton would be supportive of the SCO’s recommendation that pipelines with some market power should be subjected to monitoring,
- However, BHP Billiton would not be supportive of the airports model that is being proposed, particularly the failure of that model to monitor data relating to the Regulatory Asset Value.

The SCO makes the following proposal:¹⁰

Such a regulatory regime would mirror that applying to most of the Australian airports, whereby price monitoring operates as a default and the potential for declaration under Part IIIA of the Trade Practices Act 1974 exists if monitoring is not successful in deterring the exercise of market power.

The problem with reliance on the airports model is that when the airports were privatised, all except Sydney were privatised without an RAV in place. Instead, they were privatised with a CPI-X regime that was based on landing charge movements relative to the rate of inflation without reference to asset value. As was noted in BHP Billiton’s submission on the PC’s Draft Report, the ACCC reported that:¹¹

Total aeronautical revenue generated by the monitored airports increased by 63 per cent to \$494 million between 2000-01 and 2002-03. Increases at the individual airports over this period ranged from 49 per cent to 131 per cent.

The SOC’s Consultation Paper notes that the infrastructure industry has recently endorsed this approach as a model, and that it has facilitated the addition of substantial necessary investments.¹² However, without a detailed knowledge of the RAV values of the airport assets applied in earning landing charges, it is not clear that the extent of price rises at the airports have been justified by the investment that has taken place.

Calculating RAV values of runways at airports is more complex than it is for pipeline assets, and if the monitoring regime applied to pipelines is to be effective, BHP Billiton’s view is that this can only be effective if RAV values are also required to be calculated and monitored. It is interesting

¹⁰ MCE-SCO (2005), p.12.

¹¹ ACCC (2004) *Airport price monitoring and financial reporting*, February, p.7.

¹² Dennis O’Neill (2005) “Airports Thrive on Regulatory Framework”, *Australian Financial Review*, 11 May, p.61.

to note that the PC, in arguing against associate contract provisions being applied to asset management contracts, has stated that:¹³

Because regulators have no information about the costs of asset management businesses, they are unlikely to be able to assess whether contractual conditions are reasonable.

By the same logic, it should be apparent that unless the full costs of monitored service providers are known to the regulator, including capital costs based on RAV values, it would not be possible for that regulator to know whether the monitored prices are reasonable or not.

In summary, BHP Billiton's position is that it is opposed to changes in the NCC's coverage criteria that would weaken the application of the coverage test. However, if the coverage test would be practically weakened and a light handed monitoring model were to be applied to pipelines that would formerly have been covered, that model can only be applied:

- When the pipelines are large enough to make the application of a monitoring regime cost-effective; and
- sufficient monitoring data is collected (including data on RAV values) that relative assessments of potential excess returns can be made.

BHP Billiton also has concerns that unless the information requirements would allow participants to make reasonable calculations of competitive tariff levels, neither the participants nor the regulators will be able to act appropriately. Information asymmetry, which is a problem under full access arrangement processes, would be accentuated under a lesser information-monitoring regime. This would provide pipeline owners with significant advantages in any negotiation process, and lead to economically inefficient and distorted outcomes.

Determination of a lower threshold under the MCE's alternative model

BHP Billiton believes there may be relatively few pipelines that fall between having market power and being of a sufficient size to be covered for access regulation, and being so small that access arrangements (and therefore monitoring) are not justified. Such pipelines would be potentially the ones that would be subjected to a monitoring regime as recommended by the SCO.

Table 3.1 shows the gas transmission pipelines that appeared in the PC's Draft Report and revealed throughput levels. They have been ordered in size and the coverage status has been provided alongside. From the table it is apparent that pipelines of less than 3PJ p.a. have uniformly remained uncovered, and that in the range of 3-13PJ most pipelines have remained uncovered, although a few have been covered, presumably due to specific circumstances in which the benefits of explicit regulation was deemed by the NCC/Minister to outweigh the costs. Above the level of 13PJ almost all pipelines, are covered.

BHP Billiton's view is that unless special circumstances apply, such as the pipe being owned or controlled by an integrated downstream player:

¹³ PC (2004), p.457.

- *a lower threshold level of 10PJ p.a.* is appropriate for the introduction of the monitoring regime proposed by the SCO, with the proviso that the level of information required by that regime should be broadened above that indicated by the SCO.

Hence, it would appear that under the monitoring regime envisaged by the SCO, and the lower threshold proposed by BHP Billiton, most monitoring activity would be likely to take place in the region of 10PJ to 13PJ p.a.

Table 3.1: Coverage of transmission pipelines

Pipeline	Approx. Throughput PJ/annum	Coverage
Dampier-Bunbury	221	C
Victorian Transmission system	211	C
Moomba-Sydney (except Moomba-Marsden)	152	C
Moomba-Marsden	152	U#
Moomba-Adelaide	104	C
Burrup Extension pipeline	31	U*
Goldfields Gas Pipeline	30	C
Ballera-Mount Isa (Carpentaria)	30	C
Ballera-Wallumbilla	28	C
Wallumbilla (Roma) - Brisbane	28	C
Wallumbilla-Gladstone	27	C
Amadeus Basin-Darwin	15	C
Beharra Springs-Parmelia Pipeline	13	U#
Parmelia Pipeline	10	U#
Tubridgi	8.4	C
Karrathra-Cape Lambert Pipeline	4.8	U
Moura Mine-Queensland Gas Pipeline	3.7	U
Marsden-Dubbo (Central West Pipeline)	3.7	C
Palm Valley-Alice Springs	3.0	U
South East Pipeline System	3.0	U
Kincora-Wallumbina	2.7	U
Dawson Valley-Queensland Gas Pipeline	1.5	U
Riverland Pipeline	.68	U
Berri-Mildura	.22	U
City-Gate Berrimah	.08	U

Source: Productivity Commission (2004) Appendix C : Note "C" denotes covered, and "U" denotes uncovered pipelines
 * No application has been made to cover the Burrup Extension pipeline # The pipeline had its coverage revoked.

