

Regulatory Impact Statement

Gas Access Regime – Light handed regulation

BACKGROUND

In 2003-04, the gas industry contributed 0.2 per cent of Australia's GDP of more than \$788 billion.

Australia's natural gas consumption grew from 733 Petajoules (PJ) in 1993-94 to 1048 PJ in 2003-04. The Australian Bureau of Agriculture and Resource Economics (ABARE) has forecast that natural gas consumption will grow at about 2.8 per cent per annum to 2136 PJ in 2029-30. At this rate natural gas consumption would more than double by 2030. Over the same period natural gas is projected to increase its share of Australia's primary energy consumption from 19.6 per cent to nearly 25 per cent.

Significant investment in gas infrastructure, including pipelines, will be required to meet this level of future demand. The Productivity Commission (PC) found that while there has been impressive growth in the gas sector, the design and application of the gas regulatory regime has the potential to deter investment in the future. The PC has recommended a number of changes to the gas regulatory regime to improve the certainty for investors in pipelines and minimise the costs of regulation, while protecting customers from the misuse of market power.

PROBLEM

The PC has found that the current regulatory regime with price regulation imposes substantial costs including high compliance costs, constraints on commercial negotiations, high potential for regulatory error and the potential to distort or deter pipeline investment. Given the costs, it is important that such regulation is applied to transmission pipelines and distribution networks only where there are clearly greater net benefits to the economy.

One problem with the current Gas Access Regime is that pipelines are either subject to formal price controls, or are completely deregulated. Therefore, the regime does not provide for an efficient outcome where the National Competition Council (NCC) would have recommended coverage but has not done so because the costs of full price regulation are too high (i.e. the high cost of regulation outweighs the potential benefits that would have been derived from regulation). Furthermore, inefficiency occurs in cases where the NCC has recommended coverage but the costs associated with full price regulation are unnecessarily high.

In particular, the current binary options in the gas regime of either no regulation or formal price control are not well suited to the situation where there is emerging competition in the provision of formerly monopoly services. The NCC has also observed that as markets become increasingly competitive, the level of regulatory intervention under the Gas Access Regime might need to become less interventionist.

The current binary options were developed ten years ago when the industry mainly comprised monopoly pipeline assets with substantial market power over their transmission charges. Since then, competition has emerged in the south east Australian pipeline network and the PC has found that emerging competition and interconnection of networks have led to some ‘contestable’ and ‘imperfectly competitive’ markets in which two or more service providers can compete to supply gas. Given these developments, the Gas Access Regime with its sole regulatory option of full price regulation, delivers a sub-optimal level of efficiency for the gas market and wider economy.

OBJECTIVE

The objective of government action is to ensure that where regulation is applied, it is applied efficiently and that the form, scale and costs of regulation are appropriate / proportionate for the degree of market power present, thereby achieving an improvement in economic efficiency within the gas market for the benefit of the community as a whole.

OPTIONS

- 1) Status Quo – continue to provide full price regulation as the sole regulatory option of the Gas Access Regime.**
- 2) Introduce a ‘light handed’ form of regulation as an additional alternative to formal price control.**

Two models have been assessed as viable:

- a) Productivity Commission model**
- b) Alternative model**

The models are outlined below.

The Alternative model varies from the PC model in the following ways:

- the decision on the application of light-handed regulation would be separated from coverage;
- the existing Gas Code dispute resolution procedures would be utilised rather than relying upon new and separate procedures, thus minimising concerns about the ability for the regime to be certified as effective under the *Trade Practices Act 1974*;
- the information disclosure requirements would be able to be tailored to suit the individual circumstances of a particular pipeline;
- the AEMC would apply a net benefit test prescribed in the law to decide the form of regulation that is appropriate for a particular pipeline.

Productivity Commission model:

The light-handed regulatory regime would comprise a monitoring regime combined with binding arbitration in the case of disputes (which would likely meet the requirements for certification as an effective access regime under the National Access Regime) and several other regulatory measures.

