Response to ACCC request

for comments on

Draft Greenfields Guideline for Natural Gas Transmission Pipelines

By

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Executive Summary

The ACCC, in its draft Greenfields Pipeline Guidelines, provides a way forward for giving developers of Greenfields Pipelines a degree of regulatory certainty as to how the ACCC intends to assess new pipeline developments. Visy Paper supports initiatives such as the preparation of the draft guidelines. We do see, however, that in doing so the ACCC has not sufficiently considered the interests of other parties involved in developing a new pipeline, to the considerable detriment of the guidelines.

This submission addresses the risk reward equation faced by pipeline developers in providing surplus capacity over the needs of the foundation customers and derives a significantly different conclusion to that implied by the ACCC in its draft guideline appendices. The analysis undertaken in this submission indicates that the cost to provide a significant amount of additional pipeline capacity is very modest, which is in marked contrast to the costing structure provided by the ACCC. Because of this we recommend that as part of any application to the ACCC for an access arrangement, the pipeline developer should be required to provide independently corroborated costing information demonstrating the difference between the cost for a pipeline to meet foundation shipper requirements and for the pipeline as proposed. Such data can provide a better indication of the costs involved to provide the "blue sky" element for which regulatory protection is being sought by the developer. To substantiate its claims, the developer should also provide (on a confidential basis) the contributions and capacity requirements of foundation shippers.

The ACCC, whilst acknowledging the importance of foundation shippers, does little in the draft guidelines to quantify the magnitude of the contribution provided to the development by the foundation shippers. Our analysis indicates that the foundation shippers provide a more substantial underwriting of a pipeline's viability than does the developer, yet the guidelines do nothing to protect the interests of the foundation shippers, and worse, can lead to regulatory solutions which increase the risk profile of the foundation shippers with regard to the development.

The draft guidelines contemplate the concept of an "access holiday" or provision for uncontrolled extended regulatory periods as a mechanism for securing "greater regulatory certainty" for the pipeline developer. The ACCC does not, however, include in its assessment of such remedies that these may not only impact on the remedies available to foundation shippers, but also create an asymmetry of benefit in favour of the developer.

We are of the strong view that the National Gas Code should remain the basis for assessing any regulatory application for third party access to a natural gas pipeline, that an access arrangement should not provide for any "access holidays" and that all access arrangements permitted to be longer than five years, should include regulatory controls which permit review by the regulator

and allow future adjustment of the assumptions made at the time of application.

1. INTRODUCTION

The ACCC has issued draft Greenfields Pipeline Guidelines in response to concerns by the gas pipeline industry for regulatory certainty. Under current regulatory arrangements, both Part IIIA of the Trade Practice Act and the National Third Party Access Code for Natural Gas Pipeline Systems (National Gas Code) apply to the regulation of gas pipelines.

A prime objective of both is, inter alia, to ensure that gas transport pipelines allow access to surplus[1] capacity on natural gas pipelines at tariffs reasonably replicating the cost of providing the service, consistent with providing the service provider with reasonable returns on investments. Despite the repeated statements of concern by pipeline developers that investment in pipelines has been negatively impacted by the introduction of the National Gas Code, the contrary situation seems to be the case as since its introduction there has been extensive investment (including new proposals) in gas pipelines (both new and augmentations).

Under the National Gas Code all covered pipelines (including Greenfields Pipelines) have been reviewed and terms and conditions of access have been determined, but appeals on almost all regulatory decisions for transmission pipelines have occurred (in stark contrast to regulatory decisions for distribution pipelines). A second round of access reviews has already commenced.

The above background is germane to the question as to the extent Greenfields Pipelines should be insulated from future regulation, and whether pipeline developers and owners, when given more latitude from regulation, will use their monopoly position to extract monopoly rents?

Much has been made by the transmission pipeline industry about the risks they face under the regulatory environment extant in Australia.

The pipeline industry (which was closely involved in the development of the National Gas Code) has highlighted the many risks it takes in regard to pipeline investment and operation. These risks have been brought to the attention of regulators, government ministers and review committees for the purpose of establishing that they represent a deterrent to future investment in new pipelines. On the other hand, pipeline owners and their representatives have not substantiated their views by either highlighting where pipeline projects that are viable have not been built, or the actual cost to pipeliners for providing surplus capacity for third party access.

[1] The term "surplus capacity" is used in the submission to define the capacity of the pipeline available over and above that contracted to foundation shippers.

