SUBMISSION TO
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Review of National Pipelines Access Regime

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Introduction

IPA confines itself to one aspect of the review, namely,

Comment is invited on the relative merits of the following options for improving the investment climate for greenfields gas pipelines:

(a) the Commission's proposal to permit developers of pipelines to seek an upfront test of whether a new pipeline is likely to meet the coverage tests, and to obtain a binding ruling for a fixed period of 15 years if the tests would not be met;

(b) implementing a price regulation 'holiday' for greenfields pipelines for 15 years;

(c) whether non-price obligations should be applied to greenfields pipelines that have a price regulation 'holiday'.

It is the view of the IPA that the weaker proposals of the Productivity Commission would frustrate the essentially deregulatory intent of the proposals set out in the COAG Energy Market Review, the Parer report.

Administration of Coverage

For the reasons set out in the MCE Paper, placing a need to obtain a no-coverage ruling would reduce certainty and lead to protracted negotiations between the proponent and the ACCC. It might also alert other parties to an opportunity that the proponent had spotted and lead such other parties, who may not have needed to expend the same amount of resources searching for the opportunity, to offer alternative more intrusive regulatory arrangements.

Such arrangements are always likely to be more welcomed by bodies that have regulatory control as their main business. Seeking a binding ruling from a body that has a clear interest in maintaining regulatory controls which boost its own influence would exacerbate our concerns about any proposals that approached the greater regulation espoused by the Productivity Commission. At the very least, the approach would need to be to a disinterested party and not to the ACCC which would be administering the regulations.

The deficiencies of the present arrangements were becoming clear at the time of the application for the revocation of the coverage over the pipelines serving Sydney. In 2000 we argued,

"An additional pipeline brings new competition. This means the basic premises on which the competition policy arrangements are set for infrastructure do not apply. The regulatory arrangements are posited on natural monopoly, an oxymoron where new competition actually emerges. Regulation in those cases contains all the inevitable downside costs but no upside benefits."[1]

In our submission to the PC's review of the Competition Policy Agreements[2], we maintained that there had been a fundamental policy change as a result of the Hilmer report and its acceptance by COAG. We argued that since the agreement of governments in the competition reforms to curtail their assumptions of monopoly provisions in major areas of the economy, there had been no constraints on new developments.

Criteria for Coverage

All new pipelines by definition are greenfield sites and should, therefore, not be regulated. In order to develop a taxonomy for policy we argued,

"There are six important classifications of essential service or bottleneck infrastructure that may justify a difference in regulatory policy approach:

1. That which has been built without any market protection, especially that built since 1995 which is almost by definition "entrepreneurial" rather than regulated.
2. That which introduces new competition, albeit is not identical to existing facilities.
3. Privately built infrastructure built prior to 1995 that enjoyed no government protection.
4. That which is owned by the private sector but was built under a regime that offered protection from competition.
5. That which was owned by a government but has since been sold under contractual terms to the private sector.
6. That which was built by and remains owned by a government."

We argued that the only case for regulatory control concerned the fourth, fifth and sixth of these since the others had been built under a regime where they had no privileges. The main issue is how to remove the constraints of regulatory intrusion over those pipelines that were built under some monopoly provision and remained with market power. The effluxion of time is likely to whittle away at that power and criteria for abandoning regulation in those circumstances are necessary.

Of course, we recognised, drawing off long practices that governments will assert some controls to ensure some sort of common access to monopolies if their 'essential facility' nature became significant. Such controls have been seen since ancient times in the

[1] Price and Access Regulation of Gas Transmission Pipelines, A Submission Regarding the Regulatory Considerations of the NCC and ACCC on the Eastern Gas Pipeline and the ACCC on the Central West Pipeline, Energy Issues Paper No. 13 February 2000. http://www.ipa.org.au/files/Energy13.pdf

[2] Review of Competition Policy, The Productivity Commission's inquiry into Clause 6 of the Competition Principles Agreement, IPA 2000. http://www.ipa.org.au/files/Energy18%20.pdf

administration of ports, railways and, more recently, telecommunications. In most instances, telecommunications appears to be a recent case in point, the controls can be lifted and freedom of commerce fully restored as technology erodes an "essential facility's" market power.

