Tasmanian Gas Pipeline

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Response to Consultation Paper

Examination of the current test for the regulation of gas pipelines

18 October 2016

Public Submission

1 Introduction

Tasmanian Gas Pipeline (**TGP**) welcomes the opportunity to comment on Dr Michael Vertigan AC's consultation paper, "*Examination of the current test for the regulation of gas pipelines*", published on 4 October 2016 (**Consultation Paper**).

The Consultation Paper has been published following the Australian Competition and Consumer Commission's (**ACCC's**) final report in its Inquiry into the East Coast Gas Market, published in April 2016 (**ECGI Report**). In that Report, the ACCC recommended that the coverage test in the National Gas Law (**NGL**) be changed because the ability and incentive of pipeline owners on the East Coast to engage in monopoly pricing is not being effectively constrained by the threat of regulation, in the ACCC's view, because the current test is not suited to an industry not characterised by vertical integration.

TGP does not consider that there is a case for change to the current regulatory environment, in particular, because:

- the evidence the ACCC relied on to show monopoly pricing is occurring is flawed; and
- the current test has been shown to be effective in regulating other industries which are not characterised by vertical integration.

TGP is concerned that the changes being recommended by the ACCC would move the gas industry further away from other industries which are subject to Part IIIA of the *Competition and Consumer Act 2010* (Cth) (**CCA**), including any upcoming changes to that Part. This would result in significant uncertainty for pipeline owners. The ACCC's proposed new test would also reduce the threshold for regulation significantly, and therefore create an increased risk of over-regulation and regulatory error. There is a real likelihood that regulatory uncertainty and the risk of regulatory error will only serve to undermine investment incentives, which would be to the detriment of all industry participants who have benefitted from efficiency enhancing investments and innovation over the past decade.

The remainder of this submission is structured as follows:

- **Part 2** sets out the reasons why the ACCC has not made out a case to change the current regulatory test for coverage under the NGL. In particular, it shows that the ACCC has not established that pipeline operators are engaging in monopoly pricing and has not established that the current regulatory test is ineffective in constraining potential monopoly pricing in the industry.
- **Part 3** sets out TGP's concerns with the test being proposed by the ACCC, in particular, the uncertainty it will introduce, the risk of over-regulation, and the effect that these factors will have on investment incentives.
- **Part 4** summarises why the NGL coverage test should continue to mirror the coverage criteria in the Part IIIA test, including with any post-Harper amendments.

2 No case for change to regulatory environment

2.1 The ACCC's case for change

In the ECGI Report the ACCC bases its case for changing the coverage criteria on the following findings:[1]

[1] ECGI Report, pp 9-10.

- there is evidence of monopoly pricing by gas pipeline owners giving rise to higher prices and economic inefficiencies; and

- the ability and incentive of existing pipelines to engage in monopoly pricing is not being effectively constrained by competition; and

- the ability and incentive of existing pipelines to engage in monopoly pricing is also not being effectively constrained by the threat of regulation because the current test for regulation under the NGL (**coverage criteria**) is unlikely to be met by the majority of pipelines. The ACCC considers that this is because criterion (a) was designed to address access issues in vertically integrated markets rather than monopoly pricing.

For the reasons set out in section 2.2 below, TGP does not consider that the ACCC has made out its case that monopoly pricing is occurring and that pipelines are not effectively constrained by competition. TGP also does not agree that the current coverage criteria is unsuited to addressing monopoly pricing concerns (see section 2.3 below).

2.2 No evidence of monopoly pricing

In the ECGI Report, the ACCC found that monopoly pricing is occurring in relation to ten pipelines, including TGP, and that the ability and incentive of existing pipelines to engage in monopoly pricing is not being effectively constrained by competition.[2] One of the main issues that the ACCC points to in finding that monopoly pricing is occurring is that rates of return earned by pipeline operators on incremental investments are high.[3]

The evidence relied on by the ACCC does not show that competition is not an effective constraint on gas pipeline owners or, in particular, that TGP (and other pipeline owners) are charging monopoly prices. This is because:

- Many gas pipelines are subject to competition from other pipelines. Many gas pipelines are also are subject to competition from other energy sources. In this regard, even though TGP operates the only gas pipeline to Tasmania, it cannot be considered a natural monopoly in an economic sense because its customers have opportunities (and have, in fact, clearly demonstrated their willingness) to substitute away from gas.

