the australian PIPELINE industry association Ltd

Response to Issues Paper

Productivity Commission Review of the National Access Regime

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Contents

Introduction

The Australian Pipeline Industry Association (APIA) welcomes the opportunity to comment on the Review of the National Access Regime Issues Paper (the Paper).

APIA is the peak industry association for Australia's gas transmission industry, infrastructure essential to the Australian economy and subject to access regulation.

The access regime for gas transmission infrastructure is set out in the National Gas Law 2008 (NGL) and the National Gas Rules 2008 (NGR). As such, many of the questions posed in the paper are not directly relevant to the gas transmission industry. APIA will address those questions that are most relevant to gas transmission infrastructure.

If you would like any further information on APIA's view please contact APIA's Policy Adviser, Steve Davies, on (02) 6273 0577 or sdavies@apia.asn.au.

Is there still a need for a National Access Regime?

Q *What is the problem that the National Access Regime should address? How is this different to the problem being addressed by the state and territory access regimes? Can you give examples?*

The primary problem that all access regimes should be addressing is ensuring access to Australia's critical infrastructure to maximise the economic efficiency of the nation's supply chains.

The National Access Regime has a further purpose of addressing, or limiting, the problem of inconsistency arising across state and territory access regimes that tend to be developed in isolation.

The National Access Regime directly provides a stable, common framework for much of the infrastructure that underpins Australia's economy. The economic underpinnings of the regime were developed through a rigorous process in the mid-1990s and reviewed thoroughly in the 2001/02 review. For industry specific access regimes it provides a necessary reference and 'benchmark' to maximise consistency across regimes and to ensure the principles which deliver economic dividends to the economy are preserved.

State and Territory access regimes have greater potential to be altered for political expediency or ideological reasons, including to meet short term consumer interests, and will progressively drift from the economic principles that the National Access Regime was designed to achieve..

In considering the problems to be addressed by the National Access Regime, the Commission should have regard to circumstances where the National Access Regime shifts the problem away from one set of infrastructure to another. APIA considers the exclusion of some production facilities may be an area this is occurring. This will be addressed in our response to the relevant question.

Q *What principles should determine those facilities that should fall under the National Access Regime, and those that should be governed by industry-specific access regimes?*

Energy supply infrastructure is governed by industry specific access regimes. Gas transmission and distribution infrastructure is governed by the gas supply infrastructure specific National Gas Law 2008. The NGL shares many characteristics with the National Electricity Law 2008, governing electricity transmission and distribution infrastructure. The frameworks have many commonalities and it is clear from the reforms of 2012 that it is the preference of policy makers for convergence across the two frameworks and the level of commonality to increase.

This convergence between the energy access regimes appears to be at the expense of consistency with the national access regime. That is the electricity regime as originally developed would not have met the requirements for certification at the time when it was first implemented in the late 1990s. Because of the desire of policy makers for convergence within the energy, and because of the lack of understanding of the benefits of structure of the gas regime there has been a continuing tendency for gas to converge in the direction of the electricity regime and in so doing both have drifted away from the National Access Regime.

From the gas transmission industry's perspective this creates two concerns. The first is the move away from sound principles of access, including the objects of the regimes. A further concern is that the electricity and gas industries have very different characteristics that convergence of the two regimes has in a number or respects ignored.

The electricity transmission and distribution sectors have the following key characteristics in common:

- All are fully regulated; there are no unregulated assets of these classes of asset.
- All operate under a market-carriage framework, with little to no direct relationship with users of the assets.

- Assets share similar, to the point of being indistinguishable, investment characteristics as they serve the 'Australian energy market'.

In contrast, gas transmission and distribution assets:

- Are often unregulated. Only 13 gas transmission pipelines are subject to full regulation .A number of distribution networks are also not subject to regulation.

- Operate under a contract carriage framework[1], with direct relationships with a small number of users resulting in mutually acceptable, negotiated services.

- Serve unique markets, defined by location, industry type, gas supply and other factors. This is truer for gas transmission assets. Gas distribution assets, due to their network nature, have many commonalities.

- Transport a fuel of choice, and therefore compete with other energy sources, in particular electricity, but also LPG and diesel.