The case of access holidays covers new investment built without any assistance. We repeat our contention in our earlier paper

> "Where there are no regulatory restraints on competition, we see the most promising conditions under which entrepreneurs seek out new needs or seek the meeting of existing needs more cheaply. The outcomes of new infrastructure built under such conditions epitomise the gains made by competitive processes. For, although mistakes in competitive strategies are inevitable from time to time and excessive or wrongly sited infrastructure will be built, the outcome of the process of free market decision-making offers us the best use of resources and the widest scope for the application of human ingenuity. If excessive building occurs, unless there is (illegal) collusion the mistakes cannot be retrieved from the consumer.
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> "Indeed, in such circumstances the consumer obtains windfall gains as the rivals seek to cut their losses by expanding their market shares and in the process driving down the price.
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> "Infrastructure built by private enterprise in the "post-Hilmer" era should not be required to grant access or be subjected to price restraints. The builders of such infrastructure are responding to a profitable opportunity that they foresee, one that, by definition, also confers gains on the buyers of the service. The two parties obtain a mutual gain. The sharing of the gain is one for bargaining between the parties but the consumers of the goods that the facility supplies cannot be worse off since without it they would not have that particular access route and perhaps not the product that the access delivers.
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> "For its part, the owner of the new facility in this "post-Hilmer" era, cannot obtain gain from it by virtue of some form of government granted privilege. The owner will, moreover, usually be building a project that carries some economic risk. Such risk may emanate from a failure of the market to develop in the predicted way, new competitors, or the "howling gales of creative destruction" stemming from a technology that renders existing approaches archaic.
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> "Thus, in deciding to push ahead with the facility, the supplier had no lien on the idea and no lock on the supply itself. Once built, the facility is not protected from imitators. It may be that a successful facility becomes immensely profitable, like Microsoft Word. But it can only do so if it provides value in excess of that which imitators and new approaches provide.
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> "Such mutual gain is at the heart of the private enterprise system. Attempts to "redistribute" it can only harm the process. This can be illustrated in the case of a

> new pipeline. The owner of the pipeline will usually have considered a spectrum of alternative market projections (and perhaps a spectrum of cost projections). There is uncertainty and, implicitly or explicitly, the owner will weight each scenario in making his investment decision. If his threshold is a rate of return of 15% and he is considering scenarios that might yield rates ranging from 25% to 5% but provide a weighted average rate of 15%, cutting off the potential to earn the higher rates will reduce the weighted average to something less than the threshold. The regulatory action would then eliminate the commerciality of the project. In such a case, the sponsor and the customers would both be losers.
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> "Even if, in this case, a new developer were to arrive and build the pipeline, that developer would have done so in the light of the experience gained by the original developer. The process would still result in an inferior outcome because the regulatory process would have demonstrated a cost in originating new ideas and will deter investment in searching out new opportunities.
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> "We have seen an example of this with the Central West gas pipeline. This was a marginal project which required a Commonwealth grant in order for its owner, AGL, to justify its go-ahead. The ACCC required AGL to lower its prices based on a rate of return on capital of 7.5% compared to a rate it sought (and had been agreed by the users) of 10%. Although such an outcome brings lower costs to the customers in the area, the decision undermines entrepreneurship. It has no place in a situation where there is no monopoly. AGL had no franchise to supply gas to the area in question. It has many rivals in Australia seeking opportunities to find new markets. The outlet is from the Moomba to Sydney pipeline, largely owned by AGL but operated by EAPL as a totally independent entity. Had an AGL rival approached EAPL they would have secured the same conditions as those gained by AGL.
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> "AGL had determined that the customers for the pipeline would be willing to pay $2.78 per gigajoule in 2004 but the ACCC has determined they must pay no more than $2.32. Intervention to reduce a price sought by an enterprise in this way is a sure route to economic stagnation. At best it will lead to the entrepreneur engaging in wasteful deception to try to persuade the regulator that his costs are really higher or his market weaker than he has said they are. Most likely, it also sends a message to all businesses looking at expanding networks under the ACCC's oversight that they must please more than the target customers. Hence, the decision of the ACCC to cut the price of using the pipeline in this way will have a sobering effect on other worthwhile ventures."

