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# Economic review of gas pipeline coverage criteria in light of proposed amendments

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A report for APA Group

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## Executive Summary

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This report has been prepared for APA Group (APA) for submission to the review of the coverage criteria for gas pipelines being undertaken by Dr Michael Vertigan AC, on behalf of the COAG Energy Council. It focuses on the economic principles underpinning the ACCC's proposed amendments to the coverage criteria for gas pipeline businesses.

*The economic premise for the ACCC's proposed revisions to the coverage criteria depends on an unduly narrow interpretation of 'competition'.*

The ACCC's proposal to revise the coverage criteria turns on its proposition that competition is not sufficiently synonymous with efficiency for the purpose of determining which pipelines should be covered.

This proposition is inconsistent with fundamental economic principles and relies on an unduly narrow interpretation of 'competition' that is inconsistent with both economic theory and relevant jurisprudence.

Competition is properly defined as a process of rivalry between firms. For rivalry to be intensified in a market, it is not necessary that the number of competitors increases. Rather, an increase in competition will be promoted by any change in a market that strengthens the intensity of rivalry between firms. Changes in market conditions that increase 'at risk' profits will increase firms' motivation to compete fiercely. It is through this intensified rivalry that cost savings are passed on to consumers in the form of lower prices and higher output.

Careful review of the examples furnished by the ACCC by way of support for its core proposition suggest that – providing the materiality standard was also satisfied – each would be likely to meet the threshold for coverage under the existing criterion (a).

*The proposed criteria do not offer a better basis for making decisions.*

It follows that the ACCC's proposal does not offer a better economic basis for making declaration decisions.

*However, changing the coverage criteria would result in clear losses, risks and costs.*

Changing the structure of the coverage criteria would require the establishment of a complete new set of jurisprudence, setting back the administrative efficiency and effectiveness with which coverage decisions are made.

Until sufficient jurisprudence is developed, a proposed change to the coverage criteria of the structural magnitude suggested by the ACCC would substantially increase the degree of uncertainty associated with the gas pipeline access regime.

This would significantly increase the managerial, legal and administrative costs of developing and determining declaration applications.

*Rather, there is much to be gained by amending the criteria to maintain alignment with the Part IIIA regime.*

Rather than adopting the coverage criteria proposed by the ACCC, there is much to be gained by amending the existing criteria to align with proposed amendments to the CCA. This would not only preserve their economic alignment but also the value of existing and future jurisprudence.

# 1. Introduction

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This report has been prepared at the request of APA Group (APA), for submission to the review of the coverage criteria for gas pipelines being undertaken by Dr Michael Vertigan AC, on behalf of the COAG Energy Council.

The context for our report is the Australian Competition and Consumer Committee's (ACCC's) East Coast Gas Inquiry report (the *Inquiry Report*) and its conclusions that:

- most east coast gas transmission pipelines have significant and enduring market power and are exercising that market power to the detriment of economic efficiency, resulting in higher prices and reduced output in the provision of pipeline services;<sup>1</sup>
- the coverage regime for gas transmission pipeline services is incapable of addressing this problem because of its focus on competition in related markets rather than efficiency;<sup>2</sup> and
- the coverage criteria should therefore be reformed, so as to focus directly on the existence of enduring market power and whether or not coverage would contribute to the achievement of the NGO.<sup>3</sup>

In light of these findings, Dr Vertigan has been appointed to examine whether a new test is required for determining whether gas pipelines should be subject to economic regulation. He is expected to report back to Energy Ministers at the December Council meeting. In order to assist individuals and organisations to prepare submissions as part of the consultation process for this review, Dr Vertigan released a consultation paper on 4 October 2016.<sup>4</sup>

This report has been prepared for the purpose of assisting the consultation process. In particular, APA has asked that we review the economic principles underpinning two aspects of the ACCC's *Inquiry Report* and the proposed revised criteria contained therein, namely:

- the ACCC's premise that coverage and so regulation of pipeline tariffs could increase efficiency without increasing competition in any related market, thereby establishing a case for amending the coverage criteria; and
- the four particular examples put forward by the ACCC as evidence of circumstances where inefficiencies arise, but the current coverage criteria would not be met.

Our report is therefore structured as follows:

- section two summarises the basis for the ACCC's findings that the existing coverage criteria are not capturing circumstances that give rise to economic inefficiency, and so require amendment;
- section three considers the relationship between competition and efficiency to assess the basis for the ACCC's conclusion that changes to the criteria are warranted;
- section four discusses the economic costs that would be associated with substantive, structural changes to the coverage criteria; and
- section five provides concluding comments.

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<sup>1</sup> ACCC, *Inquiry into the east coast gas market*, pp 92-120, April 2016.

<sup>2</sup> ACCC, *Inquiry into the east coast gas market*, p 128, April 2016.

<sup>3</sup> ACCC, *Inquiry into the east coast gas market*, p 138, April 2016.