The ACCC, in its draft guidelines, challenges the allegation that pipeline investment has been affected by regulatory risk by pointing to the evidence of extensive investment[2]. The ACCC then states that:-

> "… concerns have been raised whether the relevant codes can adequately address the specific needs of greenfields investment."[3]

Against this background, the ACCC's draft Greenfield Pipeline Guidelines appear to have been developed to assess what the risk reward equation should be for pipeline developers, including the issue of the surplus capacity available for third party access on new pipelines, and how this should be addressed.

The key assumption underlying the draft is that developers should be provided with incentives to provide for surplus capacity above that underwritten by foundation customers, and that this incentive should be related to an access holiday or extended uncontrolled regulatory period, allowing the developer to enjoy effectively unregulated third party pricing rights for a nominated period.

This submission seeks to quantify the major risks faced by developers of new pipelines. The views detailed herein indicate that the reason why little quantification of the risks facing new pipeline developers has been provided is because the risks are more perceived than real.

2. *IDENTIFYING THE PIPELINE DEVELOPMENT RISK PROFILE*

Before assessing whether the National Gas Code does in fact provide developers with negative incentives to invest or to constrain their ability to gain reasonable returns from their unique position, there is a need to quantify the risks, and to assess whether the rewards which will come from providing surplus capacity outweigh the cost of providing that surplus capacity.

2.1 The Process of Pipeline Development

Much is made (both in the draft guidelines, and elsewhere by pipeliners) of the risks faced by the pipeline developer and its ability to access the "blue sky" to make its upside return.

We consider that in order to establish the way new pipelines should be regulated there is a need to assess the risks faced by a pipeline developer. It also requires an understanding of the processes involved in developing a new pipeline. In its draft guidelines, the ACCC goes to some lengths to allocate the risks of variable forecast demands with the cost to provide surplus capacity.[4]

[2] Draft greenfields guideline for natural gas transmission pipelines, page 2, col 2, para 2
[3] ibid, para 3
[4] Draft greenfields guideline for natural gas transmission pipelines Appendix 1

No pipeline is ever built without a fundamental precondition – a "bankable" end user(s). Bankable end user(s) require in turn a viable gas field which will allow them certainty of energy or feedstock supply and a cost structure which provides an overall cost reduction over the existing supply arrangements.

To achieve the most economical financing of pipelines, they are developed using a mix of debt (usually 60-70% of the funds needed[5]) with the balance being provided as equity. Few, if any, banks will lend to finance a pipeline unless there is certainty of repayment of the debt, which in turn requires sufficient guaranteed cash flows to match the debt repayment schedule, with at least 20-30%[6] surplus cash flow for repayment coverage. Thus, to develop a bankable new pipeline requires as a minimum 80% of the pipeline costs to be underwritten by bankable end users. This means that the risks faced by pipeline developers need to be assessed in recognition that at least 80% of the pipeline costs have to be covered by the foundation customers, and at most 20% of the costs are being sourced by the pipeline developer.

Equity providers rarely, if ever, invest without some high likelihood of return. Thus, of the remaining 20% of the pipeline costs, there will be a need for a significant contribution from the cash flow remaining after the debt repayments are made to provide a minimum return to the equity providers. Whilst some of this may come from the surplus coverage required by the debt providers, making allowance for even a minimum return on the equity, requires more than the 80% "bankable" return provided by foundation customers.

The much publicized peregrinations of the PNG gas pipeline[7] underlines the importance of the foundation customers and the failure to secure them, despite the need for new gas supplies in Queensland and the ready availability of gas from Papua New Guinea. At the same time Origin and International Power have proposed to develop the SEAGas pipeline to Adelaide without providing for any surplus uncompressed capacity,[8] which indicates that the foundation customers can in fact provide sufficient certainty for the development of a pipeline without the need for any need of risk of securing additional gas shippers.

Thus, the risk for the ACCC in assessing the returns gained by pipeline developers and the apparent need for unconstrained "blue sky" benefits, is that by not recognizing the overwhelming contribution made to the pipeline

[5] The ACCC uses 60% in its calculations of WACC for regulatory purposes. It has been noted (eg ACCC review of ElectraNet SA, December 2002) that the debt proportion may in fact be higher.
[6] The debt coverage sought by lenders varies with the perceived risk of the investment, the strength of the foundation customers and the duration of the loan.
[7] The many discussions of new foundation customers and the impact of the loss of AGL as a foundation customer have been widely reported in the press. For example, The AGE 23/12/02, "to be commercially viable the project must sell more than half the pipeline's 200-210 PJPA capacity."
[8] The posturing between TXU wanting gas capacity on SEAGas, and after the SEAGas developer's refusal due to no surplus capacity, TXU's proposed support for a parallel pipeline to be developed by GasNet and Duke Energy, has been widely reported in the press. This matter was finally resolved when Origin/IP agreed to increase the pipeline capacity to accommodate the needs of TXU.

development by the foundation customers, the ACCC may well be granting an excessive upside potential, which is supposedly to be balanced by an equivalent downside risk that in actual fact is, at best minimal or at worse, non existent.