If convergence is to continue between the electricity and gas access regimes, APIA believes there is a strong possibility the energy access framework will not be able to appropriately manage the different characteristics of gas transmission pipelines. The electricity access regime is characterised by a very high level of regulatory intervention and is largely devoid of commercial negotiations. In contrast, commercial negotiations are a key feature of the gas transmission industry.

Convergence between the regimes has seen, and is likely to continue to see, elements of the gas access regime replaced by more prescriptive and intrusive regulatory arrangements at the expense of more efficient commercial outcomes. As a result, APIA considers that both regimes, but particularly the electricity regime have drifted from the national access regime. The Gas regime has drifted less and is considerably more consistent with the national access regime. Moreover, the gas access regime offers better access regulation 'fit' for the gas sector and a drift towards the prescriptive and intrusive approach the electricity regime with its emphasis on consumer outcomes over economic efficiency is undesirable.

[1] The Victorian Gas Market arrangements for the Victorian Transmission System are the only exception

Q *What principles should determine when access should fall directly under the National Access Regime or a state or territory access regime, or when other regulatory measures such as planning processes or leasing arrangements may be more appropriate?*

APIA holds the view that matters of access are best dealt with by access regimes. Using other regulatory measures to achieve access can be problematic. Use of planning processes or leasing arrangements would undoubtedly be a "force fit" application of regulatory measures designed for another purpose

Significance and extent of the problem

Q *Is the scope of the National Access Regime commensurate with the problem? In terms of coverage, which of the following should the Regime include:*

- *natural monopoly industries only, or should other sources of market power be considered?*
- *only infrastructure service providers that are vertically integrated?*
- *only service providers that have sufficient market power in dependent markets to affect prices paid by consumers?*

The scope of the National Access Regime needs to recognise that infrastructure is either:

- Situationally specific (such as a gas transmission pipeline or a port) for which the primary purpose of the National Access Regime is to ensure third party access; or
- Network infrastructure (such as a gas distribution network) for which its primary purpose to regulate the terms of access.

In both cases, the principle of economic efficiency is paramount.

Q *What are the practical implications of the production process exclusion?*

The exclusion of the production process can lead to any access bottlenecks addressed by an access regime simply being moved further up the supply chain. In the case of gas transmission pipelines, the National Gas Law ensures access regulation is strong and consistent. Any party can apply for a coverage determination on a gas transmission pipeline.

However, the gas for most gas transmission pipelines is delivered into the pipeline by a gas processing facility. The owner of the gas processing facility is not subject to any access regulation and is able to control the flow of gas out of the facility. In the absence of access issues on the pipeline, the bottleneck shifts to the processing facility.

Processing facilities have been deemed part of the production process and are thus excluded from the National Access Regime. However, processing facilities are often not operating at full capacity and access to the facility itself by other gas producers would significantly increase competition in gas supply. It is very likely there are many smaller gas explorers that find it uneconomic to build a processing facility in a region to enable production of smaller fields that would benefit from having access to a large, existing processing facility.

Currently, the jurisdiction of National Access Regime commences at the exit flange of the gas processing facility, where gas from the facility enters the supply chain through a gas transmission pipeline. If the National Access Regime were to commence at the entry to the processing facility, third part access to the processing facility itself would be greatly enhanced and competition in the gas supply market would be increased.

What are the objectives of the National Access Regime?

Q *Should economic efficiency remain the primary objective of Part IIIA? Should there be other objectives? What is gained or lost by having multiple objectives, and what guidance, if any, should be given to the weightings of multiple objectives if they arise? How would this work in practice?*

Yes. Economic efficiency is the key primary objective to ensure sufficient investment in the infrastructure the Australian economy depends on. A primary advantage of the National Access Regime is that it ensures the primacy of economic efficiency, something that cannot be guaranteed in State and Territory access regimes, particularly where they are not certified.

The inclusion of multiple objectives in legislation can, over time, lead to a redefining of priorities of the regime. It is APIA's view that this has occurred in the electricity and gas access regimes as outlined below.

