Gas in the Parer Review
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The Parer report was fundamentally about the electricity market. Gas and to an even greater extent environment and regional issues were tacked on. Understandably, most commentators have not been disappointed at the quality of the electricity recommendations, but rather surprisingly in view of their secondary status, the environmental suggestions are also well thought through. The many issues concerning gas market arrangements are, however, treated in an over-truncated form.

Regulation's role in the gas industry
As with electricity, gas is best analysed as comprising four elements:
_ supply of gas (which unlike electricity might include storage),
_ transmission along high pressure pipes,
_ local distribution, and
_ retailing.

Of the four elements of gas delivery, distribution alone is an uncontestable natural monopoly. For the other elements control is normally best left to commercial market forces.

Once *in situ* a local network is unchallengeable except from alternative fuels. Although there are occasional examples of a rival duplicating an incumbent's distribution network, this is unusual and probably socially wasteful.

While transmission and production might also have monopoly features, these are likely to be far less persistent than with distribution. New sources of gas supply will usually be found if prices are attractive. With transmission, rival networks can be built to contest an incumbent's market. Such a possibility is, of course, reduced to the extent that regulation is in place and brings prices lower than those that would otherwise prevail. Gas supply and transmission are also different from distribution in that their development decisions and final customers involve commercial parties capable of contracting with each other for long periods.

The 1994 CoAG decisions
In 1994, the Council of Australian Governments (CoAG) agreed to "free and fair" trade in natural gas both intra-and inter-state. Part of this involved an agreement to create no additional exclusive franchises for retail, distribution and transmission and to make existing franchise arrangements more competitive. Government sanctioned franchises were seen to be bringing inadequate incentives for pipelines to operate efficiently and to develop. The monopoly status they created also gave rise to the need for considerable regulatory intrusion to prevent abuse.

The 1994 CoAG approach reversed previous practice under which gas pipelines were either exclusively owned by governments or were only permitted to operate with government approval. The previous approach had seen the need to vest exclusive control over a market to a single pipeline. This was based on the notion that there might otherwise be unnecessary duplication and therefore risks that investment returns might be harmed.

Under the previous approach, the transmission pipeline and distribution businesses were affiliated and prices were controlled either directly where the government owned the businesses, or indirectly where it franchised the activity. The new policy approach was designed to make the gas industry more responsive to demand and to introduce greater entrepreneurship, risk taking and therefore innovation on the part of pipeliners.

The Gas recommendations

The CoAG Review's key recommendations on gas are

- introduce binding up-front 'coverage' rulings
- offer 15 year economic regulation free periods for new transmission pipelines
- provide for up-front regulatory agreements
- change the governance and regulatory arrangements
- conduct an independent review of the Gas Code
- apply a code of conduct to non-covered pipelines to ensure a competitive market
- encourage greater competition through separate marketing
- include criteria to promote competition in acreage management regimes
- undertake a review of the industry's principles for access to upstream facilities.

The last three of these are about unravelling contracts or settling acreage on players who do not offer the best prospects of early discovery. I won't address these essentially upstream issues but doubtless Esso/BHP, Santos and others will have things to say on them.

The middle three concern governance and more detailed review. Importantly the review of the pipeline Code is overdue. It has proven to be excessively bureaucratic in its operation. The present framework has been developed on an ad hoc basis with often contradictory elements. The more important features causing this development to be flawed have been:

- _ the extremely high hurdles that the regulatory authorities have established with regard to the number of competitors required before they allow unregulated markets to operate. These hurdles would prevent almost any pipeline from being regarded as sufficiently disciplined by competition to allow for a withdrawal of regulatory control;
- a National Gas Code that is heavily weighted towards the assumption of the need for regulation with such features as a queuing policy (a role which price performs in the economy generally) and a very prescriptive cost-based guide to pricing which takes no account of market risk.

This aside, the different treatment of gas and electricity is likely to cause distortions in investment. These differences include:

- Different VoLL levels; the $10,000 per MWh in electricity is much different from the $800 a day per GJ for gas
- Bidding and rebidding is on a daily basis for gas and five minutes for electricity; clearly the gas market needs to be more frequent.
- Setting regulated prices for gas and electricity on a consistent basis. These are established on a revenue capping basis for electricity but a price cap is essentially the gas regime. Revenue capping owes its popularity to environmentalists' pressures to prevent actions that might "waste" scarce resources. It is claimed that a price cap would encourage the transmission business to sell more energy than was needed. Such notions belong to an earlier era. All businesses seek to persuade consumers to buy more of their product and the price system ensures the appropriate incentives are in place optimise increased sales with conservation of supplies.

Returning to the key recommendations of Parer, with the first three issues the draft is quite innovative and courageously so.

In looking for binding up-front rulings on coverage, the review recognises the importance of risk minimisation in achieving the optimal level of investment. Such assurances are usually resisted by regulators, who wish to maximise their opportunities to re-visit decisions. Parer rejects, or severely limits the NCC's wish to see scope for revocation of the binding.

The report is also to be commended for building on proposals, which IPA has previously made and which were endorsed by the Productivity Commission in its review of Part IIIA of the Trade Practices Act. These include "regulatory holidays" for new transmission pipelines.