Transitional arrangements under the alternative model

The SCO has also requested views on a number of administrative and transitional issues associated with the alternative monitoring model it has proposed. These responses are as follows:

Administration costs

BHP Billiton agrees that administration costs of establishing and maintaining a monitoring regime should be minimised. However, there should be no compromise on the necessity of a monitoring regime requiring the disclosure of prices, revenues and costs, and regulatory asset values (RAVs).

Greenfield pipelines

BHP Billiton's position with respect to greenfield pipelines is considered separately in Chapter 5 below.

Small distribution systems with coverage revoked

If there are small distribution systems, which have had coverage revoked, BHP Billiton agrees that they might be excluded from monitoring on the basis of materiality – for example, if they fall below a throughput of 10PJ per annum.

Transmission pipelines that have had coverage revoked

BHP Billiton agrees that if coverage of a transmission pipeline is revoked, then if the pipeline's capacity exceeds 10PJ p.a. it should be subject to the monitoring regime. However, the monitoring regime, to be effective, must not restrict itself to price monitoring, and must in addition require the disclosure of revenues and costs, and regulatory asset values.

3.4 Conclusion

The alignment of coverage criteria to be used by the NCC/Minister in determining coverage under the Gas Code with that applied in Part IIIA of the Trade Practices Act 1974 - i.e. the addition of the words 'material increase in competition' into criterion a) instead of 'an increase in competition', cannot be supported by BHP Billiton. BHP Billiton cannot support this proposal until further analysis has been undertaken by the SCO to provide an indication of whether the change would have a practical effect on coverage decisions.

However, given the difficulty in establishing whether increases in competition in downstream or upstream markets are achieved through coverage and the costs and benefits of doing so, BHP Billiton expects that there will not be a significant practical difference in the outcomes of future coverage decisions based on the alignment in words to include 'material'.

BHP Billiton is strongly opposed to the price-monitoring model with compulsory arbitration, as proposed by the PC's Final Report. A regime in which service providers are able to dictate the nature of the arbitration, and where service providers enjoy a significant informational advantage cannot be effective in curtailing market power.

The SCO's alternative proposed monitoring regime is preferred relative to the PC's recommendations, but has certain features that should be modified to strengthen its application. In

order for a monitoring regime to be effective where service providers may have some degree of market power, there should be a monitoring requirement that does not limit itself to the disclosure of prices, but also provides disclosure of revenues and costs, and regulatory asset values (RAVs).

On the issue of a lower bound of physical materiality for monitoring purposes, BHP Billiton recommends that any pipeline system with an annual throughput in excess of 10PJ p.a. should be subject to monitoring under the SCO's proposals if it is not covered, and therefore subject to explicit cost-based regulation.

Chapter Four

Greater Certainty for Mature Networks

4.1 Introduction

In this chapter we demonstrate the flaws and biases in the PC's arguments for a weakening section 8.1 of the Gas Code. Next we briefly review the nature of the PC's proposals, and the SCO's alternative proposition, which is to allow the new rule making body for energy market regulation, the AEMC, to review the issues.

4.1 The PC's case for weakening section 8.1 of the Code is flawed

The Productivity Commission's Draft and Final Report maintained that investment in the gas industry is being deterred and distorted because of 'regulatory error' in coverage (see chapter 3 above), but also through inconsistent and 'erroneous' regulatory arrangements that create uncertainty for investors. No substantial evidence of this 'regulatory error' was provided, and significant evidence to the contrary was ignored by the PC.

The analysis undertaken in the PC's Final Report on the Gas Code exhibits considerable bias relative to previous reviews it has undertaken. The Allen Consulting Group's (ACG) submission to the PC (attached to Submission 26) agreed that estimation of cost of capital is uncertain, but found strong evidence supporting the case that, due to this uncertainty, regulators have erred in favour of investors, and as a result it could not be argued that investment has been deterred. ACG's evidence showed that in transactions and in trading of regulated businesses, the ratio of Enterprise Value (EV) to Regulated Asset Value (RAV) exceeds unity, indicating that the regulatory cost of capital is higher than the commercial WACC. The PC attempted to counter this evidence by inserting a lengthy rebuttal from the Network Economic Consulting Group (NECG) questioning ACG's methodology.

An NECG study claiming to show that international regulators have been more 'generous' than Australian regulators in the provision of a regulatory WACC was held up by the PC as the final word on this issue. However, a subsequent study by ACG (submitted to the PC by the ACCC), which demonstrated that the NECG study's flawed methodologies could not allow it to make such a conclusion, was not mentioned in the PC's Final Report.¹⁴

¹⁴ See PC (2004), p.301 and ACG (2004), *Review of Studies Comparing International Regulatory Determinations*, Final Report to the ACCC, March. Attached as Appendix G to Submission 101.

The PC's Final Report was also silent with respect to the evidence provided in BHP Billiton's submission to the Draft Report showing that a regulated energy company, Envestra Limited, had significantly outperformed the ASX Index over the three years from 2000 to 2003. When the ACCC's submission noted that both Moody's and Standard & Poor's have praised the Australian regulatory environment for providing a favourable environment for investment, the PC's Final Report quoted from NECG that this was, "written from a debtholder's perspective, and hence says little, if anything, about equity".¹⁵ However, NECG's statement ignores the fact that debtholders *are* concerned about the conditions facing equity shareholders, as any weakness in their position worsens that of the debtholders. Hence the view of debtholders tells us much about the position of equity shareholders.

The PC did not search for evidence that the Australian equity market is a strong supporter of the current regulatory regime, even though this evidence is abundant. The fact that a number of infrastructure funds based on investments in regulated assets have been strongly subscribed escaped the PC's attention. In the recent float of DUET, Macquarie Bank's head of infrastructure investments, Mr. Nicholas Moore, stated that the equity investor market has actively sought regulated stocks with stable returns.¹⁶

More recently, UBS published a UBS Utilities Accumulation Index, which showed that over the last ten years it had out-performed the market by growing at 23% per annum compared with a market return of 12%. UBS noted that one of the main reasons that Australian equity investors have been attracted to regulated infrastructure companies is, "predictable earnings and cashflow via regulation and/or long term contracts."¹⁷

The fact that the PC ignored the abundant market evidence that was provided to it by BHP Billiton and others, demonstrates that the PC ignored evidence that was inconvenient, and did not support its case. Hence, the PC's recommendations, which are based on biased and flawed presumptions, cannot be supported.