- TGP's recent changes to transportation charges are not evidence of monopoly pricing. Rather, they were based on strong commercial justifications due to the impending expiry of TGP's largest long term agreement which contributes a significant amount of TGP's annual revenue.

- TGP believes that if TGP was regulated, its opening regulatory asset base (**RAB**) would be set at a level between the depreciated actual cost (**DAC**) and the depreciated optimised replacement cost (**DORC**) which would be an amount significantly higher than the acquisition cost paid by the current owners of TGP. Based on TGP's analysis, TGP believes that its current revenue is actually lower than the revenue it would be entitled to recover if it was subject to regulation. Applying a rate of return consistent with the AER's recent decisions to the higher capital base of RAB would permit TGP to set transportation charges at a rate higher than current levels.

- The ACCC's finding that returns on investments above regulated rates of return is evidence of monopoly pricing is unconvincing, because it is not uncommon in competitive markets for returns on investments to be greater than regulated rates or returns.

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2 ECGI Report, p 111.

3 ECGI Report, p 130.

These factors are considered in further detail below.

(a) Gas pipelines are subject to competitive constraints

The ACCC recognises that a number of gas pipelines (e.g. MSP, EGP and MAPS) are subject to competitive constraints from other pipelines.[4] However, the ACCC concludes that "*competition is not posing as an effective constraint on the behaviour of pipeline operators as might be expected*" and gas pipelines are charging monopoly prices.[5]

TGP disagrees with the ACCC's conclusion. TGP's experience is that competition is an effective constraint on pricing. TGP queries whether the ACCC's conclusion may come from a misunderstanding of the rates of returns earned in pipeline markets where there is competition (as discussed in section 2.2(c) below) and whether this has led it to view gas transportation charges as monopoly pricing.

TGP is also concerned that the ACCC's findings may not fully reflect the competitive constraints imposed by substitutable energy sources. In the ECGI Report, the ACCC states that: "*[c]ompetition from alternative energy sources (for example, electricity) is often cited as a constraint on the behaviour of pipeline operators, but the material gathered through the Inquiry suggests that at best competition from other energy sources provides a weak constraint on transmission pipelines."*[6]

This has not, however, been TGP's experience. TGP considers that competition from other energy sources provides a real and effective constraint on gas pipeline operators. While TGP is the only wholesale transporter of gas in Tasmania, the relevant market is best viewed as the wholesale transport of energy, of which TGP is one small supply-side participant. The transportation charge for gas is only a very small element of delivered prices in this market – even in the retail gas sector, gas transmission charges only "*make up 5−10 per cent of a typical residential gas bill*".[7] TGP has very limited power in this market due to the countervailing power of its customers and the presence of realistic substitution options.

Some of TGP's customers could realistically switch to other fuels (over time) if the price of gas delivered to them (i.e. including transportation costs, as set by TGP) increased sufficiently to justify any required capital investment.

This threat of substitution is commercially realistic and operates as a constraint on TGP's ability or incentive to engage in monopoly pricing, even for smaller customers. It is therefore clear that even relatively small customers have the ability to constrain TGP's pricing strategies by raising the prospect of substitution.

In addition, TGP's largest customers, which represent a large proportion of TGP's business, have significant countervailing power. These customers underpin TGP's business and the loss of a large customer would be likely to have a significant impact on TGP's ability to obtain a return on its investment. Given the availability of substitutes, and TGP's reliance on these customers for much of its revenue, it would be highly risky for TGP to antagonise these customers with market power-induced price rises.

(b) Recent changes to transportation charges are not evidence of monopoly pricing

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[4] ECGI Report, p 111.

[5] ECGI Report, p 111.

[6] ECGI Report, p 99.

[7] AER, State of the Energy Market 2015, p 118.

During the course of the ECGI inquiry, the ACCC identified that TGP has recently increased its transportation charges for some shippers. However, increases in transportation charges are not in themselves evidence of monopoly pricing.

(c) Tariffs would likely be higher if TGP was regulated

(d) Rates of returns on investments above regulated returns are not in themselves evidence of monopoly pricing

One of the main issues that the ACCC points to in finding that monopoly pricing is occurring is that rates of return earned by pipeline operators on investments are higher than the regulated rate of return.[8] However, it is not uncommon for firms in competitive markets to make investments where the IRR is higher than the WACC. In fact, it would be highly unusual to pursue an investment less than or equal to WACC. In addition – when deciding whether to invest in a project (new or incremental), a gas pipeline owner will need to consider and price for the risks involved in the investment including the risk that the project will not materialise or will be delayed. The ACCC did not fully examine the impact of these risks in determining whether IRRs are excessive.