<sup>4</sup> Dr Michael Vertigan, *Examination of the current test for the regulation of gas pipelines – Consultation Paper*, October 2016.

## 2. ACCC's analysis of coverage criteria limitations

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The ACCC's inquiry report contends that most east coast gas transmission pipelines have substantial and enduring market power and are exercising that market power to the detriment of economic efficiency. The inefficiencies contended by the ACCC are said to manifest as raised prices and reduced output in the pipeline services market as well as in related markets that depend on pipeline services.<sup>5</sup>

In the ACCC's opinion, these circumstances have arisen because the coverage regime that establishes the threshold for regulation of the terms and conditions of access to gas transmission pipeline services is not capable of capturing pipelines that are setting prices that can only be sustained through the exercise of market power. In its opinion, this is because the coverage criteria focus on competition in upstream or downstream markets and, although competition may be a proxy for efficiency, there are significant inefficiencies in the provision of pipeline services that have little or no impact on competition in dependent markets.

The ACCC finds that, historically, coverage criterion (a) has been most difficult to satisfy. In the ACCC's opinion, this is because pipeline operators are, with one or two exceptions, not vertically integrated. Such pipelines therefore have no incentive to deny access or to behave in a way that adversely affects competition in an upstream or downstream market.<sup>6</sup>

On these foundations, the ACCC proposes that the coverage criteria be replaced with a new test that would be triggered if the relevant Minister, having regard to the National Competition Council's (NCC's) recommendation, is satisfied that:<sup>7</sup>

- the pipeline in question has substantial market power;
- it is likely that the pipeline will continue to have substantial market power in the medium term; and
- coverage will or is likely to contribute to the achievement of the National Gas Objective (NGO).

Recall that the NGO is to:

...promote efficient investment in, and efficient operation and use of, natural gas services for the long term interests of consumers of natural gas with respect to price, quality, safety, reliability and security of supply of natural gas.

Critical to the ACCC's proposal to amend the coverage criteria is its proposition that competition is not synonymous with efficiency. The ACCC's reasoning is encapsulated in its statement that:<sup>8</sup>

...the problem with using competition as a proxy for efficiency is that competition and efficiency are not synonymous. That is, while competition may promote efficiency, significant efficiency improvement can still be achieved in upstream and downstream markets, without any change in competition in a related market, if a pipeline's market power is constrained.

The ACCC's *Inquiry Report* does not detail the economic rationale for its contention that competition and efficiency may not always accord with each other. Rather, the ACCC supports its proposition by describing four hypothetical cases for which it claims the existing criteria would not result in coverage even though this would improve efficiency. These cases may each be summarised as follows:<sup>9</sup>

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<sup>5</sup> ACCC, *Inquiry into the east coast gas market*, April 2006, p 115.

<sup>6</sup> ACCC, *Inquiry into the east coast gas market*, April 2006, p 129.

<sup>7</sup> ACCC, *Inquiry into the east coast gas market*, April 2006, p 138.

<sup>8</sup> ACCC, *Inquiry into the east coast gas market*, April 2006, p 130.

<sup>9</sup> ACCC, *Inquiry into the east coast gas market*, April 2006, p 130.

- the elimination of monopoly pricing on a regional pipeline being used by two gas retailers may not change competition because the retail market is too small to attract any other competitor;
- the reduction in pipeline charges may improve efficiency through a 'transfer of wealth' to the upstream market without affecting competition if this results in existing producers carrying out more exploration and supplying more gas;
- the reduction in charges on pipelines supplying a mining company selling into a global market may displace higher cost producers and reduce prices in that global market without affecting competition, since the global market is already workably competitive; and
- similar considerations as those immediately above apply to an industrial producer supplying into a domestic workably competitive market.

Each of the ACCC's examples involve an increase in efficiency in related markets, in the sense that prices fall and output is increased. However, the ACCC suggests that competition is unaffected, for two main reasons. In the first two examples, the ACCC states that competition would not be affected because the number of competitors would remain unchanged. This is because the improved opportunities for profits are not sufficient to elicit new entry into the dependent markets. In the final two examples, the ACCC suggests that competition cannot be increased in markets that are already workably competitive.

In deducing that coverage would promote an increase in efficiency but not competition in these examples, the ACCC adopts a very narrow interpretation of the term 'promote a material increase in competition'. Specifically, the ACCC makes an implicit assumption that 'competition' should be measured by direct reference to the number of competitors in the market.

In the next section, we discuss the relationship between efficiency and competition. We also consider each of the ACCC's examples to determine whether the ACCC's proposed amendments would be likely to result in a material difference in the matters to be taken into account in making coverage decisions.

