



Submission

Ministerial Council on Energy
Standing Committee of Officials

Response to MCE Consultation on the Gas Access Regime Review

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EXECUTIVE SUMMARY

The EUAA welcomes the opportunity to make a submission to the Ministerial Council on Energy (MCE) on the important matter of decision-making on the recommendations of the Productivity Commission's (PC) report on the national gas access Code. This is an important issue for the further development of the gas market in Australia and to the interests of both gas and electricity users.

In summary:

1. EUAA supports insertion of the objects clause as expressed by MCE focusing on the *long term interests of consumers of gas*
2. EUAA does not support the coverage test proposed by the MCE paper
3. EUAA supports introduction of light-handed regulation and enhancing regulatory certainty but not in the manner proposed
4. EUAA supports development of a national approach and harmonisation of gas and electricity regulation and the formation of an expert panel to consider this.

In regard to items 2 and 3 above, EUAA believes that:

- Coverage should be broadened to include all material pipelines, judged on the basis of size alone. This is justified by the introduction of a light-handed option for covered pipelines. The narrowing of coverage proposed by the PC and accepted by MCE would be contrary to the long-term interests of gas consumers.
- In the light-handed option tariffs must be published rather than simply subject to negotiation. This will enable gas users and regulators to judge the pipelines' proposed prices before the option is granted and would work for the benefit of both gas and electricity users.
- The pricing holiday option for greenfields pipelines should be the same as the light-handed option. It would enable pipelines to be guaranteed *up to* fifteen years on the light-handed option, subject to pre-commitment on access pricing.

EUAA would not support the introduction of a light-handed option or the pricing holiday option if coverage did not apply to all material pipelines.

EUAA believes that the above principles are essential for the continued development of a competitive gas market and would have flow on benefits to electricity markets and electricity users. Without access to all material components of the pipeline network under consistent terms and pricing, gas trading cannot develop further. This will stifle the further development of the gas market and gas fired generation. The principles will create a greater balance between pipeline owner interests and those of gas producers and users, particularly in regard to investment in new plant. These factors have the potential to significantly impact on the electricity market by enhancing the flexibility and reducing the costs of gas fired generators.

1 INTRODUCTION

Ministerial Council on Energy (MCE) officials have released for consultation a proposed MCE response¹ to the Productivity Commission's Review of the National Gas Pipelines Access Regime. The response follows an earlier round of consultation in August/September 2005 in regard to the Final Report of the Productivity Commission (PC) Inquiry entitled *Review of the Gas Access Regime* (PC Review), published on 11 June 2004.

The Energy Users Association of Australia (EUAA) is pleased to submit its views on the MCE proposal.

This submission addresses only the five matters covered in the proposed MCE response:

- Insertion of an objects clause for the regime
- Coverage test and administration
- Introduction of a light-handed form of regulation
- Enhancing regulatory certainty for greenfields projects
- Development of a national approach to energy access

This submission provides a response to the MCE consultation paper and to some of the comments made at the forum on the paper held in Sydney on 23rd November. EUAA members have been consulted in preparing this submission and it reflects the views of our members who, in the main, are large users of energy throughout Australia.

EUAA's views on other issues raised by the PC are covered in our September 2005 submission and the MCE should also consider these in the context of this submission.

It is also worth repeating our view that the PC report, whilst clearly supporting a continuation of coverage, also made recommendations that would see coverage unwound to some extent. We believe that the PC erred fundamentally in its rather too negative assessment of the current access regime's impact on investment in pipelines. It based this view largely on one-sided information provided by the pipeline industry (hardly an impartial player in this space) and a philosophical conviction that regulation is 'bad'. Our own assessment is that there is nothing to suggest that the gas access code has hindered investment. On the contrary, the period in which the Code has existed has seen one of the most significant transformations in the history of the gas industry and the building of significant new pipelines. Gas and electricity users have benefited accordingly. The importance of this should not be lost on the MCE in its decision-making on this matter.

¹ Review of the National Gas Pipelines Access Regime. Proposal for Consultation, MCE, November 2005.