The PC recommended a monitoring form of regulation to be incorporated into the Gas Access Regime that would have the following features:

- **A third party access policy formulated by the service provider which would have some minimum requirements relating to processes for negotiating access and binding arbitration in the event of a dispute over access;**
- **Subjecting service providers to provisions for anticompetitive conduct (the current s.13 of schedule 1 of the Gas Pipelines Access Law);**
- **Minimum ring fencing provisions;**
- **Scope for the service provider to adopt, at its discretion, additional features, such as a voluntary code of conduct; and**
- **Public disclosure of specified information by the service provider for monitoring purposes only.**

The PC suggested the monitoring regime include the publication of financial information (revenue, expenditure and returns), operation information, information on access negotiations and information on dealings with associates.

Under the proposed monitoring regime, information disclosure requirements would involve:

- focusing more on trend performance, including profitability
- reporting and monitoring after the event, without any need for prior endorsement by the regulator
- the regulator particularly recording cases where access negotiations have been unsuccessful.

Information disclosure requirements of the proposed monitoring regime would be set out in disclosure guidelines and developed prior to implementation of the monitoring regime.

To ensure the data disclosed by service providers under the proposed monitoring regime are accurate:

- chief executive officers (CEOs) would be required to sign a declaration stating that the data are true
- financial information and financial performance measures would be certified by an auditor
- financial penalties would be available through the courts if companies refuse to provide the required monitoring data within the established deadlines.

Matters the PC recommended considering when deciding upon the form of regulation

The Gas Access Regime would be amended to give guidance on matters that the Minister and the NCC should consider in deciding and recommending, respectively, which form of regulation would apply to a covered pipeline.

In determining the potential benefits of either form of regulation, the following matters would be taken into account:

- (a) the nature of demand for the commodities and services of end users of gas
- (b) the actual and potential level of competition from substitutes such as gas from other sources delivered through other pipelines, and other forms of energy such as electricity
- (c) the nature and extent of any barriers to entry in the market
- (d) the degree of countervailing power in the market
- (e) the degree of horizontal and vertical integration
- (f) any other significant factors, subject to them being consistent with the proposed new objects clause.

In determining the potential costs of either form of regulation, the following matters would be taken into account:

- (a) direct costs of service providers, governments and users
- (b) other costs (for example, distortion in behaviour arising from timeliness, regulatory risk and regulatory error (such as the inherent difficulties in determining efficient costs for services))
- (c) any other significant factors, subject to them being consistent with the proposed new objects clause.

Whether the light handed regime would apply would be determined at the time of coverage. The light-handed regime would operate as the default and the up-front regulatory determination of prices would only be imposed if a net benefits test was satisfied. Where the proposed monitoring option were applied, it would apply for a minimum period of five years, during which there would be no shift to access arrangement with reference tariffs regulation. After the five year period only the regulator could make an application to the NCC for full price regulation with reference tariffs. Monitoring would continue to apply, subject to a decision by the Minister, following a recommendation by the NCC, and an application from the monitoring regulator that access arrangement with reference tariffs regulation should apply. If a decision to continue with monitoring were made it would apply for a five year period. Any person could apply for revocation of coverage of a monitored pipeline at any time.

For pipelines that are not covered, any person would be able to apply for coverage at any time.

For pipelines that are covered and subject to the proposed monitoring regime, only the relevant regulator would be able to apply to the NCC to shift the form of regulation to access arrangements with reference tariffs.

Pipelines currently covered with cost-based price regulation would remain covered, and continue to be subject to the access arrangement with reference tariffs regulation. Movement from this price regulation would require an application (there would be no restrictions on either when applications can be made or who can apply) to the NCC for revocation. Following a recommendation from the NCC, the Minister would make a decision on coverage, and the form of regulation where coverage is retained.

The form of regulation decision would be covered by similar administrative processes to the coverage decision, such as public consultation and merits appeal.

Alternative model

- There would be two regulatory options available for covered pipelines, namely:
 - a continuation of the current approach, whereby the regulator would undertake up-front, periodic assessments of reference tariffs and other associated elements; and
 - a light-handed option, under which there would be no upfront assessment of reference tariffs, but rather pipelines would be monitored with binding dispute resolution as a fallback (this option is described more fully below);
- The decision about the form of regulation would be made by the AEMC in consultation with the AER, and reflect an assessment of the relative costs and benefits of applying the different regulatory options to the particular pipeline. The form of the net benefit test and its conduct would be prescribed in the national gas legislation.

