Reflections on Gas Access Regulation in Western Australia

Dr Ken Michael AM
Western Australian Independent Gas Pipelines Access Regulator

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Introduction

At the Energy in Western Australia Conference in March 2000, I provided an overview of the regulatory regime for governance of access to natural gas transmission pipelines and distribution systems in Western Australia. I also provided an overview of activities undertaken by myself as Regulator since I accepted the office in February 1999.

In the eighteen months since the conference of last year, there has been substantial progress in activities of the Regulator and many complex and challenging issues addressed. With this paper, I would like to provide you with an overview of activities over this period, focussing on some of the issues that have had to be dealt with as part of the regulatory process, and which in most instances are particular to the situations of individual pipelines in Western Australia. I would then also like to make some general comment on the regulatory regime and regulatory processes, and respond to some of the general issues raised in respect of the access regime.

Before commencing on the paper proper, I would like to point out that there are two significant regulatory matters that I am currently dealing with. These are approvals of access arrangements for the Goldfields Gas Pipeline and Dampier to Bunbury Natural Gas Pipeline. In view of the stage of these approvals and the complex analyses and deliberations that are underway in this regard, I consider it inappropriate to comment in any detail on these matters in the forum of this conference.

Approach to Regulation

Many of you will have some familiarity with the regulatory regime for access to natural gas pipeline systems in Western Australia. Indeed, I trust that many of you will have taken some interest in the regulatory decisions and consultation programmes that have emerged over the last two years. For those of you not familiar with the regime, I will provide a brief overview before progressing on to the main part of my presentation.

Access to natural gas pipelines in Western Australia is regulated under the *Gas Pipelines Access (Western Australia) Act 1998*. This Act has three principal elements, as follows.

Firstly, there is the Act itself that, *inter alia*, gives effect to the *Gas Pipelines Access Law*,[1] establishes offices of the Independent Gas Pipelines Access Regulator and the Gas Disputes Arbitrator; and establishes the Western Australia Gas Review Board.

Secondly, there is schedule 1 of the Act, containing provisions to give legal effect to the *National Third Party Access Code for Natural Gas Pipeline Systems*, commonly referred to as the Code.

Thirdly, schedule 2 of the Act comprises the Code, which establishes the national access regime for natural gas pipeline systems.

Schedules 1 and 2 of the Act together comprise the *Gas Pipelines Access Law*. The Law is uniform legislation enacted by the Commonwealth and State Governments of Australia, and causes the access regime to be a national regime, despite relevant legislation being enacted at the level of individual governments.

While being a national regime, the *Gas Pipelines Access Law* is modified in its application in Western Australia by the *Gas Pipelines Access (Western Australia) Act 1998* in several respects with the intention of tailoring the access regime to address particular circumstances and regulatory objectives in this State. Particular characteristics in application of the Law in Western Australia include:

- extension in coverage of the national access regime to include pipeline systems for gas other than natural gas;[2]
- imposition of requirements on the Western Australian Regulator in addition to requirements set out in the Code, particularly in respect of consideration of the interests of residential and small business users of gas;[3] and
- provision for costs incurred by the Regulator, the Arbitrator and the Gas Review Board to be recovered from the owners of regulated pipelines.[4]

The Regulator's principal roles under the access regime are to undertake a range of approvals processes for providers of pipeline services. These relate to access arrangements for pipelines; approval of contracts between associated businesses involved in gas transport and other gas-related activities; and additional requirements for, or exemptions from, ring fencing obligations imposed on providers of pipeline services. The Regulator undertakes these roles with the assistance of a secretariat agency, the Office of Gas Access Regulation, commonly referred to as O*ff*GAR.

Achievements

Since appointment to the office of the Regulator in 1999, I have given attention primarily, although not exclusively, to the approval of initial access arrangements for six pipeline systems in Western Australia that are subject to the regulatory regime and referred to as covered pipelines.

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[1] Schedules 1 and 2 of the Act.

[2] *Gas Pipelines Access (Western Australia) Act 1998*, section 8.

[3] *Gas Pipelines Access (Western Australia) Act 1998*, section 36.

