31 March 2000

Mr Ed Willett
Executive Director
National Competition Council
GPO Box 250B
MELBOURNE VIC 3001

Dear Mr Willett

Submission on Application for Coverage of Eastern Gas Pipeline

EAPL believes that the operational commencement of the Eastern Gas Pipeline will herald competition between EGP and EAPL to supply natural gas to the Sydney and ACT markets. This event will improve competitive outcomes for gas retailers in these markets. It will also facilitate competition between gas field producers in the Cooper and Gippsland basins.

For this reason EAPL believes that coverage should not be applied to either pipeline.

However, in recognition that some controversy surrounds the prospect of unilaterally placing the EGP outside Gas Code coverage, I attach a submission prepared for EAPL by NECG Pty Ltd which considers in detail a number of issues going to symmetrical and competitive outcomes between the two pipelines, and the range of alternative possible methods of protecting consumers in the event that coverage were removed for both pipelines.

I note that it is our intention to submit this attachment also to the ACCC, as the procedural issues which it raises involve two matters currently before the ACCC in addition to the two before the NCC.

I trust that you will give this submission full consideration as it goes to the heart of the public interest criterion which must be considered in an application for Gas Code coverage.

Yours sincerely

S.P. Ohl
General Manager
East Australian Pipeline Limited

Submission by EAPL Regarding the four related Applications which are Currently before the NCC and ACCC

Prepared by NECG Pty Ltd
31 March 00

WHAT THIS SUBMISSION ASKS THE REGULATORS TO DO

NCC

1. Consider the applications for
   - coverage of the Duke EGP and for
   - revocation of coverage of the EAPL MSP

   together, and permit a reasonable period of time for EAPL to submit to the ACCC a Part IIIA Access Undertaking before evaluating those applications. This will involve a further delay to the NCC's current process of considering the coverage of the Duke EGP.

2. Agree that in the interest of competitive neutrality between pipelines the regulatory treatment for both pipelines should be the same.

ACCC

In the interest of competitive neutrality and the avoidance of administrative processes which may ultimately prove to have been unnecessary:

1. Delay the implementation of the EAPL MSP Access Arrangement until the issues of Gas Code coverage, Part IIIA Undertakings, or alternatives for the Duke EGP and EAPL MSP are finally resolved.

2. In the event that the NCC decides the Duke EGP should be covered by the Gas Code, but the two pipelines pursue Part IIIA Undertakings with the ACCC nonetheless[1], delay the imposition of Access Arrangement requirements under the Gas Code until the issue of Part IIIA Undertakings for the Duke EGP and EAPL MSP are finally resolved.

[1] With the aim of ultimately applying for revocation in the context of approved Undertakings.

PROCEDURAL AND TIMING OBSTACLES TO AN IDEAL OUTCOME
The table below outlines the current regulatory timing anticipated for four related applications. Currently, each of these applications is being considered separately.

Regulator	**ACCC**	**NCC**	**NCC**	**ACCC**
Application	Duke EGP Part IIIA Undertaking	Gas Code coverage of Duke EGP	Revocation of coverage of EAPL MSP	EAPL MSP Access Arrangement
Applicant	**Duke EGP**	**AGL Energy Sales & Marketing**	**EAPL**	**EAPL**
Date of original Submission	18 Nov 99	7 Jan 00	Mar 00 ?	5 May 99
Close of public submissions	4 Feb 99	31 Mar 00	No public information	2 July 99
Final decision				
Activation date		June 00 ?		1 July 00

These four applications are closely inter-related. The Duke EGP Undertaking was lodged with the expectation that the EGP would not be covered under the Gas Code. The revocation application for the EAPL MSP would only be reasonable if the Duke EGP were uncovered, and vice versa. In the event that the EAPL MSP revocation application were successful, then there would be no need to proceed with the EAPL MSP Access Arrangement approval process before the ACCC.

Procedurally, the uncoordinated timing of these applications poses the serious risk of either arriving at outcomes that do not best promote competition, or forcing the parties on procedural grounds alone to accept symmetric, but sub-optimal economic outcomes.

