

SUBMISSION

REGARDING
the
EXPOSURE DRAFT

of the

NATIONAL GAS LAW
and
NATIONAL GAS RULES

made by:

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Introduction and Purpose of Document

This document seeks to provide comment on selected aspects of the Exposure Draft of the National Gas Law ("NGL"), the associated National Gas Rules ("NGR"), and related documentation.

Such comment is in response to the invitation extended by the Ministerial Council on Energy ("MCE") in its Energy Market Reform Bulletins No. 71 of 7 November 2006 and No. 74 of 22 November 2006.

This submission does not set out to provide a comprehensive review of the NGL and NGR. Rather, it seeks to address selected, salient, aspects of the proposed new regulatory regime.

'First Cut' Evaluation: Selected Aspects of the NGL and NGR

The following discussion considers the NGL and NGR both in their own right, and in the context of the regulatory regime they replace - the Gas Pipelines Access Law ("GPAL") which incorporates the National Third Party Access Code for Natural Gas Pipeline Systems ("the Gas Code").

New Aspects of the Gas Pipeline Regulatory Regime

The introduction of Light Regulation and Greenfields Pipeline Incentives provide, at a high level, a broader regulatory framework which has the potential to better accommodate the diverse circumstances applying to gas transmission pipelines and distribution systems.

However, the oft repeated phrase "the devil is in the detail" is applicable. The discussion which follows offers further comment on this observation.

The establishment of the NGL / NGR as part of a national economic regulatory framework covering gas and electricity transmission and distribution may, in the future, result in the expansion of government bodies performing economic regulatory functions.

In particular, the establishment of the Australian Energy Market Commission ("AEMC") creates a new entity established in its own right. As such, it has the potential to duplicate support functions, leading to an increase in the cost of the regulatory machinery dealing with natural gas transport infrastructure.

NGL Objects Clause

The NGL Objects Clause states (emphasis added):

The objective of this Law is to promote *efficient investment* in, and efficient operation and use of, natural gas services for the *long term interests of*

consumers of natural gas with respect to price, quality, safety, reliability and security of supply of natural gas.

Under this statement, the interests of gas producers, gas transport aggregators, and pipeline owners / operators have been subordinated to the interests of "consumers".

The criterion of "economic efficiency" is cited in many places throughout the NGL and NGR.

"Economic efficiency" requires that an equilibrium balance be achieved between supply and demand. The Objects Clause explicitly requires the distortion of such balance.

Thus, it is apparent that the Objects Clause is inconsistent with the objective of "economic efficiency". Further, the Objects Clause is internally inconsistent, as the objective of "efficient investment" and concern for solely the "long term interests of consumers" are in fundamental conflict.

The Objects Clause provides overarching guidance to the interpretation of the NGL and NGR. As the Objects Clause is internally inconsistent, it follows that the parts of the NGL and NGR which are guided by the Objects Clause will be correspondingly impacted.

Regulatory Impact Statements state the intent of regulatory policy. As such, they should be considered in any evaluation of the NGL / NGR.

The Regulatory Impact Statements addressing the NGL and NGR make many references to the need for balance between supply and demand. Thus, it may be seen that the implementation of the NGL (as distinct from its policy foundation) does not reflect the intent of the former.

Consequently, the Objects Clause should be revised to either promote a balance between supply and demand (and the interests of all stakeholders), or the criterion of "economic efficiency" cited throughout the NGL and NGR should be replaced with the requirement to promote (only) the "long term interests of consumers".

Pricing Principles

The pricing principles (as distinct from prescriptions of specific implementation) contained in the NGL are substantially different from those contained in the Gas Code, and are now stated in considerably more general terms. Comparison of NGL s.21 and Gas Code ss.2.24 and 8.1 illustrates this point.

The NGL provides for a service provider to recover "at least" its "efficient costs". This is a substantial departure from the Gas Code, which permits only "efficient" costs to be recovered. However, the 'mechanics' of price setting as

prescribed in the NGR bear a strong similarity to those contained in the Gas Code.

When dealing with regulated revenue, the NGR employs the criterion "lowest sustainable cost" in several contexts. Such a criterion is inconsistent with the NGL's overarching provision to permit recovery of "at least" the Service Provider's "efficient costs".