4.3 PC's Recommendations on Guidance to Regulators

The recommendations contained in chapter 7 of the PC's Final Report are not aimed at merely providing greater certainty to the owners of infrastructure assets, they are also aimed at weakening the basis of cost-based access regulation.

A key recommendation in the PC's Final Report is 7.1, which reproduces Recommendation 7.1 of the PC's Draft Report. BHP Billiton's submission to the PC's Draft Report sets out BHP Billiton's detailed critique of the PC's Recommendation 7.1. In that discussion it was emphasized that BHP Billiton is opposed to any changes to sections 8.2-8.49 and section 2.24 of the Code. A summary of BHP Billiton's concerns is provided in Appendix B of the current submission. These concerns are based on the undesirable flexibility that the PC's proposals would provide to vertically integrated businesses, which constitute a significant component of the Australian gas industry. On the other hand, the PC seeks to reduce the flexibility available to the energy regulator.

¹⁵ PC (2004), p. 268.

¹⁶ Macquarie Bank (2005), *AMP Capital and MBL to Joint Manage DUET with intent to IPO*, Media Release, 18 March.

¹⁷ UBS Investment Research (2005), *UBS Infrastructure & Utilities Index*. Global Equities Research. August.

4.4 SCO's recommended approach

The SCO's Consultation Paper foreshadows that a number of consequential amendments to the remaining principles in section 8 of the Gas Code should be undertaken in the context of a thorough review of regulatory pricing and process matters. This would provide a common set of rules for application to electricity and gas markets that would be administered by the AEMC as the rule making body for the energy sector regulator. The SCO believes that the PC's recommendations on these issues should be considered as part of this separate review.

The SCO notes that the setting of a regulatory asset base is not an issue for many pipelines covered by the Gas Code. This is an issue that has received attention in the past, but is now settled for all practical purposes. RAV values will not be re-opened in the context of access arrangements, and the Victorian ESC has given a commitment not to strand assets. However, the SCO believes that:

The setting of the rate of return continues to be a source of substantial uncertainty, and hence may dissuade economically efficient investment.

This statement by the SCO accepts the line of reasoning proposed by the PC, which we have seen was not based on a valid and unbiased assessment of the market evidence, and is completely at odds with the pronouncements of ratings agencies and statements by investment bankers and broker analysts who understand equity markets. BHP Billiton therefore suggests that before the SCO embarks on any analysis of rules, it preface this with its own analysis of the degree of uncertainty associated with the current regulatory regime.

The SCO proposes to establish rules guiding the assessment of regulated prices that provide an "appropriate degree of certainty" to owners of regulated assets, and that will include requiring the AER with "specified minimum requirements". This implies that if the degree of uncertainty faced by investors is reduced, there should be a commensurate reduction in the rate of return provided to infrastructure owners, and a reduction in tariff charges. This conclusion follows from the fact that the current regulatory settings for gas pipeline businesses already provide for a significant out-performance of market return expectations.

Hence, if there is to be a change in the 'regulatory package' faced by service providers, it is important that the likely impacts on users are also calculated. Before any changes to the rules are proposed, it would need to be demonstrated by the SCO:

- What the overall net gain from the proposed changes is likely to be;
- What the gains to pipeline investors are expected to be (e.g. increased equity valuations through a lowering of the cost of capital); and,
- What the gains to pipeline users are expected to be (in terms of the present value of reduced tariffs).

The SCO should only proceed with its proposed changes if all three of the above values can be demonstrated to be positive.

4.5 Conclusion

The PC's proposed dismantling of section 8.1 of the Gas Code is based on biased and flawed analysis, and its recommendations are opposed by BHP Billiton. Having said that, BHP Billiton agrees that the creation of a single national regulator for gas and electricity transmission and distribution will reduce the diversity of regulatory approaches. This approach has the potential to reduce regulatory risk facing Australian energy utility owners, although the scope of this risk reduction has been exaggerated in the PC's Final Report.

BHP Billiton supports the SCO's proposal for a review of the rules for rate of return setting and regulatory processes, but recommends that the SCO undertake its own objective analysis, so that an 'appropriate degree of certainty is provided' to pipeline investors. If greater certainty is achieved there should be a lowering of the cost of capital and lower tariffs for users, since the current regulatory arrangements already provide superior rates of return to pipeline owners.

In order to justify changes to regulatory rules and processes, the SCO's analysis should be able to demonstrate that both the service providers and the users will be better off as a result.

Chapter Five

Greenfield Projects

5.1 Introduction

In our initial submission to the PC (Submission 26), BHP Billiton provided detailed observations on greenfields projects. Since the publication of the PC's Draft Report the issues associated with greenfields have concentrated on the proposal that a 15 year 'regulatory holiday' be provided. The SCO has identified a number of other issues associated with this proposal, and we provide BHP Billiton's responses in this chapter.

In brief, BHP Billiton's main concern is that the term 'greenfields' is being applied too broadly and too loosely by commentators.

5.2 The PC's recommendations on greenfields projects

In its analysis of greenfields pipelines, the PC again started from its fundamental, and unsubstantiated, proposition that regulatory risk is stifling investment. However, rather than provide any case studies of greenfield investments being stifled by 'regulatory error', the PC chose to rely on the submission of Envestra's established, 'brownfields' gas networks, which claimed that the company had been valued at only 60 cents by JB Were at November 2000, because of exposure to 'regulatory risks' in a 'heavily regulated environment', but that when the final decision on Envestra's South Australian access arrangement was released, the valuation was increased to 80 cents. Thus, the price of 'regulatory risk' was inferred to be 20 cents a share, or one quarter of its value.