Q *Is the distinction between economic efficiency and the long-term interests of consumers important? If so, should Part IIIA and industry-specific regimes focus on economic efficiency or on the long-term interests of consumers?*

Yes, and APIA is concerned by the new emphasis in the energy access regimes on the long-term interests of consumers in place of a simple reference to efficiency. An emphasis on consumers can lead to a focus on short term pricing outcomes at the expense of longer term issues such as infrastructure investment; there are many other factors that must be balanced by the access regime. APIA considers that a clear efficiency objective best reflects this balance.

Specific consumer interests are best achieved through consumer legislation, allowing the access regime to properly address the key issue of economic efficiency for the benefit of the Australian economy.

The intent of the inclusion of the two objectives in the National Gas Law was very clear at the time of its introduction.

> *The national gas objective is to promote efficient investment in, and efficient use of, natural gas services for the long term interests of consumers of natural gas with respect to price, quality, reliability and security of supply of natural gas.*
>
> *The national gas objective is an economic concept and should be interpreted as such.*
>
> *The long term interest of consumers of gas requires the economic welfare of consumers, over the long term, to be maximised. If gas markets and access to pipeline services are efficient in an economic sense, the long term economic interests of consumers in respect of price, quality, reliability, safety and security of natural gas services will be maximised. By the promotion of an economic efficiency objective in access to pipeline services, competition will be promoted in upstream and downstream markets.*[2]

This was further reinforced by energy officials in their response to submissions on the draft NGL:

> *Issue: The intent of the objective should be clarified in the NGL explanatory memorandum*
>
> *SCO Response: Accepted. The primary intent of the objective is economic efficiency in investment in, and use of, natural gas infrastructure. This will work in the long term interests of consumers.*[3]

2 National Gas (South Australia) Bill 2008, Second Reading Speech, p 4

3 Ministerial Council on Energy Standing Committee of Officials 2007, SCO response to issues raised in submissions on the National Gas Law, 1 March, p 1

Economic efficiency was named as the primary objective very clearly as the legislation was developed and introduced.

However, over time the explanatory material around a statement in legislation becomes less relevant and the words of the legislation itself hold primacy. It is clear to APIA that this has occurred in the case of the National Gas Objective (and similarly in the National Electricity Objective).

The use of the wording 'the long term interests of consumers' places pressure on regulators, and possibly the Australian Energy Market Commission and governments, (as it seems to have done the Expert Panel on Limited Merits Review[4]) to interpret the NGO and NEO that consumer interests are the object of the legislation and that economic efficiency is not as relevant or the primary objective,

The findings of the Expert Panel on Limited Merits Review for energy access regimes led SCER to issue a statement of policy intent[5] that changes the focus of the National Gas Objective. Included in statement of policy intent are statements that SCER:

> ***Affirms*** *that, in interpreting the National Electricity Objective and the National Gas Objective, the long-term interests of consumers (with respect to price, quality, safety, reliability and security of supply) are paramount in the regulation of the energy industry.*
>
> ***Considers*** *furthermore that the long-term interests of consumers should be the sole criterion for determining the preferable decision, both at the initial decision-making stage and at merits review.*

This is a very different position to that articulated at the time of introduction of the National Gas Law and has significant consequences for the energy access regimes. The experience of the NGL and NEL shows having multiple objectives in an access regime can lead to major change over time.

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4 The Expert Panel interpreted the National Gas Objective and the National Electricity Objective as solely being about the long term interest of consumers see Review of the Limited Merits Review Regime, Stage 2 Report, Professor G Yarrow, The Hon M Egan, Dr J. Tamblyn, 30 Sept 2012

5 SCER Statement of Policy Intent: Limited Merits Review December 2012

Q *What would be gained or lost from greater consistency between the object clauses of Acts for different access regimes?*

Greater consistency between object clauses of Acts for different access regimes should ensure an equality of investment in infrastructure.

Declaration

Q *Do the ineligibility clauses provide sufficient regulatory certainty to access seekers and infrastructure service providers? Why or why not?*

There is no doubt that ineligibility clauses improve regulatory certainty; however for long lived assets such as pipelines the increase is not sufficient to materially improve a willingness to invest. This is because there is no certainty of the outcome after the ineligibility period. For gas the period is 15 years for an asset that has an economic life. This does not provide sufficient certainty to investors that value will not be easily confiscated at the end of the ineligibility period.