2.2 The risk profile of the foundation customer

A significant omission from the draft guidelines is the absence of recognition of the impact of the foundation customer(s) on the development of the pipeline and the subsequent rewards obtained by the pipeline owner, even though the report from NERA reinforces this point:-

> "Long-term transportation contracts that involve financial commitments to reserved capacity by shippers have played a fundamental role in the development of the US gas network and continue to drive new gas pipeline development."[9]

and goes on to say:-

> "… long-term transportation contracts between PSPs and shippers … underpin the size, timing and financial risks of new pipeline investments"[10]

Accordingly, it must be noted that the extent of the transfer of risk from the developer to the foundation customer has a significant impact on new pipeline economics.

> "In addition, foundation contracts with major customers mean that much of the systematic risk may be borne by that group (and reflected in the terms of such contracts)."[11]

The argument for special consideration to be provided to new pipeline developers is that they face significant downside potential if, after they provide surplus capacity for third party access, no other shipper avails itself of this capacity. They then advise that there is little upside potential if that surplus capacity is regulated in accordance with the National Gas Code, thereby capping their "blue sky" returns from new shippers. They further aver that there is always an ultimate cap on shipping tariffs due to Ramsey pricing, resulting from consumers using alternative forms of energy.

[9] Page 49, Foundation contracts and 'greenfields' gas pipeline developments: experience from the united states and other jurisdictions, NERA, March 2002

[10] ibid, page 49

[11] Page 1, Cost of Capital for Greenfields Investments in Pipelines" by Kevin Davis and John Handley, 30 April 2002.

However, to fully appreciate the reward potential of pipeline developers requires analysis of the risk taken by the foundation shippers, in relation to the overall development, and the funds effectively underwritten by each party.

When a developer involves a potential foundation shipper in a new pipeline development, the foundation shipper is required to provide, as a minimum, certainty of usage of the facility for a sufficient time to satisfy the debt providers to the pipeline that the debt can be repaid. For many infrastructure developments, which are often established on a non-recourse project debt basis, debt providers are prepared to lend for periods usually of between 12 and 15 years[12], providing the foundation customers are "bankable". Pipeline developments fall into this debt profile.

Alternatively, a pipeline developer may use its other assets and cash flow to secure the debt. In this case the debt is non-specific to a particular pipeline and the internal finance operation of the developer would apply similar criteria to a specific project as would external lenders[13], supporting the view that foundation customers do in fact carry most of the new pipeline risk and that investors do expect a return of their investment over much shorter periods than assumed by the ACCC.

Thus, the foundation shipper is often required to guarantee usage beyond the debt provision range so as to provide assurance to the equity provider with certainty of gaining a return. Further, just as the debt provider requires repayment of the debt within 12-15 years the equity provider also seeks return of its capital within a similar period. It is usual for infrastructure providers to want a return of capital within the period underwritten by the foundation customers. This means that rather than the capital of an investment being returned within the economic or technical life of an asset (as is assumed by the regulatory process), it is more likely to be recovered within the life of the period underwritten by the foundation customer(s).

The ACCC (in its draft guidelines) has evinced some concern that the pipeline owner may, in fact, not secure the "blue sky" upside benefits due to the application of the National Gas Code. However, whilst the bulk of the risk is in fact being taken by the foundation shipper(s), and due to the perception of the "sanctity of contract", the ACCC has not considered whether the foundation shipper should gain some benefit as surplus capacity is used under the open

[12] For example, see page 9, Issues for debt and equity providers in assessing greenfields gas pipelines, Macquarie Bank, May 2002

[13] For example, see Annexure A, Issues for debt and equity providers in assessing greenfields gas pipelines, Macquarie Bank, May 2002. In this instance Duke Capital would apply specific criteria to the particular pipeline to ensure the project meets internally set benchmarks, which would be similar to those of external lenders. Most companies require an internal "hurdle" rate for use of funds, regardless of source. Internal hurdle rates more commonly require an internal rate of return (IRR) of 15% or higher for new investment, although the long term average achieved may be lower than this, with an IRR of perhaps 10-12% being the bottom of the tolerable range. An IRR of 15% effectively requires a discounted cash return of the investment within 5 to 10 years depending on discount rates and cash flow profile. This reinforces the view that foundation customers do in fact carry most of the new pipeline risk and that investors do expect a return of their investment over much shorter periods than assumed by the ACCC.

access rules. It would seem that the view of the ACCC is that the foundation shipper(s) could incorporate into their contract a provision that they should pay no more than a regulated tariff. However, if the ACCC permits the pipeline owner to avoid regulation for an extended period – an "access holiday" supposedly to allow the pipeline owner to gain the benefits of selling surplus capacity – then this assumed avenue of risk mitigation will not be available to the foundation shipper.