## 3. Economic analysis of the ACCC's reasoning

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In this section we consider the relationship between economic efficiency and competition in order to assess the ACCC's premise that it is possible for economic efficiency to be improved independently of an increase in competition. We find that it is difficult to envisage any situation (outside of natural monopoly industries)<sup>10</sup> in which efficiency would be enhanced but competition would not also be increased.

### 3.1 How synonymous are competition and efficiency?

Other than its illustrative examples, the ACCC provides no explicit support for its core proposition that competition and efficiency are not sufficiently synonymous for the purpose of establishing pipeline coverage criteria that would be likely to contribute to the achievement of the NGO.

We disagree with this core proposition. It is a fundamental underlying principle of economics that competition and efficiency are inextricably linked. The incentives that encourage firms to compete with one another are the same as those that encourage firms to operate and price efficiently. All else equal, a decision on whether or not to regulate the price of an input product cannot promote one in the absence of promoting the other.

This principle is founded on a much broader interpretation of the process of 'competition' than is contemplated by the ACCC. Through its consideration of the illustrative examples, the ACCC reveals an implicit assumption that an increase in competition requires an increase in the number of competitors, and that competition cannot be improved in a market that is already workably competitive.

In contrast, competition is properly defined as the process of rivalry between firms. Competition is therefore increased by improving the market opportunities and environment such that rivalry between firms is intensified. This interpretation of what it means to promote an increase in competition is consistent with that previously adopted by the NCC and the Australian Competition Tribunal (the Tribunal). For example:

From the NCC's Moomba to Sydney Pipeline application for revocation decision:<sup>11</sup>

Promotion of competition refers to improving the opportunities and environment for competition such that competitive outcomes are more likely to occur.

From the Tribunal's Eastern Gas Pipeline decision:<sup>12</sup>

The Tribunal [in the Sydney Airport decision 2000] concluded that the TPA analogue of criterion (a) is concerned with the removal of barriers to entry which inhibit the opportunity for competition in the relevant downstream market. It is in this sense that the notion of promotion of competition involves a consideration that if the conditions or environment for improving competition are enhanced, then there is a likelihood of increased competition that is not trivial. We agree.

And from the NCC's *Gas Guide*:<sup>13</sup>

The context in which the phrase ['access (or increased access) to pipeline services'] appears in the NGL indicates that access must be provided on terms and conditions that give effect to the efficiency objective in the NGL and, accordingly, seek to replicate the outcome of a competitive

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<sup>10</sup> In markets characterised as natural monopolies, efficiency is best served by having one supplier serve the entire market.

<sup>11</sup> NCC, *Moomba to Sydney Pipeline System: Revocation Applications Under the National Gas Code – Final Recommendations*, November 2002, p 114.

<sup>12</sup> Australian Competition Tribunal, *Duke Eastern Gas Pipeline Pty Ltd*, May 2001, para 75.

<sup>13</sup> National Competition Council, *Gas Guide – A guide to the functions and the powers of the National Competition Council under the National Gas Law*, October 2013, p 32.

market. The provision of services at a competitive market price, for example, will result in an optimal level of demand for access to the services.

In practical terms, competition will be increased through any change in the market that strengthens the intensity of rivalry between firms, and so results in lower prices and higher output. In general, firms are incentivised by profits. It follows that changes in market conditions that increase 'at risk' profits, either by offering new opportunities or threatening existing profits, are likely to increase firms' motivation to compete fiercely. It is through this process of rivalry that cost savings are passed on to consumers in the form of lower prices and higher output. This is consistent with the economic literature. For example, Evans (2005) comments:<sup>14</sup>

Absent regulatory barriers to entry, profits are the catalyst to competition, entry and innovation that enhances dynamic efficiency.

By way of illustrative example, the incentive on firms to behave competitively and to offer products on more efficient price and non-price terms will be increased by any of:

- reductions in entry barriers, including improved access to bottleneck facilities, that increase the risk of profits being competed away by new entrants;
- reduced opportunities for collusion that increase the risk of rivals competing away business; and
- new opportunities for profitable sales, for example as a result of a reduction in input costs that, all else equal, increases the profit margins that incumbent firms compete to secure.

Importantly, for rivalry to be intensified in a market, it is not necessary that the number of competitors in that market increase. Although an immediate increase in the number of competitors in a market is likely to be associated with increased rivalry, the existence of a new entrant is not a necessary condition for competition to be intensified. It follows that the presence of some form of barrier to entry does not automatically preclude an increase in competition.

Similarly, the conditions or environment for competition may be promoted independently of whether a market is or is not already workably competitive. For example, in a workably competitive market the prospect of larger profits will increase the intensity of the competitive process through the actions of incumbents seeking increased market share and through the prospect of new entrants.

Correspondingly, when the term 'competition' is appropriately defined it is difficult (if not impossible) to conceive of a situation where the promotion of efficiency could take place absent the promotion of increased competition.

