

GGT



G O L D F I E L D S

G A S

T R A N S M I S S I O N

PUBLIC SUBMISSION

DRAFT RECOMMENDATION: APPLICATION FOR COVERAGE EASTERN GAS PIPELINE

**Submitted to the
National Competition Council**

6 June 2000

INTRODUCTION and EXECUTIVE SUMMARY

Goldfields Gas Transmission Pty. Ltd. (GGT), the operator of the Goldfields Gas Pipeline in Western Australia, takes this opportunity to provide its public comments on the Draft Recommendation recently handed down by the National Competition Council (NCC) on the application for coverage of the Eastern Gas Pipeline under the National Third Party Access Code for Natural Gas Pipeline Systems (the Code).

This public submission makes the following key points:

- 1) The nature and content of the Draft Recommendation does not give adequate or appropriate recognition to the fundamental issue of direct and actual competition between the Eastern Gas Pipeline (EGP) and Moomba to Sydney Pipeline (MSP). Details of process have displaced applicability of process in considering the issue of coverage under the Code. A narrow and legalistic approach can only deliver results which inhibit both competition in the gas transport market and the development of the Australian economy.
- 2) The logic used to arrive at the key elements of the Draft Recommendation is fundamentally flawed. Monopoly theory is misapplied to competing pipelines. This (gross) shortcoming, if translated into a Recommendation to the Minister, will create a regulatory precedent which will stifle rather than promote competition. In turn, this will act to the detriment of gas producers, gas end users, the wider economy, and Australian society.
- 3) The Draft Recommendation increases the already high level of regulatory uncertainty in Australia. Such uncertainty increases sovereign risk and hence discourages investment because potential returns are not commensurate with investment risk.
- 4) Competing gas pipelines should not be covered under the Code. In this case, neither the EGP nor the MSP should be subject to regimes of 'synthetic competition'. Rather, these and other competing pipelines should be subject to the discipline of actual (and not artificial) market forces and should therefore be free from regulatory intervention.
- 5) The NCC is not inextricably bound to its Draft Recommendation. Having delivered an open rather than definitive decision regarding coverage of the EGP, the NCC can now consider (with the benefit of input from key stakeholders) the wider issues at hand and the wider consequences of its actions. If the gas transport industry is given encouragement to develop new pipelines on an entrepreneurial basis (by the NCC facilitating an actual rather than synthetic competitive environment in which pipelines operate), the number of competing pipelines in Australia will increase. If this outcome is achieved, then the NCC can truly claim to have fulfilled its primary function of encouraging competition and enhancing the welfare of Australian society.

The Draft Recommendation does not give adequate or appropriate recognition to the fundamental issue of pipeline on pipeline competition.

The Draft Recommendation states (page 27) that the Eastern Gas Pipeline (EGP) has a capacity of 55 petajoules (PJ) per year, or approximately 150 terajoules per day (TJ/d). Further, the Moomba to Sydney Pipeline (MSP) has a current capacity of 172 PJ per year, or approximately 470 TJ/d (ibid). This means that the EGP holds approximately 24 percent of gas transport capacity to the state of New South Wales, and the MSP holds approximately 76 percent. The Draft Recommendation states (page 21) that the MSP currently transports about 115.8 PJ per year to NSW. The Draft Recommendation also states (page 16) that the EGP currently has transport contracts for approximately 35 PJ per year. Thus, the EGP will carry about 23 percent of the gas supplied to NSW, and the MSP will carry approximately 77 percent.

It is therefore apparent that in terms of both actual deliveries and delivery capacity, the EGP holds just under one quarter of the market for gas transport into NSW. This means that it is a significant transporter of gas into NSW.

The vast bulk of the NSW gas market is located in and around Sydney. Both the EGP and the MSP supply to this region.

Because the EGP holds a significant share of the gas transport market into NSW, neither the EGP nor the MSP can or should be considered as monopolies in the market for gas transport into NSW. As both pipelines are privately owned, operate on a 'for profit' basis, and can readily take market share from each other, they necessarily face competition from each other.

The Draft Recommendation (page 6, page 19) addresses the issue of coverage of the EGP solely under the provisions of section 1.9 of the National Third Party Access Code for Natural Gas Pipeline Systems (the Code). While this is correct insofar as the Code itself is concerned, the wider issue of competition between pipelines and the consequences of that competition for wider stakeholders is ignored.

The fundamental issue at hand is whether competing pipelines should be regulated as monopolies, rather than whether the EGP strictly satisfies all of the criteria of section 1.9 of the Code. Restriction of considerations of coverage to the provisions of the Code is an example of 'throwing the baby out with the bath water'. If section 1.9 is to be used as the sole set of criteria for coverage, considerations of process detail will have displaced considerations of applicability of process.

