Summary

This submission is designed to address issues that have been brought to a head by two new pipelines. These pipelines are:

- the major new Bass Strait to Sydney (Eastern Gas) pipeline now owned by Duke Energy and nearing completion; this is subject to regulatory reviews through separate ACCC and NCC processes
- AGL's Central West Pipeline, for which an access undertaking approved from the ACCC is required under the Gas Code and has been sought.

Ostensibly, the NCC decides if non-owners should have rights to access specific infrastructure, while the ACCC determines the price and conditions of that access.

Regulation of prices and access reduces the incentives to build private new infrastructure through the uncertainty it introduces–and more so where asset builders have a certainty that the regulators will place downward pressure on prices. Business regulation–even where it simply seeks to reproduce the outcomes of a competitive market - is now generally accepted as having detrimental effects on innovation and economic activity in general. Hence, regulation of price and access, rather than underpinning the normal commercial environment for pipelines, should be in place only when there is a monopoly.

Regulation ostensibly mimics competitive outcomes and it follows that there is no place for regulation where there are two significant sources of supply. From September 2000 when the Eastern Gas Pipeline is commissioned, there will be two major gas pipelines serving the NSW market and two effective gas supply sources. This leads to our first recommendation:

- **Revoke price and access regulation of the Moomba to Sydney Pipeline and place no regulatory requirement on the Eastern Gas Pipeline either by way of ACCC "undertaking" or NCC "Access Arrangement".**

Relaxation of regulatory controls need to go beyond this. The legitimate role for regulation is where infrastructure was put in place under a franchise that prevented rival supply or by government either as an exclusive or subsidised provider. There are now no exclusive franchises and all opportunities are open to any entrepreneur. Hence, new infrastructure can only be built where there is both a willing seller and a willing buyer and rivalry to supply the infrastructure ensures prices are competitive. Regulators can always force lower prices but in doing so they blunt the incentive to build or reduce the quality of service.

This is particularly relevant with the Central West Pipeline, which is already covered to Dubbo by the Gas Code. The ACCC in its Draft Decision required a lower tariff than AGL sought. Our further recommendations seek a diminished regulatory role:

- **The tariff for the Central West link to Dubbo be set on the basis of the AGL expectations at the time of committing to it.**
- **For any extensions of the existing line, since there is no franchise, there should be no requirement to provide a price undertaking to the ACCC nor should any party have a right to seek coverage from the NCC.**

Reforms, Regulation and Productivity

Reform and Productivity

In the early 1980s, according to Lawrence B. Lindsey the seeds were sown for the present 17-year boom of the US economy. Lindsey argues that, "A new view of the economy came to dominate public policy -- a view that differed from the old in major ways:

- Successful deregulatory experiments in transportation served as a model for deregulation of other industries -- including finance and energy.

- Capital gains tax rates were reduced in 1978, and ordinary income tax rates were cut in 1981 and 1986.

- Economists came to see "supply side" management of both inflation expectations and the supply of labor and capital as at least as important as "demand side" management of spending power."[1]

Many of these same reforms took place in Australia. The reforms to infrastructure services included corporatisation and restructuring integrated systems into separate and competing parts. These structural changes were accelerated from 1995 with the National Competition Policy Agreements. The outcome of the process has been spectacular productivity gains - both when previous government owned monopolies were not divided into different competing units (as with Telstra) and when there was a full separation (as in gas and electricity). The greatest gains have been in those firms that have been privatised – telecommunications and Victoria's electricity and gas.

The General Arrangements for Australian Competition Policy

Under Part IIIA of the Trade Practices Act, owners of monopoly infrastructure services like gas pipelines were required to grant access to allow third parties to transport their own product over the network. Access to infrastructure facilities can be brought about in three ways.

First by having "the Designated Minister, or any other person" apply to the NCC to have a service "declared", requiring the owner to allow third parties to use the facility. The terms and conditions of that access can then be negotiated and, in the absence of a negotiated outcome, these are determined by the Australian Competition and Consumer Commission (ACCC).

Secondly, a provider or intending provider may approach the ACCC and offer an "undertaking" specifying terms and conditions of operations. This grants immunity from legal challenge under the Trade Practices Act.

