ACCC - Draft Greenfields Guideline for Natural Gas Transmission Pipelines

Consultative Forum – 19 November 2002

Questions raised by attendees

Kevin Lewis – Standard & Poors
Question directed to Greg Houston from NERA

In drawing your comparisons with the US and Australia one of the points you made was that Australia was less developed than the US and also that Australia used a volume based approach to regulation rather than capacity. I was wondering if your observations indicate that by choosing a volume based approach, and thus striving for regulatory flexibility, this has created some complexity in regulation in Australia, making it a less transparent process?

Greg Houston: I'd agree. The charts used by David Chapman [ACCC] in his presentation are concerned with determining the right incentives in the regulatory arrangements or regulatory contract at the beginning of the period. And then various trigger points are developed in the event that actual demand turns out to be different later on. Really the focus of this approach is the volume demand certainty and I think that is quite a complex thing to administer as a regulatory arrangement and so the flexibility that you get from volume based regulation has the cost of some complexity down the track.

It is also important to note that you can't look at just any one dimension of the regulatory arrangements here and compare it with the US and say one is better and one is worse because each of these dimensions fit together and generally, the whole package probably has a not dissimilar effect. The US may have simpler regulation, but it also has other more complex administrative processes for discovering real market demand. In Australia, the equivalent processes are much less formal and most likely less complex Therefore there is a trade off, and I think it is wrong to conclude that the way it is done in the US is any less complex.

It is also important to understand that the geography and the population density in the US makes the whole environment completely different from Australia. The US is a significantly more populous country and this means that the whole market, in terms of pipeline users and the market demand for gas, is much deeper and so the addition of one more pipeline is a much smaller increment to that market than it is in Australia. This means that the magnitude of some of the risks arising from demand etc in Australia are quite different in means of scale and probably relatively.

Kevin Lewis – Standard & Poors
Question directed to John Handley

In the past the ACCC has matched the regulatory reset period with the benchmark risk free rate in the case of a 5 year access arrangement. If the regulatory period is extended to 15-20 years, under this approach, should we take it for granted that this period would be matched in the benchmark risk free rate? What is your opinion on this?

John Handley: I have the view that if it is a long term investment, then matching the risk free rate with the regulatory reset period would be advantageous. I think that the policy decision of until late has been to use the five year rate for reasons already stated. Certainly it might only become an issue when the terms of interest rates are either steeply upward sloping

or steeply downward sloping. However, in the current environment this is probably not an issue.

David Chapman: I think it is important to recognise that the five year rate used previously has been for regulatory periods of five years. If you had a reset period of 10 years than we would apply a risk free rate of 10 years and if it's a longer period then we would construct a risk free rate for 15 years or 20 years, as the case may be.

Peter Berry – Flinders Group

Question directed to John Handley

What are the systematic risks? Can you identify some of them?

John Handley: Identification of individual systematic risks is an inherently difficult task and therefore, in theory and in practice, you often go back to a general framework and look at the factors which guide systematic risk. The general definition of systematic risk is 'risk factors that are common across all companies' as opposed to factors which will affect an individual company in isolation. So these are economy wide type risks, i.e. anything which essentially moves the market or economy in a forward direction or leads to a contraction of the economy. For example, market wide changes in interest rates, exchange rate volatility, inflation rates, natural disasters and the impact of political policy.

Determining the actual impact on an individual company is often difficult and therefore the most common approach has been to adopt a statistical type method which basically uses the returns on the market and the returns on a particular list of companies to determine the extent of the systematic risk. It is these key economy wide factors which impact on the demand cash flows of the individual company or project. Broadly if a beta equals one the project or company is equally as risky as the market, a beta of greater than one means it is more risky and a beta of less than one is less risky.

Question from the Floor (unidentified speaker)

The Macquarie Bank slides indicated that debt providers would require a ROE commensurate with the risk of the project. Is this referring to systematic risk only?

John Handley: Maybe this is a question best answered by Reece. In many cases when capital providers discuss risk they are implicitly talking about systematic risk as opposed to total risk. When you look at the world financial markets, the most important investors and capital providers are large institutions which are reasonably well diversified. The implication from this is that they will only need a return based on the systematic risk.

Reece Edwards: From an equity point of view investors take into account a lot of issues in terms of risk that may not be systematic. For example they will obviously look at the investment environment, competing pipelines, the current financial environment, the debt facilities that the proponent would be able to get into place and any exit strategies regarding the liquidity of their investments.

When equity investors estimate risk it is not usually a scientific calculation and from an equity point of view it is not generally classified as systematic risk, however, this certainly may not always be the case. There obviously may be forward positions on what equity providers perceive the investment rate of return for a particular project should be. This might not necessarily be based upon systematic risk, however I suppose it would be taken into account when they come up with equity.