[4] *Gas Pipelines Access (Western Australia) Act 1998*, section 87.

Access arrangements set out general policies and principles of access to each pipeline system, as well as terms and conditions and tariffs for a range of standard or "reference" gas transportation services. An owner of a covered pipeline is required to submit a proposed access arrangement to the Regulator, who then undertakes an assessment of the proposal against a range of principles and guidelines set out in the Code, culminating in an approval of the access arrangement which then is set in place for a period of typically five years prior to review.

The six pipeline systems in Western Australia that are currently covered by the Code are:

- the Mid-West and South-West Distribution Systems;
- the Dampier to Bunbury Natural Gas Pipeline;
- the Goldfields Gas Pipeline;
- the Kalgoorlie to Kambalda Pipeline;
- the Parmelia Pipeline; and
- the Tubridgi Pipeline System.

Proposed Access Arrangements were submitted for all of these pipelines over the period May 1999 to December 2000, with the exception of the Kalgoorlie to Kambalda Pipeline for which a two-year extension of time was granted for submission – this will be discussed further a little later in this paper.

Access arrangements have been approved for the Mid-West and South-West Distribution Systems and the Parmelia Pipeline. Draft decisions on proposed access arrangements have been issued for the Tubridgi Pipeline System, the Dampier to Bunbury Natural Gas Pipeline and the Goldfields Gas Pipeline. A final decision on the access arrangement for the Tubridgi Pipeline System is imminent, and final decisions in respect of the Goldfields Gas Pipeline and Dampier to Bunbury Natural Gas Pipeline will be issued as soon as possible, with an intention of having approved access arrangements in place early in 2002.

In the process of assessing proposed access arrangements, several matters have had to be dealt with that are characteristic of the individual pipelines. This has required the application of provisions of the Code with recognition of the situations and characteristics of individual pipelines, and to some extent the situations of pipelines in Western Australia vis a vis elsewhere in the country. I can briefly describe some of these matters to emphasise that the Code has and is being applied in Western Australia in a manner giving due consideration to local circumstances.

Firstly, the Kalgoorlie to Kambalda Pipeline. This is a relatively small pipeline of 44 km in length and 219 mm diameter, owned by Southern Cross Pipelines Limited. It is currently used solely for the transport of gas from Goldfields Gas Pipeline at Kalgoorlie to the operations of WMC Resources at Kambalda. To date there has been no application to the owners of this pipeline for third party access. In view of the absence of evident demand for third party access and the small size of the pipeline, the Regulator utilised powers available under the Code to grant a substantial extension of time for submission of an access arrangement. This power was exercised in the absence at the current time of any foreseeable benefit to having an access arrangement in place, taking into account the cost of preparing and approving an access arrangement.

Secondly, the Parmelia Pipeline and Tubridgi Pipeline System. Matters arose in respect of the access arrangements for these pipelines that are possibly unique in regulation under the Code to date in Australia. Assessment of proposed access arrangements involved a problem of asset valuation arising from the pipeline systems currently operating at substantially less than capacity and with considerable uncertainty over future gas throughput. The problem lay in deciding whether assets should be valued on the basis of current throughput and arguably redundant pipeline capacity, or whether assets should be ascribed a value that takes into account some prospect for increased gas throughput? The first option may penalise the pipeline owner in the event that a substantial increase in gas throughput does eventuate, while the latter option may penalise users of pipeline services if gas throughput remains static or decreases. With the Parmelia Pipeline, this dilemma was addressed by recourse to provisions of the Code relating to capital redundancy. Values were ascribed to the assets that are higher than may be directly justified by current or projected gas throughput, but with a requirement that a redundant capital policy be incorporated into the access arrangements that would result in the asset value being reduced in the future if increases in gas throughput do not eventuate. This approach has the effect of giving the pipeline owner some "benefit of the doubt" in respect of throughput forecasts and maintaining incentives for the pipeline owners to increase gas throughput, while protecting the interests of pipeline users in the event of significant throughput increases failing to eventuate. For the Tubridgi Pipeline System, the draft decision on the access arrangement indicated a requirement that the access arrangement be amended to include a redundant capital policy that provides for the capital base to be reduced at the end of the access arrangement period in accordance with pipeline throughput and the use of pipeline assets at that time.