Thirdly, by a State based regime that the NCC has recommended is an "effective" access regime to the Commonwealth Treasurer and where the Commonwealth

[1] Lawrence B. Lindsey (American Enterprise Institute),
"The 17-Year Boom," Wall Street Journal, January 27, 2000,

Treasurer has accepted that recommendation. Eventually the State based regimes, at least in the Eastern States' reticulated energy industries, are likely to fall under the ACCC.

The ACCC cannot accept an undertaking if the service is already "declared". Nor may the NCC recommend a service be declared if it is subject to an access undertaking.

Competition Policy Arrangements for Electricity and Gas Transmission

The approach for electricity under the National Electricity Market follows the general approach. The first line of regulation in the system is the National Electricity Code Administrator, Code change decisions in which need to be ratified by the ACCC.

The ubiquity of electricity in interconnected systems has meant there is little at issue with access, except for the newly discovered element of "entrepreneurial interconnects". These are essentially private lines that trade electricity between markets that are not fully connected and which therefore have price differentials. The interconnects are to be regulated as de facto generators and need not offer open access to all users. For these and other lines, the NCC and Ministers cannot seek to control price and access conditions of the service provider when it has had an undertaking accepted by the ACCC. (This is known as the "effective undertaking approach").

In the case of gas, there is no economic regulation covering the overall production and distribution chain. Rather, there is the National Gas Code, which is an "effective access regime". On one interpretation, this requires access to conform with a comprehensive series of steps with price based solidly on costs that are defined in some detail. On this interpretation, which is the one adopted by the NCC, undertakings are largely irrelevant and do not prevent a party seeking "coverage".

Duke Energy, the owner of the Bass Strait to Sydney Eastern Gas Pipeline has put an undertaking proposal the ACCC based on the Trade Practices Act (s.44ZZA). The ACCC has undertaken to pursue the Duke proposed undertaking indicating it does not share the view that the rigid Gas Code approach is the only route that must be followed.

This indicates a regulatory demarcation dispute in which the two parties: the ACCC and the NCC, may have little in the way of substantive disagreement. Indeed, it is worth noting that the Gas Code itself likens the process of obtaining an Access Arrangement to that of an Undertaking under Part IIIA. It states

Under the Code, the owner or operator of a Pipeline that is Covered under the Code is required to lodge an Access Arrangement with the Relevant Regulator. The Access Arrangement is similar in many respects to an undertaking under PartßIIIA of the Trade Practices Act and is designed to allow the owner or operator of the Covered Pipeline to develop its own Tariffs and other terms and conditions under which access will be made available, subject to the requirements of the Code.

Regulatory agencies can lose their influence if circumvented by rival agencies. But unlike the demarcation disputes involving trade unions, those concerning turf battles

by regulators are totally indefensible since regulators have no claim to represent any of the parties – the regulators are purely a construct of governments.

Regulation and the Entrepreneur: Killing the Goose

Successful though the competition reforms have been, they remain vulnerable to some of the same features that detracted from efficient management when the infrastructure industries were firmly under political control. Chief among these is the intercession of a regulatory entity in many firms' crucial business decisions. That intercession concerns price and access to facilities that are said by regulatory authorities to be natural monopolies.

Firms operating under regulatory supervision automatically incur additional costs. These include management and other resources directed at pleasing and persuading the regulator rather than the customer. And when, as normally occurs, the regulator seeks to become a champion of the customer, longer-term benefits of a robust and dynamic industry are often sacrificed for short-term gains in lower prices.

The major regulatory agency in Australia, the ACCC, now has powers that are arguably greater than those rescinded by governments under the National Competition Policy Agreements. These derive from the ACCC's ability to grant immunity from court challenge where it makes a determination of the correctness of a particular course. This and its corollary, an ability to prevent a development of which it disapproves, is tempered only by an appeal avenue to the Trade Practices Tribunal. Such an appeal process is normally impracticable in the business world where deals must be struck quickly or not at all; moreover, the Tribunal is composed of individuals who increasingly share a common philosophy with the ACCC.