2 COMMENTS ON MCE'S PROPOSALS

2.1 INSERTION OF AN OBJECTS CLAUSE FOR THE REGIME

2.1.1 MCE Proposal

In view of the MCE's objective of promoting a seamless approach to energy access across the energy sector, it has decided that an objects clause mirroring that already contained in the NEL for the electricity sector would be appropriate for gas:

"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".

2.1.2 EUAA Comments

The EUAA supports the inclusion of an objects clause in the new gas access regime and strongly supports the specific reference to the interests of end-users and to the price, quality, reliability, safety and security of supply factors that end-users consider important.

EUAA nevertheless finds the MCE's comment on page 8 that "competition is only a means to an end rather than an end in itself" somewhat alarming in the context of the gas access regime, the purpose of access being that it would facilitate competition in upstream or downstream markets, which would enhance efficiency. Having an access regime that does not focus on competition may prove to be a barrier to achieving a more competitive gas market.

It is also not clear why the MCE should hold this view about gas when, in the electricity sector, the competitive market paradigm is well accepted and participation in the NEM is compulsory for generators, as well as transmission and distribution networks.

The EUAA noted comments made by various supply side players at the forum on the MCE Consultation Paper to the effect that the inclusion of words recognizing the long term interests of consumers of natural gas would not be consistent with the objectives currently specified in the national third party access regime under Part IIIA of the *Trade Practices Act, 1974*. This refers to the need to promote competition in upstream and downstream markets. We do not agree with their position.

In fact, it should be clear that the *promotion of 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*, as outlined in the proposed objects clause, does not preclude the consideration of upstream and downstream interests. Given that the proposed clause specifically refers to *efficient investment* and *efficient*

operations of gas pipelines, it would be odd if this were not considered in any decisions where the proposed objects clause was a factor.

Moreover, there are distinct advantages in having the objects clause in gas closely match that in electricity, eg the desire of the MCE to see greater convergence between gas and electricity, and the need to put in place policy settings that support the MCE's desire to optimize competitive and national policy reform in both sectors. To set an objects clause in gas which is different to, or narrower than, that applied in electricity would be contrary to the fundamental objectives of the MCE energy reform process.

It is also relevant that the National Electricity Law includes an access regime and the objects clause therein is not considered to hinder the consideration of matters relevant to an efficient access regime. Why should it be any different in gas?

The MCE has also stated its desire to include other gas market matters in the new National Gas Law and is proceeding with work on the development of the gas wholesale market. It would be advantageous to establish an objects clause now that could fit within this broader context. The current proposal does that.

2.2 COVERAGE TEST AND ADMINISTRATION

2.2.1 MCE Proposal

MCE supports the PC recommendation that the gas pipeline coverage criterion should be amended so that only those pipelines, for which coverage would generate a material increase in competition in related markets, would be covered. MCE notes that this will align the coverage test with Part IIIA of the *Trade Practices Act 1974*.

MCE also notes that the existence of a formal test for coverage is a point of difference between electricity and gas, in that Governments have adopted a policy position that electricity transmission assets should be regulated.

2.2.2 EUAA Comments

Coverage is the most critical issue in relation to the gas access regime and its assessment raises significant difficulties. The key problem is that non-coverage can mean any one of number of different outcomes, namely:

1. No access for third parties
2. Access for third parties only on negotiated terms
3. Access for third parties on terms published by the pipeline operator

Coverage is judged prior to the outcome being known, particularly in the case of greenfields pipelines, and it is quite feasible that non-access to a material pipeline could result from a coverage decision.

EUAA believes that non-access to material pipelines would significantly weaken development of a competitive gas market and would not be in the best interests of gas users, since it would restrict trading through that pipeline.

This could be particularly damaging to the prospects of gas-fired generation, which relies upon flexibility of gas supply for its ability to meet peak and intermediate load. Gas-fired generation is critical to meeting increasingly peaky electricity demand and barriers to investment in it will have costly flow ons to the economy.

Barriers to gas market development would be contrary to MCE's desire to stimulate development of a competitive gas market. It is also contrary to the directions taken in the NEL, under which all significant generators, transmission networks and distribution networks are registered participants in the NEM and access to wires is therefore guaranteed.