Another practical problem is the time required to obtain an ineligibility decision is incompatible with the development cycle for assets such as pipelines, which require decisions sooner than are typically available under the reviews of ineligibility applications.

Declaration criteria

Q *When taken together, how effective are the declaration criteria in reflecting the economic problem that the National Access Regime is seeking to address?*

The criteria are sufficient. APIA is not aware of any indicators that the declaration criteria, which are substantially replicate in the NGL coverage criteria, need further refinement, since the 2002 review by the Commission.

Certification

Q *How effective is certification in delivering benefits from greater consistency between access regimes? What should 'consistency' mean in the context of industry-specific access regimes?*

Certification would deliver greater consistency as it ensures the overarching framework of the National Access Regime protects against drift to objectives, principles and practices that are not directed to the efficiency of the national economy. Jurisdictional changes to State and Territory access regimes, including

cooperative schemes such as the Gas Access Regime are open to adjustment to respond to policy and/or political objectives that diverge from the overarching objective of national economic efficiency.

An undertaking in the establishment of the NEL and the NGL was that the regimes would be certified under the National Access Regime. This has not yet occurred, despite an investigation by the Commonwealth in 2010. While APIA understands that the Gas Access Regime should meet the criteria for certification, it may be that there is some residual concern about the electricity regime that has led to the jurisdictions not seeking for certification of either regime which completed their reform program in 2008.

Consistency would mean that industry-specific access regimes:

- Would have equivalent objectives; and
- Would have equal access to merits review and the review regimes would be the same, including review body.

Q *Should Australian Government access regimes be subject to certification? Why or why not?*

Yes. Certification would ensure industry-specific access regimes would remain consistent with the key economic objectives and principles in the National Access Regime. Moreover it ensures coherency in access practice nationally avoiding piecemeal approaches.

Lack of certification allows Governments to respond to political motivations by changing regimes to suit short-term purposes. APIA is concerned that the significant modification to the limited merits review regime for energy is a current example of this.

Undertakings

Q *How could the process and criteria for assessing undertakings be improved?*

It is appropriate to point out that the certification of an industry-specific regime will remove the possibility of an access provider seeking to provide access other than through a relevant industry access regime.

The negotiate–arbitrate framework

Q *What evidence is there that the negotiate–arbitrate framework has proven successful at resolving access disputes?*

The negotiate-arbitrate framework has worked well for gas transmission. Light regulation, essentially negotiate-arbitrate with price monitoring, has been implemented for multiple pipelines successfully.

Pricing principles and determinations by the ACCC

Q *How appropriate are the pricing principles for regulating access prices under Part IIIA? How much certainty do they provide for access seekers and service providers? When is price discrimination appropriate?*

The pricing principles are essential for regulating access and for ensuring delivery of economic efficiency. The pricing principles should be (and currently are for the National Access Regime) entirely consistent with the objects of the regime, but provide a necessary explanation of how that is achieved through pricing and in so doing reduce regulatory uncertainty.

Q *How should access prices incorporate a return that is commensurate with the regulatory and commercial risks involved? How important is this in providing an incentive for the efficient operation of, use of, and investment in, infrastructure?*

The absence of a principle requiring prices incorporate a return commensurate with the regulatory and commercial risks involved is that regulated returns will become out of kilter with the returns required by investors and capital supply to infrastructure will be constrained below the level needed by an efficient economy. It is therefore essential to the good working of the Australian economy that investors in infrastructure be given this confidence.

The costs and benefits of the National Access Regime

Q *What are the benefits and costs of the National Access Regime relative to other regulatory options, including the risk of regulatory failure?*

The National Access Regime provides clear economic guidance for access regulation, which yields benefits to the economy through access to facilities for there is no economic detriment through such access and providing a framework for efficient investment use and operation. The fact that it is National means that the benefits of the scheme accrue to the whole economy and distortions and inefficiencies that could arise from jurisdictional schemes are avoided.