### 3.2 Review of the ACCC's illustrative examples

The ACCC supports its proposition that the promotion of competition is an inadequate proxy for efficiency with four examples, which it contends illustrate situations where efficiency, but not competition, would be increased by coverage. However, careful review of these examples by reference to a more comprehensive interpretation of the concept of 'competition' suggests that each of these would be likely to meet the threshold for coverage under the existing criterion (a) – providing, of course, that the materiality standard was also satisfied. Further, there is no fundamental basis for concluding that any difference would arise in applying an efficiency as distinct from a competition standard.

In the sections below, we set out the basis for this conclusion in relation to each of the ACCC's examples. We also provide a further illustrative example, in section 3.2.5, that considers a situation in which neither a competition nor an efficiency threshold would be met.

<sup>14</sup> Lewis Evans, *The efficiency test under competition law and regulation in the small distant open economy that is New Zealand*, New Zealand Economic Papers, December 2004, p 20.

In reviewing the ACCC's four examples, we have assumed that the test that would be applied under criterion (a) would be a 'with and without declaration' test, rather than a 'with and without access' test. This is consistent with the government's recent decision and associated exposure draft (released on 5 September 2016) proposing amendments to the Part IIIA declaration criteria to clarify that criterion (a) is a test of access (or increased access) on reasonable terms under declaration.<sup>15</sup>

### 3.2.1 Pipeline supplying two retailers in a regional area

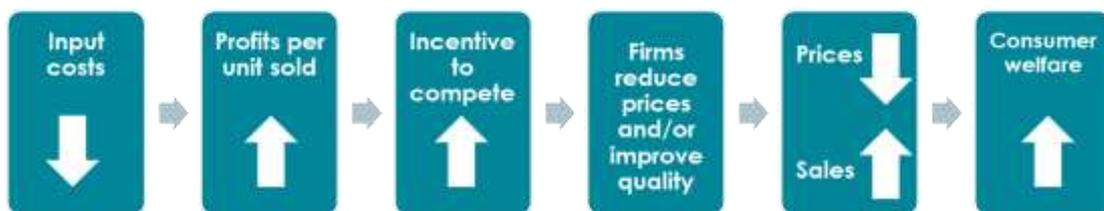
The ACCC's first example is described as follows:

The elimination of monopoly pricing on a pipeline that is used by two retailers to supply gas to a regional area may not give rise to any change in competition in the retail market (for example, because the scale of the market may be too small to attract any other competitors) but could still benefit consumers in the region if the cost savings are passed on.

In drawing the conclusion that the pipeline in this example would not meet the existing criteria for coverage, the ACCC has implicitly equated a 'material increase in competition' with an increase in the number of competitors in the retail market. Although an increase in the number of competitors does indicate an increase in competition, it is not the case that an increase in competition *requires* an increase in the number of competitors.

Central to the ACCC's example is the proposition that consumers in the region would benefit, and efficiency would be improved, if the cost savings from lower pipeline charges *are passed on*. However, these input cost savings would only be passed on to consumers if rivalry between the incumbent firms is increased. Competition is the mechanism through which such savings are passed on to consumers, as illustrated in the following flow chart.

Figure 1: Illustration of competitive process through which cost savings are passed on to consumers



Under the conditions described by the ACCC, coverage would increase the incentive on incumbent retailers to compete more intensively for the higher margins initially available. The ability to earn higher profits per unit sold would also reduce barriers to entry, although the effect on competition would occur regardless of whether the cost reduction was sufficient to result in an immediate increase in the number of competitors in the market. Providing these changes were material, it seems likely that the pipeline in this example would meet the current coverage criterion (a).

Our conclusion is consistent with past pipeline coverage decisions. For example, in the Goldfields Gas Pipeline decision, the NCC noted:<sup>16</sup>

GGT contends...that there can be no promotion of competition in this downstream gas sales market as a result of coverage, as the market is dominated by a small number of participants locked into long term contracts...

<sup>15</sup> See: House of Representatives/The Senate, *Competition and Consumer Amendment (Competition Policy Review) Bill 2016, Exposure draft*, 5 September 2016, and accompanying explanatory material.

<sup>16</sup> NCC, *Application for revocation of coverage of the Goldfields Gas Pipeline under the National Gas Access Regime – Final Recommendation*, November 2003, pp 131.

Competition is not a static concept but a process. The state of competition observed by GGT to exist in the downstream gas sales market presents an opportunity for a significant promotion of competition as a result of coverage, if coverage were to create the environment for new entry. The Council notes that this new entry does not have to be fast in coming for such a promotion of competition to satisfy criterion (a).

Similarly, in the Moomba to Sydney Pipeline coverage revocation decision, the NCC noted:<sup>17</sup>

The “promotion of competition” test assesses whether coverage would make the dependent market more conducive to competitive behaviour and new entry. The Council considers, as a general principle, that the removal of one barrier to competition is a positive step towards promoting competition, even if some other issues may remain. A progressive removal of barriers may be sufficient to encourage market entry or exercise discipline on incumbent producers.