In relation to the net benefit test, it is intended that the legislation would provide the AEMC with clear criteria on the form and conduct of the assessment of the relative costs and benefits of implementing the light-handed option. The criteria are yet to be developed; however, they are likely to be similar to the criteria proposed by the PC (as outlined above).

- The information disclosure requirements under the new light-handed regulatory option would be developed for the initial National Gas Rules to be made under the proposed National Gas Law. The information disclosure rules would be applied by the AER and, as with other rules, be subject to the rule change process administered by the AEMC on application. It is intended that the rules would provide scope for the disclosure requirements under the light handed option to be applied in a manner that reflects the particular circumstances of individual pipelines.

Establishing the net benefit test for the light handed regulatory option in the law, with information disclosure rules to be applied by the AER and administered by the AEMC, would provide certainty to stakeholders and ensure an appropriate

separation of the criteria for determining the light-handed option and its application and enforcement.

- The timing of the decision about the form of regulation that is appropriate for a particular pipeline would be as follows:
 - where a pipeline is *already covered* (and so has approved reference tariffs in place), a decision to switch to the light-handed regime could occur at any time, and would have effect after the expiry of the current access arrangement (so that, under the light-handed option, there would be no requirement to submit a revised access arrangement for assessment); and
 - where a pipeline is *covered for the first time*, the decision about the form of regulation would be made prior to the submission of a proposed access arrangement (so that, under the light-handed option, there would be no requirement to submit an access arrangement for assessment).
- Once a decision is made by the AEMC on the form of regulation of a pipeline, the pipeline would be subject to that form of regulation for the balance of the regulatory period, currently five years, and reassessed towards the end of the period as part of the consultation on arrangements to apply for the next period.
- Revocation would be by application to the AEMC, with a recommendation to the relevant Minister.
- If a regulated pipeline applied for revocation, and the application was rejected by the Minister after considering the analysis of the AEMC, the pipeline could still apply to the AEMC for monitoring for the next regulatory period.

Note: For clarification, it is important to note that while the AEMC will take on the function of assessing and making recommendations on coverage (and revocation of coverage), the NCC would continue to carry out this function until the regimes have been certified. Once this has been achieved the AEMC would take over this function.

The key features of the light-handed regime referred to above would be as follows:

- the pipeline owner would be free to negotiate prices and other terms and conditions with access seekers, with the Gas Code's existing dispute resolution procedures operating as a fallback;
- the existing other regulatory measures would continue to operate – namely, the ring fencing obligations, the requirement not to hinder access and the provisions related to contracts with associates;
- information disclosure requirements would be the same as those by the Productivity Commission, but able to be tailored, at the discretion of the AER, to the specific circumstances of each pipeline to ensure that compliance costs are minimised.

- as noted above, the existing coverage process would remain, and hence continue to permit pipelines that are subject to increasing competition to seek complete deregulation, as has been the case already for a number of important pipelines in South East Australia.

This model would preserve the key theme of the Productivity Commission's proposal, which is to ensure that regulatory reviews of prices are only undertaken where the benefits clearly exceed the costs and, in parallel, to maximise the opportunities for commercially negotiated arrangements.

Previous alternative model (based on the regime applicable to airports)

An alternative model for light-handed regulation (based on the regime applicable to airports) was also exposed to wider consultation in a previous consultation paper. The model comprised the following key features:

- the light-handed regime would be a price monitoring regime only (that is, no ability to seek binding arbitration), with the information disclosure requirements similar to that proposed for the Productivity Commission model;
- the light-handed regime would apply to all pipelines that passed a simple threshold (for example, a threshold based upon the materiality of the pipeline) with the existing coverage process (including the revised test) to determine whether formal price control should be imposed; and
- a number of measures were proposed for transitioning the monitoring regime and for addressing the circumstances of greenfields projects.

The distinguishing features of this alternative regime were that the regulatory regime would be more light-handed than proposed by the Productivity Commission (involving monitoring only), but would apply to a wider class of pipelines.