We set out similar cases in considerations covering duplicated facilities. We see any extension of a pipeline to be a Greenfield pipeline which automatically qualifies for absence of regulation. Where the pipeline is part of an extant system that is covered by regulatory provisions for expansion to meet demands of new customers that are defined contractually, then those obligations should, of course, remain.

Parer recognises that when a regulator places obstacles in the way of a new facility being constructed, there is a loss to the economy. The case for new pipelines to be free of price regulation is no less strong than that for new bakeries, car plants or any other facilities that have no government franchise. Regulation that closes off market entry by insisting that incumbents underprice their services is just as harmful to a healthy economy as regulation that forbids competition.

Although the regulators will maintain that they are simply ensuring a price that gives a fair return to the provider, they cannot but set a price above that which the market would justify. This is because no customer is obliged to pay the price that the pipeline is obliged to supply the service.

It follows that, though it might be said that the facility may, once completed, enable its owner to extract 'monopoly' prices, this cannot be the case. A new facility is introduced in a situation where life went on peacefully and productively. Whatever price the new facility requires cannot leave the customers worse off since they have the choice of not accepting its services at the price sought. And, indeed, if the facility is able to earn very high returns, this simply demonstrates that it is highly innovative or that its builder was taking a considerable risk. In either case it is both premature and counterproductive to tax away these gains with regulatory measures.

Requiring *new* pipelines to be regulated is gratuitous and contrary to efficiency. New pipelines enjoy no exclusivity and by definition have no franchise or monopoly. For gas customers they can only bring benefits. Unless or until a facility can be regarded as "essential", regulating it will impede its development and any redistributive changes the regulation might bring would not compensate for the reduced level of efficiency that regulation entails. The new pipeline competes for customers in the same way as all other goods and services and has no lien on the consumer dollar.

Removal of Coverage

It should be accepted without further analysis that once a new pipeline has a regulatory holiday, any existing pipeline with which it is engaged in serious competition should be immediately removed from regulatory coverage. To do otherwise is to penalise the existing pipeline with paperburdens and inflexibilities that its new rivals don't have. In all likelihood, as the regulator cannot impose a higher than competitive market price (since the customers would migrate to the new provider), the incumbent pipeline will have its price set too low by the regulator. This is likely to harm the abilities of both pipelines to operate according to the optimum interaction of customer and supplier.

Sadly, the regulatory authorities have not always exhibited such common sense wisdom and have sought to maintain coverage, for example over the Moomba to Adelaide pipeline after the SEA gas line was commissioned and the Moomba to Sydney pipeline after the Duke pipeline was commissioned. Hence we consider that provision should be made explicit to extend parallel regulatory holidays to pipelines that compete for the same customers where such a provision is agreed for a Greenfield pipeline

Conclusion

While there is a case for pipelines originally built under franchise protection remaining under regulatory control until new competition emerges, this is not so with the post 1995 era pipelines. Post 1995 era pipeline developers rely on market discovery and business acumen to profitably meet consumer needs, just like entrepreneurs contemplating any other investment. Setting more onerous terms for new pipeline developments will bring sub-optimal levels of capital expenditure on them.

Accordingly, we would recommend a regulatory holiday of 15 years for all new Greenfield pipelines. Such pipelines should have neither price guidelines or determinations nor non-price obligations. Existing pipelines that serve the same markets as the Greenfield pipeline should automatically have their coverage revoked.