Alan Moran – Institute of Public Affairs

With a new pipeline we have no monopoly, no franchise but there's this discovery process driving into a market trying to meet its needs and they have no protection. This is not like the situation which prevailed before Hilmer where you had franchise pipelines which were protected from competition. To some degree you still have those in the US, but even it is also moving away from this, though I don't know that there are any pipelines that FERC has said are competitive. What we've actually done though, is we've abandoned the exclusive franchise. We did so because it was costing customers money and it was thought that there wasn't enough entrepreneurial activity involved. In doings so, we have been hoping to see the withering away of the regulatory role. But the new pipelines are actually creating a good environment, a good product to compete with each other and anything the government does in terms of insisting on certain level of return, certain planning conditions and ornate systems of risk profiles to regulate this stifles the investment process and in doing so will reduce the economic well being of the economy.

John Martin: Alan I think what you are discussing here are essentially policy issues which fall outside the scope of this forum.

Alan Moran: *Let me just say that the role of this hearing is very narrow, but this role is not in a vacuum. We've had the industry commission report and Parer put forward the proposal of access holidays, so then don't we have to start changing this draft to actually accommodate a more forward looking approach. We are regulating something that doesn't need regulation. My views are that it may need regulating 15-20 years down the line but it doesn't need regulation at the present time because there is no monopoly to regulate. There is nothing there, it cannot create value. How do we propose to do that?*

John Martin: I take some of the points you are making but we are acting in the regulatory framework that we have got at the moment and maybe it is developing, but we are dealing with the arrangements currently in place.

Greg Shales: What is at the heart of the issue is whether or not it is truly an entrepreneurial pipeline.

If it is then it may not need to be regulated at all. In my presentation, and chapter 3 of the guideline in particular, the relevant considerations are set out.

What we do in chapter 3 is not advocate one form over the other but to identify the relevant decision points of the process. In the example of a truly entrepreneurial pipeline with no market power then on that basis it presumably need not be regulated.

Alan Moran*: But it's a greenfields pipeline? What's the definition of a greenfields pipeline?*

[Reference is made to Slide 48 of the ACCC presentation]

A greenfields pipeline can be a new pipeline to a region not previously serviced by natural gas or it could be a new pipeline to an area already serviced by gas. What we didn't want to exclude, for example, was a competing pipeline into an established market.

This forum and the guideline are to discuss what uncertainties can be accommodated in the existing regulatory framework and the very first step in all that process is to make an assessment as to whether or not the pipeline in fact needs to be regulated.

If it is to be regulated, then the next relevant consideration is what is the optimal route – an Access Arrangement or an Access Undertaking?

Alan Beasley – APIA

The issue for industry is that the solution outlined in the draft guideline still doesn't meet that element of certainty and predictability. We've heard today about access periods that may be 5 years in normal circumstances, 10 years in the case of the Central West decision and we've heard 15-20 from you in your presentation today. So we've got 5, 10, 15, and 20 – its almost a pick a box in terms of discretion for the regulator.

My question goes to Reece Edwards and John Handley in terms of their input into this process. You've both had an opportunity to review the greenfields guideline and you've made comments in your submissions about certainty and the sorts of mechanisms that might apply. Having read the guidelines, does the guideline itself meet the needs that you've set out in your submissions?

Reece Edwards: In terms of providing an opinion on whether we think that a particular regulatory period is sufficient or not, from our point of view, debt and equity suppliers want certainty in the regulatory environment.

Debt suppliers would have to look at the project proponent to make sure they have the requisite experience dealing with the regulator and making sure that they liaise with the regulator regarding the WACC, revenues and market demand that they will require.

In terms of whether it is 5, 10, 15, or 20 years I don't think it is at the discretion of the regulator as to which one they would prefer in negotiation with the proponent. To a certain extent the proponent should have its financiers together negotiating with the regulator – which would be the most appropriate in terms of getting secure cash flows. Because in the end secure cash flows is what it is all about.

John Handley: I think it is important to realise the terms on which we were asked to advise the Commission. What we were required to come up with were a number of comments and opinions expressed in the conceptual framework.

It is important to recognise that applying them in the practical framework, translating the conceptual to practical has potential limitations. There may be a number of paths by which you can go. Based on our reading of the guideline it certainly appears consistent with the views that Kevin and myself have put forward and I think that is clear throughout the document.

The guideline makes reference to the views that we've put forward and the particular form of which some of those issues are being addressed is not a matter for us to express an opinion on, and certainly please don't interpret that in a negative way.

Greg Shales: To clarify, it is definitely not a case of "5, 10 or 15 years pick-a-box"; there is no regulatory 'chocolate wheel' approach to this process.