That ACCC philosophy has a strong focus on the detrimental effects of monopoly which is seen to be able to charge excessive prices from customers. In fact most such monopolies are short-lived since if they extract high prices this rapidly attracts competition.

In addressing the prices that firms it regards as monopolies may charge, possibly because of the frameworks set for the industries it regulates, the ACCC tends to adopt arithmetical and highly formulaic price-setting arrangements. These centre on a form of profit control based on the Weighted Average Cost of Capital.

Any modern regulator's pricing decision can only work in one direction. Since no regulator is in a position to restrict supply, its price decisions can never have the effect of raising prices above the market level[2]. The only effect can be to reduce prices. Yet, forced price reductions also make it difficult for competitive rivals to enter the market. Thus regulators' decisions tend to prevent competition, the very process they were created to enhance. Forced price reductions have two other detrimental effects:

- they reduce the incentive of the owner to maintain the facility at its peak service levels, and,

[2] Although in some of their earlier speeches, ACCC Commissioners were under the impression that the prices they could set might be above market levels, thereby attracting wasteful competition.

- they deter new investment both by the owner and others in similar circumstances.

In short, a forced price reduction acts against the longer term interests of all consumers by discouraging investment in new facilities, preventing rivals contending the regulated facility and reducing the incentives of the regulated facility's owners to optimise service levels.

The National Competition Council's regulatory powers overlap those of the ACCC where the issue is access to essential facilities. However, for gas pipelines the NCC can merely determine that the facility in question is "covered", that is its operations are subject to regulatory oversight on price and access. The NCC having determined that the facility is covered leaves the subsequent price and access arrangements to be ultimately determined by the ACCC.

Regulatory agencies have a self-preservation interest in discovering the need to make judgements. Both the ACCC and the NCC have defined roles for themselves where there is no monopoly in the sense that the facility cannot be duplicated. The NCC, for example, has sought, with Rio Tinto's Western Australian rail facilities (which are readily duplicable), to require an infrastructure to carry its rival's products – ultimately on terms that a regulator will determine. Such requirements will lead businesses to defer expenditure on new facilities in the hope that a rival will undertake the expenditure and a regulator can be prevailed upon to grant access on terms more favourable than those that would emerge from negotiation. The price expectations of regulators can be gauged by the outcome of reviews set out in Attachment 1.

The profit regulation and subsequent price sets are likely to lead to sub-optimal infrastructural development so that the owner can deny access because of capacity constraints rather than leave the process to well-meaning but short-sighted regulatory decisions.

The Achilles Heel of the Australian regulation reforms is the possibility that zeal to lower prices or prevent "wasteful" duplication of facilities will deter or distort new investment. The performance of both our regulatory bodies demonstrates an over-willingness to intervene to set prices where such intervention is unnecessary. Where, as with gas, there is also a demarcation dispute with both bodies seeking to assume control of the regulatory arrangements, there is a dual potential for unnecessary costs to be incurred.

The Need for Regulation of the Eastern Gas and Central West Pipelines

Competition Introduced by New Gas Pipeline

An additional pipeline brings new competition. This means the basic premises on which the competition policy arrangements are set for infrastructure do not apply. The regulatory arrangements are posited on natural monopoly, an oxymoron where new competition actually emerges. Regulation in those cases contains all the inevitable downside costs but no upside benefits.

In principle, this is acknowledged by regulators. Thus, the NCC said in one of its own publications [3], "Against these benefits (of increasing competition by giving a business a right to use another business's infrastructure), access regulation can also entail costs if it is applied inappropriately or too widely." Although such wording leaves the agency with maximum scope not to interpret its own activities as "inappropriate" or "too wide" this is a useful acknowledgement. The NCC notes that such regulatory actions would be detrimental for a number of reasons but most importantly by reducing incentives to invest in infrastructure, rather than free-ride on others, thereby reducing overall competition.

Revocation of "Declarations"

In its Assessment of the National Gas Access Regime, the NCC noted, "Three submissions [PG&E, IPA and Chevron] argue that regulation of access to a pipeline becomes unnecessary when there is competition in providing services. The Council concurs with this view, in the sense that regulation of a monopoly service seeks to replicate, as much as possible, outcomes in competitive markets[4]."