The only case for regulation of new pipelines, now that franchises are no longer part of the Australian regulatory regime, rests with their eventually becoming an "essential facility"; competitive conditions make this unlikely but the Review's proposal of a 15 year regulatory holiday would accommodate such possibilities.

Allowing provision for up-front regulatory arrangements is a variation of this.

In seeking to limit regulatory oversight, the Parer report recognises the disincentive that a regulator, always anxious to avoid being stigmatised as having been "captured" by the industry it regulates, will prescribe rates that are seen by the developer and risk taker as too onerous.

Since the implementation of the National Gas Code, a number of decisions made by the ACCC and other regulators have forced pipeline owners to accept prices that are lower than those that would have been voluntarily entered into by the interested parties in the market-place. GasNet is the latest of those, with the ACCC setting a WACC return about 20 per cent below that sought by the company as well as reducing the company's allowable capital expenditure.

New pipelines

Parer recognises something that both the NCC and the ACCC have not always acknowledged, namely 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.

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.

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 1994 era pipelines. Post 1994 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.

In this respect, the ACCC still has not got it. They have a paper on Greenfield pipelines which stipulates the way allowable prices should be determined on such pipelines.

Existing pipelines

The CoAG Panel recognised the importance of avoiding regulation of new pipelines in its first three recommendations specifying 15 year holidays and similar regulatory relief. However the regulatory arrangements also need to recognise that monopoly situations tend to be eroded, especially if regulators do not prevent new competition by setting prices at levels that are too low.

Even pipelines established in the pre-Hilmer era are showing signs of competitive pressures. The regulatory authorities should be obliged to lift controls over existing pipelines covered by the National Gas Code when a credible competitive threat emerges.

The issue of when adequate competition is in place is a vexed one. Clearly a multitude of competitors offers the best insurance against monopolistic price gouging, and US authorities generally regard five suppliers of similar size to be adequate to ensure no such power exists.

Nonetheless, robust competition can persist with even two competitors, especially if the competitive framework is one where other products or services offer some useful substitution or could rapidly enter the market. Such conditions exist in the case of Coke versus Pepsi, Boeing versus Airbus or even Qantas versus Virgin.

Such a situation was accepted by the NCC with the Parmelia Pipeline in Western Australia; the NCC however has erred in not accepting a similar outcome with the Duke and Moomba to Sydney (MSP) pipelines. For the MSP, it bases the case for continued regulation on synthetically estimated prices undertaken by the ACCC that calculate the "competitive" price on the pipeline would be some 32 per cent lower than at present. It is difficult to have greater faith in a synthetically constructed price than in one that emerges from competitive interaction.

In this respect it is worth bearing in mind that facilities like the seventeenth century ports and nineteenth century railways were the forerunners of today's "declared" facilities subject to regulation. They eventually experienced changed competitive circumstances. In some cases, the on-going regulation designed to promote fairness actually caused the bankruptcy of the regulated assets' owners. The regulations remained in place in spite of the emergence of rival means of supplying their markets and seriously impeded their managements' abilities to respond to the different competitive situations.

Property rights to transmission

A second matter where the draft needs to be clarified concerns gas in Victoria. Victoria's "market carriage" approach is inconsistent with the basic premise the Panel (correctly) sets for efficient pipeline operations, namely tradeable pipeline capacity; Victoria's "market carriage" regime cannot have capacity trading since there is no ownership of capacity; as a result, customers have less than optimal certainty, and the pipeline operator has diminished incentives to seek better use of capacity.

Under the Victorian model, gas shippers and suppliers make offers on a daily basis for gas they have contracted which is surplus to their requirements and for gas shortages they anticipate. Although the market is efficient in that it clears at a price that reflects the scarcity value of the gas, it assumes that the carriage will always be available.

Events of July 22 2002 showed that the transport might not always be available and users were disconnected. This rather devalues the VENCorp case made three days earlier that

"the market carriage regime established by the MSOR of itself reduces the need for long term certainty. In particular, by removing the need for long term gas haulage contracts (and applying a spot market model instead), the MSOR establishes a market environment in which market participants have a reduced need for long term certainty"

Doubtless, the Victorian system can be made more efficient by the use of hourly locational prices but whether this is as efficient as a system that dispenses with the central planner and controller, VENCorp is doubtful. The Victorian operating system is unique. It reduces the incentives of the owner, GasNet, to find means of increasing capacity and to develop new products like hierarchies of gas availability. It reduces the possibility of users to reduce risk by having tradeable rights to capacity. And it increases risk for gas wheeled through the GasNet system to other pipelines.

Some consideration of how to move to a system that better allows the property right solution is required over the next few years.

Concluding Comments

Gas pipeline regulation requires some urgent attention. The Parer Report offers some sound ways forward in:

- Ensuring reduction of regulatory risk for new pipelines
- Recommending a review of the National Gas Code

Other issues that need to be addressed include:

- A better stipulation of when regulations should be lifted on existing pipelines
- Bringing gas and electricity regulations into accord
- Ensuring the important Victorian pipeline system has the property rights to carriage that Parer rightly considers to be essential