



13th September 2005

Manager – Energy Market Reform Team  
National Energy Market Branch  
Dept. of Industry, Tourism and Resources  
GPO Box 9839  
CANBERRA ACT 2601

REF: DW0175

To : The Manager – Energy Market Reform Team

GasNet welcomes the opportunity to comment on the “Consultation Paper – Review of the National Gas Access Regime” released by the Senior Committee of Officials.

Our comments on the Paper are provided in the attached submission. GasNet also endorses the submission made by the Australian Pipeline Industry Association, which provides a more detailed explanation of the views of the gas transmission pipeline industry.

If you have any questions our submission, please contact me at your convenience.

Yours sincerely,

A handwritten signature in cursive script that reads "David Whitelaw".

**David Whitelaw**  
**Regulatory Manager**

GasNet Australia (Operations) Pty Ltd © ABN 65 083 009 278 © 180 Greens Rd, Dandenong Vic 3175  
ph: +61 3 9797 5222 © fax: +61 3 9797 5295 © web: [www.gasnet.com.au](http://www.gasnet.com.au)



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**GasNet Australia Pty Ltd**

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**Submission to the Standing Committee of Officials of  
the Ministerial Council on Energy**

**GasNet Response to the SCO Consultation Paper on the  
Productivity Commission's Review of the Gas Access Regime**

**13<sup>TH</sup> SEPTEMBER 2005**

Prepared By David Whitelaw  
Regulatory Manager  
Phone: 03 9797 5186 Fax: 03 9797 5220  
Email: [dwhitelaw@gasnet.com.au](mailto:dwhitelaw@gasnet.com.au)

# **GasNet Submission on the MCE Response to the Productivity Commission Review of the Gas Access Regime**

## **1. Summary**

The Standing Committee of Officials (SCO) recently released a Consultation Paper on the proposed response by the Ministerial Council on Energy (MCE) to the Productivity Commission Review of the Gas Access Regime.

The proposed response comes more than a year after the release of the Productivity Commission Report, and more than two years after the initial referral to the Productivity Commission by the Federal Treasurer. GasNet is concerned that the principal response of the SCO is to defer consideration of the majority of the substantive recommendations of the Report, and to conduct a 'clean slate' review of access principles and common rules for both the gas and electricity industries.

GasNet believes the reform agenda is too important to allow further and unnecessary delays in the policy process. Investors in energy infrastructure are looking for certainty and stability in the regulatory framework, not for an open-ended 'clean-slate' review of the entire regime. The Productivity Commission Report is a substantial body of work that can and should be implemented immediately. To the extent that provisions of the revised Gas Access Regime are relevant to the electricity industry, the Productivity Commission recommendations can also form the template for the development of a national energy access regime.

## **2. Context – the Energy Reform Agenda**

In the December 2003 report to COAG, the MCE identified a number of key objectives for the energy reform program, including to:

- strengthen the quality, timeliness and national character of governance of the energy markets, to improve the climate for investment;
- streamline and improve the quality of economic regulation across energy markets, to lower the cost and complexity of regulation facing investors, enhance regulatory certainty and lower barriers to competition; and
- further increase the penetration of natural gas, to lower energy costs and improve energy services, particularly in regional Australia, and reduce greenhouse emissions.

A key theme of the reform program has been the need to provide certainty for investors, and to promote new investment in the pipeline network.

In a Supplementary Report in May 2004, the MCE identified a number of priority areas for further reform of the gas industry. In the area of gas regulation, the MCE made a commitment to consider and respond to the Productivity Commission Review of the Gas Access Regime.

The Productivity Commission Final Report appeared in June 2004, with some 54 recommendations aimed at achieving these objectives.

In GasNet's view, this Report represents the most authoritative and substantive body of work on regulation of the gas industry in Australia. GasNet, and the pipeline industry in general, have consistently supported the implementation of the Productivity Commission recommendations in their entirety, without any attempt to 'cherry pick' those recommendations which favour the industry.

### **3. The SCO Response**

The SCO Consultation Paper makes a brief response to a number of high level principles from the Productivity Commission Report, which are discussed later in this submission and in greater detail in the submission from the Australian Pipeline Industry Association. However, the Paper manifestly fails to deal with the bulk of the substantive issues raised by the Productivity Commission, despite the fact that 15 months has elapsed since the Report was issued. Instead, the Paper recommends a further delay whilst a new, 'clean-slate' approach to energy access is developed, with a common set of rules for both the gas and electricity industries.

How, when and by whom this review is to be conducted is not explained. Based on progress to date, it is reasonable to expect that it will take at least a further two years to formulate a new set of 'clean-slate' principles, to consult with stakeholders and to implement the final recommendations.