It is also difficult to imagine how non-access could lead to satisfaction of the objects clause, i.e. how potential users could gain any benefit from non-access. As the coverage test will prevail over the objects clause in determining coverage, the coverage test should be changed.

In view of the MCE proposals to introduce a light-handed form of regulation, which will enable covered pipelines to avoid price regulation while remaining covered, EUAA believes that all pipelines other than minor pipelines, for which the costs of developing an Access Arrangement cannot be justified, should be covered. A market power test should then be used to determine whether material pipelines should be price regulated or subject to light-handed regulation, as discussed below.

2.3 INTRODUCTION OF A LIGHT-HANDED FORM OF REGULATION

2.3.1 MCE Proposal

MCE proposes to introduce a light handed regime in which the owner of a covered pipeline would be free to negotiate prices, and terms and conditions of access with access seekers, while other measures such as ring fencing would continue to apply. Disclosure of information would be tailored to ensure that compliance costs are minimised.

2.3.2 Comments

2.3.2.1 Determining the form of regulation for covered pipelines

The current regime is essentially a two tiered structure: a pipeline is either covered, and subject to all the provisions of the regime; or uncovered, and not subject to the regime other than the threat of coverage. The PC introduced the concept of a three tiered structure in which the middle tier is a "light-handed" option, which subjects pipelines to (some) non-price provisions of the regime and to price monitoring instead of price regulation, which currently applies to all covered pipelines.

MCE has opted for a version of this structure in which the coverage test is applied to all pipelines and covered pipelines can be price monitored or price regulated. The AEMC would determine coverage and the AER would make the decision as to the form of price “control” applied to covered pipelines, subject to criteria to be developed by the AEMC.

As noted above, since covered pipelines are offered the two choices of price “control”, EUAA believes that all pipelines should be covered, other than minor pipelines for which the costs of developing an Access Arrangement cannot be justified. For covered pipelines we believe that the AEMC, rather than the AER, should determine whether pipelines should be price regulated or subject to light-handed regulation, using a test based on the market power of the pipeline. This structure would represent an appropriate separation of powers, taking the price regulation option decision away from the regulator.

This envisages a two stage regulatory process for a new covered pipeline:

1. The AEMC determines whether the pipeline should be price regulated or subject to light-handed regulation, unless the pipeline opts for price regulation
2. The pipeline submits an access arrangement to the AER for approval under whichever regulatory option is determined by AEMC.

A covered pipeline’s status at the end of the term of the access arrangement would remain unchanged unless appealed by the pipeline or users. This would also apply to any existing covered pipeline.

EUAA would not support the introduction of a light-handed option if coverage did not apply to all material pipelines.

2.3.2.2 Structure of the light-handed regulation option

EUAA believes that the MCE’s light-handed proposal would, from a user’s perspective, be indistinguishable from non-coverage, because all pricing would be negotiated. The light handed regime should instead look more similar to the price regulated regime, in that reference tariffs should be offered, i.e. negotiation should not be the only option, and terms and conditions should be published and subject to regulatory approval along with other non-price elements. Access arrangements under both regulatory options would then be very similar but, under the light-handed option, access arrangement information would be much reduced and the AER would not be approving the reference tariffs.

Under this structure it would be sensible for new covered pipelines to submit their reference tariff proposals to the AEMC, as knowledge of the proposed tariffs would greatly simplify and expedite the AEMC’s decision process compared to the alternative of determining a pipeline’s market power. Tariff submissions to the AEMC could be made obligatory or remain optional.

It is noted that some uncovered pipelines, such as the Eastern Gas Pipeline, currently publish tariffs and terms and conditions and we therefore do not believe that the above proposal would be unduly restrictive on pipelines.

Information disclosure in the access arrangement information of a pipeline subject to light-handed regulation needs to be such as to enable the AER to make reasonable estimates of the tariffs that would apply if the pipeline were price regulated, and thereby monitor the market power being exercised by the pipeline under this pricing option. The MCE information disclosure proposal does not appear to have this objective.

EUAA therefore does not support the MCE proposal as drafted and supports a modification to deal with our concerns noted above. This would involve:

- The use of published reference tariffs;
- Published terms and conditions subject to regulatory approval; and
- Information disclosure such as to enable the AER (or users) to monitor any market power.