This model would potentially result in a net increase in the quantum of regulation applied to the industry that is contrary to the objective of the Ministerial Council on Energy (MCE). Furthermore, since binding arbitration would not be available under this option, there would be difficulties in having this model certified as an effective access regime under Part IIIA of the *Trade Practices Act 1974*. For these reasons this model has not been deemed to be a viable option and is therefore not analysed further.

IMPACT ANALYSIS

Major stakeholders that are likely to be affected by the following options include: pipeline owners, upstream gas producers, major gas users, final consumers, regulators and the Government.

1) Status Quo

Benefits

- Not providing an additional ‘light handed’ form of regulation as a regulatory option would result in no implementation costs. This option would avoid any changes and disruption to existing legislative, regulatory and commercial arrangements.

Costs

- The real economic cost of this option arises from the efficiency benefits foregone by failing to implement an additional regulatory option that would help to ensure that the most efficient form of regulation with the greatest net benefit is adopted for regulated pipelines.
- Maintaining the current binary regulatory arrangement of either formal price controls or complete deregulation would continue to generate a sub-optimal level of efficiency. Firstly, inefficient outcomes would arise in cases where the coverage assessor would have recommended coverage but has not done so because the costs of full price regulation are too high, and secondly, in cases where the coverage assessor has recommended coverage but the costs associated with full price regulation are unnecessarily high (i.e. the net benefit is not as great as it would have been if a lighter handed form of regulation was applied). Such inefficiency in the gas market is contrary to the interests of all stakeholders in the longer term as well as the wider community.
- The PC found that the current regulatory regime with access arrangements and reference tariffs has the potential to truncate investment returns above a certain threshold and may therefore be discouraging investment in pipelines. The current regime therefore potentially imposes costs and inefficiency losses for all stakeholders in the longer term.
- Given that a light handed monitoring option would mitigate these potential distortions to investment in pipelines, maintaining the status quo and thereby full price regulation as the sole regulatory option would fail to minimise the potential for investment to be distorted or deferred.
- Under the status quo such inefficient outcomes are likely to become more frequent given that competition amongst pipelines has been and is likely to keep on growing, making it less necessary for a highly interventionist regulatory regime to be in place.
- The PC found that the costs of the current regulatory option (access arrangements with reference tariffs) are substantial and may outweigh the benefits for some covered pipelines.
- Rather than facilitating market based outcomes, reference tariffs have become the price at which most, if not all, third party access to a covered pipeline is provided. Therefore, this model is constraining potentially efficient commercially negotiated agreements from taking place.

2) Introduce a ‘light handed’ form of regulation as an additional alternative to formal price control.

Benefits of the light handed regulatory options outlined above

- Such an option would help to ensure that where regulation is applied, it is applied efficiently and that the form, scale and costs of regulation are appropriate / proportionate for the degree of market power present, thereby achieving an improvement in economic efficiency within the gas market for the benefit of the community as a whole.
- The PC found that the current regulatory regime has the potential to truncate investment returns above a certain threshold and may therefore be discouraging investment in pipelines. The availability of a light handed monitoring option reduces the scope for asymmetric truncation to take place under the Gas Access Regime and may therefore encourage investment in pipeline projects. (This argument to address truncation relates only to those pipelines that would otherwise be subject to an access arrangement with reference tariffs.)
- It is likely that a regime that delivers a more efficient market outcome will also encourage greater investment, interconnection and competition to take place between gas pipelines, and thereby facilitate improved reliability of supply and lower long term prices for the benefit of consumers and the wider community.
- Where monitoring is adopted as the alternative form of regulation instead of full price regulation, service providers and regulators are likely to benefit from foregoing the requirement to establish access arrangements. Both stakeholders would benefit from a significant reduction in administrative costs.

In cases of dispute and binding arbitration taking place there is potential for the cost savings, derived from foregoing the establishment of an upfront access arrangement, to be incurred at a later date and thereby to be effectively lost. This is because the arbitrator would be required to conduct an information gathering and assessment process that is similar to that undertaken in the course of establishing an upfront access arrangement.

However, given the prospect of binding arbitration and the costs and uncertainty associated with the process, it is likely that parties will actually be encouraged to negotiate in good faith and employ their best endeavours to reach commercially negotiated outcomes in the first instance.

