PUBLIC SUBMISSION

to the

INDEPENDENT GAS PIPELINES ACCESS REGULATOR

on the

DRAFT DECISION

for the

ACCESS ARRANGEMENT

for the

DAMPIER to BUNBURY NATURAL GAS PIPELINE

made by

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Objective of Submission

This submission is made with the objective of contributing to the debate flowing from the release of the Draft Decision for the Access Arrangement (Draft Decision) for the Dampier to Perth Natural Gas Pipeline (DBNGP) regarding the commitment of capital funds to the expansion of natural gas transmission pipeline infrastructure in Western Australia.

This submission is intended to address issues which apply to the DBNGP, to other natural gas transmission pipelines, and to the wider natural gas industry.

'Second Class Citizens' and Expansion of Pipeline Capacity

<u>'Second class citizens'</u>

Comments made at the Public Forum on the DBNGP Draft Decision and in public submissions on the DBNGP Draft Decision put forward the argument that the cost of expanding the capacity of the DBNGP (and by implication any other natural gas transmission pipeline) may be incorporated into the regulatory Capital Base for that pipeline, and that as a consequence all Users of the pipeline will equally bear the cost of pipeline expansion through uniformly applied gas transport tariffs.

The thrust of this argument is captured succinctly and effectively in the following excerpt from the joint submission by various parties to the Independent Gas Pipelines Access Regulator (the Regulator) titled "Submission to the Gas Access Regulator concerning Epic Energy's 'Second Class Citizens'":

> There would be no "second class citizens" on the DBNGP if the costs of expansion were simply added to the capital base in accordance with provisions of the Code.
>
> Adding expansion costs to the capital base would result in a change to the tariff payable by all shippers. It would ensure that all shippers within a zone would pay the same tariff, with no shipper being at a disadvantage. There would be no "second class citizens"; economic development in the South-West of the State would not be constrained.

A straightforward interpretation of the National Third Party Access Code for Natural Gas Pipeline Systems (the Code) supports this proposition insofar as it goes.

However, the Code also grants the Service Provider (i.e. pipeline operator) absolute discretion regarding its own investment in a regulated pipeline. Sections 3.16 and 6.22 of the Code provide clear indication that a Service Provider is <u>not obliged</u> to fund New Facilities, but rather <u>may (or may not) choose</u> to do so if and as it so desires.

It is therefore apparent that the 'second class citizen' argument advanced in the joint public submission to the Regulator is an accurate but restricted one, predicated on the Service Provider choosing to fund expansion of pipeline capacity. Further, the position put forward by Epic Energy (i.e. Users utilising capacity provided by expansions will pay more for gas transport) accurately presents the general case. These issues are discussed below.

Obligations and (dis)incentives to expand pipeline capacity

Under the Code, a Service Provider is required to provide access to Third Parties seeking to transport natural gas in a regulated pipeline. However, a Service Provider is not required to make any form of capital expenditure to extend or expand a regulated pipeline.

If a Service Provider chooses not to fund capacity expansion, a pipeline User may make a capital contribution to fund the provision of additional capacity it desires. Such a capital contribution must be made in accordance with the terms and conditions applicable to the Reference Service(s) specified in the pipeline's Access Arrangement, or may be determined through commercial negotiation between the User and the Service Provider.

If a Service Provider exercises its right to not commit funds to the expansion of its pipeline, a pipeline User seeking to utilise capacity provided by expansion of that pipeline must fund that expansion at that User's cost of capital. In many cases, this cost of capital will be greater than the regulated rate of return applicable to the pipeline in question.

In the case of a Reference Service, a pipeline User which funds pipeline expansion will pay the same transport tariff (i.e. the Reference Tariff) as other users of that service, but will be additionally liable for the capital cost of the expansion. Thus, it is evident that if the Service Provider elects to not fund the expansion of its pipeline, Users seeking access to capacity which is provided through pipeline expansion will incur a higher unit transport cost (i.e. dollars per gigajoule) than Users of existing capacity.