2.4 ENHANCING REGULATORY CERTAINTY FOR GREENFIELDS PROJECTS

2.4.1 MCE Proposal

MCE proposes to introduce two measures to create greater certainty of regulatory outcome for greenfields pipelines, with a view to enhancing the pipeline investment climate:

Measure 1: Binding no coverage ruling

This will enable pipeline proponents to apply to the AEMC for an upfront coverage assessment, leading to a binding 15 year no coverage ruling if the AEMC recommends that the pipeline does not meet coverage criteria.

Measure 2: Price regulation holiday

This will enable pipeline proponents to apply to the relevant Minister for a 15 year price regulation holiday without seeking a coverage assessment. If a price regulation holiday is granted, the pipeline would submit an access arrangement covering non-price terms to the AER for approval. The criteria applying to the Minister's decision do not refer to the market power of the pipeline or to any proposed pricing schedule.

2.4.2 EUAA Comments

EUAA supports measures to create greater certainty for pipeline investors, including commitment to long-term pricing arrangements. However, both of the MCE proposals as drafted contain serious flaws.

Binding no-coverage would have our support if the coverage proposal itself were supportable. As noted above, EUAA considers that the proposed coverage test will allow too many pipelines to remain uncovered. It appears quite feasible that a material pipeline could obtain a binding no coverage ruling for 15 years and subsequently be purchased by

another entity owning competing pipelines, in whose hands the acquired pipeline has significantly greater market power, which would justify full price regulation. It may be argued that the change of ownership would be prevented by application of the TPA, but this is not guaranteed.

This reaffirms our view that no-coverage should apply only to minor pipelines and would support *binding no coverage* for such pipelines.

EUAA would not support the introduction of a *binding no coverage* option if the PC's coverage test were adopted.

EUAA concerns with the MCE *price regulation holiday* proposal are:

- The criteria for approval are not sufficiently specific. A price regulation holiday can only be justified if the pipeline has very limited market power or if it is prepared to commit to a long term (maximum) price schedule, the reasonableness of which could be assessed by the Minister. Long-term price commitments are essential to user certainty and confidence in making new investments that underpin economic prosperity, a factor of equal importance to pipeline owner/investor certainty, though this was evidently not apparent to the PC.
- The access arrangement submitted should match that required under the light-handed regulation model, i.e. the price regulation holiday would be equivalent to guaranteed application of the light-handed model for up to 15 years.
- The MCE proposal seems to imply that, barring a coverage decision in the interim, at the end of a price regulation holiday a pipeline would (continue to) be uncovered. Continuing non-coverage does not seem consistent with the pipeline previously having had to submit an access arrangement.
- There is an apparent inflexibility about the 15 year period which could prevent periods of different length being used in appropriate circumstances. Experience with pipelines in Queensland, where derogations from pricing regulation have been provided bears out the undesirability of having fixed and inflexible periods. Moreover, this has worked both to the advantage and disadvantage of pipelines. This point needs to be clarified and some flexibility allowed for.

EUAA would therefore support the price regulation holiday option as an extension of the light handed model with two additional features. First, that provision of proposed reference tariffs to the AEMC would be obligatory in this case. In addition, in view of the near inevitability of change over a 15 year period, principles specifying when and how tariffs and terms and conditions would change must be submitted for approval by AEMC. The process of change, if required, would be administered by the AER.

The rules applicable at the end of the holiday period would be as for any pipeline on the light handed model at the end of an access arrangement period, i.e. it would remain on the light-handed model for another access arrangement period (of five years) unless appealed.

We believe that combining the price regulation holiday and light-handed options also has the merit of reducing the unnecessary multiplication of regulatory options and the resulting additional complexity in the National Gas Law. Both options would also be decided by the same body (AEMC), ensuring decision-making consistency and eliminating the prospect of regulator shopping, which could occur under the MCE proposal. As with the light-handed option, provision of reference tariffs (obligatory in this case) would simplify and expedite the AEMC's decision process on the price regulation holiday.

The provision of the price-regulation holiday should enhance the prospects of investment in new pipelines, thereby increasing competition between producers and benefiting users, including gas-fired generators, which are expected to make up a significant proportion of growth in gas usage.