As such, the price setting provisions of the NGL / NGR are internally inconsistent.

The Regulatory Impact Statements level considerable criticism at the pricing provisions in the Gas Code. However, the mechanics of price setting as mandated in the NGR (as distinct from the high level principles) are remarkably similar to those contained in the Gas Code.

As such, the NGL / NGR do not address the problems with the Gas Code identified by the proponents of the NGL.

Consequently, the NGR require substantial revision to make them compatible with the high level pricing principles articulated in the NGL.

Light Regulation

The specific requirements of Light Regulation, while less onerous than 'full' regulation under either the Gas Code or the NGL, are nevertheless more heavy handed than what may be deemed necessary.

As such, a welcome policy initiative has been diluted by the nature and form of its implementation.

Greenfields Pipeline Incentives

A Greenfields Pipeline may receive a 15 year regulation exemption if it does not meet the 'standard' coverage criteria, which in turn must be considered in the context of the Objects Clause. In other words, a Greenfields Pipeline can not receive a 15 year regulation exemption if it satisfies the coverage criteria.

It is evident that the 15 year regulation exemption for Greenfields Pipelines is by no means assured. This uncertainty may be seen as yet another government approval hurdle, as pipeliners are likely to place their plans for new pipelines on hold during the assessment of Greenfields Pipeline Incentives applications.

Greenfields Pipelines which are potentially of most benefit to society are most likely to satisfy the coverage tests. Thus, it is likely that Greenfields Pipeline Incentives will apply only to minor pipelines.

Consequently, it is likely that a welcome policy initiative which has the potential to benefits pipeline owners / operators and pipeline users alike will be rendered ineffective due to the manner of its implementation.

Competitive Tender

Pipelines subject to the Competitive Tender process become covered if the Competitive Tender process is provisionally approved in the first instance but this approval is subsequently revoked. Further, the duration of the 'tendered' access terms and conditions (as opposed to those mandated by a Regulator in a 'standard' Access Arrangement) is uncertain (as it is prescribed by the Regulator at its discretion).

Such arbitrary coverage and uncertain tenure of 'tendered' access terms and conditions may be seen to make participation in the Competitive Tender process unattractive to pipeliners.

Such constraint is contrary to the objective of encouraging investment.

Further, automatic coverage of pipelines the subject of the designated Competitive Tender process is contrary to the NGL's coverage criteria. As such, the NGL is internally inconsistent.

Associate Contracts

In dealing with Associate Contracts, the NGL specifies a potentially open ended definition of "Associate" (i.e. a definition which extends beyond that published in the Corporations Law, and which could feasibly encompass any "person"). The definition of "Associate" is provided in the Regulations, which have yet to be released and which may be easily changed.

The widening of the definition of "Associate" may be seen to lead to uncertainty constituting considerable regulatory risk.

Merits Review

The winding back of merits review provisions under the NGL may be seen as compromising procedural fairness.

In turn, this increases regulatory risk.

Information Gathering

Under the NGL, regulators' information collecting powers have been considerably increased. Regulators have unrestricted powers to obtain information from "any person".

The substantial increase in Regulators' information gathering powers is likely to result in unnecessary additional load on pipeliners and other stakeholders. Regulators may seek information purely because they have the right to do so. As such, 'fishing expeditions' into the business affairs of pipeliners, producers, shippers, end users, and other stakeholders are made possible.

The weakening of protection of confidential information has consequences for pipeliners and other stakeholders alike.

Ring Fencing

Under the NGL's Ring Fencing provisions, Regulators are empowered to oversee and prescribe the nature and form of many of the business processes employed by Service Providers. The potential extent of such intrusion is effectively unlimited.

Under Ring Fencing provisions, Regulators are also empowered to make public the business processes employed by Service Providers.

The provision permitting Regulators to prescribe and oversee pipeliners' business processes is unwarranted and unnecessarily intrusive. The function of a regulator is to prevent the unreasonable exercise of monopoly power, and not to participate in the day to day running of a private sector enterprise.