The 'second class citizen' argument advanced by the authors of the joint submission incorporates the unstated yet critical assumption that a Service Provider will automatically increase supply of transport services (and hence pipeline capacity) to match demand.

In the ideal world of perfect competition espoused by classical economics and the historical world of state owned gas pipeline assets, this 'utility paradigm' may hold true. However, in today's real world of privately owned but regulated infrastructure assets, the user is required (under the Code) to pay, and pay for its share.

Given the low regulated rate of return (7.85 percent before tax real), low Initial Capital Base (approximately half of purchase price) and substantial tariff reduction (approximately 25 percent) prescribed in the DBNGP Draft Decision, it is not surprising that the DBNGP's owners have stated that they are not willing to fund future capital works. Given that the DBNGP Draft Decision reflects regulatory outcomes for other pipelines in Australia (which have also mandated substantial tariff reductions and low values of Initial Capital Base), it is also likely that other pipeline owners may choose to not invest in future pipeline expansions.

It is likely that such decisions will at least in part be influenced by the interests of the many Australians whose savings for retirement are placed with the superannuation funds which have invested in the DBNGP and other pipelines.

Such reluctance may be exacerbated by the fact that return on expansion capital and return of expansion capital begin only after the tariff reset following this expenditure. Under 'normal' circumstances, this might not happen for several years.

The Code does allow a Service Provider to re-submit its Access Arrangement at "any time", which will initiate a tariff reset. However, Australian regulators are taking years to approve Access Arrangements, rather than the six months foreshadowed in the Code. Further, a Service Provider is reliant on a regulator's discretion to factor this time value of money consideration into its tariff redetermination.

Thus, it is apparent that a Service Provider runs the risk of having its entire expansion capital stranded during the critical first few years of its employment.

A Service Provider also faces the risk that a regulator may decide (under the relevant sections of the Code) that any part of any capacity expansion which is not contracted following completion of the expansion works constitutes speculative investment or redundant capital. If this were to be the case, a Service Provider would be faced with recovering only a portion of its expansion capital expenditure, as well as receiving a regulated return on that portion. Given the narrow interpretations of the Code made by Australian regulators, this risk is likely to be interpreted as significant by pipeline owners.

This raises important considerations for Service Providers, pipeline Users, regulators, the natural gas industry, and the wider Australian public.

Service Providers currently face a strong disincentive to invest in their own pipelines because of the position taken by the regulators of natural gas pipelines in Australia. Thus, new pipeline capacity must be funded by pipeline Users.

Therefore, as identified above, the 'second class citizen' argument put forward by Epic Energy (i.e. that new Users face higher unit transport costs) is valid.

Pipeline expansions which are funded by Users whose cost of capital is higher than that mandated by pipeline regulators will lead to increased prices for those products which use as a factor of production natural gas transported by regulated pipelines. In the case of the DBNGP, such price increases will apply to residential consumers of natural gas and electricity.

Wider Implications for the Development of WA's Gas Reserves

Cost of Capital

Around three quarters of Australia's natural gas reserves are located in Western Australia. Further, reserves in established gas provinces such as the Cooper Basin are depleting. Therefore, development of Western Australia's huge natural gas resource base is critical to Australia's long term future energy needs.

The cost of capital required to develop Western Australia's natural gas resources is high compared to many other industries. This is because of the inherently risky nature of the upstream natural gas industry.

The cost of offshore pipelines comprises a substantial part of the upstream component of the development cost of Western Australia's natural gas resources. This is because the vast bulk of these gas resources are located significant distances offshore, and offshore pipelines are expensive to install, operate and maintain.

Historically, offshore gas pipelines in Western Australia have been installed and operated by the producers operating offshore natural gas fields. Consequently, the required rate of return on the capital cost of these offshore pipelines has been comparatively high.

It is likely that third party pipeline companies could install, operate and maintain offshore pipelines at a lower cost of capital than that applicable to producers. This is because third party pipeline companies do not face the exploration success risk which inevitably confronts the upstream industry.