On the other hand, if the reduction in pipeline input costs somehow did not increase the incentives to compete, retailers would retain that cost reduction in the form of higher profits. The consequence would be that neither prices nor sales would be affected and consumers would be no better off as a result of coverage. In other words, the reduction in pipeline service charges would simply transfer profits between businesses at different stages of the supply chain, with no effect on the outcomes for gas consumers or efficiency. Under these market conditions, the pipeline is unlikely to satisfy either the existing coverage criterion (a) or an efficiency-based set of criteria.

### 3.2.2 Pipeline effecting a wealth transfer from producers

The ACCC's second example is described as follows:

Restricting a pipeline operator's ability to effect a wealth transfer from producers can also be expected to result in efficiency improvements in the upstream market, but may not have any effect on the level of competition in this market if it results in existing producers carrying out more exploration and supplying more gas into the market. In this example, there would be an efficiency improvement and an improvement in consumer welfare but no change to the level of competition.

As for its previous example, the ACCC appears to equate a ‘material increase in competition’ with an increase in the number of competitors (in this instance, gas producers) in a market. However, proper consideration of the way in which a reduction in the price of pipeline services would incentivise gas suppliers to increase their exploration and supply demonstrates that the intensity of rivalry would, in fact, be increased.

Gas producers will be prompted to increase investment in exploration and supply of gas by the prospect of increased profits resulting from lower gas transportation costs. However, securing the additional sales necessary to absorb the increase in supply will require producers to compete more fiercely for available customers. This process will inevitably result in lower prices to end users and increased demand for gas.

Absent such an increase in rivalry, gas prices and consumer demand would remain unaffected. In that circumstance, there would be no opportunity for gas producers to sell additional units of gas and, as a result, no gain to be had from increasing exploration activity and supply. In other words, for the immediate wealth transfer to affect the conduct of upstream producers and for that wealth transfer to be converted into improved efficiency, it must be the case the competition is increased.

Ordoover and Lehr considered a similar, albeit inverted, example in their seminal paper:<sup>18</sup>

The combination of lower upstream and downstream margins from above-competitive transport rates, will tend to reduce incentives to invest in both upstream and downstream markets and therefore have an adverse effect on competition in both of these markets.

<sup>17</sup> NCC, *Moomba to Sydney Pipeline System: Revocation Applications Under the National Gas Code – Final Recommendations*, November 2002, p 218.

<sup>18</sup> Ordoover, Lehr, *Should Coverage of the Moomba-Sydney Pipeline be Revoked?*, 2001, p 13.

On the reasoning we set out above and subject again to the materiality threshold being met, it seems likely that the pipeline in the second scenario described by the ACCC would also meet the existing coverage criterion (a).

### 3.2.3 Pipeline supplying a mining company competing in a global commodities market

The ACCC's third example is described in the following terms:

Eliminating monopoly pricing on a pipeline that is used to supply a mining company competing in a global commodities market that is already workably competitive could result in greater investment by the mining company (that is, because the risk of hold up is reduced) and increase the volume of commodities it supplies into the market. If the mining company is a lower cost operator, then the increase in supply would displace higher cost suppliers and the equilibrium commodity price would fall. In this example, restricting a pipeline operator's ability to engage in monopoly pricing would result in an improvement in economic efficiency and consumer welfare but would have little to no effect on competition if the market is already workably competitive.

Hold-up occurs when the returns on one party's sunk investment are dependent on the future prices (or other terms and conditions) set by a trading partner. Hold-up can result in underinvestment in relationship-specific assets, and therefore inefficiency, if investors are concerned about the future conduct of the counter-party. In this case, a mining company may be unwilling to invest without some assurance that the pipeline operator will not unreasonably raise prices in the future.

Under these conditions, regulation may take the place of long-term contracts by assuring the mining company that the pipeline will not be permitted to set monopolistic prices. However, we disagree with the ACCC's assessment that this could result in a reduction in the commodity price with 'little to no effect on competition if the market is already workably competitive'. In this example, the very process by which commodity prices would be reduced is through increased competition. Since the elimination of monopoly pricing has reduced the risk of hold-up, a low cost operator is able to expand its supply in the market. Such expansion could only affect market prices if it intensified the degree of rivalry by incentivising those firms now enjoying lower costs to compete more fiercely for sales.

By this reasoning, and again subject to the materiality of the circumstances, it seems likely that such a pipeline would satisfy the existing coverage criterion (a). Reducing the risk of hold-up in relation to the cost of an input would improve the conditions for competition and promote rivalry by reducing a barrier to effective competition. This is consistent with the findings from Ordovery and Lehr's review of the Moomba to Sydney pipeline revocation application:<sup>19</sup>

Coverage may reduce the risk of anticompetitive behaviour associated with the threat to expropriation of sunk costs by constraining prices and the scope of feasible contracts for transport.