The SCO justify the deferral of the policy process by claiming that a consistent approach is required to the regulation of gas and electricity networks. Whilst this is a desirable outcome at a high level, the SCO Paper does not explain what level of consistency they believe is appropriate, nor why this justifies a substantial delay in the reform of the gas regulatory regime.

### **4. The Preferred Approach**

Rather than start again with a 'clean-slate', GasNet's preference is an evolutionary approach which builds on the good points of the existing regime, and makes the necessary improvements identified by the Productivity Commission.

In GasNet's opinion, the recommendations of the Productivity Commission Report provide a sound and well-thought-out approach to economic regulation of the gas industry. The argument for consistency with the electricity regime is both undefined, and does not take into account the differences between the gas and electricity industries, and certainly does not justify further delay to needed reform of the gas industry.

The gas and the electricity regulatory regimes have developed in substantially different directions, partly for historical reasons, and partly because of intrinsic differences in industry structure and dynamics. The goal of consistency in national regulation does not require that one regime be an exact duplicate of another regime. The gas and electricity industries are sufficiently different that this goal would be inefficient. To the extent consistency is desirable, it should be applied at a high policy level, such as in the legal framework, and in the degree of certainty that is provided to investors. However the

specifics of regulation should take into account the differences between the electricity and gas industries in terms of their structure, economics and market drivers.

Therefore the least-cost and most effective approach to regulatory reform is to adopt the recommendations of the Productivity Commission Report for the gas industry, and to put this into a broad legal framework which is consistent at the appropriate level with the electricity regulatory regime. The industry specific elements of the Electricity Access Regime can then be developed separately and concurrently.

GasNet's recommendation to the SCO is therefore to:

1. Respond fully and in detail on the merits of each recommendation from the Productivity Commission Report.
2. Agree the final regulatory principles for the gas industry based on the Productivity Commission recommendations, and immediately commence the process of building these recommendations into legislation.
3. Progress the development of the Electricity Access Regime concurrently, using the Productivity Commission Report as a guide to efficient regulation.

## **5. Comments on Specific Issues Raised in the SCO Paper**

### **5.1 Objects Clause**

The SCO accepts the principle that a single over-arching objects clause should replace the multiple objectives in the current Gas Code. However, the SCO has amended the objects clause recommended by the Productivity Commission, by adding an additional clause (shown in bold below). In a second option, the SCO proposes the same additional clause but omits the reference to promoting competition. This additional clause mirrors the objects clause used by the Essential Services Commission in Victoria.

*“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.**”*

The reason that it is desirable to introduce a single over-arching objects clause is that it provides clear and unambiguous guidance to the decision maker in situations where other principles in the Code are seen to be in conflict. The over-arching objective, in the opinion of the Productivity Commission, is economic efficiency. However the SCO, whilst endorsing the principle of a single objects clause, has in effect created a set of multiple objectives within one objects clause. This subverts the very intention of introducing a single over-arching objective.

If further objectives are to be added to the objects clause, then it would make sense to include other interests, such as those of upstream, transmission and distribution businesses.

GasNet endorses the objects clause recommended by the Productivity Commission.

## **5.2 Form of Regulation**

One of the key themes of the Productivity Commission Report was the need to reduce the cost and intrusiveness of regulation in markets where competition is emerging. They therefore recommended a more light-handed regulatory regime with the aim of minimising the need to resort to heavy-handed price setting regulation.

Under the Productivity Commission's recommendations, if (and only if) a pipeline was deemed to have sufficient market power to warrant coverage, then the pipeline would be subject to either a monitoring regime (for a period of 5 years), or a full access arrangement regime. The relevant decision maker would only recommend an access arrangement regime if the net benefits of such a regime were markedly greater than those obtained under a monitoring regime. This process would be reviewed at five yearly intervals.

The intent behind the Productivity Commission recommendations is clearly to raise the bar before full price-setting regulation is imposed. The SCO Paper instead proposes to retain full price-setting regulation on covered pipelines, but to impose a monitoring regime on (currently) un-covered pipelines. They argue that the option of price monitoring will make the coverage decision less likely.

The regulatory model in the SCO Paper lacks clarity as to the specific criteria which will guide the decision maker in choosing between no regulation, monitoring and full price-setting regulation. The argument that the option of price monitoring will make the coverage decision less likely is vague and not the result of any detailed analysis. Furthermore, there is no guidance on the principles that would guide the decision of applying either a monitoring regime or no regulation to an uncovered pipeline. The effect of this model is more likely to expand the reach of regulation, rather than to raise the regulatory bar.

GasNet therefore supports the recommendations of the Productivity Commission Report.