EUAA would not support the introduction of a price regulation holiday if coverage did not apply to all material pipelines.

2.4.3 Application to the PNG Pipeline

The proponents of the PNG Pipeline have said that they require financial closure by June 2006 and that certainty about the regulatory arrangements for the pipeline are critical to this. They have therefore expressed a strong preference for a 15-year price holiday, whilst retaining coverage for all other aspects of the pipeline's regulatory structure.

EUAA believes that the price regulation holiday option outlined above would provide a suitable framework for progressing the PNG Pipeline, whilst providing reasonable protection for gas users (end users and gas generators). In particular, a decision regarding the price regulation holiday would be based on a sound long-term regulatory model. However, the fact that a new National Gas Law containing this option does not exist and may not be brought into being before June 2006 creates some timing issues for the proposed PNG gas pipeline.

The PNG project is a large and significant one with the potential to have a major impact on gas and electricity markets in Australia. Users (gas and electricity) could derive significant and sustained benefits from the project. However, this would only occur if the project is delivered in such a way as to maximise competitive prices and supply of gas into eastern and southern Australia. Generally speaking, users are very keen to see the project proceed, but only on such a basis.

While we remain uncertain about the ultimate significance to the project of any delay in financial closure due to an absence of regulatory certainty, the project could merit consideration of interim changes to the existing Third Party Access Code to implement the price regulation holiday option as expeditiously as possible if it could be shown conclusively by the proponents that the project would be materially threatened by any such delay. The similarity of the option proposed by EUAA to the existing price regulation model, apart from price regulation itself, would facilitate and presumably simplify interim arrangements.

2.5 DEVELOPMENT OF A NATIONAL APPROACH TO ENERGY ACCESS

2.5.1 MCE Proposal

The MCE recognises that further harmonisation of the regulatory framework in the energy sector is required to reduce potential regulatory distortions of investment and to reduce compliance costs of participants in both competitive and regulated sectors. The MCE proposes to commission a “panel of experts” to provide advice on the issues that need to be addressed and the steps to be taken. The panel will release an issues paper for consultation with interested parties.

2.5.2 EUAA Comments

EUAA supports harmonisation of the regulatory framework between gas and electricity as far as possible and believe that this will benefit users of both gas and electricity. We also support the commissioning of the panel of experts as proposed by the MCE if it can assist in delivering this.

However, we note that some of the MCE’s own proposals for the gas access regime, such as the coverage proposal, appear to present barriers to harmonisation and gas market development.

The key difference between electricity and gas markets and regulation in the eastern states is that:

- In electricity there is the NEM, which defines how generators are dispatched and how the transmission network is operated. All material generators and transmission/distribution networks participate in the NEM, i.e. access to the network is guaranteed by the NEL.
- In gas there is just access to pipelines. Retailers and generators purchase gas from producers (currently under long-term contracts) and transport it to customers through the pipeline network. Pipelines are operated as independent entities and gas scheduling is determined largely by retailers subject to the pipeline balancing rules (and a spot market in Victoria).

The MCE is concerned about aspects of the gas market, such as its lack of transparency, and has initiated a gas market development program. A Gas Market Leaders Group is being formed to produce a gas market development plan. It is not completely clear to us that there is no overlap between the expert panel and the Gas Market Leaders Group or how their work will be integrated and apportioned.

EUAA believes that, short of imposing a NEM-like structure on the gas industry, which would be unpopular in many sectors, all development options will be critically dependent upon improved access to the pipeline network, including:

- Coverage of all physically material pipelines

- Greater consistency of terms and conditions of access and pipeline operations
- A wider range of flexible services, such as backhaul, interruptible services and non-firm gas (which could be beneficial to gas fired generators and the electricity market), under predictable pricing

It is noted that access regulation has been used pro-actively to direct market evolution in countries such as the US, Canada and Europe. By identifying specific economic and technical barriers to competition in upstream and downstream markets, presented by conditions of access, and removing the barriers as they arise over time, governments and regulators have further stimulated competition at all levels.

EUAA trusts that the expert panel will recognise these requirements and make the appropriate recommendations.