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An Analysis of the Proposed National Code

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A Pipeliner's Perspective

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An Analysis of the Proposed National Code – A Pipeliner's Perspective

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History of the Code

In August 1992 I prepared a paper in which I said "This paper will address some of the public and industry policy issues on access to natural gas transmission pipelines currently being discussed and will offer some suggestions for the development of a gas industry code of practice for access to pipelines. The code of practice, together with oversight by the Prices Surveillance Authority (PSA) and the Trade Practices Commission (TPC), is being offered as a means by which access to existing and new pipelines can be gained by producers or users of gas under a pricing regime which is acceptable to all parties and for which the principles are well understood. Such a code of practice should encourage interstate trade and discourage governments from implementing heavy handed regulation for the control of access and pricing. The code of practice will also provide a framework for conflict resolution between parties."

My paper also referred to a National Strategy for the Natural Gas Industry presented to Federal Parliament by Hon. Alan Griffiths MP, Federal Minister for Resources, on 28 November 1991, the principal elements of which were:

- a commitment to remove barriers to interstate trade in natural gas to facilitate exploration and development and ensure there are no constraints to finding commercial markets;
- adoption of a light handed approach to regulation with recourse as necessary to the Trade Practices Commission (TPC);
- open access to pipelines on non-discriminatory commercial terms;
- reform of the Pipeline Authority towards a more commercial role.

Six years on, the only item from this list that has really happened is sale of the Commonwealth's Pipeline Authority in June 1994.

One outcome was the creation of the Gas Industry Advisory Group, which was made up of representatives from the Commonwealth, states and industry. From its ashes arose the Gas Reform Task Force.

In 1992, representatives of the gas industry and government, convened by Australian Gas Association (AGA), the Australian Petroleum Exploration Association (APEA) and the Australian Pipeline Industry Association (APIA) proceeded to develop a Third Party Access Code for Natural Gas Pipelines which was completed in July 1993. But it failed to gain acceptance by pipeline companies and customers, primarily because it had no legislative backing. It was felt by the proponents that it would be applied by the participants in the same way as the "Oil Code" developed by the Australian Institute of Petroleum for managing sale of refined products. In a way, that Code incorporated all the principles that the various factions of the industry have been arguing about in the context of the new National Third Party Access Code for Natural Pipeline Systems and which have appeared in various forms since then.

The objectives of gas reform were listed in my 1992 paper. They are still valid so it is worthwhile repeating them:

- The terms and conditions for access to gas pipelines should be determined through commercial negotiation.
- Pipeline owners/operators will consider and respond within a specified time frame to any request from a prospective user for third party access.
- The parties will negotiate on a bona fide basis for a charge for system use including the type of tariff to be applied.
- The pipeline owner is not obliged to expand the system or carry gas for a third party if it is not safe to do so.
- Principles for price determination and technical terms for connection shall be freely available to potential shippers of gas.
- Contract terms shall not be published unless agreed by the parties.
- In a force majeure situation where there is a shortfall in pipeline capacity, priority of supply shall be to the maximum extent possible on a fair share for all basis unless prior contractual obligations require otherwise. In normal situations all contractual obligations will be met.
- Disputes within a contractual situation shall be settled by the process specified in the contract.
- Bona fide disputes between pipeline owners and potential users on matters of access policy and pricing can be referred to the Trade Practices/Prices Surveillance Authority for resolution.

Unfortunately, these basic objectives of gas reform seem to have been lost in a bureaucratic process to which we, as gas industry players, have been subject and in which we have mostly been spectators rather than players.

Progress has been inordinately slow and after 5 years of effort, only small pockets of true gas on gas competition exist. We all started off with high hopes that we could introduce competition into the industry in a short time. We were encouraged by the Hilmer report, but special pleadings by entrenched monopolies, the agendas of governments wishing to sell assets and the usual differences between states and the Commonwealth, have conspired to slow down the process. The gas industry and its customers have been the poorer as a result of the delays.

Influence of Industry Consultation

With respect to public consultation on the development of the Code, this has been a “mixed bag”. The Gas Reform Task Force, which was established in 1995, began with a firmly stated aim that it would be open to continued public consultation. In the event, the gas industry associations were largely sidelined, and despite strong representations by some gas industry associations and some major pipeline companies, the public consultation process that went on in the third quarter of 1996 was largely illusory, since few, if any recommendations offered to the Task Force found their way into the draft that was finalised in December 1996 when the Gas Reform Task Force was wound up.

Subsequently, and somewhat surreptitiously, the Gas Reform Implementation Group (GRIG) was created from the bureaucratic representatives from the Task Force together with some members of the original consultants' team. This group laboured on the December draft of the Code to add further modifications and develop a legislative framework for implementation. It was not until April 1997 that GRIG was opened up to industry – which had rejected the December draft and wanted further changes. In short, public consultation was not considered to be important at this final and very critical stage of the development of the Code.