Subsequently, procedures for seeking revocation were published. These follow the same format as those seeking coverage and state, "Any person (including the regulator) may apply to the Council for revocation of coverage of a pipeline".

Gas Transmission in NSW and Victoria

The NCC has not made any public utterance suggesting that there is a case in view of the Eastern Gas Pipeline for revocation of the regulations covering gas pipelines into NSW.

The IPA seeks such revocation in this submission. As the Eastern Gas pipeline squarely competes with the existing Moomba to Sydney EAPL line no regulation of either is warranted. Regulation should be removed. In practical terms this should proceed by:

- the draft undertaking being sought by Duke Energy for the Eastern Gas pipeline should be simply accepted without demurral,
- the now redundant coverage of the Moomba to Sydney EAPL line should be withdrawn (as it can be under s.44 ZZA(7) of the Trade Practices Act).

IPA makes this application on the grounds provided for by the Council[5]. The procedures for revocation mirror those in the Code with regard to applications for coverage. They provide that the Council must recommend that coverage be revoked if it is *not* satisfied that the pipeline meets one or more of the following matters:

[3] The National Access Regime A Draft Guide to Part IIIA of the Trade Practices Act, NCC , August 1996 p.7

[4] National Gas Access Regime, *Recommendation to Gas Reform Implementation Group on the National Third Party Access Regime for Natural Gas Pipeline Systems,* September 1997, Assessment against the Competition Principles Agreement National Competition Council.

[5] Application for Revocation of Coverage of Pipeline – National Gas Access Code

(a) that access (or increased access) to Services provided by means of the Pipeline would promote competition in at least one market (whether or not in Australia), other than the market for the Services provided by means of the Pipeline;

(b) that it would be uneconomic for anyone to develop another Pipeline to provide the Services provided by means of the Pipeline;

(c) that access (or increased access) to the Services provided by means of the Pipeline can be provided without undue risk to human health or safety; and

(d) that access (or increased access) to the Services provided by means of the Pipeline would not be contrary to the public interest.

Clearly, there is a rival pipeline system serving at least the NSW market. It might be claimed that the pipelines do not fully compete and that only parallel pipelines meet this criteria. Such a view of competition defines away the very concept. If Ford can only be regarded as competition with Honda when it builds identical cars, the role for regulators usurps all competitive processes.

It might also be argued that the reserves in the Cooper Basin are less than those in Bass Strait and longer term the EAPL may face a disadvantage over the Eastern Gas pipeline in its source of supply. This line of argument is intrinsically flawed–no two fields are identical – and is weakened by the time spans under consideration. Thus it will be a decade from now before the Cooper Basin *may* be facing reduced reserves, and if it were facing reduced reserves there is little the authorities could or should do - it makes no sense (and is anti-consumer) to hobble one competitor because of its rival's weaknesses. Moreover, unless prevented by regulatory actions, there are likely to be new sources of gas entering NSW from Queensland, and the Connor dream of piping gas across the continent from WA may even be commercially possible.

The Eastern Gas Pipeline means the NSW market is open to the full gales of competition. We have Coke versus Pepsi in pipelines to Sydney and the case for their regulation has disappeared. With the construction of the Eastern Gas pipeline, the conditions that could warrant either an undertaking or any other form of regulated price and access conditions disappear. The two pipelines themselves have considerable over-capacity and they will be engaged in a price war. In short, the issue is not whether the ACCC or the NCC should have jurisdiction but why should either have a regulatory role. With two pipelines supplying an area, as long as there is no collusion, the case for regulation rests solely on the benefits to the regulators themselves.