The decision regarding coverage of the EGP will be a landmark in the regulation of Australian gas pipelines. It will establish regulatory precedent which will have marked and lasting impact on the gas transport industry. This impact will be felt by producers and end users alike. A narrow and legalistic approach can only deliver results which inhibit both competition in the gas transport market and the development of the Australian economy.

Draft Recommendation logic is fundamentally flawed.

The Draft Recommendation states (page 11) that the EGP may not promote competition in the sale of natural gas in south east Australia because the EGP could abuse its market power. In particular, the EGP could restrict its throughput and hence charge artificially high prices.

This argument should be considered in light of the following:

- The EGP will transport approximately one quarter of the gas supplied to NSW. Its competitor, the MSP, will transport the balance.
- The EGP and the MSP are separate entities with separate ownership.
- The EGP and the MSP compete head to head.
- The EGP and the MSP currently have significant spare capacity.
- A "significant amount" (Draft Recommendation page 25) of 'banked gas' is available from the Cooper Basin.

If the EGP were to restrict its throughput to charge "higher prices that otherwise would be the case" (Draft Recommendation page 11), its competitor, the MSP, would be capable of accommodating the outstanding demand. Restriction of supply by the EGP would therefore be to its commercial disadvantage. The only economically rational option available to both the EGP and the MSP is to compete vigorously with each other.

It is therefore clear that the NCC's argument that the presence of the EGP does not necessarily promote competition is fundamentally flawed.

The argument presented by the NCC in the Draft Recommendation regarding curtailment of supply to increase profit reflects conventional economic theory of the behaviour of profit maximising monopolies. Such monopoly theory is widely accepted and is taught in many introductory economics classes.

However, the EGP is not a monopoly. It holds a partial share of the market for gas transport into NSW. It therefore naturally follows that the EGP's competitor, the MSP, is also not a monopoly.

Thus, application of monopoly theory to pipelines which are not monopolies is simply incorrect.

If misapplication of theory becomes incorporated and legitimised in regulatory precedent, the subsequent impact will inevitably become magnified. Misuse of theory directly engenders distortion of the market mechanism. Such distortion adversely impacts actual competition. All three major links in the gas chain (i.e. producers, pipeline operators, and end users) stand to lose in the long run if competition is inhibited.

In turn, the wider Australian economy is the loser and the ability of Australian industry to compete in the global market is diminished.

The Draft Recommendation increases regulatory uncertainty, increases sovereign risk and discourages future investment.

The gas transport industry in Australia is currently undergoing profound change. State owned pipelines have recently been or are in the process of being privatised. 'De-regulation by re-regulation' is being promoted as the path to lower delivered gas prices. Open Access legislation (which incorporates the Code) requires that a balance between the competing interests of producers, pipeliners, end users, and the wider public be achieved. Some recent and impending decisions by regulators have attracted considerable controversy. The times taken by regulators to hand down Draft and Final Decisions have understandably and reasonably (given the nature of the Code) far exceeded the nominal schedules laid down in the Code.

It is therefore reasonable to observe that the level of uncertainty surrounding the regulation of the gas transport industry in Australia immediately prior to the handing down of the Draft Recommendation was at an all time high.

The Draft Recommendation does not provide a decision on the question of whether the EGP should or should not be covered under the Code. Rather, it provides a list of some but not all of the options available to the NCC in dealing with the issue of coverage of the EGP.

The absence of a decision in the Draft Recommendation regarding coverage of the EGP creates considerable new regulatory uncertainty for the gas transport industry in Australia. Proponents of potential new pipelines in Australia do not have a clear basis for understanding which, if any, regulatory regime might apply to their project(s). Further, proponents of new pipeline projects may reasonably expect similar indecision and uncertainty to surround the regulation of their projects when they materialise.

The regulatory uncertainty currently faced by the Australian gas transport industry is a manifestation of sovereign risk. It is risk which is present because the implementation of government policy does not provide a stable and predictable business environment for pipeline operators. Higher sovereign risk is something which is normally linked to investment in third world countries. Regrettably, this association now extends to the Australian gas transport industry.

The bulk of gas pipelines in Australia are now held in private ownership. Further, any future new Australian gas pipelines will almost certainly be privately owned. Therefore, it is the (private) investor in existing and new pipeline projects, and not the government or the taxpayer, who directly bears the risk arising from the uncertainty surrounding the regulatory framework for the Australian gas transport industry.

The rate of return compared to associated risk (i.e. uncertainty of return) is a key criterion for making investment decisions.

