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29 November 2005

Mr John Polack
Ministerial Council on Energy (MCE) Secretariat
Department of Industry, Tourism and Resources
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Dear Mr Polack

**Submission by the National Competition Council to the Ministerial Council on
Energy on the proposed response to the Productivity Commission review of
National Gas Pipelines Access Regime**

Thank you for the opportunity to comment on the Proposal for Consultation developed by officials as the basis for the Ministerial Council on Energy's (MCE) response to the Productivity Commission review of the National Gas Pipelines Access Regime.

The National Competition Council has provided the attached submission on the Proposal for Consultation.

The Council has also provided copies of its submission to the Australian Government Treasurer and State and Territory Treasurers.

Yours sincerely



David Crawford
President

Encl: submission

**Submission by the National Competition Council to the Ministerial Council on
Energy on the proposed response to the Productivity Commission review of
National Gas Pipelines Access Regime
30 November 2005**

The National Competition Council has considered the Proposal for Consultation paper developed by officials as the basis for the Ministerial Council on Energy's (MCE) response to the Productivity Commission review of the National Gas Pipelines Access Regime. The Council understands that, following the current period of consultation, officials will finalise a response for consideration by energy Ministers, with Ministers to make a decision by 7 December 2005. The Council of Australian Governments has agreed that the energy Ministers' decision will constitute the response by governments to the Productivity Commission review.

The Council considers that there are significant flaws in the MCE officials' proposal. These flaws derive in the main from the philosophy that appears to underpin the approach to regulation and from the arrangements proposed for implementing the objective of a seamless national approach to energy access covering electricity and gas transmission and distribution. In particular, the proposed arrangements could potentially lead to significant differences between the regulation of access to bottleneck infrastructure under part IIIA of the *Trade Practices Act 1974* and the regulation of pipelines under the National Gas Pipelines Access Regime, creating considerable regulatory uncertainty.

Although purporting to be informed by the Productivity Commission review, the proposal departs significantly from that report's recommendations. The Council considers therefore that there is value in taking additional time (beyond the scheduled date of 7 December) to recast the proposal to be considered by energy Ministers so that it more closely aligns with the scope of the Productivity Commission's analysis and recommendations.

Alternatively where the Productivity Commission's analysis and recommendations are to be departed from, the proposal needs to include more explanation to set out the underlying rationale in order that Ministers and the community more generally can understand and evaluate the alternatives recommended by officials. As they are, many elements of the proposal are incomplete and/or poorly elaborated. In some cases, the underpinning analysis is not apparent, or at best reflects a degree of consideration that might be suitable for an initial discussion paper but falls well short of what should be expected as a basis for final policy decisions.

The National Competition Council comprises (currently) four independent private sector experts appointed by governments by agreement. It has had considerable experience with administering the coverage test in the National Gas Pipelines Access Regime and in considering applications for declaration and certification under the Trade Practices Act. The Council's concerns about the MCE officials' proposal to energy Ministers arises from this experience with administering coverage and access matters.

The underpinning philosophy: an imbalance of economic interests

A troubling aspect of the proposal is its apparent acceptance of the notion that regulated access prices and other terms provide an inappropriately low return to asset owners and that this discourages investment in assets that may be subject to coverage. While the Productivity Commission did note the potential for the coverage regime to deter investment, the proposal appears to elevate this potential to fact, and then as a basis for arrangements that could significantly tilt the access regime to favour asset owners at the expense of gas producers, consumers and intermediaries. The availability of monopoly profits will of course encourage investment in assets that return such profits, but the higher prices faced by the wide range of parties forced to use such assets will have adverse effects on the availability and use of gas.

Related to this, several previous submissions by regulatory bodies have indicated that access regulation has had no observable effect on investment levels in the gas sector or elsewhere. The evidence presented in these submissions appears to have been overlooked in weighing the costs and benefits of the proposal, and is not appropriately addressed in the consultation paper.

Drawbacks of the proposed arrangements for recommending on coverage

The proposal appears to be based on a view that regulation of the gas sector should mimic that of the electricity sector. While there may be benefits from a common process for regulating the energy sector, there are significant potential costs, which in the Council's view are likely to outweigh the benefits.

The proposed approach may divorce the energy sector from the generally applicable access frameworks and principles that governments established under the Competition Principles Agreement and the Trade Practices Act. Although finally brought together by a common appeals body, the proposed separation of the making of recommendations on the coverage of gas pipelines from equivalent declaration activity in other sectors (which arises from the proposal's focus on achieving common regulation of the energy sector as a priority over maintaining a comprehensive access regime of general application) significantly increases the likelihood that administration of the two tests will diverge.