The Different Marketing and Cost Recovery Approaches of the Gas Code and Duke

The competitive pipeline process also allows competition in marketing approaches as a result of the different strategies of laid out in the Gas Code (which EAPL may

follow) those of Duke. Duke favours setting prices openly so that all possible users know what the price is and that they are assured of obtaining the lowest possible price. This single price, which also finds favour with the consumerist inclinations of the ACCC, according to Duke offers customers more confidence in choosing to use gas since they know that they will automatically benefit from improved prices negotiated by a rival or any other similarly placed business. The Gas Code takes a more individualistic line, one that focuses heavily on a business to business negotiating philosophy. Although regulator sanctioned "reference" prices are likely to be the norm, the Gas Code envisages prices being set to meet individual customer circumstances and lower prices to a single customer being negotiated if the alternative is to loss of a sale

Ostensibly the Code and Duke also adopt a different approach to setting the overall amalgam of prices. Duke has developed vectors of possible market outcomes based on different prices and volumes, has set its required rate of return and, competitive conditions permitting, intends to hold the same maximum real price over the course of twenty years. The Code envisages the possibility of low start prices to bring new users into the market and capitalisation of early year losses which can be recouped later. Prices are based on an explicit target rate of return rather than the Duke approach of an implicit target.

Gas-on Gas Competition

The benefits of deregulation also encompass Victoria since the Eastern Gas pipeline is to link with the Victorian system at Sale. Already with the Albury interconnect EAPL and Duke have negotiated prices to allow the latter to service customers in the Sydney area with Bass Strait gas. Some modest competitive pressure is evident in the NSW market. With full-blooded competitive capacity, this pressure will also impact on Victoria. Duke has already signaled the backhaul rate it intends to offer for gas from Sydney to Sale.

The ACCC has been campaigning to try to have the partners in the Moomba Basin and in Bass Strait market their gas separately rather than as joint ventures. This would clearly reduce the price. It is not however possible for the Commission to dissolve the contractual arrangements that permit joint marketing arrangements to continue, which is just as well since the damage done to property rights from such an intervention would be considerable. However, the Eastern Gas Pipeline allows robust competition in the NSW market - and probably the Victorian market - for the first time.

The ability to pipe gas from either Bass Strait or Moomba means the owners of the fields themselves must be forced to reduce prices. Although this is already evident in the limited trade that can take place through the Albury interconnect, the capacity of the link is such that the full pressure of the Bass Strait reserves cannot be imposed on the Moomba fields.

With Eastern Gas's 110 petajoules pipeline coming onto stream in September of this year adding to the 152 petajoules available on the Moomba line, this position will change dramatically. Suddenly, there is some 60 per cent of the combined capacity of the pipelines under-utilised. And the two fields' owners will see opportunities to win

competitive shares. This will occur despite the common ownership of ESSO with a 20 per cent share in the Cooper Basin (the ownership of which is dominated by Santos) and as the operator with 50 per cent in the Bass Strait Joint Venture. That cross ownership is unlikely to prevent considerable rivalry from the two fields putting downward pressure on prices. The different composition of the two joint ventures will force each field to seek to undercut the other's prices in order to win market share. The general provisions of competition policy thwart collusion to prevent rivalry.

Ironically, by the regulators placing impediments in the way of full frontal competition, the process of dissolving the regional monopolies that have long exercised price controlling strangleholds in all the Eastern States is deferred. The uncertainty over permitted pricing levels and access regimes means delays in the marketing programs of both Duke and EAPL and defers the ability of customers to benefit from the lower prices.

The Central West Pipeline

The ACCC has published a draft decision on the Access Arrangement proposed by AGL for its new Central West Pipeline. In doing so its decisions typify the shortcomings of the highly intrusive regulatory arrangements that have been put in place. The Gas Code is inflexible in its provisions for coverage. It is bureaucratic in design, requiring a five-year re-set, and tariffs structured to costs. It sets prices based on a regulated return.

The Central West pipeline is a marginal project which required a Commonwealth grant in order for AGL to justify its go-ahead. Under the ACCC's Draft Decision, AGL is required to lower its prices based on a rate of return on capital of 7.5% compared to a rate it sought of 10%. On the face of it such an outcome is beneficial. After all, it reduces prices to the customers in the area. But price setting by a regulator will undermine entrepreneurship. It has no place in a situation where there is no monopoly. AGL had no franchise to supply gas to the area in question. It has many rivals in Australia seeking opportunities to find new markets. The outlet is from the Moomba to Sydney pipeline, largely owned by AGL but operated by EAPL as a totally independent entity–had an AGL rival approached EAPL they would have secured the same conditions as those gained by AGL.