In the analyses prepared for the ACCC appended to the draft guidelines[14] the assumption is made that the capital invested will be returned over much longer durations (30 years for machinery and 60 years for the pipelines). Whilst such assumptions are appropriate for the setting of tariffs, they do not recognize the benefit provided to the pipeline developer of the cash commitment of the foundation shippers. The calculation for return of capital (depreciation) in the regulatory assessment does not provide recognition for the fact that much of the capital will be recovered much faster through the foundation shipper due primarily to the requirements of the debt providers.

Further, the approach taken by the ACCC must not reduce the rights and abilities of the foundation shipper(s) to mitigate their risks. Acceptance of an "access holiday period" or an extended "uncontrolled" regulatory period would directly impact the foundation shipper(s).

2.3 The development of additional pipeline capacity

Another key element in assessing the risks faced by pipeline developers for providing capacity above that underwritten by foundation customers, is the estimate of costs for providing any additional (surplus) capacity.

In its draft of the greenfields pipeline guidelines, the ACCC goes to significant lengths to establish the costs which might be attributable to surplus capacity, and how this might be treated within the regulatory environment[15]. However, the analysis by the ACCC is, in part, flawed due its costing assumptions for constructing increased capacity.

When a new pipeline is being developed the basic model is to provide for the initial demand in an uncompressed state, with future augmentations relying on increasing compression on the pipeline.[16] The basic example used in Appendix 1 indicates that the cost to increase capacity by 50% for an uncompressed pipeline is of the order of 20%.

However, this increase in costs is assessed as being too high, and does not replicate the costs of construction. To identify the real cost increase, it is necessary to examine what is different in the construction costs between two pipelines of marginally different sizes. As most of the cost of a pipeline is

[14] Draft greenfields guideline for natural gas transmission pipelines Appendices 1 and 2
[15] Draft greenfields guideline for natural gas transmission pipelines Appendices 1 and 2.
[16] See, for example, SEAGas pipeline where open access capacity requires compression.

related to the pipe and the laying of it, a close look at the actual differences between the building of the smaller and the larger pipelines will provide a guide.

As an example, increasing the cost of a 350 mm pipeline to 450 mm pipeline, increases the uncompressed capacity by 65%. The differences between supplying and laying the two pipeline sizes are[17]:-

1. Amount of steel increase is 30%, with a cost increase of about 20%.
2. Pipeline coating increases by 30%, with a cost increase of about 15%.
3. Survey costs and easement acquisition costs are identical.
4. Site preparation costs are identical.
5. Trenching needs to be only 100 mm wider in a trench width of at least 1 m. Costs are much the same as slightly wider excavation equipment is used.
6. Pipe delivery costs will be identical as in this case trucking capacity is determined by volume, rather than weight.
7. Pipeline handling and laying costs (equipment and time) are identical.
8. Set up and aligning time is identical.
9. Welding time increases by 30%.
10. Time used and cost for protective wrapping are identical.
11. Pipeline padding (cost and time to lay) is identical.
12. Backfill time is identical.
13. Site reinstatement costs are identical.

As can be seen from the above illustration the increased construction costs to change to a pipeline with 65% increased capacity affect only a few of the elements of construction and therefore would only require an increase in cost of no more than 5% as distinct from the increase of 20% used in the Appendix 1[18] example. It should be noted that as the diameter of the pipeline increases, the percentage cost increase for providing additional capacity reduces below that shown for the example above.

Operating costs of both sizes of pipelines will be similar for the same volume of gas pumped, with perhaps less power needed for the larger pipeline due to lower friction losses.

The ACCC needs to recognize that the cost for providing additional capacity above that underwritten by the foundation customers is very low, and even the ability to increase capacity by large percentages requires only a very small amount of additional capital. Because the additional capacity is available at almost no premium, the financial risks faced by the developers in building in surplus capacity are extremely modest.

[17] Data supplied on a private basis by an experienced construction engineer
[18] Draft greenfields guideline for natural gas transmission pipelines Appendix 1

2.4 The impact of regulatory control over surplus capacity

What is often overlooked in the debates over how to treat new gas pipelines is that the Gas Code was written with the recognized need to include the application of regulation by the Code to new gas pipelines. Pipeline owners as well as pipeline developers were intimately involved in the preparation of the Gas Code, as were end users and gas producers. The Code was seen as representing **a balance of the interests of all parties involved in the transportation and use of natural gas.**

Experience over recent years has shown a pattern of continuous efforts by gas transmission pipeline owners to modify the Code to allow them to increase their returns from these monopoly assets[19]. In the case of Greenfields Pipelines, a proposal from pipeline owners has been to modify the National Gas Code to require the application for an extended grace period on the basis that if the National Gas Code is applied they will be only permitted a revenue stream which does not allow them sufficient return on the risks they (supposedly) face in providing surplus capacity on new pipeline developments.