What the PC failed to say was that between April 2000, when the SA regulator's draft decision was released, and November 2000, Envestra had already out-performed the ASX index by about 15%, and that prior to the release of the final report in December 2001, Envestra was yielding 11%, had refinanced \$650 million of debt at very favourable rates compared with regulators' assumptions, and had received a favourable regulatory ruling from the QCA on its Queensland network. In short there were numerous reasons for the growth and out-performance of Envestra's total shareholder return (including regulatory conservatism in favour of the company).

The PC felt that the best option for dealing with regulatory risk was to remove it by providing a lengthy regulatory holiday. Following representations by pipeline owners, the PC rejected the ACCC's Draft greenfield guidelines as being too flexible, and therefore subject to regulatory risk. Hence, the PC Final Report's Recommendation 9.1 suggested that the Gas Code should be amended so that if a proposed pipeline does not meet the coverage criteria, an up-front, binding no-coverage ruling could be obtained for 15 years. After 15 years, the pipeline should remain uncovered unless there is a successful coverage application. Critically, no definition of the term 'greenfields pipeline' was provided by the PC, and a reading of its recommendations could be misinterpreted as meaning 'any new pipeline'.

5.4 SCO's review of the greenfields issue

The SCO expressed a view that maximising the potential for investment in greenfields pipelines is an imperative, and that an appropriate climate for facilitation of such investment should be maintained. The SCO also noted the PC's position that regulation could result in under-sized pipelines and an 'asymmetric truncation' of returns, and that the COAG Energy Market Review had recommended providing all greenfield gas transmission projects with exemption from price regulation for 15 years. On the other hand, the SCO noted that pursuit of a binding non-coverage ruling could delay investment and add to costs, and was concerned that if a greenfields pipeline possesses market power, the public interest could be harmed by non-regulation.

Outlined below are the issues upon which the SCO has sought comment.

Practicality of identifying 'greenfields pipelines'

The SCO put the 'practicality of identifying 'greenfields' pipelines' at the end of its list of issues, but this is the critical question: what is a 'greenfields pipeline'? It is BHP Billiton's view that:

- ***A greenfields pipeline***, for the purposes of special treatment with respect to regulatory arrangements, should be defined as a pipeline that is **speculative** in nature. That is, it is a pipeline whose demand base is not underwritten with foundation contracts, which result in a level of risk sharing with shippers. Thus, it is a high risk proposition that is difficult for accurate assessment by a regulator, and given the level of risks, should not be regulated.
- ***A new, non-speculative pipeline***, may be commonly referred to as 'greenfield', but is distinguished by significant, commercially negotiated risk sharing with foundation customers. As a relatively lower risk pipeline, its required rate of return is potentially capable of accurate estimation in the event that it would be covered. Such a pipeline should not be subject to special provisions with respect to regulation.

Thus, a regulatory holiday period should only be considered for 'greenfields pipelines' as defined above, i.e. those that are speculative, and where the prospect of a higher return is required to justify the risk that demand will materialise. It is these cases that are potentially deterred by a regulatory constraint if that constraint is not applied flexibly enough, there is difficulty in accurately estimating required returns, and there is a perception that future high expected returns may be disallowed by a regulator.

Binding up-front ruling on coverage for 15 years

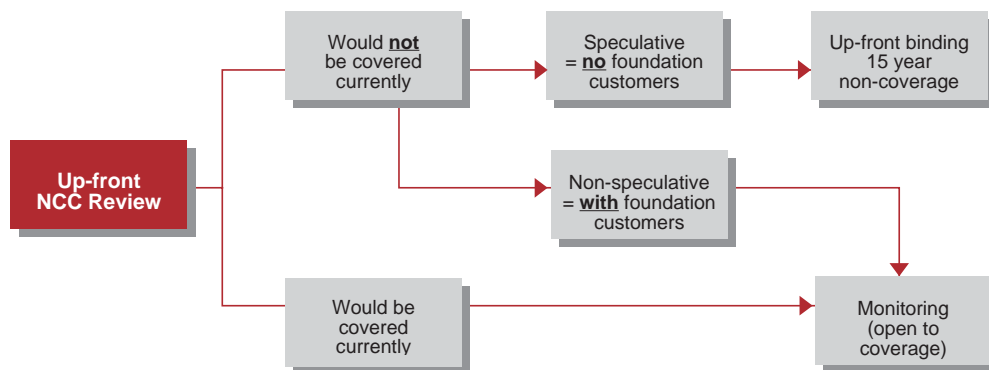
BHP Billiton is not opposed to the principle that a 15 year, up-front, binding ruling on non-coverage ruling be provided to a genuine greenfields pipeline that has 'speculative' high risk characteristics, as defined above. However, BHP Billiton is strongly opposed to a lengthy non-coverage ruling being obtained by pipelines that do not share such high-risk characteristics.

Implementation of a 15 year price regulation holiday

The implementation of a greenfield pipeline regulation holiday can be considered with the aid of Chart 5.1 below. After being approached for an up-front ruling, the first issue that the NCC should consider is whether, upon the completion of construction, the pipeline would be likely to be covered or not, if an application for coverage were to be made. If the pipeline would likely not be covered, this means that the pipeline either has no foundation customers (i.e. is speculative), or has foundation customers (i.e. is not speculative), but there is no market power being exercised (or with the potential of being exercised) that would cause it to be covered under the coverage criteria.

- If the proposed pipeline would not be covered currently (i.e. upon completion) and is genuinely speculative, it should be provided with a binding ‘no-coverage’ ruling.
- If the proposed pipeline would not be covered currently (i.e. upon completion) and there are foundation customers underpinning its commercial viability, no ruling should be provided, the pipeline should be subjected to monitoring and be open to a coverage application at a future date.
- If the NCC’s review of the proposed pipeline found it would be likely to be covered upon completion, it would need to be deemed to have a significant degree of market power. Upon completion such a pipeline would also need to be monitored, and be open to a coverage application.