Alan Beasley: *I want to clarify that, because I've listened to the discussion today and David Chapman has said that its normally five years, but the guideline itself refers to 10 years in its case example and your presentation referred to 15-20 years. This is an example of the discretion that can actually be applied by the regulator and the problem with this process is that a service provider has to put forward an access arrangement at total regulatory risk of exactly how the regulator responds to that.*

Greg Shales: I think that you've answered the question yourself in the latter part of your comment.

The service provider has to put forward the access proposal. All of the periods of time that you referred to, whether 5, 10, 15 or 20 years are illustrative examples. What we have also emphasised in our presentations is that the onus is on the project proponent to table an access proposal that best accommodates its unique circumstances.

David Chapman expressly made reference to the point that the term of a project's foundation contracts and/or initial forecast periods as perhaps being relevant indicators of what the most optimal initial access arrangement period might be.

It is important that I clear up that misconception. It is not a matter of regulatory discretion. It is for the service provider or project proponent to put to the regulator what is the optimal arrangement for their purposes.

Alan Beasley: *Its regulatory discretion whether to accept, reject or modify those particular arrangements and that is why the private sector participants aren't investing under this code and I think that's exactly why alternative policies have been developed by Parer.*

John Martin: As part of this process we are trying to communicate the options. It is not just an exercise. There are considerations for whether it might be 15 or it might be 20 years. Now ultimately there is a basis on which this is decided. You make a point about alternatives which are policy issues and that is not what we are here to discuss.

Graham Holdaway - KPMG

Suppose I look at a major investment of a $100 million dollars and I take a view that perhaps it should be unregulated but my financiers and interest holders are not prepared to take the risk of subsequent coverage. And I also take the view that a non-binding indication by the NCC is not sufficient. Then I'm in a position where I need to submit an access arrangement.

When could I do that? What's the first time at which I can submit the access arrangement?

Greg Shales: In terms of the optimum timing to gain certainty as to how your access proposal will be treated, I would say right at the outset. From the time of first contemplating the project talk to the relevant regulator or regulators and flesh out the details.

Graham Holdaway*: Are you indicating that you would sign up to an access arrangement before I spend the money?*

Greg Shales: What the guideline notes, and it is one of the recommendations in John Handley and Kevin Davis' report, is that the optimal time to get the regulatory decision is likely to be at the time of financial commitment or financial close for the project. And that is what the Commission is undertaking that it would work towards in such a circumstance.

Dave Robinson – Ernst and Young

The ACCC and other regulators in estimating beta often rely on data from comparative firms or do their own calculations or a combination of both.

My question is that given the situation of the pipeline or greenfields projects where you don't really have the comparative benchmarks available, and international comparators effectively have a zero rating in that consideration, how do we then derive an equity beta in this situation?

John Handley: The way that we have approached this is to not specifically try to find comparative firms so that we could benchmark these betas. If there was a whole sample of

firms out there which were only engaged in greenfields pipelines then there's our answer, we could benchmark those firms. Unfortunately, this type of data isn't readily available so we look at alternative comparators, benchmarking the greenfields beta based on the beta for developed or existing companies. Therefore we calculated beta for an existing company and, as briefly covered in our presentation and our report in more detail, we then considered whether the beta for a greenfields should be higher, lower or the same as the beta for an existing company.

The net conclusion was that there were some factors which suggested it should be higher, but there were also some factors inherent in the greenfields project which will mitigate that risk. Our ultimate conclusion was, though difficult to determine, the difference is small and therefore you should use the upper end of the beta estimate for a mature pipeline or project.

Greg Houston: It does seem that there are companies who have invested in Australia which have characteristics not significantly different from that of a greenfields project. There are financing vehicles for toll roads, for which most of these roads are not yet built. I'm not going to suggest that is what you should look at, but it does seem that we're not looking at an empty set in terms of comparative entities.

Peter Rose – Freehills

In issuing its next version of this draft, I wonder if it would be possible to get some greater guidance on the Commission's thinking about whether it is appropriate to apply a distance weighted approach to determining tariffs as opposed to a postage stamp approach or some hybrid approach such as zonal tariffs.

I note that you addressed the issue of postage stamp tariffs in your Central West determination. Is this sort of approach typical of a greenfields proposal?

David Chapman: This is a difficult issue and I don't think you can provide a general response on it because it is something which has to be dealt with on a case by case basis.

For example, where you have a number of different customers who are located a fair distance apart on the pipeline, and you use a distance based approach, the customer right at the end of the pipeline ends up paying the highest price. Therefore, you may find that, on this basis, the customer no longer wishes to purchase the gas anymore and that part of demand might dissipate. This may mean that the remaining customers have to cover a greater portion of the construction costs, and so they may also reassess whether or not they still want to ship gas on the pipeline.