The National Gas Code as written recognizes that the pipeline owner needs to recover the reasonable costs of the pipeline in its entirety. To achieve this, the Code provides for the reasonable costs of owning and operating the pipeline to be allocated to all users in proportion to the use made of the assets. Thus, in the regulatory access reviews undertaken using the National Gas Code, accurately establishing the forecast of future volumes has become a vital determinant. In the event that a pipeline has unused capacity, the tariff established under the Code amortises the cost over the actual volume of gas transported and so places no penalty for unused capacity. This is in stark contrast to (say) the US access rules, where the regulated tariffs are based on the total capacity of a pipeline.

The National Gas Code even allows owners the benefit of partial recovery from the impact of incorrect volume forecasts[20] further reducing their risk.

However, the Code does not permit the regulator to change the contributions entered into between foundation shipper(s) and the pipeline owner, and as the tariffs set under the Code assumes that the revenue from the foundation shipper tariffs equates to the regulated tariff established under the Code, the revenue arising from the open access to the surplus capacity is in fact significantly higher than the revenue needed to match the marginal cost of providing the additional capacity.

2.5 The real risk/reward equation

[19] For example, see comments in section 1 above.
[20] For example see the GasNet 2003 application for K-factor adjustment and the ACCC Final Decision acceptance of this.

It has been generally (wrongly) assumed and accepted that surplus pipeline capacity is built at a high cost and the "blue-sky" surplus capacity is therefore provided at high risk. Pipeliners aver that if the future demand above the foundation shipper demand is weaker than forecast there is not the ability to increase tariffs to retain the expected cash flow enhancement. Conversely, if the future demand exceeds expectations, the pipeliners are concerned that regulations will cap cash flows, thus creating asymmetry of risk. This argument has weight if, and only if, the increased investment to create the surplus capacity is symmetrical with the overall cost of the pipeline.

Assessment of the draft guideline implies that the ACCC assumes that the cost to surplus capacity equation has a high degree of symmetry. As the foundation shippers underwrite well over 80% of the cost of the facility[21], the cost to provide significant additional capacity can be included in the original design for very little additional exposure to the developer (as demonstrated earlier).

The bulk of the pipeline's risk is borned by the foundation shipper(s) who effectively have to fund a return of most of the debt in a period much less than the depreciation period assumed for regulatory purposes.

To further increase the transfer of risk away from the pipeline owner, the Australian Government has instituted a mechanism to benefit infrastructure development by the use of accelerated depreciation for taxation reasons, which serves to significantly increase the cash flow to the pipeline owner in the higher risk early years of the new pipeline[22].

The revenue arising from the regulated tariff for the surplus capacity is significantly higher than the marginal costs involved with providing the surplus capacity. Thus, in reality the cost to surplus capacity equation is heavily biased in favour of the developer, as is the revenue arising from a regulated tariff which applies to this surplus capacity.

Our investigation shows that the risk reward balance for providing surplus capacity above the needs of the foundation customers is heavily weighted and remarkably biased towards the pipeline developer. In fact, it can be shown that the small amount of capital needed to supply this surplus capacity generates a very high reward as the surplus capacity is taken up.

Thus, the argument of asymmetry of returns from low surplus demand versus high surplus demand loses credibility when the real cost of providing the surplus capacity is taken into consideration.

[21] This amount assumes that only the debt element is underwritten by the foundation shipper(s). This percentage is higher if allowance is made for some or all of the return on equity to be underwritten by the foundation shippers.

[22] Page 5, Cost of Capital for Greenfields Investments in Pipelines" by Kevin Davis and John Handley, 30 April 2002.

3. PROVIDING AN "ACCESS HOLIDAY" OR EXTENDING THE REGULATORY PERIOD

There is considerable interest by pipeline owners and developers in the proposal that their "blue sky" risk would be protected by the introduction of an access holiday or by the setting of an extended regulatory period without any reviews beyond the five years implicitly provided in the National Gas Code. Currently, the Code permits an applicant to request a longer regulatory period than five years, but the regulator has the power to ensure mechanisms are in place to reflect the changes from the initially assumed circumstances during the agreed period of the access arrangement.