Notwithstanding, we note that if the dependent market is already effectively competitive it may be more difficult to conclude that a reduction in monopolistic pricing of an input product would improve the competitive outcome. From the Moomba to Sydney decision:<sup>20</sup>

If the dependent market is already effectively competitive, it would be difficult to argue that regulated access would improve the competitive environment. The Council accepts that Australia's export and import-competing industries tend to be exposed to a competitive international environment. In this sense, while regulated access may improve the competitiveness of particular Australian firms, it is not apparent that coverage would enhance the broader competitive environment in the markets in which those firms operate.

The critical distinction between these two examples is that, in the latter case, the implication is that market prices are unaffected by the improvement in the competitiveness of the particular firm that is to benefit from

<sup>19</sup> Ordovery, Lehr, *Should Coverage of the Moomba-Sydney Pipeline be Revoked?*, 2001, p 21.

<sup>20</sup> NCC, *Moomba to Sydney Pipeline System: Revocation Applications Under the National Gas Code – Final Recommendations*, November 2002, p 113.

reduced pipeline charges. In this circumstance, total market output would be unaffected and neither competition nor efficiency could be said to have been improved. Importantly, in this situation, neither the current criteria nor an alternative, efficiency-based criterion would be met.

The comparison between these two circumstances highlights that there is no universally accepted set of parameters that define 'workable competition', although we note the observation in the Chime Communications matter that:<sup>21</sup>

Perhaps the best shorthand description of workable competition is to envisage a market with a sufficient number of firms (at least four or more), where there is no significant concentration, where all firms are constrained by their rivals from exercising any market power, where pricing is flexible, where barriers to entry and expansion are low, where there is no collusion, and where profit rates reflect risk and efficiency.

Under this definition of workable competition, there is no reason to assume that the intensity of competition could not be further increased. However, workable competition is sometimes also equated to the circumstances where no firm is able to influence the market price for goods.<sup>22</sup> Adopting this reference point, which is clearly different from the ACCC's illustrative example, it may be more difficult to show that a reduction in input costs for one or a small number of competitors – each, say, supplying into an international market – would affect competition or efficiency.

This highlights the importance of the need to consider the conditions of competition and how these might be affected by coverage rather than proceeding immediately from an observation that a market is 'workably competitive' to a conclusion that competition therefore cannot be enhanced.

Finally, it is important to note that the ACCC's example implicitly assumes that no other dependent market would be affected by a decision to declare the relevant pipeline. By contrast, the existing criterion (a) requires only that declaration would promote a material increase in competition in at least one market. There is no minimum scale or materiality threshold applying in relation to the size or significance of that market. In the example put forward by the ACCC, the evaluation of criterion (a) would also invite consideration of the potential implications of access for the upstream market for the supply of gas to the mining company as well as any other downstream markets that draw upon the relevant pipeline services, such as a retail gas supply market.

Of much potential significance for these considerations, the ACCC's own *Inquiry Report* found shortcomings in the intensity of competition in upstream markets encompassing the exploration for and production of gas. By way of example, the ACCC states:<sup>23</sup>

.....there are significant gains that could be achieved from bringing on new supply and increasing the diversity of suppliers in the southern states. If significant competition in the southern market re-emerges, the pricing outcomes of negotiations are likely to fall closer to the seller alternative price.

And further that:<sup>24</sup>

[This]...also highlights the effect of pipeline tariffs across the east coast gas market on pricing outcomes in the southern states. As the gap between buyer and seller alternatives is determined by the transport costs between Wallumbilla and the buyer's location, any monopoly pricing by pipeline operators could be exacerbating the pricing outcomes for domestic users in the southern states in the environment where gas prices are shaped by the buyer alternative.

<sup>21</sup> Justice Finkelstein (President), R Davey, Professor Round (2009) *Application by Chime Communications Pty Ltd (No 2)* [2009] ACompT2, para 37.

<sup>22</sup> See, for example, Justice Finkelstein (President), R Davey, Professor Round (2009) *Application by Chime Communications Pty Ltd (No 2)* [2009] ACompT2, para 35.

<sup>23</sup> ACCC, *Inquiry into the east coast gas market*, April 2006, p 52.

<sup>24</sup> ACCC, *Inquiry into the east coast gas market*, April 2006, p 53.

On its face, these particular findings by the ACCC imply that many east coast gas transmission pipelines operate in circumstances where – subject to the materiality threshold being met – the elimination of monopoly pricing has the potential to promote an increase in competition in one or more upstream gas markets.

Further, even under the narrow construct of the example described by the ACCC, if one or more of the mining companies drawing gas from the relevant pipeline was using the services of a gas shipper or other intermediary transacting between it and the pipeline services provider, the impact on competition in that market (for the provision of intermediary services) would also be relevant to the application of the coverage criteria.