So in some instances, a distance based approach may not always be very sensible, as the pipeliner may not be able to get any customers under that type of tariff structure. In these circumstances a postage stamp approach might prove to be better. Customers who are close to the source of gas might pay a bit more, but if everyone participates then it's probably socially preferable for that to happen, rather than having a cost reflective tariff. I think that it is economic arguments like that which will provide some direction in the way that you would structure your tariffs. I'm not sure that it's a relevant issue to address in the greenfields guideline, as it is something you need to consider on a case by case basis.

Question from the Floor (unidentified speaker)

The notion of flexibility has pervaded the entire discussion this afternoon. I just think it would be helpful to have some guidance on the way the code applies to these pipelines, and

some indication as to whether or not the types of approaches articulated in the Central West decision are likely to be applied elsewhere or whether that was a one off.

David Chapman: I think you can be pretty sure we would consider the arguments put to us by the proponent very seriously and that was the case in Central West. We would be unlikely to include reference to the Central West decision in our guideline if we no longer took that view.

John Martin: Are there any other questions? If there are not I might leave it there.

I did make reference earlier to the four questions we had on notice. We have actually developed a response to them, but given the timing we might not try to address them today, rather we will put a response to those specific questions on our website. Today's discussion will be minuted and also placed on the website.

I thank you all for your attendance and we look forward to the development of this process.

CLOSE

ACCC responses to written questions submitted with registration forms

I would like to understand why the ACCC wants to take guidance from a document it has prepared itself rather than refer to the Gas Code? ***Azhar Abidi, Hastings Funds***

Answer: The aims of the Draft greenfield guideline are clearly set out in paragraph three of page one of the guideline.

Could you please advise how the guideline is meant to deal with the problem of 'regulatory truncation' (ref: Productivity Commission' s Inquiry Report No. 17, Chapter 11, and recent submissions by authors such as King and Davis & Handley). ***Les Godfrey, QLD Comp. Authority***

Answer: Section 6 of the Draft greenfield guideline (page 26), and section 6.3 (page 28), specifically address the issues of securing the necessary ex-ante certainty in an access proposal so as to preserve expectations of obtaining the 'blue sky' potential of a project. The ACCC presentation slides 23 to 35 of 19 November 2002 also address this issue.

In summary the Draft greenfield guideline sets out a number of options that could be utilised to ensure an access proposal reflects a project's ex-ante expectations and that these are recognised in the regulatory process.

Why is regulation needed when competition is provided by alternative energy sources in greenfield projects and why are not access holidays promoted as proposed by the Productivity Commission. Also does the ACCC support changing the Code to support access holidays for greenfield projects? ***Geoff Towns, United Energy***

Answer: Chapter three of the Draft greenfields guideline describes the current regulatory framework and relevant considerations as to whether or not a natural gas pipeline does in fact need to be regulated.

The remaining queries raised above relate to policy issues that are outside the remit of the ACCC's role as regulator of natural gas transmission pipelines. The Draft greenfields guideline deals only with the existing regulatory regime (Gas Code and Part IIIA of the Trade Practices Act) and the flexibilities and options therein that can be utilised to provide the necessary ex-ante certainty for greenfields type projects.

It is anticipated that analysis and debate of these policy related issues are likely to be matters for consideration in a review of the Gas Code and / or responses to the COAG Energy Market Review.

Mistrust of market mechanisms is apparent in the June 2002 ACCC draft "greenfields" guidelines for gas transmission pipelines. This follows US practice of requiring the pipeliner to submit its proposed charges to the regulator prior to receiving approval to levy those tariffs. Unfortunately the ACCC proposals therefore attempt to graft approaches designed for risk-free standing monopoly pipelines to

pipelines that face all the uncertainties of an entrepreneurial proposal. This central planning approach to investment decision making is the pre-Hilmer model under which pipelines were granted protective franchises and under a government entity ensured that the pipeline would be viable. The ACCC should condemn such central planning notions. ***Alan Moran, Institute of Public Affairs***

Answer: The primary question to be addressed is whether or not a new natural gas transmission pipeline needs to be regulated.

Chapter three of the Draft greenfields guideline describes the current regulatory framework and relevant considerations as to whether or not a natural gas pipeline does in fact need to be regulated. If it is to be regulated then the next relevant consideration is what is the optimal route – an Access Arrangement or an Access Undertaking.

The ACCC is not aware of any owners of established regulated pipelines supporting the concept that they own "*risk-free standing monopoly pipelines*".

The remaining points raised relate to policy issues that are outside the remit of the ACCC's role as regulator of natural gas transmission pipelines. The Draft greenfields guideline deals only with the existing regulatory regime (Gas Code and Part IIIA of the Trade Practices Act) and the flexibilities and options therein that can be utilised to provide the necessary ex-ante certainty for greenfields type projects.

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