In the draft guidelines, the ACCC considers that there may be benefits in permitting new pipelines to exercise a monopoly position by use of "access holidays" or extended regulatory periods without mechanisms for review of changes in the initial assumptions. Equally, the Code permits the pipeline owner to request an access review at any time. This incongruity of the Code and the ACCC considerations, introduces an asymmetry in favour of the pipeline owner – if revenue exceeds expectations, the benefits stay with the pipeline owner, if revenue is under expectation, the pipeline owner can seek redress at its option by requesting a review.

3.1 A comparison for an "access holiday" or extended regulatory period

An access holiday or extended regulatory period can be likened to the awarding of a patent.

A patent is awarded by a sovereign Government on the principle that a party may expend considerable effort and capital to develop a new concept. The patent is intended to prevent any competitor using the same concept and so allows the developer to enjoy the monopoly benefits of the new concept for a limited time. Patents are granted for a maximum duration of 15 years from the time the patent application is lodged to when competitors can use the exact same concept and in theory commence competition with the developer.

In practice, if a new concept is profitable, competition will commence as soon as others see the potential upside of the concept[23]. In the case of technology patents, competitors will seek to circumvent the patent and bring to the market a similar product.

The development time from lodging a patent to having a saleable product is usually of the order of two to four years. Thus, the benefit of a patent is usually 11-13 years at most. However, in practice the development of "me too" products follows within 3-5 years, often based on the principles included in the patent. It is because of this that many developers elect not to patent

[23] For example, within 2-3 years of the McDonald's franchise demonstrating attractive profits, a myriad of competitors opened up fast food and burger chains.

their new concept, taking the risk that they can get their concept to the market before another party and so enjoy the rewards of being the innovator.

Once constructed the new pipeline operates as a monopoly. This point can be compared to the award of a patent. Whereas development of the patented concept may take 2-4 years giving 11-13 years of apparent protection, in practice, the inherent monopoly position returned by the developer of a new concept may only be for 3-5 years. It would be incongruous if a pipeline development was granted enhanced monopoly rights over industry operating in a competitive environment.

Regulation is a surrogate for competition. As circumstances for the pipeline change (the equivalent of the application of competition in competitive industry) there must be a limit placed on the pipeline owner's ability to harvest the excessive rewards of its monopoly position. A pipeline owner should not be able to benefit from excessive monopoly returns any longer than competitive industry can for its innovation (an effective maximum of 11-13 years if a patent cannot be circumvented). For the true application of competitive pressure on the pipeline owner, an uncontrolled monopoly period should not extend beyond actual monopoly durations (5-8 years) experienced by competitive industry.

In a competitive environment, even the award of a patent is no guarantee of securing a return on the investment, let alone securing "blue sky" profits. In fact, most products patented (and then perhaps developed) never see the light of day, let alone ever give a return to the investors. Thus, to grant a (monopoly) pipeline even some protection for its blue sky profits, is granting the monopoly asset owner an advantage not available to any competitive industry.

It is inappropriate that pipeline owners should be granted uncontrolled monopoly benefits extending beyond a regulatory period exceeding the normal 5 years duration, a regulatory duration clearly anticipated by the Gas Code.

4. COMMENTARY ON THE DRAFT GUIDELINES

4.1 The regulatory framework

The National Gas Code was specifically developed to serve the gas industry. While it is accepted that Part IIIA of the Trade Practices Act can be used to provide regulatory oversight of the gas industry transport monopolies, it is rather inappropriate that a Code developed for a specific purpose should be discarded in favour of a generalist regulatory approach.

We therefore support the ACCC in its view that whether an application is made under one or other Code, given the similarities between the two, the ACCC would seek guidance from the industry specific Code when assessing an application under a more generalist Code, and that an applicant should have a sound rationale for seeking to use the generalist Code.

4.2 Risks faced by greenfields pipelines

The ACCC provides a comprehensive analysis of the risks faced by pipeline developers and notes that the developer has a number of remedies available to minimize its risk profile. We accept that the National Gas Code either explicitly or implicitly provides for the pipeline owner to recover many of the costs associated with minimizing these risks.

Of concern is any proposal to permit the pipeline owner the right to extended regulatory periods, without the inclusion of controls for changed circumstances. This introduces another asymmetry in favour of the pipeline owner, in that it can institute a review at any time whilst the regulator (and shippers) cannot do so. This allows the pipeline owner to retain upside benefits with impunity (through having an extended review period), whist having the ability to mitigate downside potential (by initiating a review).