### 3.2.4 Pipeline supplying an industrial customer competing in a workably competitive market

The ACCC's fourth example is described as follows:

In a similar manner to the previous example, restricting a pipeline operator's ability to engage in monopoly pricing on a pipeline that is used to supply an industrial customer that competes in a workably competitive market in Australia could result in greater investment by that company in its facility and greater output. While this may not give rise to any change in the level of competition in the market, there would still be an efficiency improvement and if the industrial customer is a lower cost producer, it could also result in a reduction in prices for that product, which would benefit consumers.

The issues in this example are fundamentally similar to those in the previous one. The ACCC describes a situation in which one firm is able to influence the market price for goods or services, which is inconsistent with the construct of 'workably competitive' that would be less likely to promote an increase in competition, as discussed above. There is no reason to presume that the intensity of competition could not be further increased in the dependent market described by the ACCC.

Even if the reduction in pipeline prices for the industrial company doesn't result in any immediate entry into the market, for lower prices and improved efficiency to eventuate it must be the case that competition is increased. There is no economic basis from which to contend that expansion in the market has been encouraged and prices have been reduced but that the intensity of the process of rivalry (ie, competition) has not also been increased. An increase in supply in a market, whether by means of new entrants or expansion by incumbent firms, will inevitably intensify the degree of rivalry as firms compete to sell their products. Until prices fall, there will be over-supply in the market, which can only be rectified by firms competing by reducing their prices to secure additional sales.

In our opinion, and with the usual qualification as to the materiality of the change in circumstances hypothesised in the ACCC's example, the pipeline operator in this example would also be likely to satisfy the existing criterion (a) for pipeline coverage.

Further, as for the previous example, a decision regarding declaration would need to consider the implications on competition in all potential dependent markets, for which the ACCC has itself identified upstream gas markets as a strong potential candidate for increased competition. Although the ACCC's example is only briefly developed, it would also seem unlikely that an industrial customer of the type described example would be the only user – and, furthermore, a direct user – of the relevant pipeline services.

### 3.2.5 Additional example – pipeline supplying an entrenched monopolist

In addition to the examples provided by the ACCC, it is insightful to consider the situation in which the elimination of monopolistic charges for a pipeline service would not give rise to an increase in competition in a related market, because barriers to entry protect an incumbent monopolist. For example, if a downstream gas retail market was subject to a territory-based exclusive licencing regime, each regional gas retail market would be served by a monopolist firm that did not face the threat of entry by new competitors. In such a

market, access at a lower price to a monopolised gas transportation service may not change the (monopolised) retail price of gas by much, if at all.

Under these conditions, coverage criterion (a) would seem unlikely to be satisfied, because the elimination of monopolistic pipeline charges would simply result in a transfer of wealth from a pipeline owner to the gas retailer with no material effect on consumer outcomes. However, it is important to recognise that this circumstance would also not give rise to any efficiency gains. It follows that such a pipeline is unlikely to meet the criteria for coverage under either the existing criterion (a) or an efficiency-focused set of criteria.

The contra-distinction is where the downstream market is workably competitive (under the definition set out in the above quote) in which case lower input charges would, sooner or later, flow through into lower retail prices. The process by which this takes place involves three distinct steps, as follows:

1. input prices fall and so retail margins rise;
2. retail suppliers compete more intensively both to retain their existing customers and to poach those of rivals, and new suppliers may enter the market; and
3. retail prices fall and output will rise.

Intrinsic to this dynamic process is that, faced with the prospect of temporarily higher profits due to the reduction in costs (and hence higher margins), there will be an increase in the intensity of rivalry amongst retailers that sooner or later causes the higher profits to be competed away. In other words, competition, defined as a process of rivalry, is increased.

## 4. Costs of substantively amending the criteria

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In the previous section we concluded that the economic reasoning by which the ACCC proposes a revised coverage test relies on an unduly narrow definition of competition. Further, we showed that there is no fundamental difference between applying a competition as distinct from an efficiency-based criterion to the question of pipeline coverage. In other words, the coverage criteria proposed by the ACCC do not offer a fundamentally better basis for making decisions regarding regulatory intervention.

Nevertheless, the substance of the discussion and conclusions set out in the *Inquiry Report* disclose a strong intention by the ACCC to lower the threshold for regulatory intervention in response to perceived shortcomings in the existing coverage criteria. In this section we examine the costs and risks that would likely be incurred as a result of reducing the threshold for regulation by moving away from the current criteria.

### 4.1 Costs associated with lowering the threshold for coverage

It is evident from the *Inquiry Report* that the ACCC's strong preference is to lower the threshold for regulatory intervention. The fundamental premise underpinning the ACCC's proposed revision to the coverage criteria is its contention that the current criteria are unable to constrain monopolistic pricing for gas pipeline services.<sup>25</sup>

Further, the ACCC states that consideration should also be given whether any pipelines that are not presently covered should be deemed to satisfy any revised coverage test, at least initially, ie:<sup>26</sup>

From an administrative perspective, there would also be value in considering whether any other unregulated pipelines should be deemed to satisfy the test and be subject to full or light regulation from the date the new test takes effect, as was done when the Gas Code was originally implemented.