With the access arrangement for the Mid-West and South-West Gas Distribution Systems, specific provisions of the Western Australian legislation influenced the application of the Code in respect of the assessment of proposed reference tariffs for gas distribution services. Section 38 of the *Gas Pipelines Access (Western Australia) Act 1998* requires the Regulator to take into account the fixing of appropriate distribution charges as a means of extending effective competition in the supply of natural gas to small-business and residential gas consumers. This requirement was addressed by giving explicit consideration to the potential influence of proposed distribution tariffs on competition in the retail gas markets for small-business and residential gas consumers once these markets become contestable. The effect on the access arrangement was to ensure that the cost allocation and reference tariffs were determined in such a way as to not unreasonably limit potential retail margins for new gas trading companies entering the natural gas market.

Finally, in regard to the proposed access arrangements for the Goldfields Gas Pipeline and Dampier to Bunbury Natural Gas Pipeline, consideration is being given to complex issues arising from the particular circumstances in the history of these pipelines. With the Goldfields Gas Pipeline, the issues arise from a pre-existing State Agreement Act that provided authority for the construction of the pipeline and established an initial regime of third party access. With the Dampier to Bunbury Natural Gas Pipeline, issues arise from legacies of the third party access regime that preceded the Code, and from the process of privatisation of the pipeline. For both pipelines, these issues and many others remain under consideration at the current time. In resolving these, I will give attention to the range of matters required by the Code to be considered, as well as whatever legal constraints may apply, to arrive at an

outcome that I consider will comply with the Code and other applicable legislation, and will achieve an appropriate balance of interests between the provider of the pipeline services, users and potential users of these services and other interested parties.

With the application of the Code in Western Australia to date, I have found myself reasonably satisfied in the scope that exists under the national access regime to take into account the particular circumstances of pipelines in Western Australia.

Regulation Under Review

Having made these observations in relation to individual pipelines in Western Australia, I would now like to proceed to making some more general observations on the access regime.

Before the end of my term as Regulator, I hope to have access arrangements in place for covered pipelines in Western Australia. Further, I hope to be able to make a substantial contribution toward review of both the Code as it has been applied in Western Australia and the internal processes of O*ff*GAR in implementing the access regime in this State. The purpose of this review will be to learn from the experience of the first three years of regulation under the Code, and thereby improve and streamline the regulatory process in Western Australia.

While I would not wish to pre-empt a detailed review of the Code and administrative processes that will be undertaken under the auspices of the National Gas Pipelines Advisory Committee and the Ministerial Council on Energy Policy, I would like to comment on some aspects of the regulatory process to date.

The first point that I would like to address is the criticism both in Western Australia and more widely of the timeliness of the regulatory process, particularly in respect of the approval of Access Arrangements.

Timeliness is an issue of concern to both myself and obviously for other parties including the providers and users of pipeline services. Throughout states of mainland Australia, the assessment and approval of access arrangements has typically taken well in excess of 12 months to complete. I personally consider this to be unacceptable.

If I look to causes for the lengthy periods for assessment and approval, the major factor appears to be an absence of common understandings between service-providers, regulators and users as to acceptable provisions of access arrangements. In my view this has been to some extent an expected outcome of implementing a new regulatory regime in Australia. However, I also consider it to be an outcome of the nature of the Code, which provides a set of principles and broad methodological guidelines for access arrangements rather than providing a prescriptive and mechanistic formula for determining terms and conditions of access. It is my view that a regulatory code in this form is generally desirable as it allows regulation to adapt to particular circumstances, the benefits of which I have just illustrated. But this does not mean that issues of timeliness should not be addressed.

To improve timeliness in approvals processes under the Code, I believe it is important to achieve a greater commonality of expectations between the Regulator, service providers, users of pipeline services and other interested parties.