A further asymmetry implicit within an extended regulatory period occurs within the development of the WACC. The ACCC has consistently maintained (correctly in our view) that the setting of the "risk free" return should be related to the regulatory period on the basis that such a return best reflects the forward risk profile for the regulatory period. For a preponderance of time, Australian Government Bonds (used to set the risk free return) have a rising forward curve (ie rates increase with the term of the bond reflecting the greater uncertainty with longer durations). Should the ACCC calculate WACC's based on longer term bonds for longer term regulatory periods, then in most cases the return to the regulated business will be increased, reflecting the greater forward uncertainty. However, as the regulated business has the right to request a review and reset at any time (a right not available to the regulator and user) the business can use this flexibility to maximise its revenue. For example, should bond rates rise, a new application can be made to increase tariffs; equally if they fall there is no opportunity for users to benefit as the regulator has granted a long term WACC based on the higher (and no longer appropriate) bond rate. Thus, inherent within the granting of the extended duration arrangement is an asymmetry clearly favoring the monopoly provider.

We have addressed in some detail above the supposed risks faced by pipeline developers (particularly the cost for surplus capacity versus the benefit of blue sky reward) and we believe that our analysis strongly supports the view that the risk profile faced by pipeline developers has been grossly overstated with the intention of convincing regulators to allow them more latitude in maximizing the benefits of their monopoly position. What is absent from the available documentation and analysis undertaken for the ACCC is a

detailing of the risks faced by foundation customers. As the foundation customer is clearly identified as the basis for new pipeline viability, an analysis of new pipeline risks cannot be complete without examining the risks applying to and remedies available to the foundation customers.

An end use customer's business usually hangs on the certainty of gas supply for energy or as feedstock. Delays to the start of supply, interruptions during supply, contracting for supply durations well beyond normal business cycle times, and contracting for guaranteed minimum volumes form the basis of foundation customer risks.

While not intended to be comprehensive, such a listing of risks would include:-

- The risk of developer failure at any time prior to construction being completed.
- The risk of the developer seeking a "double dip" if development costs increase - this happens after the foundation customer has committed funds for conversion or has commenced construction of its new facility.
- A delayed commencement of the service will financially impact on the customer, with particular severity if the service is to a new facility of the customer where there is no alternative supply. Contractual damages are usually insufficient to cover the costs associated with such delays.
- If the pipeline is "lost", the owner can recover its asset through insurance, but any contractual damages are likely to be insufficient to cover the foundation customer losses.
- The customer's risks associated with its specific business which affect the demand for the gas, such as business seasonality, variable volume demands of product and drought.
- The long term commitment to pay for the service, even if the customer ceases operations at that location.
- Future permanent reduction in demand below the guaranteed minimum take by the customer results in a higher gas costs per unit.
- Loss of access to lower costs if future alternative energy options appear.
- The pipeline owner offering lower transport tariffs to new entrants (even competitors).

The ACCC has extensively recognised the risks by pipeline developers, and provided them comfort. However, the approach taken may negatively impact on the rights and remedies of the foundation shippers. As the bulk of the risk of the pipeline development is predicated on the foundation shippers, the ACCC must ensure that the remedies proposed to be provided to the pipeline owners are modified so as to keep a fair balance of risks between owners and foundation shippers.

4.3 Additional risk mitigation considerations

We concur with the ACCC assessment for the setting of the Initial Capital Base (ICB), subject only to ensuring that the benefits from any risk mitigation proceeds (eg damages for late completion, etc) are incorporated into the ICB to offset any unforeseen cost increases, and that there is an assessment (and adjustment if necessary) that the pipeline as constructed provides only for reasonable costs for construction. Such an overstatement of costs may eventuate (or result) in the instance of a pipeline developer which is also the constructor. For example, the decision of Offgar to reduce the RAB in the case of the Dampier Bunbury Gas Pipeline below the actual cost of construction would could be seen to support the apparent generally held view that the pipeline construction costs were not well controlled and significantly exceeded reasonable costs for its construction. As this pipeline holds a monopoly position in gas supply to Western Australia's south west, up to the time of the Offgar decision, users have been paying higher tariffs for transport than were reasonable due to these construction cost over-runs.

We note that the ACCC considers that foundation customers can provide some risk mitigation to themselves through properly crafting their contracts. However, as noted above, it is of great concern that the risk mitigation provisions proposed to be granted to the pipeline owner, may impact on the ability of the foundation customer to utilize its contractual remedies. Any risk mitigation capability granted pipeline owners must be viewed in light of its impact on foundation customers.

4.4 Managing uncertainty and blue sky opportunities

In principle benefit sharing is seen as an equitable approach to recognizing the risk to reward equation. For it to be truly effective, this approach requires significant disclosure of the true state of affairs of the pipeline in a fully transparent way.