Different treatment of access to the services of gas facilities from access to the services of other bottleneck facilities may increase regulatory uncertainty and cost. The fact that the coverage criteria and processes would be specified in law would not overcome the potential for divergence. There is necessarily a significant element of judgment involved in developing recommendations against the statutory (coverage and part IIIA) criteria.

Moreover there are differences in the nature of electricity and gas infrastructure that may warrant some differences in the approach to regulating the two sectors. Electricity infrastructure is generally networked to a far greater degree than gas infrastructure, which provides more of a point to point service. Gas infrastructure is therefore likely to have greater similarities with other infrastructure providing point to point services (regulated under the Trade Practices Act) than it does with electricity

infrastructure. Imposing a regulatory scheme designed for electricity markets onto the gas sector may therefore lead to over regulation and excessive intervention.

A further concern is the proposed division of the functions of recommending on coverage (which is to rest with the Australian Energy Market Commission (AEMC)) and the form of coverage (which is to rest with the Australian Energy Regulator). In practice, options for regulation are relevant to the decision on whether a pipeline should be regulated, suggesting that the same body should consider and recommend on both elements.

There also appears to be insufficient recognition in the proposal of the importance of the principle of the separation of regulatory roles. The separation of roles, whereby regulators are not involved in determining the scope of the regulatory regimes they administer, is critical to removing incentives for regulatory creep, whereby a regulator seeks to address regulatory issues or difficulties by extending the reach of its regulatory power. As the AEMC is responsible for rule making in respect of natural gas transmission and distribution functions, and monitoring the effectiveness of these rules, it may have an incentive to extend the scope of regulation beyond that which is necessary. It may also have reduced incentive to consider issues of regulatory error that arise from the rules it has made when evaluating the costs and benefits of coverage.

Questions about certification of the proposed regulatory arrangements as effective

The form of light-handed form of regulation now proposed is a significant improvement on an earlier proposal (in essence the model described in the consultation paper as the alternative to the model recommended by the Productivity Commission). However, whether or not the current light handed option would be certified as an effective regime depends critically on the detail of the arrangements for arbitration. These are not disclosed in the consultation paper. While adoption of the existing Gas Code dispute resolution arrangements may improve the prospect of certification, it would be premature to assume that certification will occur without the detail of what is to be implemented being available.

Issues with the proposed regulation of greenfield pipelines

The essential trade off with a greenfield pipeline is between the desire of pipeline owners to maximise profit and the objectives of the pipeline users, who want to see the pipeline built but who also have an interest in the prices charged. There is a case for providing regulatory certainty for all these parties at the time that the commitment to construct the pipeline is made. However there is a significant risk that mechanisms that provide such certainty will also transfer income among the various parties.

Therefore, while the Council supports the introduction of a binding no coverage ruling, it considers it preferable to be able to tailor the period of a ruling (or vary a default period) to each particular circumstance rather than impose a predetermined 15 year period. As the Council has previously advised such flexibility is consistent with maximising the opportunity for implementing greenfield arrangements and ensuring a proper balance between all interests.

The proposal also provides for a 15 year price holiday for greenfield transmission investments, including extensions but not expansions of existing pipelines. Many investments linked to existing pipelines seem likely to comprise elements of both: it is unclear how this is to be dealt with. In addition, the approach proposed for determining holidays removes any role for an independent expert body, with Ministers (presumably on advice from officials) directly determining applications. This significantly reduces the transparency of decision making and so is contrary to the underlying objectives of the competition agreements entered into by all Australian governments.

The proposed approach to determining whether a pipeline is a greenfield investment suggests that a pipeline would qualify if a significant dependent market is served by at least one other pipeline. This 'two is enough' criterion is a crude and inadequate substitute for a proper analysis of the constraints on the market power possessed by new pipelines. Given the likely effects on other parties (gas producers, consumers and intermediaries), it is important that a proper analysis of a pipeline's market power be undertaken before exempting any investment from generally applicable competition law.

Finally, the Council would like to correct the statement in the MCE officials' Proposal for Consultation that the rationale for introducing the 15 year price holiday option is that decisions on binding rulings may not be sufficiently timely to provide regulatory certainty. The proposal suggests that such decisions may take 12 months. There is no basis for such a claim. The Council's experience is that coverage decisions have been delayed where pipeline operators alone possess information that is relevant to such decisions and have an incentive to delay. In the case of a pipeline operator seeking a binding coverage ruling however, the incentive is to provide information in a timely way. Thus determining a binding ruling is likely to take no longer than 3-6 months.

National Competition Council
November 2005