From April 1997 through to the completion of the final draft in September, the gas industry has been an active participant through AGA and APIA. In addition, there have been many detailed discussions between GRIG and major pipeline companies, organisations representing gas consumers and producers. In short, public consultation has been active but only a little of its input has been incorporated in the Code. In respect of the pricing principles, the National Competition Council in its assessment states:

> *…amendments to the pricing principles in section 8 of the Code – resulting from the public consultation process – are essentially refinements and clarifications of options that have always existed in the Code rather than substantial modifications.*[1]

In summary, since the Code was first drafted in 1996, it is quite clear that the writers have persisted with an agenda which has been influenced only a little by the public consultation process.

The Resultant Code

While I may appear to be pessimistic about the progress of reform in the gas industry, I am pleased that the nine usually disparate jurisdictions in this country have agreed upon the text for a common National Third Party Access Code of Natural Gas Pipeline Systems and that it will soon be implemented through similar legislation in each of the jurisdictions. It is unfortunate that all of the jurisdictions could not agree on the appointment of a single regulatory body to oversee the Code.

This disagreement was brought about, in part, by the insistence of the Commonwealth that natural gas distribution systems should be covered by the Code as well as transmission systems. This aspect clouds the issue, since investment in and operation of distribution systems are significantly different from long distance transmission pipeline systems. Because of the different economic drivers there must be correspondingly different requirements of a regulatory system.

Political and customer demographics are also substantially different for distribution systems. They serve domestic consumers who form the bases of political constituencies. Prices of gas to consumers have political implications and no state or territory government wants energy prices to be set in other than traditional ways by an outsider whose independence must, by its very definition, make it unsympathetic to political aspects.

Because of these aspects, the major jurisdictions have decided to regulate distribution systems within their own state borders. However, at the time of writing this paper, all jurisdictions except Western Australia have agreed that the Australian Competition and

Consumer Commission will regulate transmission systems except Western Australia, which plans to appoint its own regulator. It will be a matter for the National Competition Council to determine whether the implementation of this decision by Western Australia meets its "independence test" [2].

Two of the most blatant instances of special pleadings by jurisdictions which resulted in substantial changes to the Code were:

- competitive tender process – required by Queensland; and
- non-contract carriage – required by Victoria

Neither of these adds to the Code and in fact each detracts significantly from it because each of them in their own way tilts the regulatory regime away from fairness and equity and works against entrepreneurial pipeline companies who want to develop Australia's much needed infrastructure to reduce gas prices and increase gas on gas and pipeline on pipeline competition.

The competitive tender process allows any party, other than a pipeline company, to call tenders for the construction of a pipeline to serve that party's interests. A producer or a customer could use this process to call bids for a pipeline to serve its market or load to the detriment of other producers or customers, who could be competitors.

The competitive tender process could be acceptable in the case where it gives credence to regulatory regimes introduced to facilitate government asset sales, but in no other circumstances would it be acceptable, since conflicts of interests will always arise. Even where a government perceives a need for a natural gas pipeline, it should offer licenses to all players who need only pass a probity and competence test and then allow them to seek the market and plan the pipeline. The one who achieves the market and has acceptable access principles would proceed.

Non-contract carriage is a concept introduced into the by the Victorian Treasury's Energy Projects Division whereby shippers do not book capacity on a pipeline, but instead bid on a day to day basis for carriage on a pipeline system. This process is managed by an independent system operator who directs the pipeline owner to operate the pipeline system to accommodate the shippers' needs.

The concept of non-contract carriage raises some questions about the bankability of pipelines and is yet to be tested. Non-contract carriage also offers nothing to the entrepreneurial pipeliner and would not suit circumstances where new infrastructure is required. The proposal to establish non-contract carriage in Victoria has been strongly criticised by the gas industry and gas customers alike, but was introduced so late in the process of development of the Code that appropriate public comment was prevented. Unfortunately, its inclusion in the Code gives it a veneer of respectability without it having been the subject of proper debate.

No one can ever be completely satisfied with the final version of a code or document which is required to go through the sorts of processes forced on the National Access Code. It is the result of its authors' attempts to reach compromise between conflicting requirements

and agendas – if the challenge of satisfying nine Australian jurisdictions is not enough, the Code was also pushed and pulled by producers, pipeline companies, distribution companies and end-use customers. The end result is probably a workable document in the hands of a well informed and well resourced regulator. However, all parties must be prepared to change it as soon as sections of it appear to be difficult to apply or, worse still, have a negative effect on investment in new infrastructure.