In its analysis, the ACCC analysed a small set of incremental investments which have been made in the industry. [9] In respect of this sample of investments, it found that pipelines are charging above regulated returns. However, the selected projects are often low-value and all involve an *incremental* expansion of an existing pipeline. Rates of returns on incremental projects are typically high (and higher than rates of returns on existing infrastructure) in competitive unregulated markets, as they leverage off existing investments and know-how in the firm.

2.3 Current test can be applied to gas pipelines

Under the NGL, a pipeline can only be "covered" and therefore subject to price regulation if it satisfies all the coverage criteria. The NGL currently provides for coverage where the relevant Minister, having regard to the NCC's recommendation, is satisfied that:

(a) access (or increased access) to the services provided by means of the pipeline would promote a material increase in competition in at least one other market (**criterion (a)**);

(b) it would be uneconomic to develop another pipeline to provide the services provided by means of the pipeline (**criterion (b)**);

(c) 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) access (or increased access) to the services provided by means of the pipeline would not be contrary to the public interest.

(**Current Test**).

In deciding whether or not the coverage criteria are satisfied, the Minister is required to have regard to the National Gas Objective (**NGO**) which 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 natural gas*".[10]

In the ECGI Report, the ACCC stated that the ability and incentive of existing pipelines to engage in monopoly pricing is not being effectively constrained by the threat of

[8] ECGI Report, p 130.

[9] ECGI Report, Chart 6.1.

[10] Section 23, NGL.

regulation, because criterion (a) in the Current Test has proved difficult to establish for gas pipelines and was designed to address access issues in vertically integrated markets rather than monopoly pricing. It therefore recommends that the Current Test be replaced with a new test that would be triggered if the relevant Minister, having regard to the NCC's recommendation, is satisfied that:

(a) the pipeline operator has substantial market power;

(b) it is likely that the pipeline will continue to have substantial market power in the medium term; and

(c) coverage will or is likely to contribute to the achievement of the NGO.

(**ACCC's Proposed Test**).

However, in TGP's view, criterion (a) in the Current Test was never intended only to address economic concerns relating to vertical integration, and a similar criterion (in Part IIIA of the CCA) has successfully been applied in other non-vertically integrated industries.[11] Indeed, the Australian Competition Tribunal relevantly stated that "*the provisions in Pt IIIA of the Act are not limited in their application to a vertically integrated organisation*".[12]

The relevance of competition to whether or not firms have an incentive or ability to monopoly price has also been recognised by the Productivity Commission. In its review of the National Access Regime, the Commission stated that:[13]

> "***Where there is an enduring lack of effective competition in markets for infrastructure services, a provider might*** *deny access to, or restrict output and* ***charge monopoly prices*** *for, its infrastructure service. This can reduce economic efficiency where access to the service is required for third parties to compete effectively in dependent (upstream and downstream) markets*."
> (Emphasis added).

As regards the argument that criterion (a) is difficult to establish for gas pipelines, the ACCC gives examples that it considers would meet an efficiency based criterion (such as the one it proposes) but not a competition-based criterion. Its analysis in these examples is driven by its view that economic efficiency and competition in dependent markets are not synonymous.[14]

However, TGP considers that the promotion of efficiency is in fact an integral part of considering criterion (a). Efficient outcomes are a reflection of a competitive environment and the pursuit of efficiency takes place in the context of an objective of decreasing costs and increasing sales to remain competitive. The interaction of the promotion of competition and efficient outcomes is explicitly recognised in the Current Test through the requirement that the Minister have regard to the NGO when considering whether the coverage criteria (including criterion (a)) are met.

Accordingly, TGP does not agree that the Current Test is not able to address monopoly pricing concerns.

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[11] For example, services at the Sydney and Melbourne airports and at the Port of Newcastle have been declared.

[12] *Re Review of Freight Handling Services at Sydney International Airport* (2000) ATPR ¶41-754 at para 11. National Competition Council, Declaration of Services: A guide to declaration under Part IIIA of the *Competition and Consumer Act 2010* (2013) at paragraph 3.17.