- Information provision requirements would be less onerous compared with full price regulation requirements. These stronger information provision requirements are currently largely required by the regulator to assist with the setting and revision of reference tariffs. Therefore, service providers subjected to light handed monitoring would benefit from a reduction in ongoing compliance costs.

- Service providers are likely to benefit from a greater scope for commercial negotiations to take place. Service providers would have the freedom to set access tariffs at levels determined by the market.
- Both light handed regulation options provide service providers with the flexibility, when facing a material change in circumstances, to seek a revocation of coverage without having to wait for the expiry of a mandatory coverage period. Similarly, access seekers benefit from the flexibility to seek coverage of a pipeline at any time.

Costs of the light handed regulation options outlined above

- Where monitoring is adopted as the form of regulation in place of full price regulation, upstream producers and gas users may incur additional costs and a greater degree of uncertainty in negotiating contracts with service providers.
- Some gas users may face higher prices since they no longer have a regulated price to serve as a benchmark.
- Given the period for monitoring is fixed for a minimum period of five years, there may be potential for the market power of service providers to increase during this time. If this was to occur and service providers chose to exercise their market power, gas users may suffer from higher access prices until the end of the five year period.

The likelihood of service providers exercising potential market power is small given the upfront assessment of market power, the information provision requirements and monitoring undertaken by the regulator, and the credible threat of being moved to full price regulation at the end of the five year period.

- Without a detailed assessment of costs upfront a regulator may find it difficult to assess whether service providers are making excess profits. The cost of this would likely be borne by gas users and upstream gas producers.
- Short term uncertainty is likely to take place as regulatory bodies come to interpret and apply both new and amended regulatory criteria.
- With the addition of a new regulatory option, additional regulatory processes will be adopted in order to facilitate the additional step of determining the appropriate form of regulation and allowing covered pipelines to move between forms of regulation.

Impact of a light handed ‘monitoring’ form of regulation on major stakeholders

Upstream gas producers	<ul style="list-style-type: none"> Increased pipeline investment, interconnection and penetration of gas are likely to enable producers to supply more markets in the longer term. Potential for pipelines to be monitored in instances where the NCC would previously have recommended no regulation due to the higher costs of administering full regulation with reference tariffs. 	<ul style="list-style-type: none"> Additional costs and uncertainty in negotiating contracts with service providers may be incurred. Potential transitional period of uncertainty as regulatory bodies come to interpret and apply new regulatory measures and criteria.
Pipeline owners	<ul style="list-style-type: none"> More likely that regulatory obligations would be proportionate to the pipeline’s degree of market power – may benefit from being subjected to a lighter handed form of regulation. Where a lighter handed form of regulation is applied, pipeline owners may benefit from: <ul style="list-style-type: none"> - reduced administrative costs associated with foregoing the requirement to establish upfront access arrangements; - less onerous information provision requirements and therefore reduced ongoing compliance costs; - greater scope for the commercial negotiation of contracts; and - greater investment as the scope for truncation of investment returns is likely to be reduced. 	<ul style="list-style-type: none"> Potential transitional period of uncertainty as regulatory bodies come to interpret and apply new regulatory measures and criteria. In cases of dispute and binding arbitration, cost savings associated with foregoing the requirement to establish upfront access arrangements may be lost. Given the additional regulatory assessment required to determine the form of coverage, pipeline owners may be subjected to a lengthier upfront regulatory process.
Gas users	<ul style="list-style-type: none"> Greater interconnection and penetration of gas is likely. Increased competition in the longer term is likely to lead to lower prices. Potential for pipelines to be monitored in instances where the NCC would previously have recommended no regulation due to the higher costs of administering full regulation with reference tariffs 	<ul style="list-style-type: none"> Additional costs and uncertainty in negotiating contracts with service providers may be incurred. Some gas users may face higher prices in the shorter term. However, the potential for pipeline owners to exercise market power would be limited. Potential transitional period of uncertainty as regulatory bodies come to interpret and apply new regulatory measures and criteria.