How procedure may lead to sub-optimal outcomes
Given the procedural difficulties there is a likelihood that both the NCC and the ACCC may find that the simplest path is to place both pipelines under Gas Code coverage, to reject EAPL's revocation application, and to reject the Duke EGP Undertaking. This approach would at least be symmetrical, and procedurally straightforward.

Such an outcome would be unfortunate because it would foreclose, on procedural rather than merit-based grounds, the exploration of an alternative to the Gas Code which has the potential to deliver superior pricing outcomes for pipeline customers, and to incent pipeline owners to pursue innovative price/service packages.

The reasons why alternatives, such as Part IIIA Undertakings, are preferred to Gas Code coverage are outlined in more detail in Appendix 2, but the essence of these arguments is as follows:

- The Gas Code's emphasis on revenue maintenance and cost recovery could give the two pipeline owners the motive and the opportunity to avoid meaningful price competition.

- The opportunity to avoid meaningful competition is provided by the elaborate cost-price disclosure which is mandatory under the Gas Code. This transparency may greatly facilitate tacit price collusion between the pipeline owners.
- Some innovative price and service offerings would be less likely to occur under the Gas Code because the pipelines would have diminished incentives to make such innovative offerings.

Possibility of outcomes that do not best promote competition

One danger is that the two NCC applications may be decided differently because they are separate applications which have been lodged at different times. Of the four possible permutations, two would be highly prejudicial to effective competition between the pipelines:

1. EGP covered and MSP coverage revoked,
2. EGP not covered under Gas Code and MSP revocation application refused.

Either of these outcomes would diminish efficient competition between pipelines for the reason that the two competitors would be working under substantially different regulatory rules, with large differences in the required level of information disclosure, different regulatory procedures for instituting price changes and responding to competitive pricing initiatives, and ultimately different regulatory philosophies. These issues are discussed in more detail in Appendix 1 – 'Why asymmetric regulation is harmful to competition.'

In the event that both pipelines are ultimately not covered under the Gas Code, the other danger is that during the period in which EAPL is required to follow the Access Arrangement procedure with the ACCC it will be forced to disclose a wide range of cost, contractual and demand forecast information which it may ultimately not be required to disclose. The present disclosure of such information on a unilateral basis may prove detrimental to EAPL's competitive position relative to Duke, which is currently under no obligation to provide such information.

PREFERRED REGULATORY PROCESS

The ideal regulatory process would permit the NCC to consider the applications for

- coverage of the Duke EGP and for
- revocation of coverage of the EAPL MSP

together, and permit a reasonable period of time for EAPL to submit to the ACCC a Part IIIA Access Undertaking before evaluating those applications. This will involve a further delay to the NCC's current process of considering the coverage of the Duke EGP.

Ideally, the NCC would also agree that in the interest of competitive neutrality between pipelines the regulatory treatment for both pipelines should be the same.

In similar vein, the ideal process would permit the ACCC to delay the implementation of the EAPL MSP Access Arrangement until the issues of Gas Code coverage, Part IIIA Undertakings, or alternatives for the Duke EGP and EAPL MSP are finally resolved.

In the event that the NCC decides to cover the Duke EGP but the two pipelines pursue Part IIIA Undertakings with the ACCC nonetheless[2], the ACCC would ideally also delay the imposition of Access Arrangement requirements under the Gas Code until the issue of Part IIIA Undertakings for the Duke EGP and EAPL MSP are finally resolved.

TRANSITIONAL REGULATORY ISSUES

Since the preferred regulatory process outlined above involves delays of several months to some of the current proceedings, it may be argued that it would result in

1. NCC's handling of the application for coverage of the EGP not to be timely, or
2. ACCC providing EAPL MSP with a period of several months in which no accepted Access Arrangement was in force.

Taken on their objective merits, neither of these objections seem likely to lead to adverse market outcomes. At present the Duke EGP is neither covered under the Gas Code, nor in operation. Construction is not expected to be completed until September 2000. A delay to the NCC's processing of the application for coverage, so long as it did not extend past the September 2000 operational commencement date, seems unlikely to be signficant.