[13] Productivity Commission, Inquiry Report, National Access Regime, 25 October 2013, page 6.

[14] ECGI Report, pp.130-1.

2.4 The gas pipeline industry is currently promoting the NGO

There is no evidence to suggest that gas pipeline owners have been slow to respond to customer needs through investments and innovation in recent years. Indeed, in the ECGI Report, the ACCC recognised the significant investments and innovation that have taken place to date:[15]

> "*Evidence received through the Inquiry indicates that pipeline operators have responded relatively well to the changing demands by offering more innovative services (for example, bi-directional services, peaking transportation services, interruptible services and premium storage services), shorter-term GTAs and multiple services across inter-connected pipelines (for example, storage, compression, redirection and transportation services).*"

As regards to its own investments, TGP committed to investing $18m in the connection of TGP to the Victorian Gas Transmission System to develop TGP as an interconnected pipeline. As regards to innovation, TGP has introduced premium storage services in Victoria and Tasmania for its customers and allowed for temporary increases in park service quantities to meet shipper demand. It also made significant changes to its Gas Transportation Agreements to provide greater flexibility for shippers, including by offering shorter term specialist contracts, flexibility in firm forward MDQ provisions, and by not requiring that shippers contract firm MDQ for their entire demand and instead allowing them to partially rely on overruns.

TGP also notes that secondary capacity trading is taking place between shippers using its pipeline, and trades occur on a regular basis.

As can be seen – under the current regulatory framework – the industry has been working in a manner consistent with the promotion of the NGO. It does not, therefore, seem necessary to introduce a new and untested regulatory test, the main aim of which would be to ensure that the NGO is being promoted.

3 Concerns with the ACCC's proposed test

3.1 Uncertainty of proposed test

The introduction of the ACCC's Proposed Test would lead to significant uncertainty for the industry. The Current Test mirrors the Part IIIA criteria and is therefore well understood and subject to extensive jurisprudence. This will be undermined if the Current Test is replaced with a new and untested set of criteria. Resulting uncertainty will reduce incentives to invest in pipelines and pipeline expansion and may also distort the build/buy decisions of new players looking to enter the market.

3.2 Low threshold to meet test likely to lead to over-regulation

The Productivity Commission has noted that:[16]

> *"Access regulation can address an enduring lack of effective competition, due to natural monopoly, in markets for infrastructure services where access is required for third parties to compete effectively in dependent markets. This is the only economic problem access regulation should address*."

Any coverage test should be designed to address, and go no further than is necessary to address, this economic problem. The ACCC's Proposed Test creates a threshold for regulation which goes further than necessary to address this problem. Under the ACCC's Proposed Test:

[15] ECGI Report, p 95.

[16] Productivity Commission, Inquiry Report, National Access Regime, 25 October 2013, page 2; also see p 7.

- there is no requirement for there to be a “natural monopoly” before regulation is imposed, which would set the NGL apart from other access regimes;

- the pipeline operator may have to bear the onus of showing that it does not have substantial market power;

- there is no causal relationship between the existence of market power and the particular behaviour that is being regulated; and

- where a pipeline operator is unable to show that it does not have substantial market power, the regulator need only be satisfied that coverage is likely to “contribute to” the achievement of the NGO.

Part IIIA and the NGL to date have focused on regulating services provided by means of infrastructure displaying natural monopoly characteristics. So too have specific sector regulation such as Part XIC of the CCA which focuses on regulating enduring bottleneck services.[17] Criterion (b) of the Current Test is directed to ensuring that services displaying natural monopoly characteristics are the only services caught by regulation.

The Proposed Test, however, reduces this threshold to one requiring only that the pipeline operator has substantial market power – there is no causal element between that market power and the particular behaviour that is being regulated. The ACCC also indicates that pipeline operators should bear the burden of proving that they do not have market power, because operators have better access to information for this purpose. It is unusual to reverse an onus of proof in civil law and seems particular unfair in circumstances where, unlike an administrative body, pipeline operators would not have the powers to compel relevant persons to provide information in order to prove that it does not have market power.

Regulation could therefore be imposed in relation to any service where a pipeline operator is unable to show that it does not have substantial market power and the regulator is satisfied that ‘*coverage will, or* ***is likely to, contribute to*** *the achievement of the National Gas Objective’* (emphasis added). Whether a matter “is likely to contribute to” another matter is a much easier hurdle to mount than if a matter “would promote” or “would result in” the other matter.