Chart 5.1 Greenfield pipelines: Up-front Review



Source: BHP Billiton

The next issue is what length of time a ‘regulatory holiday’ should be provided for. The PC has recommended a flat 15 year period. BHP Billiton agrees that a flat 15 year period should be adequate to provide regulatory certainty for a genuine ‘greenfields’ project.

Application of non-price obligations to exempted pipelines

A further issue arising in relation to a regulatory holiday is whether exempted pipelines should be exempted from all forms of monitoring, including non-price monitoring. BHP Billiton's view is that non-price obligations should not be applied to exempted pipelines in the period of the regulatory holiday, as this would create an element of uncertainty that is not warranted. However, this recommendation would not apply to safety, health and environmental requirements.

5.5 Conclusion

The key issue associated with the application of a 15 year 'regulatory holiday' for greenfield pipeline projects is the definition of what constitutes a 'greenfield pipeline' in this context. It is BHP Billiton's view that only speculative pipelines that are built without the benefit of foundation customers should be able to qualify as 'greenfield pipelines' for the purposes of a 'regulatory holiday' application. Proposed new pipelines that are underwritten with foundation contracts that share the risks should not be provided with an up-front binding 15 year regulatory holiday. Such pipelines would be monitored upon completion, and subjected to potential applications for coverage. BHP Billiton is not opposed to genuine 'speculative' pipelines being provided with an up-front binding 15 year non-coverage guarantee.

Chapter Six

Other Regulatory Matters

6.1 Introduction

In this chapter we consider a number of other regulatory issues that were raised in the SCO's Consultation Paper, including the administration of the coverage test, establishing a common set of provisions for the electricity and gas industries, and the treatment of associate contracts.

6.2 Administration of the coverage test

The SCO's Consultation Paper raised two matters in relation to the administration of the coverage process:

- First the SCO endorsed the PC's recommendation that coverage assessment be separated from regulation. BHP Billiton also endorses this principle.
- Secondly, the SCO invited comment on the relative merits of the National Competition Council or the Australian Energy Market Commission (AEMC) assessing the coverage of pipelines. BHP Billiton believes that the relative advantages of these institutions making coverage assessments are as follows:

AEMC:

- As the rule making authority for energy markets, would possess a deeper understanding of energy market issues.

NCC:

- As the assessor of coverage issues in a variety of markets, would possess a greater ability to assess relative merits of coverage and maintain a uniformity of standards in coverage across industries.
- As the existing assessor of coverage, has the experience that would need to be developed within the AEMC over time.
- Would be weakened as an institution if the coverage of energy assets were taken to the AEMC, and would therefore not have as much strength to undertake assessments in other industries.

In view of the relative advantages set out above, BHP Billiton recommends that the NCC continue as the administrator of the coverage test for energy businesses, including pipelines.

6.3 Common set of regulatory provisions for electricity and gas industries

The SCO noted that there are a number of differences between regulatory arrangements under the Gas Code and decisions made under the National Electricity Rules, and proposed that a common set of laws governing access in these industries should be developed. BHP Billiton believes that this is likely to be a reasonable approach in general, and is an issue that should be investigated, but that there may be specific differences between gas and electricity that might require a differentiated approach on some issues. In some cases, it may be preferable for regulation of gas pipelines to adopt approaches used in the electricity sector and vice versa.

Scope of the regulator's discretion

Under the Gas Code the regulator's role is to reject an access proposal from the service provider if it is outside of a plausible range, whilst under the electricity regimes regulators are required to issue their own determinations. This is an area in the Gas Code that has caused some controversy and debate.

Under the Gas Code the regulator is expected to review a service provider's access proposal in light of the objectives set out in section 8.1 and the factors of section 2.4, and section 8.2 of the Code. The factors listed in section 8.2 include a requirement that the regulator be satisfied that the Total Revenue that a Reference Tariff is designed to recover is calculated consistently with the principles contained in section 8 of the Code, which include principles for determining the Rate of Return.

The PC's proposals to weaken section 8 of the Code are a concern to BHP Billiton, as is the fact that the Code does not provide guidance on the boundaries of a 'plausible range'. On the other hand, section 8.2(e) of the Code does state that, "the Relevant Regulator must be satisfied that... any forecast required in setting the Reference Tariff represent *best estimates* arrived at on a reasonable basis" (emphasis added). BHP Billiton considers that this is a requirement for the regulator to review the service provider's proposal and compare it with what is the best estimate based on current market conditions and knowledge.

BHP Billiton would prefer that all of the current requirements in section 8 be maintained. However, if changes are made to the section, they should only be made after analysis has demonstrated the benefits to all parties (see chapter 4 above), and in order to remove any doubt that the best estimate is required, BHP Billiton recommends that gas regulation should adopt the electricity regulation approach, in which the regulator provides its own determination on the basis of a best estimate of cost of capital and other parameters.

Hence BHP Billiton supports the Consultation Paper's proposal that it is best to "empower the AER to make the best decision it can".¹⁸ The PC's recommendation that the decision making criteria of the regulator be changed to (or affirmed as) only being able to reject a service provider's proposals if they are outside a 'reasonable range' is rejected, as this would raise uncertainty, not lower it.

¹⁸ MCE-SCO (2005), p.20.

Information gathering

BHP Billiton agrees with the SCO Consultation Paper's proposals that information gathering powers should be robust, as uncertainty in the regulatory framework would be raised by inadequate or incomplete information sources. BHP Billiton's views on the scope of existing information collecting powers and the incentives of service providers not to reveal information were provided in our initial submission to the PC.¹⁹

Since information-gathering powers are greater in the electricity industry, BHP Billiton supports the application of similar levels to the gas industry. In chapter 3 we have also outlined our opposition to a price-monitoring regime unless robust information gathering (including the RAV) and analysis is undertaken.

Appeals

The SCO Consultation Paper notes that while the right to qualified administrative (merits) appeal exists for regulatory decision in gas, such appeal rights do not exist for pricing/revenue decisions under the National Electricity Rules.