The Effect Of The Code On Existing And Future Investments In Transmission Pipelines

The objectives of the Code and the legislation which establishes it are:

> *(a) to facilitate the open and efficient development and operation of a national gas market, and to safeguard against abuse of monopoly power;*
>
> *(b) to promote a competitive market for gas in which customers are able to choose which supplier (including producers, retailers and traders) they will trade with;*
>
> *(c) to provide a right of access to transmission and distribution networks on fair and reasonable terms and conditions, with a right to all persons and parties to a binding dispute resolution mechanism.* [3]

It is disappointing that the objectives of the Code do not overtly encourage investment in pipeline infrastructure. The objectives seem to be concentrated on limiting monopoly powers.

The text of the Code refers in many places to the concept of the recovery of costs, for example in Section 8.1(a)

> *A Reference Tariff and Reference Tariff Policy should be designed with a view to achieving the following objectives:*
> *(a) providing the Service Provider with the opportunity to earn a stream of revenue that recovers the efficient costs of delivering the Reference Service over the expected life of the assets used in delivering that Service;…* [4]

This is an unfortunate emphasis, because the concept of recovery of costs does not have to enter into a tariff determination. However, pipeline investors are given some hope in the preamble to Section 8 of the Code, which states:

> *The Reference Tariff Principles are designed to ensure that certain key principles are reflected in the Reference Tariff Policy and in the calculation of all Reference Tariffs. Within these parameters, the Reference Tariff Principles are designed to provide a high degree of flexibility so that the Reference Tariffs Policy can be designed to meet the specific needs of each pipeline system. The overarching requirement is that when Reference Tariffs are determined and reviewed, they should be based on the efficient cost (or anticipated efficient cost) of providing the Reference Services.*
>
> *The Principles also require that, where appropriate, Reference Tariffs be designed to provide the Service Provider with the ability to earn greater profits (or less profit) than anticipated between reviews if it outperforms (or underperforms against) the benchmarks that were adopted in setting the Reference Tariffs. The intention is that, to the extent possible, Service Providers be given a market- based incentive to improve efficiency and to promote efficient growth of the gas market (an Incentive Mechanism).*

> *The Reference Tariff Policy and all Reference Tariffs should be designed to achieve a number of objectives, including providing the Service Provider with the opportunity to earn a stream of revenue that recovers the costs of delivering the Reference Service over the expected life of the assets used in delivering that Service, to replicate the outcome of a competitive market, and to be efficient in level and structure.* [5]

These pricing objectives may establish an acceptable environment for investment in new pipelines and the expansion of existing ones. However, the realisation of these objectives will be entirely dependent on the discretion of the appointed regulator, who might determine that only simplest cost of service tariff setting methodology should be applied to a new pipeline whose proponent wishes to take risks on market growth and effectively "back-end" its revenue; in which case, it is doubtful that the new pipeline would be built.

While no owner or operator of a regulated facility can complain too much about the regulator's powers to obtain financial information to assess a tariff regime, the Code has continued to demand comprehensive and detailed disclosure to "interested parties". Pipeline companies do not wish to expose their financing plans to competitors. In response to criticism from the pipeline industry, GRIG claims to have reduced the requirements for disclosure. However, there seems to have been little change to the disclosure requirements since the December 1996 draft, except that the regulator is now required to exercise its discretion in determining what financial information is made public.

The objectives in Section 8 make it clear that the regulator can select one of three methodologies for determining tariffs – Cost of Service, Internal Rate of Return and Net Present Value. The latter two could be quite complicated in their application, since they must take into account future demand for gas and the expansions that may be necessary to the pipeline system to accommodate higher throughputs. The pipeline proponent would be required to present the regulator with a considerable quantity of information to justify the loads and costs. The regulator (or its financial advisers), in turn, would have to use complex modelling techniques to replicate the pipeline proponent's models, or alternatively audit them to satisfy itself that they were credible and represent an acceptable basis for tariff setting.

Despite strong representations to GRIG over the last 8 months, the Code does not specifically address the concept of market based tariffs, nor does it allow for non-discriminatory tariffs, each of which has the prospect of increasing competition in the gas market – both upstream and downstream. For example, PG&E said in its submission to GRIG in July 1997:

> *……in the hands of a service provider with pro-competitive objectives, the operation of the transmission infrastructure can facilitate the market and supply development necessary for significant growth in energy-intensive industries. This is accomplished by implementing non-discriminatory principles for open access to the transmission system at uniform, published rates for service with tariffs that send effective and up to date price signals from market to supply. Properly established, these tariffs will provide incentives to the operator of the transmission system to participate actively in developing markets and supply sources.* [6]

In an attempt to establish a balance between risk and reward, the Code provides some mechanism for the regulator to establish a nexus and to determine:

> *….a return which is commensurate with the prevailing conditions in the market for funds and the risks involved in delivering the Reference Service.*[7]

Again, this is encouraging, but, like the method for determining the methodology for establishing tariffs, is entirely at the discretion of the regulator.