TGP believes that the proposed test will result in overregulation of pipeline services because any regulation that “contributes to” the NGO could be allowed where the operator cannot prove that it does not have substantial market power (noting that, in the ECGI Report, the ACCC appears to consider most pipeline operators have substantial market power, even those subject to competitive constraints).[18] Although the manner in which the Courts would determine whether a particular matter will “contribute to” the NGO is yet to be tested, this only serves to increase the amount of uncertainty which the industry would face if the proposed changes were realised.

3.3 Change to regulation risks discouraging investment and innovation

As set out in section 2.4 above, TGP and other industry participants have – under the current regulatory framework – invested heavily in pipelines and pipeline enhancements and introduced a number of innovative responses to industry needs.

This level of investment and innovation will be put at risk with a change in regulatory environment, particularly a change that will create uncertainty for the industry. As noted by the ACCC, the key risk of regulation is that it can impede investment and innovation incentives.[19] In the face of uncertainty, infrastructure owners, including TGP, find it harder to make decisions about future investment and innovation. For example the expectation that a project could be regulated in the future may deter investments or cause investors

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[17] See ACCC, Final Report, Public Inquiry into the fixed line services declarations, April 2014, section 2.1.2.

[18] CGI Report, p 111.

[19] ECGI Report, p 136.

to delay construction until future prospects of regulation are more certain. A change in regulatory framework will create uncertainty and potentially lower future investment returns. This may, in return, result in reduced investments, innovation and efficiency. Increased regulation will also impose a compliance cost on businesses.

Further, if pricing regulation is introduced and the regulated price set too low *"this can lead to delayed investment in infrastructure, or the non-provision of some infrastructure services*."[20] In 2004, the Productivity Commission found that the then price regulation of all pipeline operators was distorting investment, delaying development of pipelines and discouraging innovation:[21]

> "*There is a prospect that the regulation of prices is leading to a distortion in investment (towards lower risk projects) and delaying the development of new pipelines, which then slows down the emergence of competition in related energy markets and between pipelines*."

The ACCC has expressed concerns that pipeline investments have expected returns that exceed the WACC. However, as noted above, a regulated return fails to account for the risks borne by the investor, including that some projects may fail. If prices are regulated and investors earn insufficient returns this will stifle investment and innovation. This has been recognised by the Productivity Commission, when it stated that "*the possibility of earning higher than normal returns on successful projects may be required to balance the possibility that some projects will fail. If regulatory pricing arrangements inadvertently appropriate upside returns on successful projects … then overall investment levels are likely to be reduced*".[22]

In the ECGI Report, the ACCC does propose some mitigants to address the risks to investment, mainly a 15 year no coverage mechanism. TGP does not, however, consider that this would be sufficient to mitigate the risks to investment because it only relates to investment not innovation, and only relates to the construction of new (greenfield) pipelines in circumstances where most pipeline investments are expansions to, or improvements of, existing pipelines. Further, the process for making an application for no-coverage is difficult and time-consuming.

Regulation that inhibits investment and expansion is detrimental to efficiency and to customers. It is therefore essential that policy reform does not suppress investment and reduce economic efficiency, and that a thorough cost-benefit analysis is undertaken before the regulatory framework for gas pipelines is changed. In TGP's view, for the reasons set out in this submission, no case for change has at this point been properly made out by the ACCC.

4 Consistency with Part IIIA

As set out above, gas pipelines are not sufficiently different to infrastructure regulated under Part IIIA to be treated differently. A number of non-vertically integrated entities are subject to Part IIIA, including airports and ports. Further, the Part IIIA coverage test has been subject to extensive judicial consideration, and to depart from it will leave the gas pipeline industry in a very uncertain operating environment.

For these reasons, TGP believes that the coverage test under the NGL should continue to be consistent with Part IIIA, including any upcoming changes following Harper's recommendations.

[20] Productivity Commission, Inquiry Report, National Access Regime, 25 October 2013, page 8.

[21] Productivity Commission, Review of the Gas Access Regime, No 31, 11 June 2004, p XXVIII.

[22] Productivity Commission, Review of Price Regulation of Airport Services, No 40, 11 December 2006, p XXI.