In our initial submission to the PC, BHP Billiton outlined its support for the principle of symmetric appeal rights, which are not available to gas pipeline users under the current Code.²⁰ Under the existing Code (section 2.48), if the service provider either accepts the regulator's final decision, or negotiates a variation to the final decision with the regulator, the user's right of appeal is never triggered. This is an anomaly that should be corrected in any revision of the Code.

The next issue for consideration is the scope of the appeal process. There appear to be three main views being put forward:

- **Partial review with old papers:** This is the appeal provision that exists under sections 38 and 39 of the Gas Pipeline Access Law. That is, the review is one of constrained scope, limited to correcting errors in single issues, and based on existing documents that were used in the original regulatory decision.
- **Full review with old papers:** This is the approach that has been recommended by the PC under its recommendations 11.5 and 11.6, and has also been supported by the ACCC. Under this approach, all the matters considered by the regulator would be open to review, and only the original documents used by the regulator would be considered in the review.
- **Full review with old and new papers:** This approach was supported by the Australian Pipeline Industry Association (APIA) in its submission to the PC, and allows the review of all issues with reference to documents used in the original decision as well as any new documents.

¹⁹ BHP Billiton (2004), pp.101-103.

²⁰ BHP Billiton (2004), pp.299-101.

BHP Billiton is concerned that partial reviews are not helpful, as they allow ‘cherry picking’ of issues, while the regulatory decision should be viewed as a whole (i.e. as a ‘package’). There is also a concern that if a full merit review is allowed with new and old papers, there will be an incentive for participants to game the regulatory process, and could allow the review body to become the *de facto* regulator.

The SCO Consultation Paper noted that an additional consultation paper will be released later in 2005 to canvass views on the issue of merit review principles. In summary, BHP Billiton’s preliminary views on the main issues are:

- Merit reviews are supported in principle as they act as a discipline on regulators, but users should have equal access with service providers to initiate a merit review.
- Full merit reviews are supported, but with reliance on old papers.

6.4 Treatment of associate contracts

In our initial submission to the PC, BHP Billiton outlined concerns with respect to the vertical integration that is prevalent in the Australian gas industry.²¹ A major concern is the ability of a vertically integrated pipeline to provide contracts to related parties (associates) that would result in unfair competition with independent retailers. Currently there are provisions in the Code requiring associates to have these transportation contracts authorised the regulator. The PC argued in its Draft Report that this requirement imposes unnecessary costs, for very little gain. As a result the PC (Recommendation 10.1) has proposed that rather than require authorisation of associate contracts, the service provider be required to merely provide the contract and any necessary information to the regulator.

BHP Billiton is opposed to the PC’s Recommendation 10.1, as this represents a weakening of the regulatory oversight that currently exists in a highly vertically integrated market. It is not valid to argue as the PC has done, that the costs of authorisation result in higher costs for consumers. The interests of consumers would be better served by an industry structure that was not vertically integrated, as competition among retailers would be unfettered. However, given the fact of vertical integration, regulatory oversight of associate contracts is required where pipelines are covered, and therefore have been found to exhibit a significant degree of market power.

The SCO Consultation Paper has also requested comment on how associate contracts should be treated under the monitoring regime. BHP Billiton’s view is that in these circumstances, the PC’s Recommendation 10.1 could be applied, as information about the contracts would provide another component of the overall information requirement under monitoring.

On the other hand, BHP Billiton does support the PC’s recommendation 10.2, which proposes that the associate contract provisions be amended to clarify that these provisions do not apply to asset management contracts. These management contracts are a different issue to the vertical relationships with retailers discussed above. As was argued by the PC, without full information about the costs of asset management businesses, a regulator would not be able to determine whether the contractual conditions were reasonable.

²¹ BHP Billiton (2004), chapter 5.

6.5 Conclusions

In summary, BHP Billiton's views on a number of other regulatory matters highlighted by the SCO's Consultation Paper are as follows:

- The NCC should continue as the administrator of the coverage test for energy businesses, including pipelines.
- With respect to regulatory discretion, the status quo should be maintained for section 8 of the Code, however, if a change were found to be justified by demonstrated net benefits to all parties, then the electricity industry approach should be adopted, whereby the regulator provides its own determination on the basis of a best estimate of cost of capital and other parameters.
- The SCO Consultation Paper's proposals that the regulator's information gathering powers should be robust are agreed, and the powers available to regulators in the electricity industry should be applied where they are more robust.
- Merit reviews are supported, but it is recommended that users should have equal access with service providers to initiate a merit review. Full merit reviews with reliance on old papers are also supported.
- Associate contracts between retailers and vertically integrated pipeline owners should continue to be authorised by the regulator. Where a monitoring regime applies, information on associate contracts should be provided to the regulator.

Appendix A

Summary of Responses on PC and MCE-SCO Recommendations

PC Rec.	MCE-SCO response/proposal	BHP Billiton response/proposal
5.1	Accept overarching objects clause, seek comments on: a) acceptance of PC proposal b) consistency with electricity (NEL) c) alternative mirroring NEL and national access regime	Accept SCO proposal c) but with the word 'investment' removed, i.e. The objective of the gas access regime is economically efficient investment in, and economically efficient operation and use of, natural gas pipeline services thereby promoting effective upstream and downstream competition and the long term interests of consumers of natural gas with respect to price, quality, reliability, safety and security of supply of natural gas.
5.2	Consider under 7.1 below	Consider under 7.1 below
5.3	Consider under 7.1 below	Consider under 7.1 below
5.4	Consider under 7.1 below	Consider under 7.1 below
5.5	Consider under 7.1 below	Consider under 7.1 below
5.6	Consider under 7.1 below	Consider under 7.1 below
6.1	Accept same threshold test for cover under national access regime	Accept
6.2	Accept addition of 'material increase in competition' to NCC coverage criterion a) for consistency with Part IIIA'	Cannot accept until the SCO's analysis of the likely impact of the change would not result in a practical difference in the likelihood of coverage relative to the current criterion a).
6.3	Accept NCC/Minister to commend/decide on form of regulation when covering a pipeline	Accept
6.4	SCO invites comment	This recommendation of the PC appears superfluous in light of the SCO's alternative monitoring regime, which relies on the NCC/Minister to determine coverage and a low cost rule (such as the 10JP p.a. rule suggested by BHPB) to determine the lower bound for monitoring.
6.5	SCO invites comment re PC and SCO monitoring options	Accept in principle, but should not follow the airports model, and should not be restricted to price monitoring. In particular, monitoring should result in public disclosure