While a delay to the ACCC's assessment of the EAPL MSP Access Arrangement may theoretically leave that pipeline in a regulatory vacuum, it should be recognised that it has been in such a situation since the passage of the 1997 legislation which gave rise to the Gas Code. Furthermore, and no less important, it is understood that the majority of MSP's capacity is contracted until 2002. As a result, a further delay is unlikely to materially harm market outcomes.

A further possible objection is that until Part IIIA Undertakings are actually accepted by the ACCC, the NCC may find it difficult to recommend against coverage of either pipeline. This objection arises because an application to uncover a pipeline is likely to ride on the test of whether Gas Code coverage would enhance competition in some other market. The analysis in Appendix 4 supports the conclusion that unless an accepted Undertaking is in place Gas Code coverage will indeed facilitate competition in another market.

It is unclear whether the Gas Code is sufficiently flexible to permit the NCC to recommend uncoverage/revocation **conditional** upon a future ACCC acceptance of undertakings. Legal advice may be required to clarify that point.

[2] With the intention of ultimately applying for revocation in the context of approved Undertakings.

SECOND-BEST OUTCOME
Given some of the possible objections and transitional issues raised above, consideration may be given to a second-best procedural solution which is more straightforward, although more costly to the parties, and that would ultimately deliver the same outcomes. The steps in this solution would be as follows.

In the event that the NCC recommends coverage of the Duke EGP,

1. the NCC would probably be obliged on public interest grounds to reject EAPL's application for revocation of the MSP.
2. Duke and EAPL would each simultaneously submit draft Part IIIA Undertakings to the ACCC which, if accepted, would take effect from the date of any future revocation of Gas Code coverage.
3. If these Undertakings were both accepted by the ACCC, Duke and EAPL would each simultaneously apply to the NCC for revocation of coverage of their respective pipelines on the grounds that
    a. with accepted Part IIIA Undertakings forming the basis of access arrangements, continued Gas Code coverage would not result in competitive benefits to another market, and that
    b. therefore the continued administrative burden of continuing to implement Gas Code requirements would be contrary to the public interest.

Procedurally, this approach is more straightforward. However, it is second best because, compared to the preferred approach, it imposes very onerous administrative burdens and costs on the two pipelines, as well as the regulators—particularly the ACCC, who would need to follow the Access Arrangement procedure with the Duke EGP only to find later that it would be set aside. The NCC would also face unnecessary administrative activity as it would have to consider revocation applications for each pipeline essentially twice.

All of these administrative costs and inconvenience would ultimately come to rest on the customers of the two gas pipelines who, through the cost recovery logic of the Gas Code, would be obliged to fund the entire process.

Thus in conclusion, the second-best approach is simpler but far more costly to administer, to the disbenefit of the pipelines, regulators, and customers.

APPENDIX 1 – Why asymmetric regulation is harmful to competition

If a situation were to eventuate in which one pipeline was regulated under the Gas Code and the other pipeline were subject to a Part IIIA Undertaking or no coverage instead, then the pipeline covered by the Gas Code would find itself at a severe competitive disadvantage.

This disadvantage arises from three sources primarily:

1. Onerous information disclosure requirements imposed by the Gas Code would not apply to the Part IIIA pipeline.
2. The mandatory policy content of an Access Arrangement under the Gas Code is more prescriptive and rigid than the required policy content of a Part IIIA Access Undertaking, greatly limiting a covered pipeline's policy flexibility.
3. Relatively more prescriptive pricing rules under the Gas Code would limit the covered pipeline in its ability to launch pricing initiatives and to respond in a timely fashion to its competitor's pricing initiatives.