	Costs	Benefits
Final consumers	<ul style="list-style-type: none"> • Greater interconnection and penetration of gas is likely. • Increased competition in the longer term is likely to lead to lower prices. 	<ul style="list-style-type: none"> • Some consumers may experience an increase in price in the short term. However, this is unlikely given the incentives for service providers to negotiate in good faith and refrain from exercising market power.
Government	<ul style="list-style-type: none"> • Likely to encourage investment in gas infrastructure. • Likely to encourage a greater penetration of gas. 	<ul style="list-style-type: none"> • Costs associated with establishment and administration of the new arrangements.
Regulator	<ul style="list-style-type: none"> • Reduced administrative costs associated with establishing upfront access arrangements. 	<ul style="list-style-type: none"> • In cases of dispute and binding arbitration, cost savings associated with foregoing the requirement to establish upfront access arrangements may be lost. • The NCC/AEMC may incur short term costs as it determines the appropriate interpretation of the amended coverage criterion. • In some cases the AEMC may find it difficult to assess whether service providers are making excess profits without an assessment of upfront costs. • Where a pipeline is covered, the AEMC would be required to undertake an additional regulatory process in determining the form of regulation to apply.

Benefits specific to the PC Model

- Having one body recommend whether a pipeline should be covered as well as recommend, as part of the process, the form of regulation to apply would be a more streamlined and less costly process. Integrating both processes when a revocation application occurs would also be more streamlined and less costly. For instance, where coverage is not revoked the pipeline could be moved to the monitoring form of regulation as part of the one process.

Costs specific to the PC Model

- The decision on the form of regulation to apply would be integrated with the decision on coverage, thereby potentially increasing the complexity of coverage assessments.

- without a detailed assessment of costs upfront, a regulator may find it difficult to assess whether service providers are making excess profits, thereby resulting in a lower level of protection for gas users and upstream gas producers.

Given the AEMC would be party to information gathered by the AER, the AEMC would be in a better position than the NCC to consider the practical ability of the AER to effectively conduct monitoring. However, under the PC model it is the NCC that is tasked with deciding upon the form of regulation. This model therefore increases the potential for the regulator (AER) to be tasked with monitoring a pipeline without the adequate means or information to do so.

Alternative model

The refinements to the model for light-handed regulation proposed by the Productivity Commission are that:

- the decision on the application of light-handed regulation would be separated from coverage;
- the existing Gas Code dispute resolution procedures would be utilised rather than relying upon new and separate procedures, thus minimising concerns about the ability for the regime to be certified as effective under the *Trade Practices Act 1974*;
- the disclosure requirements would be able to be tailored to suit the individual circumstances of a particular pipeline.
- the AEMC would apply a net benefit test prescribed in the law to decide the form of regulation that is appropriate for a particular pipeline.

In relation to binding dispute resolution procedures, the two models essentially differ in the following ways: The PC Model proposed that the service provider should specify in its access policy a commercial dispute resolution process and outline who the arbitrator will be. Therefore, this option would provide the service provider with the ability to privately appoint and designate its preferred arbitrator. The Alternative Model, on the other hand, appoints the regulator with the sole authority to conduct binding arbitration.

The PC Model would provide service providers with the flexibility to choose an arbitrator of their preference, however this approach also presents a number of drawbacks, including:

- i) Access seekers would bear additional costs arising from the complexity of being faced with different procedures and arbitrators to gain access to pipelines owned by different parties. This could also include an integrated transmission and distribution system where these two elements had separate owners who used different arbitration procedures;

- ii) This approach would create a greater divergence in access arbitration outcomes within the gas sector;
- iii) Given the greater divergence, it would be difficult for precedent to be developed, resulting in greater uncertainty for all parties in the longer term.

It is important to note that the Alternative Model would not limit the ability of a Service Provider and User to reach an agreement about access without recourse to dispute resolution procedures specified in the Gas Code. The Code does not limit the terms and conditions on which a Service Provider and User can reach agreement. The provisions would apply only if parties cannot reach agreement and a dispute is notified to the Relevant Regulator.

In relation to ring fencing arrangements, both the PC and Alternative models would be amended so that they only apply to matters of relevance to a monitoring regime. Obligations relating to the Gas Code's pricing principles would be removed or amended since these are not of relevance to a monitoring regime.