Such investment by pipeline companies is not new. Third party ownership and operation of offshore pipelines is common in the Gulf of Mexico.

If the cost of capital required to provide offshore pipeline infrastructure could be lowered, development of Western Australia's offshore gas reserves would be promoted.

However, the implementation of regulatory regimes currently applying to Australian 'essential infrastructure' provides a strong disincentive to third party pipeline owners and operators from investing in offshore pipelines.

Therefore, the regulation of pipelines which is intended to encourage the development of other sectors of the natural gas industry is in fact inhibiting such growth and progress.

Regulatory Coverage

If third party pipeline companies were to invest in offshore pipelines servicing Western Australian offshore gas fields (and indeed offshore gas production in other states), it is likely that these pipelines would sooner or later become subject to 'essential infrastructure' regulation.

If such third party offshore pipelines were to become regulated, it is then likely that existing proprietary offshore pipelines owned and operated by producers would also become regulated.

Such regulation would almost certainly be perceived by producers to be to their considerable disadvantage.

Consequently, the development of third party offshore pipelines may not necessarily be encouraged by producers, despite the potential for third party pipelines to reduce offshore production development and operation costs.

It is therefore apparent that regulation introduces two forces inhibiting the development of the natural gas industry.

Multiplier Effects and Myopia

The benefits to small business flowing from the natural gas industry in Western Australia have been adequately identified in other public submissions on the DBNGP Draft Decision and are periodically stated in a variety of publications. Environmental benefits deriving from the use of natural gas as a fuel are widely reported both in the media and the popular and academic press. Therefore, this submission will not discuss these issues any further, beyond stating that inhibition of infrastructure development has both direct and indirect negative impact on state and national economies.

However, these wider considerations have received inadequate attention in Australian gas pipeline industry regulatory decisions to date.

This shortcoming may be due to the general approach to regulation adopted by Australian gas pipeline regulators. An increasing number of observers view this as being blinkered and myopic, constituting a triumph of ideology over practicality and rhetoric over empirically justified argument.

Draft and Final Decisions are increasing in volume over time. However, this increased bulk does not represent wider consideration of the issues at hand. Rather, it reflects regurgitation of precedent and increasing immersion in the fine grain detail of the 'rule book' regardless of both its merits and shortcomings. Decisions also demonstrate an unwillingness to actively research (as distinct from passively solicit) relevant information, and avoid the judicious exercise of wider discretion and the explicit consideration of the long term fortunes of both the natural gas industry in particular and the Australian economy in general.

The Regulator has explicitly adopted the position of consumer price advocate in a number of his Decisions to date. This bias is in conflict with parts of his basic charter, which require him to act in a fair and reasonable manner towards pipeline owners and operators, and to facilitate the development and operation of a national market for natural gas. It also demonstrates a concern with the present (i.e. today's price) and a lack of concern for the future (i.e. the long term health of the industry).

As an aside, it is interesting to note that the Regulator's concern for the wider public does not appear to extend to the interests of the beneficiaries of the superannuation funds which have invested in the DBNGP. At the Public Forum on the DBNGP Draft Decision, a representative of the Regulator's Office stated unambiguously (in response to a specific question) that the sources of funds used to purchase the DBNGP (i.e. including those funds put up by superannuation funds) were neither relevant nor considered in the Draft Decision.

Regulation of the natural gas transport industry has effects which extend far beyond Service Providers and pipeline Users. Small, medium, and big business and the residential customer are all affected both directly and indirectly in the short, medium and long term by today's regulatory decisions. Experiences in the Californian electricity industry and the British water supply, sewerage, and rail industries show that short term price gains to consumers are immediate but transitory. Long term price rises, interruptions to supply, and general degradation of infrastructure take some time to manifest themselves but take even longer to remedy.

It can only be hoped that regulators in Western Australia and other states do not allow this kind of history to repeat itself to the wider detriment of the community.