		of revenues, costs and Regulatory Asset Values.
6.6	SCO notes legislation has been introduced to remove 'forum shopping' between National Access Regime and Gas Access Regime	Accept
7.1	SCO invites comment on: a) PC's pricing principles b) SCO's common pricing principles	The PC's analysis of pricing principles contained in its Final Report is extremely biased, and flawed. Hence the PC's recommendations regarding pricing principles are opposed (see DR96 for details). The SCO's proposal is that the AEMC will develop new rules for setting of regulated prices to provide greater certainty for asset owners. If so, there should be a commensurate reduction in required rates of return and gas transportation tariffs.
7.2	Consider under 7.1 above	Consider under 7.1 above
7.3	Consider under 7.1 above	Consider under 7.1 above
7.4	Consider under 7.1 above	Consider under 7.1 above
7.5	Consider under 7.1 above	Consider under 7.1 above
7.6	Consider under 7.1 above	Consider under 7.1 above
7.7	Consider under 7.1 above	Consider under 7.1 above
7.8	Consider under 7.1 above	Consider under 7.1 above
7.9	Consider under 7.1 above	Consider under 7.1 above
7.10	Consider under 7.1 above	Consider under 7.1 above
7.11	Consider under 7.1 above	Consider under 7.1 above
7.12	Consider under 7.1 above	Consider under 7.1 above
7.13	SCO invites comment on the PC's proposal that service providers don't need to include information on cost allocations between users/services	Disagree, since this information could be important for regulatory oversight, and is particularly important in the case of vertically integrated operations, where regulatory gaming could be facilitated.
7.14	SCO invites comment on the PC proposal that regulator only use information collected under powers specified in the Gas Access Regime	Accept
7.15	Accept clarification of Code that expansion of a covered pipeline will be covered	Accept
8.1	Accept in principle that a light handed monitoring regime be an alternative to access arrangement regulation	Disagree that they are alternatives when market power is present. A monitoring approach can be useful where there is likely to be some market power.
8.2	SCO invites comment on the PC proposal that the monitoring form of regulation include binding arbitration and specified information disclosure	Disagree that a binding arbitration model be applied. Agree that a monitoring model requires specified information disclosure.
8.3	SCO invites comment on the PC proposed monitoring regime provide for binding	Opposed to binding commercial arbitration, particularly if the service provider were to:

	commercial arbitration	<p>a) Write the rules of the arbitration</p> <p>b) Not make public the outcomes of the arbitration process and ruling by the arbitrator</p>
8.4	SCO invites comment on scope and required elements of the PC proposed monitoring regime making parties subject to anticompetitive conduct provisions of the Gas Pipelines Access Law	Access seekers should have recourse to s.46 of the TPA
8.5	SCO invites comments on the ring fencing arrangements to apply under either or both options for a monitoring regime	Accept no allocation must also be fair and reasonable
8.6	SCO invites comments on the scope and required elements of disclosure requirements of a proposed monitoring regime	PC's regime envisages trend profitability performance, but this can't be interpreted unless the economic asset base is known (i.e. RAV values must also be known to make sense of profitability numbers)
8.7	SCO invites comment on PC's proposal that an agency (eg NCC) develop guidelines for disclosure requirements under monitoring	Accept, but RAV values are a necessity.
8.8	SCO invites comment on PC's proposal that regulator should publish (without comment) the annual information under a monitoring regime	Disagree. Regulator should publish an analysis of relative data, including rate of return data, so that participants are fully informed.
8.9	SCO invites comment on PC's proposal that disclosed information be signed off by the CEO and an auditor	Accept
8.10	SCO invites comment on the time periods which should apply to pipelines subject to monitoring	Monitoring of pipelines should be open-ended as long as inclusion criteria are fulfilled and a successful coverage application has not been made.
8.11	SCO invites comment on PC's proposal that only the regulator be able to apply to the NCC to shift from monitoring to access arrangements	Disagree. The right to lodge a coverage application with the NCC should remain as it is.
8.12	<p>Accepts that currently covered cost-based regulated pipelines continue.</p> <p>SCO invites comment on PC's proposal that revocation of cost-based coverage follow a recommendation of the NCC/Minister</p>	<p>Accept.</p> <p>Participants should be able to apply for revocation as currently</p>
8.13	SCO addresses PC's recommendation on modification of clause 6 of the Competition Principles Agreement in its response to 6.1,6.2,6.6	Accept in principle, but only in terms of the SCO's recommended framework of coverage plus monitoring, and with certain reservations with respect to data reported.

9.1	SCO invites comments on options for facilitating investment in greenfields investments	Accept in principle the desirability of an up-front, 15 year exemption from coverage for genuine greenfields pipelines with high risk (speculative) characteristics and without foundation contracting with major shippers.
9.2	SCO notes that if 9.1 were implemented, certification of the regime can provide immunity from declaration	Agreed.
10.1	SCO invites comment on PC's proposal that s.7.1 of Gas Code be amended to require a provider making an associate contract at the reference tariff to lodge the contract and information with the regulator SCO also invites comment on how associate contracts should be handled re monitored service providers	Disagree. The associate contract should be authorised with the regulator, who might not otherwise have a means to control such arrangements. Associate contracts for monitored service providers should be lodged with the regulator.
10.2	SCO invites comment on PC's proposal that associate contract provisions be amended to clarify they don't apply to asset management contracts	Accept
10.3	SCO invites comment on PC's proposal that s.4.1 of the Gas Code be amended to ensure an Associate of a Service Provider establish separate accounts and make cost allocations transparent	Accept, provided they are fair and reasonable
10.4	SCO invites comment on PC's proposal that sub-sections to s.4.2 of the Gas Code be added require compliance with accounting guidelines set out by the regulator	Accept
10.5	SCO invites comment on PC's proposal that the term 'otherwise fair and reasonable' be deleted from s.4.1(e) of the Gas Code to remove potentially conflicting objectives.	Accept
11.1	SCO invites comment on PC's proposal that a regulator only be able to extend the period of approval for an access agreement by 2 months once, except if judicial proceedings commence, noting that this is to be further considered as part of the development of common rules for the regulatory process under a national energy access regime	Accept
11.2	SCO invites comment on PC's proposal that the Gas Access	Accept