A key element in such a regime is the willingness to invest in infrastructure that contributes to the economic welfare of all Australians. Variability and uncertainty that could arise without a National Regime are undesirable.

Efficient investment in infrastructure

Q *What is the evidence that the access regime has had an effect on investment? In particular, possible 'chilling' effects, or apparent strategic responses relating to investment decisions, including infrastructure capacity, to limit competitor access? What evidence is there that efficient investment has proceeded as a consequence of access regulation?*

It is very difficult to measure the direct effect the access regime has had on investment, as it is not possible to observe what investment might have occurred. We can only observe what has occurred.

APIA does not consider it can be demonstrated that access regulation has led to efficient investment in gas transmission pipelines.

It is clear that investment practice in Australia for gas transmission pipelines is to construct to a capacity sufficient to meet currently contractible demand. There is the potential for significant efficiency to be gained by building to meet readily foreseeable demand. Construction costs do not vary in direct linear relationship to the capacity of the pipeline. In the case of steel pipelines, expanding the diameter of pipeline installed from 25cm to 30cm would increase capacity by 44% for an increase in costs of less than 10%[6]. The only real change to cost is the material for the pipe itself, construction costs such as easement clearing, trenching, welding and

[6] Pipeline capacity increases in proportion to diameter to the power of 2.5 and costs of pipelines increase at in proportion to the 0.5-0.6 power. I.e. $Q \propto D^{2.5}$ and $Cost \propto D^{0.6}$. Therefore $Cost \propto Q0.24$.

manpower would be largely unchanged. Incrementally increasing the diameter of a pipeline will lead to a much greater increase in capacity than it would in cost.

However, in investing to meet contractible demand, pipeline investors are not taking advantage of the available economies of scale. In fact, in many recent pipeline expansions, a project to further expand the pipeline commences shortly after, or even prior, to completion of an expansion project.

One driver of this incremental form of investment is regulatory risk. If a pipeline with spare capacity is subject to a coverage application, it runs the risk of being forced to allow access to the spare capacity under a regulated service and tariff. There is a real chance that the regulated tariff would be calculated on the basis of a pipeline's total capacity, which does usually not reflect the cost of the capacity at the margin.

A typical pipeline in Australia has experienced multiple expansions over its life. The original customers and contracts pay a tariff that covers the costs of the original construction. As time progresses, the costs of original construction are depreciated and original customers benefits from access to the original, depreciated asset.

New capacity enabled through an expansion project will not have the same cost as the original capacity. Capacity built through an expansion will always be charged based on the costs of that expansion. Pipeline owners actively seek customers at time of investment decision to maximise the buildable capacity, but will not build capacity above what is committed to by customers. A tariff for the expansion is agreed and the project proceeds.

If spare capacity was built during an expansion (at high economies of scale) and subsequently subject to a regulatory determination, a regulator is likely to consider the cost of accessing the total pipeline capacity, which includes the original depreciated asset and the new expansion. Certainly the proponent of a coverage application is highly likely to argue for this approach. If a tariff is determined on this basis it would lead to a much lower tariff than that paid by foundation customers of the expansion. All foundation customers on the expansion would insist on the lower tariff and may indeed have contractual rights to a lower tariff. This tariff would not be based solely on the cost of expansion and will have made the expansion uneconomic and the pipeline investor will be unable to recover its investment.

APIA does not contend this is the only factor leading to the 'just-in-time' investment paradigm for gas transmission infrastructure. A clear limiting factor is the willingness of financiers to underwrite uncontracted pipeline capacity. However,

APIA can assert that regulatory risk means that pipeline owners rarely, if ever, develop business cases for speculative (or uncontracted) capacity.

Solutions to this issue could include:

- The 'regulatory holiday' or greenfields incentive available in the National Gas Law could be made available to speculative capacity investments on existing infrastructure. As investment in speculative capacity does not occur, it could be argued that such investment is 'greenfield'.

- The access regime specifically recognises that pipeline tariffs are linked to each expansion of a pipeline and must be different.