Under the NGL, the definition of Marketing Staff has been substantially widened compared to that contained in the Gas Code. This widening is unnecessary and likely to increase the regulatory burden on Service Providers. Such cost may ultimately be passed on to "consumers".

Summary Conclusions

- At a high level, the NGL / NGR may be seen in a positive light.

Light Regulation and Greenfields Pipeline Incentives are additions which might be viewed favourably by pipeliners and pipeline users alike.

The addition of the criterion "at least" to permitted cost recovery by Service Providers may (in itself) promote investment in pipeline infrastructure.

The requirement that increases in competition be "material" under the new pipeline coverage criteria similarly has the potential to avoid unnecessary regulation and its associated burden.

- However, the oft repeated phrase "the devil is in the detail" applies strongly to the NGL / NGR.

- The NGL / NGR incorporate a number of internal inconsistencies, resulting in a flawed (new) regulatory framework.
- The Light Regulation regulatory regime, while less prescriptive than regulation under the Gas Code, is nevertheless more heavy handed than that recommended by the Productivity Commission.
- "Incentives" for Greenfields Pipelines are likely to apply only to minor pipelines, as major new pipelines are likely to satisfy the coverage criteria.
- The increase in Regulators' information gathering powers impacts both pipeliners and other stakeholders, including producers, shippers, and end users. These powers provide the potential for unwarranted and disruptive intrusion.
- Regulators' powers to prescribe Service Providers' business processes and to make these business processes public are potentially inefficient and may potentially deprive Service Providers' of unique competitive advantage against other pipelines and alternative forms of energy.
- The discretion bestowed on regulators has increased, meaning that regulatory decisions may become more unpredictable.
- Regulatory uncertainty has not been reduced, but rather potentially increased.
- The resulting impact on investment has yet to be seen.

It is likely that the situation facing pipeliners and users of pipeline services will not change under the NGL. As such:

- Load growth will result in all Australian pipelines becoming 'full' (i.e. operating at maximum capacity) if they are not already so. In Western Australia, both major pipelines - the Dampier to Bunbury Natural Gas Pipeline and the Goldfields Gas Pipeline - are 'full'.
- New pipelines will be constructed with capacities optimised to match foundation contracts (only). Similarly, expansions of existing pipelines will match pre-existing demand (only). Thus, new capacity (however provided) will be fully committed at the time of its initial operation.

Such sizing is socially inefficient. As a case in point, if capital expenditure is increased by 10 percent in order to over-size the diameter of pipeline, that pipeline's capacity is increased by over 25

percent. Correspondingly, a 20 percent increase in capital cost results in a capacity increase of over 55 percent¹.

- Pipeliners can not be required to fund new pipeline capacity.
- Pipeliners are unlikely to fund new capacity themselves (directly or indirectly) if they consider they will not receive an adequate return on investment.
- Consequently, new pipeline capacity will be funded (directly or indirectly) by those seeking to access new pipeline capacity.
- Up-front capital contributions incur the cost of capital faced by the prospective pipeline user.
- A 'rational' pipeliner would install new capacity at its own cost only if it could achieve at least its minimum required rate of return through the application of the required pipeline transport tariff. Correspondingly, a 'rational' prospective user would pay such a tariff if the pipeliner's rate of return was lower than the cost of capital of the prospective pipeline user.
- The result of this situation is that pipeline capacity would be in continual short supply.

Pipeliners would not build additional capacity in anticipation of new demand, but rather would wait for that demand to materialise. Then, such new demand would, if satisfied, deliver returns to the pipeliner at a cost of capital equal to or greater than the pipeliner's minimum required rate of return, and not at a lower regulatory rate of return.

In other words, new demand would remain unsatisfied unless seekers of capacity were willing to fully fund expansions either directly or indirectly.

- It may be seen that for 'full' pipelines, economic regulation which does not allow adequate returns to pipeliners can have the effect of inhibiting, rather than promoting, the interests of prospective pipeline users. In turn, the "long term interests of consumers" are compromised.

If the economic regulatory environment fails to deliver adequate returns to pipeliners in the future, the above situation is likely to endure.

¹ For relatively small increments of pipeline diameter, construction costs increase roughly linearly, but pipeline capacity increases according to a 2.5 power law.