	Regime be amended to remove the regulator's ability to make a 'further final decision', noting that this is to be further considered as part of the development of common rules for the regulatory process under a national energy access regime	
11.3	SCO invites comment on PC's proposal that regulator can specify a date by which a service provider must submit proposed amendments to an access arrangement, noting that this is to be further considered as part of the development of common rules for the regulatory process under a national energy access regime	Accept
11.4	PC proposes to amend s.39 of the Gas Pipeline Access Law to allow a full merits review of access arrangements. MCE SCO notes that a consultation paper will be released later in 2005 on this issue	Accept on condition that both the service provider and users have an equal ability to instigate a full merits review.
11.5	PC proposes to amend s.39 of the Gas Pipeline Access Law to allow full merits reviews of access arrangements to rely only on materials presented to the primary decision maker. MCE SCO notes that a consultation paper will be released later in 2005 on this issue	Accept, since there would otherwise potentially be an incentive for parties to withhold information.
12.1	Accept agency recommending coverage should also recommend form of regulation	Disagree. Under the SCO's proposed framework an NCC/Minister decision to cover (i.e. significant market power is present) should result in access regulation, with monitoring being determined as the default (provided materiality achieved).
12.2	Accept agency responsible for coverage/form recommendations be separate from regulator	Accept. That agency should be the NCC, which has a broader experience than the AEMC.

Appendix B

The PC's Proposed Dilution of Section 8.1 of the Gas Code

Current Gas Code Sec. 8.1	PC's Recommendation 7.1	BHP Billiton's Comments
<p>A Reference Tariff and reference Tariff Policy should be designed with a view to achieving the following objectives:</p> <p>(a) providing the Service Provider with the opportunity to earn a stream of revenue that recovers the efficient costs of delivering the Reference Service over the expected life of the assets used in delivering that Service.</p> <p>(b) replicating the outcome of a competitive market.</p> <p>(c) ensuring the safe and reliable operation of the Pipeline.</p> <p>(d) not distorting investment decisions in Pipeline transportation systems or in upstream and downstream industries.</p> <p>(e) efficiency in the level and structure of the Reference Tariff.</p> <p>(f) providing an incentive to the Service Provider to reduce costs and to develop</p>	<p>The relevant regulator must have regard to the following principles when approving a reference tariff or reference tariff policy:</p> <p>(a) that reference tariffs should:</p> <p>(i) be set so as to generate expected revenue across a service provider's regulated services that is at least sufficient to meet the efficient long-run costs of providing access to those services.</p> <p>(ii) include a return on investment commensurate with the regulatory and commercial risks involved.</p> <p>(iii) generate revenue from each service that at least covers the directly attributable or incremental costs of providing the service.</p> <p>Not addressed</p> <p>(b) That reference tariff structures should:</p> <p>(ii) not allow a vertically integrated service provider to set terms and conditions that disadvantage competitors of associated businesses in upstream or downstream markets, except to the extent that the cost of providing access to these competitors is higher.</p> <p>(b)(i) allow multi part pricing and price discrimination when it aids efficiency</p> <p>(c) that reference tariffs should be set so as to provide incentives to reduce costs or otherwise improve productivity.</p>	<p>The Gas Code recognises that even regulated businesses are subject to a probability distribution of outcomes and returns cannot be guaranteed as this would impose insurance costs on consumers and taxpayers. Efficient costs include an appropriate return on investment and of capital to the service provider.</p> <p>The PC Draft recommendation is unworkable as a regulatory commitment to generate "expected" revenue (probabilistic) that is "at least sufficient" (certain) or "at least covers" (certain) is inconsistent and illogical.</p> <p>The "outcomes" rather than the "structure" of a competitive market are important, and are consistent with the high-level "efficiency" objective.</p> <p>Reference tariffs should be consistent with safe and reliable operation of the pipeline.</p> <p>Whilst the PC's proposed objects clause seeks to "promote" investment in pipeline transportation, the principle of not distorting investment "upstream" and further "downstream" is lost.</p> <p>The PC's suggested wording is more complex and more restrictive relative to the current wording of s.8.1(d). It is rejected by BHPB.</p> <p>The PC's wording is potentially open to abuse in a vertically integrated market structure. BHPB rejects the PC's suggestion, preferring the original wording in S.8.1(e)</p> <p>These are essentially the same. This sub-section illustrates that the Code provides for incentive regulation so service providers can earn more than</p>

the market for
Reference and other
Services.

the recovery of efficient costs. The
PC's suggested wording could be
applied.

Appendix C

Herfindahl-Hirschman Index

The Herfindahl-Hirschman Index (HHI) is a commonly accepted measure of market concentration. It is calculated by squaring the market share of each firm competing in the market and then summing the resulting numbers. For example, for a market consisting of four firms with shares of thirty, twenty, and twenty percent, the HHI is 2600 ($30^2 + 30^2 + 20^2 + 20^2 = 2,600$). The HHI takes into account the relative size and distribution of the firms in a market and approaches zero when a market consists of a large number of firms of relatively equal size. The HHI increases both as the number of firms in the market decreases and as the disparity in size between those firms increases.

Markets in which the HHI is between 1000 and 1800 points are considered moderately concentrated, and those in which the HHI is in excess of 1800 points are considered to be highly concentrated.