APIA is aware that the large diameter pipelines being constructed in Queensland to supply gas to the multiple LNG export facilities in Gladstone are building capacity for future demand. There are good reasons why this experience is not relevant to Australia's gas transmission industry:

- These pipelines are part of vertically integrated enterprises that produce, transport, covert to LNG and export gas. The owners of the pipeline have the ability to fully utilise the capacity of the pipeline in the future. This is a fundamentally different premise to the primary business of Australia's non-integrated gas transmission industry, which to sell capacity services to users of natural gas.

- The first two pipelines have been awarded 15 year no coverage determinations under the NGL and face no regulator risk. This 'greenfields' incentive can only apply to new pipelines. The majority of Australia's gas demand growth will be met through expansions of existing pipelines, which are not eligible for this incentive.

Weighing the benefits against the costs

Q *What is the overall impact of the Regime on Australia's economic growth and productivity?*

There has been significant investment, including in pipelines, because of the National Access Regime – including ports, rail links, water, which would probably have been slower coming on line and in some cases not at all. In the case of pipelines potentially more efficient pipelines if the regime provided better for economies of scale, which in pipelines are very significant.

Institutions and processes

The decision-making framework

Q *Do all of the institutions involved in Part IIIA contribute to effective and efficient decision-making? If so, how? If not, how could their roles, or the interaction between them, be improved?*

There are no obvious problems with the institutional arrangements of the National Access Regime, neither standout problems nor obvious refinements.

The role of Ministers

Q *What is the rationale for, and costs and benefits of, the role played by state and territory Ministers in the Part IIIA declaration process?*

In APIA's experience with ministerial decisions (coverage and certification decisions) the Minister's role has seemed appropriate.

Deemed decisions

Q *What process is appropriate where Ministers do not make decisions on a declaration recommendation within the 60 day time period?*

IN APIA's view deeming is appropriate; however the Minister should be given the opportunity to extend his decision making timeframe.

The role of review bodies

Q *Ahead, and in light of the High Court decision and the legislative amendments to merits reviews, will review arrangements under Part IIIA be appropriate, cost-effective, timely, fair and transparent? If so, why? If not, how could this be remedied?*

APIA believes the review arrangements are appropriate and is concerned by the proposal being considered by the Standing Council on Resources and Energy to alter key aspects of the appeals process (and the review body itself) for the electricity and gas access regimes.

The implication of SCERs considerations is that the review arrangements under Part IIIA are inadequate or sub-optimal – a conclusion that has not be made or even sought.

APIA is concerned with the consistency of appeals regimes for industry-specific access regimes. The proposal to develop a new, non-judicial review body for energy access regimes, currently identified as SCER's preference, would lead to the removal of merits review for coverage decisions on energy assets. This would create a level of inconsistency with the National Access Regime that is inappropriate.

Is merits review appropriate?

Q *What is the rationale for merits reviews under Part IIIA? Could judicial review suffice?*

No, judicial review cannot suffice. Judicial review can assess the decision maker's adherence to law and procedure; it cannot assess the decision maker's judgement.

In regulatory decisions where the regulator's discretion can impact hundreds of millions of dollars in revenue and there is a real possibility of error in judgement, there must be the ability to review the merits of a decision.

Q *Are merits reviews of ministerial and ACCC decisions appropriate in the context of Part IIIA? Why or why not?*

Yes, Ministerial and ACCC decisions are subject to discretion and judgement. In exercising these, error can be made.

The broader policy framework

Q *What evidence is there that governments have considered the use of price monitoring as an alternative to access regulation? In what circumstances should governments consider price monitoring as more effective than access regulation in promoting economic efficiency?*

The effective application of light regulation under the National Gas Law is a useful example of price monitoring successfully replacing access regulation.

What should be the future role of the National Access Regime?

Q *Is there an ongoing need for a National Access Regime? If so, what role should it play?*

Yes. The National Access Regime has created a sound framework for access nationally and is largely applied and replicated in industry or state-specific regimes. It has also been applied to situationally specific infrastructure investments. These roles continue to be important.

The continuing role of the NAR will be to ensure that access continues to be provided and regulated under regimes that are consistent with the NAR and ensure maximum economic benefit from infrastructure investments through application of the NARs economic principles.