The above suggestion in particular appears not to recognise that regulation itself is a far from perfect exercise and that the direct and indirect costs associated with coverage are likely to be significant. Price control should only be contemplated when the benefits of regulation can reasonably be presumed to outweigh the associated detriment to productive and dynamic efficiency.

The wording of the ACCC's proposed revised coverage test reflects the adjectival standard for making rules under the National Gas Law (NGL), ie, the AEMC may only make or change a rule if it is satisfied that the rule will or is likely to contribute to the achievement of the NGO.<sup>27</sup> Although this threshold may well be appropriate for making a rule, it is not necessarily appropriate for determining whether or not the services provided by a particular infrastructure facility should be subject to formal price control, particularly given the costs associated with regulation.

Notwithstanding, it remains unclear precisely how the criteria proposed by the ACCC would be interpreted and applied in practice and, therefore, what standard might be adopted in giving effect to a revised threshold for coverage. Until sufficient jurisprudence is developed, a proposed change to the coverage criteria of the structural magnitude suggested by the ACCC would substantially increase the degree of uncertainty associated with the gas pipeline access regime. As such, it would give rise to increased legal and administrative costs and eliminate the significant benefits of the gas pipeline coverage criteria being framed in the same terms as the wider, Part IIIA regime.

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<sup>25</sup> ACCC (April 2016) *Inquiry into the east coast gas market*, p.128.

<sup>26</sup> ACCC (April 2016) *Inquiry into the east coast gas market*, p.140.

<sup>27</sup> Section 291(a), NGL.

## 4.2 Costs associated with change in and of itself

We explained in section 3 why it is difficult to conclude that the ACCC's proposed test would provide a better basis for determining whether a gas pipeline should be subject to regulation.

However, it must also be recognised that the way in which the proposed criteria would be interpreted and applied would necessarily be developed through jurisprudence. It follows that the ACCC's proposed amendment to the criteria would significantly increase the degree of uncertainty associated with the gas pipeline coverage regime. This uncertainty is itself likely to affect decision-making by gas pipeline operators as well as businesses in related markets. Further, in bringing and assessing applications, businesses and regulators are likely to incur significantly higher management, legal and administrative costs as various parties attempt to interpret and apply the new criteria.

There would also be considerable ongoing disadvantages from divorcing the gas pipeline access regime from the Part IIIA access regime. At present, advances in the interpretation of and methods for assessing applications under Part IIIA are leveraged into the processes for applying the gas pipeline access. This includes jurisprudential as well as administrative developments, such as the government's proposed amendments<sup>28</sup> to clarify the interpretation of Part IIIA.

Given the absence of any economic principle that supports the adoption of revised criteria, a new test for gas coverage that departs from the foundational framework established in Part IIIA would involve the introduction of administrative complexity and ambiguity for no apparent gain.

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<sup>28</sup> See: House of Representatives/The Senate, *Competition and Consumer Amendment (Competition Policy Review) Bill 2016*, *Exposure draft*, 5 September 2016, and accompanying explanatory material.

## 5. Conclusion

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The reasoning by which the ACCC proposes a revised coverage test for gas pipelines relies on an unduly narrow definition of competition that is both economically flawed and at odds with established jurisprudence in relation to the meaning of 'the promotion of a material increase in competition'. Proper consideration of the relationship between competition and efficiency, including by reference to each of the ACCC's illustrative examples, demonstrates that there is no reason to presume that the proposed amended criteria would result in decision-making that would be more likely to promote the NGO.

However, amending the coverage criteria would result in clear losses in terms of understanding and administrative efficiency. Such losses would include:

- a significant increase in regulatory uncertainty and risk, which is likely to affect decision-making at all stages of the gas supply chain;
- significantly higher management, legal and administrative costs until the interpretation and application of the new criteria is established through jurisprudence;
- ongoing higher management, legal and administrative costs due to the disconnection between the coverage regime for gas pipelines and the declaration criteria under the generic, Part IIIA regime; and
- the risk of inefficient over-encompassing regulation of the gas pipeline sector, depending on the way in which the threshold for application is interpreted.

Rather than adopting the coverage criteria proposed by the ACCC, in our opinion there is much to be gained by amending the gas coverage criteria to align with those now proposed by way of amendment to the Competition and Consumer Act 2010 (CCA), thereby preserving their economic alignment, as well as the value of existing and future jurisprudence.

In sum, the ACCC's proposed criteria does not provide a better basis upon which to make declaration decisions but would result in significant costs to the gas pipeline sector, dependent markets and regulators.



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