AGL had determined that the customers for the pipeline would be willing to pay $2.78 per gigajoule in 2004 but the ACCC has determined they must pay no more than $2.32. Intervention to reduce a price sought by an enterprise in this way is a sure route to economic stagnation. At best it will lead to the entrepreneur engaging in wasteful deception to try to persuade the regulator that his costs are really higher or his market weaker than he has said they are. Most likely, it also sends a message to all businesses looking at expanding networks under the ACCC's oversight that they must please more than the target customers. Hence, the decision of the ACCC to cut the price of the pipeline in this way will have a sobering effect on other worthwhile ventures.

One approach favoured by the Gas Code to try to introduce some market orientation into the price setting process was to allow tariffs in new areas to be determined through a market tendering process for a pipeline that is yet to be built. This has merit, especially if the galaxy of different prices and qualities can be reduced to a single number. And the linking up of the northern Victorian towns in 1996 was accomplished using such an auction system with the consumers in those areas accepting that their tariffs would be above those of the rest of the State.

However, the Victorian initiative occurred in a situation where no market outcome had previously been permitted: there was only one permissible supplier and the Government insisted that all consumers in the State were covered by the same tariff schedule. These conditions should not apply in the future and it should be far more open to suppliers (or indeed customers) to take action to build new pipelines. It is seldom the case that there will be several suitors for a particular line. And if there are it would be because one firm, observing the keenness of a rival to supply an area will offer an alternative bid. This ability to free ride on other firms greatly diminishes the value of searching out information on market needs and will reduce producer responsiveness to consumer needs.

A subsequent decision under similar circumstances to the gas extensions to the northern Victorian towns was made in June 1999 to supply Mildura [6]. This followed a competitive tender in which Envestra was successful and was granted the access arrangement by the Office of the Regulator-General with a pre-tax real rate of return of 9 per cent. That rate provides a benchmark for a market based rate of return for a new pipeline to a rural area, though interest rates may have fallen slightly since 1997 when the Mildura competitive tender was conducted.

Unlike the regulatory turf battle with the Eastern Gas pipeline, the matter of jurisdiction over the Central West Pipeline has not arisen. The NCC has apparently acquiesced in the ACCC taking the decisions on Central West. Doubtless, the NCC will argue that this is because there was an application for coverage with regard to the Eastern Gas Pipeline under the Gas Code. But if it must act on such applications then all rivals will seek to frustrate new competitors within the regulatory tribunals. This will hamper the ability of new businesses to win customers since they will be unable to offer firm tariffs. And the regulatory arrangements agreed by CoAG were designed to facilitate competition not hamper it.

[6] Access arrangement for Envestra Limited in respect of the proposed Mildura Natural gas distribution system, Final decision,, Office of the Regulator General, 3 June 1999

Attachment 1

Regulators' Price Decisions

ISSUE	REGULATOR	Applicant charge	Determined charge	Date
AGL gas contract market	IPART	Annual revenue reduction from $140m to $128m	Annual revenue reduction to $99m	May 1997
Vic gas	ACCC/ORG	9.7-10.2 return real pre tax	7.75% return real post tax	Oct 1998
Wagga gas (GSN)	IPART	Original 11.1% later offer 9.0%	7.75%	March 1999
Telstra Interconnect	ACCC	4.7c/minute	2.0c/minute with 1.6 c suggested Sept 1999	June 1999
Adelaide Airport	ACCC	8.89% real pre-tax or $3.66/passenger	8.25% real pre-tax or $3.45/passenger	June 1999
Mildura gas	ORG	Tender at 9% real pre-tax	9% real pre-tax	June 1999
Albury gas	IPART	9.6%	7.75%	July 1999
NSW vesting contracts	ACCC	43.64 cents	no more than 40 cents	Sept 1999
NSW distribution prices	IPART		16% real price reduction 1999-2004 7.5% (7.75% AIE, AE) 15% O&M reductions (10% AE, 5% AIE)	Sept 1999 Draft Determination
AGL Pipelines for the Central West Pipeline	ACCC	Real pre-tax WACC of 10% tariff increasing after 2001 at CPI+1.36%	Real pre-tax WACC at 7.5% meaning prices are frozen in real terms post 2001	Sept 1999 Draft Decision