A means of streamlining the regulatory process may be to follow the initiatives of service providers, other stakeholders and the Victorian Office of the Regulator General in respect of review of access arrangements for the Victorian gas distribution systems. Long periods were also taken for assessment and approval of initial access arrangements in Victoria. With these access arrangements scheduled for review by early 2003, the Office of the Regulator General is seeking to establish well defined positions in respect of substantive elements of access arrangements. To achieve this, the Office of the Regulator General has embarked on a process of consultation in advance of the service providers submitting revisions to access arrangements in March 2002. To date, the Office of the Regulator General has released a consultation paper and a position paper as part of this process.[5,6]

I would like to see the Regulator in Western Australia embarking on a similar process to that of the Office of the Regulator General over the next two years. I envisage that this would be undertaken in conjunction with some simplification of Code processes.

A second general matter that I would like to give attention to is criticism from some participants in pipeline industry in relation to rates of return on investment that are contemplated in the setting of tariffs under access arrangements. I would like to make a general response to this criticism as it illustrates an important issue in the broader regulatory process.

The criticisms levied against the regulatory process in respect of rates of return have generally suggested that rates of return accepted by Regulators throughout Australia are not sufficient to motivate investment in pipeline infrastructure, particularly investment in new pipeline systems where financing takes the form of venture capital.

I would like to make two general comments in relation to this criticism.

Firstly, I am in no way dismissive of concerns expressed by the pipeline industry in regard to regulated rates of return, or for that matter any issue in relation to the regulatory process. I am well aware that sufficient rates of return must be allowed for under the regulatory regime if there is to be an efficient energy sector in Western Australia, and indeed that in the international history of energy regulation a case can be made that from time to time regulated rates of return that are too low may have contributed to a stifling of investment in energy infrastructure.[7]

Notwithstanding this, my second point in relation to rates of return is that both myself and other regulators throughout Australia have given considerable attention to finance theory and available empirical evidence in assessing rates of return for pipeline businesses. This is a difficult exercise in view of the complexity of relevant theory and the difficulty of empirically examining rates of return for real businesses. Nevertheless, in any review of rates of return attention is given to whatever objective evidence is available at the time, including actual data from stock markets and

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[5] Office of the Regulator-General, Victoria, May 2001, 2003 Review of Gas Access Arrangements, Consultation Paper 1.

[6] Office of the Regulator-General, Victoria, September 2001, 2003 Review of Gas Access Arrangements, Position Paper.

[7] A major case in point being the energy sector of the USA in the 1970s. See for example the discussion in Carron, A.S. and MacAvoy, P.W., 1981. *The Decline of Service in the Regulated Industries*, American Enterprise Institute Studies in Government Regulation, American Enterprise Institute for Public Policy Research, Washington and London.

evidence on rates of return contemplated by private investors. Furthermore, in recognition of the importance of ensuring adequate rates of return, I have tended to err in favour of the interests of pipeline owners in instances where there is uncertainty as to the underlying parameters in estimating rates of return.

I mentioned that the issue of rates of return is illustrative of a more general issue in respect of the regulatory process. The point I wish to make is that the appropriateness of outcomes from the regulatory process is a function of the quality of information and debate on such issues as the rate of return. The approvals process for access arrangements as established by the Code gives substantial emphasis to consultation and draft decisions, and is designed to foster debate and ensure that different views can be taken into account in regulatory decisions. In Western Australia, I have been fortunate in that there has been a great deal of public participation in the regulatory process. Indeed I have received comment from outside of Western Australia as to the quality of public submissions made in this State and the benefit of these submissions to the regulatory process. I sincerely hope that this level of industry participation continues.

Conclusions

In closing, I would like to reiterate that the regime has been demonstrated to be sufficiently flexible to take into account the circumstances of individual pipelines while at the same time providing for national consistency in the regulatory process. I am sure that experience coupled with a considered review and amendment of the Code will see regulatory processes streamlined.

In Western Australia, the proposed establishment of an economic regulator should assist the improvement of regulatory processes. Under the current proposal arising from the Machinery of Government Taskforce, a single economic regulator will assume responsibilities for existing regulatory regimes in respect of gas, water and railways with electricity to be developed. There is likely to an opportunity for public comment in the development of the enabling legislation for the economic regulator. I encourage the participants in the relevant industries and other interested parties to respond to any such opportunity.