Regulators covering the Australian gas transport industry have to date mandated rates of return for Australian gas pipelines which are generally seen to be applicable to 'safe' public utilities. However, the risks faced by investors in pipelines arising from the regulatory uncertainty in Australia are greater than those faced by investors in an actually 'safe' public utility. In Australian regulatory Decisions handed down to date, potential upside gains and downside losses have generally been treated asymmetrically. 'Incentive mechanisms' mandated by regulators have typically been blunt instruments to 'motivate' pipeline operators to further reduce costs, rather than genuine incentives to innovate in a rapidly changing business environment. However, no 'safety nets' have been provided to protect pipeline operators on the downside. Such regulatory asymmetry inevitably increases risk, as pipeline operators and their owners have no means of hedging or otherwise mitigating regulatory risk on the downside, and are prevented from realising upside gains.

Consequently, the economically rational investor will invest in alternative opportunities which offer either a higher return for the same risk, or lower risk for the same return. The current rash of attempted on-selling of recently privatised government utilities by their new owners provides stark evidence of this.

The effects of loss of investment in new pipelines will not be felt immediately. New pipelines are not built every day. Existing pipelines have, to varying degrees, some spare capacity. Thus, in the short term, the impact of the sovereign risk facing the Australian gas transport industry will not be noticed. It will probably be several years before gas transport capacity becomes progressively tighter. Because prices are capped by the regulatory process, the operation of the market mechanism will be distorted. Investment in new pipeline infrastructure will be less than in an unconstrained environment. Other energy sources will by default become more viable, and the national market for gas will suffer. In turn, this will lead to a reduction in competition between gas, electricity, and other forms of energy. The net loser will be the Australian economy and Australian society.

Because of the inertia associated with capital intensive projects, legal and regulatory precedent, and changes to government legislation, there will be no quick solutions to the problem once the effects of a shortage of gas transport capacity are felt. The negative impact of today's inappropriate regulatory decisions will continue to bite long after the problem first manifests itself. The Australian natural gas industry, users of natural gas, the wider economy and the environment will continue to pay for regulatory mistakes long after they are recognised.

Competing pipelines should not be covered under the Code.

Natural gas pipelines can most definitely be natural monopolies. However, not all gas pipelines are monopolies. In particular, the EGP and the MSP are not monopolies. The Parmelia Pipeline in Western Australia is not a monopoly. The Interconnect is not a monopoly. When the PNG pipeline becomes operational, the Wallumbilla to Gladstone and Roma to Brisbane pipelines in Queensland will not be monopolies.

The Code indicates (Introduction point (b)) that the pipelines it covers are monopolies. Major provisions of the Code clearly address monopolies. Section 1.9(b) (coverage criteria) addresses natural monopolies. Section 8.1(b) (tariff setting principles) mandates the replication of a competitive market.

Thus, it is apparent that the Code is intended to regulate monopoly pipelines.

The EGP, MSP, and other pipelines mentioned above are not monopolies.

The application of a regulatory regime which is intended to apply to monopolies is not appropriate for competing pipelines. This is because of the obvious and fundamental differences between monopolistic industry structures and competitive industry structures. Regulation in the presence of actual competition where pipelines operate in a sphere of rivalry will inevitably reduce, rather than promote, competition. In turn, this outcome directly contravenes the cornerstone of Open Access legislation, and will act to the detriment of the Australian economy and Australian society at large.

Applying the Code to the EGP, MSP, Parmelia Pipeline, the Interconnect, in the future the Wallumbilla to Gladstone and Roma to Brisbane pipelines, and any other competing pipeline constitutes the use of the wrong tool for the job at hand. Just as a sledgehammer is not the appropriate tool for repairing a Swiss watch, application of the Code to competing pipelines is a glaring example of the application of an inappropriate regulatory regime.

Competing pipelines should not be covered under the Code.

Conclusion: the NCC can move forward positively.

The NCC is not inextricably bound to its Draft Recommendation. In offering a variety of options rather than a decision on whether the EGP should be covered under the Code, the NCC is in a position to accept public comment (such as this) to assist it in reaching a final and definitive Recommendation to the Minister. Such a consultative approach is entirely in keeping with the overall philosophy of transparency and public input which underpins Open Access regulation.

The NCC is now poised to provide regulatory leadership to the gas transport industry and the various industry regulators. The NCC is well positioned to

consider (with the benefit of input from key stakeholders) the wider issues at hand and the wider consequences of its actions.

If the gas transport industry is given encouragement to develop new pipelines on an entrepreneurial basis, the number of competing pipelines in Australia will increase. If this outcome is achieved, then the NCC can truly claim to have fulfilled its primary function of encouraging (actual) competition and enhancing the welfare of Australian society.

World events over the past ten to fifteen years have dramatically demonstrated that market based, and not centrally planned economies deliver superior outcomes. Interpolation of this phenomenon and subsequent application to the Australian natural gas transport industry is not only valid but necessary. The NCC, by recommending against coverage of the EGP and giving meaningful consideration to current and future applications for revocation of coverage by competing pipelines, can promote the market based (and not bureaucratically based) development of the Australian natural gas industry and contribute to the development of the Australian economy as a whole.