Benefits specific to the Alternative model

Given its similarity to the PC model in a number of respects, this model would provide many of the benefits already identified above.

Additional benefits unique to this model include the following:

- information disclosure requirements as proposed by the Productivity Commission would be imposed, but would be able to be tailored to the specific circumstances of each pipeline to ensure that compliance costs are minimised (especially for small pipelines).
- the decision on the application of light-handed regulation would be separated from coverage, thus ensuring that the complexity of coverage assessments would not increase.
- the AEMC would apply a net benefit test prescribed in the law to decide the form of regulation that is appropriate for a particular pipeline. Having the AEMC make this decision has the following benefits:

Given the provision for information sharing between the AEMC and the AER, the AEMC would be party to the information supplied by covered pipelines to the AER, and would therefore be in a more favourable position than the NCC to make a decision on the most appropriate form of regulation to apply.

Therefore, the AEMC would benefit from access to relevant information (through the AER), and is likely to be more independent than the regulator in deciding upon the form of regulation to apply. The AEMC would be less likely to lean towards full price regulation than the regulator.

- without a detailed assessment of costs upfront, a regulator may find it difficult to assess whether service providers are making excess profits, thereby resulting in a lower level of protection for gas users and upstream gas producers. Given the AEMC will be party to information gathered by the AER, the AEMC would be in a better position than the NCC to consider the practical ability of the AER to effectively conduct monitoring in deciding upon the form of regulation to apply to a pipeline.

Costs specific to the Alternative model

- in the case of pipelines becoming covered for the first time, there may be some additional costs associated with regulatory process (in comparison with the PC model), given the additional time and steps involved in the separate assessment of coverage and the form of regulation.

CONSULTATION

- The Treasurer asked the Productivity Commission (PC) to examine current gas access arrangements on 13 June 2003. The Inquiry involved wide industry consultation with a variety of groups within, and related to, the gas industry, including pipeline owners and operators, gas users, industry associations, regulators and other government agencies. A total of 76 submissions were received in response to the issues paper that the PC released in July 2003. The Commission also held two rounds of public hearings in Perth, Adelaide, Melbourne, Brisbane and Sydney.
- The Draft Report was released for public comment on 15 December 2003. A total of 50 submissions were received in response to the draft report and a number of modifications were subsequently incorporated into the final report. The final report was presented to Government in June 2004.
- An initial Consultation Paper outlining options under consideration for MCE's response to the Review in relation to the key issues was released on 15 August 2005. A further 22 submissions were received.
- A second updated Consultation Paper was released on 9 November 2005.
- An open forum for stakeholders to make their verbal submissions on the updated consultation paper was held by MCE's Standing Committee of Officials (SCO) officials in Sydney on 23 November 2005. Fourteen further written submissions were also received.

In this context, interested parties have had a number of opportunities to comment on possible models of light handed regulation. The idea of introducing price monitoring as a supplementary form of regulation generally received either full or qualified support from all parties, including the pipeline industry, gas users and regulators. However, there were differences of opinion as to the most effective model and the detailed requirements to be included under an effective monitoring model. The pipeline industry generally strongly endorsed the PC model, seeing it as workable and efficient, and likely to encourage a more competitive and dynamic industry.

User groups were more guarded in their support for a monitoring regime. A particular concern was that more specific information on the requirements to be imposed on service providers under a monitoring regime was needed before it could be effectively assessed. There were also differences of opinion on whether there should be binding arbitration to resolve access disputes under a monitoring regime. The Energy Users Association of Australia (EUAA) expressed concerns that binding arbitration is a lengthy and costly process which could end up being more intrusive and expensive than upfront price regulation.¹ In contrast, the Major Energy Consumers group felt that binding arbitration was essential, since without it price monitoring would be a toothless mechanism.²

Regulators have been cautious in their appraisal of a monitoring regime. The Australian Competition and Consumer Commission (ACCC) cited examples of price monitoring in other sectors and expressed concerns that these had led to significant price increases in service provision as well as regulatory uncertainty.³ The concern about price increases under a monitoring regime was also echoed recently by the Independent Pricing and Regulatory Tribunal of New South Wales.⁴ However, the Essential Services Commission of Victoria commented that “a price monitoring regime may prove to be effective if it is well-specified, accompanied by a clear regulatory threat and applied in the appropriate circumstances”.⁵ These sentiments were also expressed by the Utility Regulators Forum in its submission to the SCO consultation paper in September 2005.