In the same context of assessment of risk, the Code is still silent on the pro-competitive effect of inclusion of spare capacity (the sale of which would be at risk) in a transmission pipeline by an entrepreneurial pipeline company. This aspect was addressed by PG&E in its submission to GRIG:

> *Without the incentive to construct transmission systems with spare capacity which link multiple suppliers to the marketplace, the most likely result will be systems constructed to meet the initial contracted demand only. The Access Code, therefore, must establish meaningful incentives for pipeline owners to include spare capacity in the construction of transmission systems and to anticipate market growth with timely incremental expansions. In short , pipeline owners must be encouraged to take the risks associated with construction of spare capacity and incremental expansions by establishing realistic incentives in the Access Code, including the opportunity to earn returns which are commensurate with the risk of constructing the additional capacity. The pricing principles currently embodied in the Code will discourage the construction of spare capacity, and therefore will defeat the fundamental objective of creating a natural gas marketplace with active competition which benefits consumers of natural gas.*[8]

The period for the application of a tariff path is also subject to the regulator's discretion. This adds further risk to a pipeline owner, whose financial horizon often extends to 20 years and beyond. Representatives of the consultants to GRIG suggested that a regulator would consider a 20 year time horizon as reasonable, but this remains to be seen after the first few determinations are made by the regulator. Precedents will also play a large role in the regulator's determination, so one can only hope that some of the early decisions are sufficiently market oriented to encourage investment in infrastructure while at the same time driving tariffs lower to encourage market growth. If this is the case, then such decisions should be substantially different from those already taken by some of the state based regulators.

Perhaps one of the most serious aspects of the Code is that it condones discrimination between customers with differing market power:

> *Where a User is receiving a discount (which implies the Service Provider is receiving less revenue from that User than that assumed in the calculation of Reference Tariffs), and such a discount is 'prudent', the Regulator has the discretion (when Reference Tariffs are set initially or reviewed) to permit the Service Provider to recover some or all of that shortfall in revenue by raising Reference Tariffs to other Users."*[9]

While some might argue that this allows the concept of special deals for foundation customers, it actually implies a subsidy which passes from small business and other small industrial customers to the large industries and aggregators, who may be competing in the same markets. It is an inequity that the end-use customer representatives on GRIG must have supported on behalf of the larger members of their constituency to the detriment of the small ones who often provide more employment opportunities.

Derogations

Each jurisdiction has indicated that it requires some form of derogation from the Code – "Make me pure, O Lord – but not just yet" – in order to cement special arrangements in place between state governments and some of their more powerful interests. This action has the effect of diluting the influence of the Code on existing transmission pipeline and distribution systems where it is in Australia's interest to open them up to competition as soon as possible. Despite the problems the immediate implementation of the Code might cause for a limited number of sectional interests, all derogations should be resisted by consumers and pipeline system owners alike.

Revocation of Coverage

The Code does not address properly the concept of pipeline on pipeline competition and offers no simple path for revocation of coverage for pipelines which would compete directly against each other. The Australia pipeline industry is maturing and there are a number of examples where two pipelines could serve a single market from similar supply basins. Under the current Code they would be regarded as Covered and would need to be regulated, even though they would be competing with each other.

Summary

The Code in its present form can best described as "developmental". It is required in the marketplace, but will not satisfy the marketplace. All segments of the industry from suppliers to pipeliners to end use customers are dissatisfied with it. One can only hope the regulators, in particular ACCC, will be able to apply it sensibly and consistently without damaging an embryonic competitive natural gas market, and that the industry can work with ACCC and NCC to amend the Code as quickly as possible when its limitations become all too obvious in application.

One can also hope that reason will prevail among the jurisdictions and that they all will appoint ACCC as the regulator for all natural gas pipeline systems throughout Australia to avoid the "rail gauge" problem. We are still paying for that act of independence by the fledgling colonies. We have had the opportunity to get it right in the gas pipeline industry, but collectively we are slow learners with no sense of history.

References

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[2] Ibid. Page 11
[3] Gas Reform Implementation Group, *National third party access code for natural gas pipeline systems*, Draft of 20 September 1997 P.1
[4] Ibid. P.46
[5] Ibid. P.44
[6] PG&E Corporation (McDanold, Kimber), *Submission to the Gas Reform Implementation Group on July 1997 Draft of National Third Party Access Code for Natural Gas Pipeline Systems* 21 July 1997 P 2
[7] Gas Reform Implementation Group, *National third party access code for natural gas pipeline systems*, Draft of 20 September 1997, P.45
[8] PG&E Corporation, *Submission to the Gas Reform Implementation Group on July 1997 Draft of National Third Party Access Code for Natural Gas Pipeline Systems* 21 July 1997 P 4
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