The SCO Paper also raises concerns about the likely effectiveness of the regulatory regime proposed by the Productivity Commission. However it is premature to reject the Productivity Commission recommendations on this basis, as these concerns do not appear to be informed by advice from the relevant authorities. There is also the option of amending the relevant legislation governing effective regulatory regimes if this proves to be an issue.

## **5.3 Greenfields Pipelines**

The SCO Paper supports the Productivity Commission recommendation of a regulation free period of 15 years for greenfields pipelines. For the reasons advanced in the Productivity Commission Report, GasNet strongly supports this recommendation.

However the SCO Paper raises caveats which limit the application of this regulation free period to those pipelines with a substantial speculative component to future cash flows. This is presumably because such pipelines have a greater incentive to increase flows, which will act to constrain the exercise of market power.

The SCO Paper does not define how this speculative component would be determined, and moreover any attempt to impose a rigid definition would risk arbitrary or inappropriate outcomes. For example, if the regulation-free period was restricted only to pipelines with significant spare capacity, then those pipelines which are sized to the demand would be

discriminated against. In GasNet's opinion, all greenfields pipelines have a degree of speculative capacity, since the bare pipe capacity can always be increased at relatively low cost by adding compression.

Therefore GasNet believes that the caveats suggested by the SCO Paper are an unnecessary complication, lack clarity, and create additional uncertainty for investors. Since the aim of a regulation-free period for greenfields pipelines is to increase investor confidence, the caveats raised by the SCO should not be introduced into regulatory policy.

There are a number of other issues raised by the SCO Paper on the practical application of the greenfields policy. This is an area where government and the industry should work together to define policy details which would promote new investment and increase investor certainty.

#### **5.4 High Level Issues**

The Gas Access Regime is founded on the principle that a regulated service provider puts forward an access arrangement for approval by the regulator. This allows for service offerings which are tailored to the circumstances of each pipeline. Within this framework it has been established by the Australian Competition Tribunal that a regulator may only reject a proposal if it is outside a reasonable or plausible range of acceptability. That is, it is not the role of the regulator to propose their own preferred option, but rather to reject only clearly unacceptable proposals.

This argument has been most relevantly applied to the determination of the rate of return. However, the SCO Paper proposes to over-turn this framework, and to allow a regulator to impose their own view of the appropriate rate of return.

The SCO Paper asserts that their proposal would lead to greater certainty and less dispute. However, the reality is that the current framework is both workable and justified on theoretical grounds.

There is growing theoretical support for the proposition that the costs of setting the WACC too low (deterring investment) are greater than the costs of setting the WACC too high.

For example, Lally in a submission to the NZ Commerce Commission<sup>1</sup> says:

*"Given that there is some uncertainty as to the correct parameter estimates, and that the consequences of judging excess profits to exist when they do not are more severe than the contrary error, my view is that one should choose a WACC value from the higher end of the distribution."*

*"These results reflect the model that is used and possible deficiencies in the process by which parameters are estimated. These points include the possibility that the CAPM does not fully describe expected returns, that the version used is inappropriate, and the possibility of error arising from the fact that the "market" portfolio in the CAPM is proxied by listed equity. In general these issues give rise to further uncertainties concerning the WACC, and therefore suggest selecting a WACC value from an even higher point in the probability distribution."*

Similarly, in their recent Draft Decision on Telstra<sup>2</sup>, the ACCC make use of a range argument. In C.6.2 of the Draft Decision (p. 76), the ACCC responds to the contention that

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<sup>1</sup> Prof. Lally M (2004) The Weighted Average Cost of Capital for gas pipeline businesses. School of Economics and Finance, Victoria Univ. of Wellington, 24 Nov. 2004

<sup>2</sup> Assessment of Telstra's ULLS and LSS monthly charge undertakings. Draft Decision Public Version August 2005

the costs associated with setting the WACC too high are small in comparison to the costs of setting the WACC too low, by saying:

*“It is true that there is some support for this proposition and the ACCC must take into account investment incentives when setting the WACC.”*

The ACCC goes on to employ a range argument, i.e., selecting a WACC from near the top of the reasonable range.

It has also been demonstrated that the range argument is workable in practice. The following recent decisions have been made by reviewing the plausible range of the WACC, and taking a value near the top of the range.

#### ERA Decisions (2005)

- Goldfields Gas Pipeline,
- Dampier-Bunbury Pipeline, and
- Alintagas Networks.

#### IPART Decisions (2004, 2005)

- NSW Electricity Distributor (2004)
- AGL Gas networks (2005)

#### NZ Commerce Commission

- Gas Control Enquiry: Final Report (2004)

#### ACCC (August 2005)

- Telstra Draft Decision

On this basis GasNet strongly recommends that the SCO accept the ‘propose-respond’ model which underlies the Gas Access Regime, and in particular accept that the rate of return proposed by a service provider must be accepted if it is within a reasonable range.