APIA COMMENTS ON ACCC DRAFT GREENFIELDS GUIDELINE FOR NATURAL GAS TRANMISSION PIPELINE DEVELOPMENT

Introduction

The Commission, in publishing the draft Guideline, acknowledges the importance of creating an environment in which investors in greenfield pipeline developments can proceed with confidence, and a significant proportion of the draft Guideline is given to discussion of features of the current regime which, in the Commission's view, create such an environment.

If greenfield investment is not to be deterred, unnecessary sources of regulatory uncertainty must be removed. In particular, the 'truncation' problem must be overcome – the regime must provide ex ante certainty that the investor will be able to share in the economic profits generated when a project is successful to balance the ex ante probability of unsuccessful outcomes. Despite the Commission's arguments in the draft Guideline, APIA has serious doubts as to whether that certainty can be provided under the current regime founded as it is on the principle that services should be delivered at efficient cost, including a return on capital.

In APIA’s view the regime must be changed fundamentally if it is to be conducive to greenfield investments. We therefore take encouragement from the attention given to the subject in the recent Productivity Commission and Parer reviews. Both reviews recommend significant changes to the access regime, including the treatment of greenfield investments, and support a review of the Gas Code. At the same time, APIA notes that the draft Guideline has been prepared in the context of the current regime and (quite rightly) that it is beyond scope for it to canvass changes to the regime and policy.[1]

On that basis, and given the Government's responses to the Productivity Commission and Parer reviews, and the impending review of the Gas Code, APIA sees little value in devoting resources to developing the draft Guideline further. The efforts of participants would be better invested in the review and change processes.

Propositions canvassed in the draft Guideline

- *The current regime offers prospective investors flexibility (s3)*

  The proponent of a project may have flexibility in deciding the regulatory approach it will adopt and what form of arrangement it will propose, but the Regulator also has broad

[1] As evidenced by the Commission's response to questions bearing on policy and regime change raised by stakeholders, for example at the forum held in November 2002, and frequent statements in the draft Guideline itself.

discretion as to what it will approve, both initially and in the course of reviews over the life of the project. Moreover, Regulators consistently argue that they cannot and will not give long term commitments especially if to do so would have the effect of binding future Regulators. They also state routinely that a decision made in respect of one pipeline cannot be taken as a precedent for another.

- *Unlike the Regulator, the investor may seek a review of an access arrangement at any time*

  It may be open to an investor to seek a review of an access arrangement if projections do not materialise or when circumstances change, however that opportunity is of little if any value if a project is inherently unsuccessful e.g. because ex ante expectations for market growth and revenue fail to materialise. A regulatory review can do nothing to improve that situation.

- *A sharing mechanism may ameliorate risk*

  The Commission suggests, as one option, a sharing mechanism to ameliorate risk (s6.3). Contrary to the Commission's analysis, the suggested mechanism clearly cannot be symmetrical in practice given that it would result in the investor foregoing some of the blue sky when the project is successful whereas, on the other side, the opportunity to charge higher prices can be of no value if the project is inherently unsuccessful. Likewise, the opportunity to carry forward unrecovered capital (p29) is of no value in those circumstances.

- *Mechanisms for accommodating successful outcomes*

  The Commission suggests mechanisms for enabling the investor to enjoy some of the blue sky of a successful outcome including a longer initial review period (p30) and/or a commitment to base future regulatory reviews on forecasts of volumes established at an earlier review or at the inception of the project (p29).

  Despite the justification in the draft Guideline, there are serious doubts as to whether the Code as currently structured can permit, let alone ensure the right of an investor to enjoy higher returns which may be associated with a very successful project, even if that outcome were within the range of high side scenarios considered reasonable at the project's inception. The Code is founded on the principle that services should be provided at efficient cost, including a return on capital. Apart from the capital base, which is uplifted from one review to the next, and any Fixed Principles, all inputs to Reference Tariffs are to be determined at a review on a forward-looking basis. The Code does not provide, as of right, for long term recognition to be given to ex ante assumptions and assessments of key variables such as volumes: on the contrary, volume forecasts are specifically precluded from being locked in as a Fixed Principle.

Concluding remarks

The Commission's consultants, Davis and Handley, observe correctly that the rational investor will invest only if there is an ex ante expectation that the project return will be at least equal to WACC. This expectation will reflect the probability-weighting of a range of possible outcomes ranging from successful scenarios where, if unconstrained by regulation,

ex post returns will be greater than WACC, perhaps by a significant margin, to unsuccessful scenarios where ex post returns will be below WACC.

These observations provide a guiding principle for establishing the duration of the initial regulatory period or, more appropriately, an access holiday. That is, the duration of the holiday should be set such that the ex ante expectation of return over the period of the holiday is at least equal to WACC. Anything shorter and there will be an expected residual at the end of the holiday period and ex ante expectations will be eroded accordingly. This erosion will occur because of uncertainty about the form of the regulatory regime to apply after the holiday expires or, if the form is known, because of an expectation that returns will be truncated if the project is successful.

Under this option the proponent and the Regulator would negotiate the term of the holiday to apply to the project on the basis of a guaranteed regulation free "floor" of 20 years duration (the floor providing the necessary guidance to regulators on the minimum duration of the access "holiday"). The same term would be available to any other developer of the project. The proponent would then decide whether to proceed. If the Regulator has taken an unreasonably hard line in negotiations then it is still possible that the project will not proceed.

There are other options for achieving ex ante certainty including (as an illustrative example) a sharing mechanism modelled on the Petroleum Resource Rent Tax (PRRT). The PRRT is an established regime for sharing the economic profits (if any) of an offshore petroleum production project.[2] Under this option, if applied to greenfields developments, sharing would begin only if and when the cumulative NPV of the project becomes positive. The negotiation between proponent and regulator will be on the basis for sharing once sharing is triggered.

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[2] The Commission's example of a volume trigger i.e. sharing begins if/when volume reaches a predetermined level, is a poor proxy for the hard economic criteria which define the duration of the 'holiday' in each of the two options outlined here.