The Australian Government and state jurisdictions support the adoption of a light handed form of regulation as an additional regulatory option.

IMPLEMENTATION AND REVIEW

The MCE decision would be incorporated into the NGL, which is currently being developed as part of the gas legislative package. The MCE aims to release an exposure draft of this package by the end of February 2006 for stakeholder consultation.

It is expected that the new NGL will be introduced into the South Australian and Western Australian Parliaments in mid 2006. Application Acts will also be introduced into other jurisdictions' Parliaments. The NGL would then be proclaimed and come into force in all jurisdictions on 1 January 2007.

Under the new gas legislative package it is proposed to give the AEMC the same powers to conduct reviews in relation to gas on the direction of the MCE as it currently has in relation to electricity. The MCE would then be able to direct the AEMC to conduct a review which may include assessing the effectiveness of the

¹ Energy Users Association of Australia, Final Submission – Review of the National Gas Pipelines Access Regime: response to the SCO Consultation Paper, September 2005, p11

² Major Energy Consumers, Response to the Consultation Paper, September 2005, p14

³ Australian Competition and Consumer Commission, Submission to the Productivity Commission Draft Report: Review of the Gas Access Regime, 17 March 2005, pp36-37

⁴ Independent Pricing and Regulatory Tribunal of New South Wales, Submission to Consultation Paper on the Productivity Commission's recommendations for the gas access regime, 9 September 2005, p3

⁵ Essential Services Commission, Submission to the Draft Report of the Productivity Commission Review of the Gas Access Regime, 7 April 2004, p22

change to the coverage criteria and the National Gas Law more broadly. The AEMC would report its findings and recommendations to the MCE, which would decide whether changes to the coverage criteria or the broader National Gas Law would be appropriate.

CONCLUSION

Maintaining the current binary regulatory arrangement of either full price regulation or complete deregulation would continue to generate a sub-optimal level of efficiency. In addition, the PC found that the current regulatory regime with access arrangements and reference tariffs has the potential to truncate investment returns and may therefore be discouraging investment in pipelines. This option is therefore contrary to the MCE's objective of facilitating the penetration of natural gas and does not address the PC's recommendations.

Considering the costs and benefits set out above, it is recommended that the MCE endorse option 2, being the introduction of a 'light handed' form of regulation as an additional alternative to formal price control. A 'light handed' form of regulation would contribute greatly toward achieving the objective of ensuring that where regulation is applied, it is applied efficiently and that the form, scale and costs of regulation are appropriate / proportionate for the degree of market power present. At the same time, the Gas Access Regime would continue to protect gas users from the misuse of market power, given that service providers would be subject to monitoring and the credible threat of being moved to full price regulation with reference tariffs.

Of the two options outlined, it is recommended that the MCE endorse option 2 (b) - the Alternative Model.

Option 2 (a) – the PC Model – was generally supported by the pipeline industry and is in line with achieving the stated objective. However, there is room to further improve the model and therefore option 2 (b) – the Alternative Model, which has built upon the PC model and incorporated a number of improvements, has been deemed to be the preferred option.

Option 2 (b) – the Alternative Model – is recommended because it combines the favourable elements of the PC Model with amendments to help ensure that the most efficient form of regulation is adopted. The Alternative Model charges the AEMC with determining the form of regulation to apply and carrying out the net benefits assessment as part of the process. The additional benefit of this model is that the AEMC would have available to it, through the AER, more comprehensive information about a pipeline's circumstances than the NCC. At the same time, the AEMC would be likely to be more impartial than the regulator in deciding upon the form of regulation to apply. Therefore, by having the AEMC rather than the NCC/Minister or the AER making the decision on the form of regulation, this model would provide greater certainty that the most efficient form of regulation is adopted. Furthermore, this model preserves the separation between the body recommending the form of regulation and the body administering the regulation. This is in line with the improved governance arrangements as recommended by the PC.