Firstly, section 2.7 of the Gas Code makes mandatory the disclosure of information under the following categories by a (pipeline) service provider to interested parties (list is contained in Attachment A to the Gas Code):

- Access and Pricing Principles (including Tariff determination methodology and cost allocation approach)
- Capital Costs
- Operations and Maintenance costs, including:
    - i. Fixed versus variable costs;
    - ii. Cost allocations between services, zones, asset categories;
    - iii. Wages and salaries;
    - iv. Cost of services by others;
    - v. Gas used in operations;
    - vi. Materials & supply;
    - vii. Property taxes.
- Overhead and Marketing costs
- System Capacity and Volume Assumptions, in cluding:
    - i. Average daily and peak demand;
    - ii. Existing and expected future volumes;
    - iii. Annual volume across each pricing zone, service, or asset category
    - iv. System load profile;
    - v. Number of customers in each pricing zone, service or asset.
- Key performance indicators.

In comparison, no cost information whatever is required to be provided in the context of a Part IIIA Undertaking. Neither is any itemisation mandated of the revenue requirement, or volume forecasts.

The unilateral disclosure of this type of commercially confidential information would leave the covered pipeline highly vulnerable, and would fundamentally undermine its competitive position.

Secondly, while the Gas Code Access Arrangement is parallel in many ways to the Part IIIA Access Undertaking, there are profound differences in the mandatory policy content of Access Arrangements as compared to Undertakings.

An Access Arrangement must, as a minimum, include the following elements outlined in section 3 of the Gas Code:

- Services Policy
- Reference Tariffs and Tariff Policy
- Terms and Conditions
- Capacity Management Policy
- Trading Policy
- Queuing Policy
- Extensions/Expansions Policy
- Review and Expiry of Arrangement.

The precise content requirements of these policies are elaborately specified in sections 3.1 to 3.20 of the Gas Code.

In contrast, Part IIIA of the Trade Practices Act establishes no mandatory content for an Access Undertaking. The ACCC's guidelines on Undertakings recommend the following content be included:

- Framework for negotiation
- Procedures for requesting and negotiating access
- Dispute resolution process
- Access prices
- Service standards
- Additional requirements for vertically integrated providers
- Provisions for regular review of undertaking.

In fact, the Duke EGP draft Undertaking does canvass most of the policy areas required under the Gas Code, although arguably not to the precise level of detail required by the Code.

Nevertheless, these stark differences in what policy commitments are required to be placed in an Access Arrangement versus and Undertaking will serve to limit the ability of a covered pipeline to respond flexibly to new market situations. Should circumstance require the revision of policies contained in an Access Arrangement, a regulatory process involving extensive public consultation would be required to effect the change. The uncovered competing pipeline need only face such a process if a policy change involves a change to its Undertaking. Clearly this leaves the uncovered pipeline in a much more flexible market position.

Thirdly, pricing under the Gas Code is more prescriptive than pricing under a Part IIIA Undertaking because the Gas Code mandates a revenue adequacy principle as the basis of pricing, and the review periods for Access Arrangements are generally five years or shorter.

Section 8 of the Gas Code establishes a set of principles for determining reference tariffs. While these are not in themselves unduly prescriptive of particular price outcomes, which can be the result of negotiations, they do mandate a revenue adequacy approach to pricing, whether this is expressed as a 'cost of service', 'IRR', or 'zero NPV' method.

EAPL's current draft Access Arrangement is proposed for a five year term. In contrast, the Duke EGP draft Undertaking proposes a 20 year term.

This type of discriminatory oversight of pricing would clearly damage competition between pipelines, and would therefore be contrary to the public interest in having vigorous competition in markets.

APPENDIX 2 – Why Part IIIA Undertakings are preferred to Gas Code coverage

The following points provide a brief outline of the argument as to why Part IIIA Undertakings are considered a preferable mechanism for economic regulation of the two transmission pipelines serving the Sydney market.