However, as has been seen in recent regulatory reviews, this "benefit sharing" provisions can be readily under-mined by the pipeline owner, such as inappropriate declaration of operational costs and asset allocation between customer classes, revelation of "unsustainable savings", transfer of activities between access arrangements, and so forth. The provision (or not) of information supporting the benefit is entirely at the discretion of the owner, albeit under the National Gas Code, the regulator can request additional information it deems necessary. Whether the information is provided in the form required by the regulator is at the discretion of the asset owner. The ability of the regulator to seek additional information is also constrained by the regulator knowing what additional information to seek. Conversely when it is in the interests of the asset owner, extensive information is readily made available when such disclosure supports the claims for increased revenue.

Thus, in the actuality of an access arrangement, there is considerable concern by users as to the efficacy of benefit sharing. However, for an

arrangement to include benefit sharing, care must be taken to ensure foundation shippers are not disadvantaged, that the true costs involved in provision of surplus capacity are provided, and that volumes and usage pattern information is accurate.

The ACCC must be alert to the fact that benefit sharing provisions can be readily 'gamed' by the pipeline owner, and that adequate controls are included to prevent any such 'gaming'. The benefit sharing approach must recognize the importance of the foundation shippers, and must not be permitted to negatively impact on their ability to mitigate their risks.

4.5 Consultation and provision of information

As Part IIIA of the Trade Practice Act does not prescribe the information needed to assess an access undertaking, we strongly concur with the ACCC that an access arrangement sought under Part IIIA should provide the same extent of information disclosures as that provided for in the National Gas Code.

However, as the foundation contracts underpin the viability of new pipeline, and as the construction contracts form the basis of the ICB, the ACCC should have access to sufficient information included in these to assist in the setting of open access arrangements. In particular, this information must permit the ACCC to assess the risk/reward equation in relation to the surplus capacity provided by the design of the new pipeline.

Further, the information provided regarding the foundation contracts should specifically include what arrangements are in place to mitigate foundation customer risk, so that the ACCC does not grant an access arrangement which may negatively impact on the contractual remedies available to the foundation shippers to minimize their risks.

It is accepted that such information provided in foundation contracts would be treated as “commercial in confidence” and not made publicly available except in aggregated form.

5. CONCLUSION

The draft guidelines are seen as a good start to clarifying the regulatory approach to greenfields pipelines under the Gas Code (or Part IIIA of the Trade Practices Act) to improve and understand how the ACCC would apply the Codes, and so meet the request by the pipeline industry for regulatory certainty. However, we are of the view that in providing this certainty, the ACCC has overlooked a number of features of pipeline development which can used by developers to greatly improve the expected returns arising from the construction of this monopoly asset.

- It is clear that the National Gas Code is to apply to both new and existing pipelines. The Code has already been adequately applied to new pipelines and there has been significant investment in new pipelines since its introduction. There would appear to be no fundamental reason for there to be a change.
- There is clearly no lack of investment in new pipelines where the demand has been identified. In fact there has been

competition between competing pipelines development for essentially the same service.[24]

- Claim by pipeline investors that the Gas Code does not permit them to acquire adequate returns for providing surplus capacity over the needs of the foundation shippers is difficult to sustain. The ACCC must require the pipeline industry to provide its quantification of the costs to provide surplus capacity, and the contribution to the revenue from foundation shippers.
- Analysis of the way
    - surplus capacity can be added;
    - the costs associated with its provision;
    - the capital outlaid by the pipeline owners;
    - the revenue contributed by foundation shippers; and
    - the revenue that the National Gas Code would provide under tariffs set by the Code;

  all indicate that there is more than adequate return for the risk for providing surplus capacity without providing access holidays or extended uncontrolled regulatory periods.
- The Gas Code provides risk mitigation features to pipeline owners arising from inaccurate forecasting (K-factor) and basing tariffs on actual gas flows rather than on capacity, both of which minimize the downside risk faced by pipeline owners. Such features need to be assessed as part of any assessment of the apparent loss of "blue sky" upside returns.
- There is no apparent reason for the Code to be changed (or for regulators to permit) the granting of access holidays, or to permit uncontrolled extended regulatory periods.
- Access holidays are inappropriate for the Australian regulatory environment. Third party access must be made available under regulator oversight.
- If regulators do consider granting extended regulatory periods they must consider that such action may impinge on the mitigation provisions foundation customer(s) may (and are able to) have inserted in their contracts to minimize the risks they face. Thus, any review for changing the National Gas Code or the way the regulator may intend to act under it, must consider the rights foundation shipper(s) have within their contracts in order to manage their risks.

[24] For example the SEAGas Pipeline and the proposed GasNet/Duke/TXU pipeline from Otway to Adelaide