- Under the Gas Code the two pipeline owners will have both the motive and the opportunity to avoid meaningful price competition.
    - The motive is provided by the recognition that in a pipeline context, cutthroat Bertrand competition may develop, which would see prices fall to levels far below either pipeline's average cost of service.
    - The opportunity to avoid meaningful competition is provided by the elaborate cost-price disclosure which is mandatory under the Gas Code. This transparency will greatly facilitate tacit price collusion between the pipeline owners, by permitting the competitors to compare cost structures, demand forecasts, and other information relevant to pricing strategy.
- Under the Gas Code the two pipeline owners will have neither the motive nor the opportunity to respond flexibly to demand conditions in the marketplace.
    - The revenue adequacy philosophy of Gas Code pricing principles removes the motive to adjust prices in response to changing demand conditions.
    - The Gas Code's mandatory policy requirements described in Appendix 1 will work to limit each pipeline's opportunity to adjust to changing market circumstances and develop new service offerings.
- Some innovative price and service offerings would be less likely to occur under the Gas Code because the pipelines would have diminished incentives to make such innovative offerings. In particular, they would need to disclose these offerings, which would make competitive imitation easy. Additionally, they could not limit the scope of any incentives they offered, as all users would naturally seek similar terms and conditions.

- The relatively short term of Access Arrangements may not pose significant problems for monopoly pipelines with small risk of asset stranding. However when there are competing pipelines the risk of asset stranding is substantially increased. In that environment, short review periods are likely to create substantial disincentives for investment, for example in expanding capacity.

APPENDIX 3 – Ability of ACCC to accept an undertaking for a facility which is currently covered under the Gas Code

We are aware of a legal opinion that the ACCC is permitted to accept a Part IIIA Access Undertaking for a facility which is currently covered under the Gas Code.

As a fallback it may be possible to submit a draft undertaking to the ACCC the commencement date of which would be the future date of revocation of Gas Code coverage.

APPENDIX 4 – Whether Gas Code coverage would promote competition in another market

Section 1.9 of the Gas Code identifies four criteria which the NCC must consider in reaching a coverage determination. If all four are met, then the NCC must recommend coverage. If any of the four are not met, then the NCC must not recommend coverage. Paraphrased, the criteria are:

(a) access (or increased access) provided by the Gas Code would promote competition in at least one market other than the market for pipeline services;
(b) it would be uneconomic for anyone to develop another pipeline to provide the services provided by that pipeline;
(c) access (or increased access) can be provided without undue risk to human health or safety; and
(d) access (or increased access) would not be contrary to the public interest.

In past cases, the NCC has granted revocation of Gas Code coverage for several pipelines in Western Australia. Those applications for revocation which have succeeded argued successfully that criterion (a) above was not met. They then argued that consequently continued regulation was contrary to the public interest (d).

Significantly, in none of the revocation cases of which we are aware has criterion (b) ever been found by the NCC not to be met. In other words, the NCC has never to date found that it would be economic for anyone to develop another pipeline. It has been unsuccessfully argued in some of these applications that relatively short pipelines are economic to duplicate. In the case of the Tubridgi Pipeline, the NCC found that it was

uneconomic to duplicate notwithstanding the fact that another pipeline (the Griffin pipeline) ran parallel to it. This precedent may be relevant to the question of whether either the EGP or MSP is considered uneconomic to duplicate. In light of this precedent, the simplistic argument that the MSP is economic to duplicate since it is being duplicated cannot be assured of success.

Concentrating now on criterion (a), the critical question is whether, absent Gas Code coverage, competition in another market would be diminished. To evaluate this question, one must consider what type of regulatory scheme, if any, would apply in the absence of Gas Code coverage.

If a completely unregulated pipeline monopoly or duopoly is the alternative to Gas Code coverage, then the NCC may well take the view that competition both upstream and downstream may be impaired. Competition upstream (between gas producers of the Cooper Basin and the Gippsland Basin) may be impaired if access by one of these producers to the pipeline connecting it to Sydney is not available on comparable terms as access by its competing producers to the other pipeline. Competition downstream (in the Sydney retail gas market) may be impaired if some retailers receive favourable treatment by one of the pipelines.

If the alternative to Gas Code coverage is Part IIIA Undertakings accepted by the ACCC in respect of each pipeline, then it is far from certain that Gas Code coverage would convey any additional competitive benefit in these other markets. On the strength of this argument, criterion (a) would not be met if accepted Part IIIA Undertakings were in place for both pipelines. In that case it would be arguable that continued coverage under the Gas Code, with its onerous reporting and procedural requirements, would be contrary to the public interest (d).