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

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EXECUTIVE SUMMARY

This submission is intended to provide a review of the July 1997 draft of the National Third Party Access Code for Natural Gas Pipeline Systems ("Code") and to address the aspects of it which PG&E Corporation considers to act as a discouragement to investments in new and existing pipeline infrastructure and which will not promote the original objectives of reform of the gas industry. This submission also makes some suggestions for the addition of several other provisions in the Code to allow it to encompass what might be termed "entrepreneurial" pipelines, where a pipeline owner or proponent plans to take some risks in development of a pipeline and expects commensurate reward. By proposing to supplement the Code, PG&E Corporation intends to enable the Gas Reform Implementation Group (GRIG) to continue to satisfy its objective to prescribe third party access rules for reluctant transmission service providers or for those who would seek to frustrate access to transmission services or to extract monopoly rents for such access.

Since 1992, governments through the Council of Australian Governments (CoAG) and industry associations have been engaged in the development of a Code, backed by legislation, if necessary, to provide "third party" access to natural gas pipeline infrastructure. Unfortunately, the Code in its present form does not facilitate what its original proponents envisaged – **light handed regulation to promote free and fair trade in natural gas through the introduction of competitive commercial forces.**

Fundamentally, the essential purpose of an open access regime is to allow and promote the vigorous gas-on-gas commodity competition that will reduce consumer prices, facilitate infrastructure development and catalyse gas demand growth. In this submission, PG&E Corporation seeks to suggest an alternative regulatory framework which will assist in creating appropriate market behaviour and incentives for transmission service providers who desire to promote and develop the natural gas market.

As presently drafted, the Code ignores the objective of promoting free and fair trade in natural gas and concentrates on policing negative behaviour by pipeline operators through highly prescriptive and heavy handed regulation. PG&E Corporation believes that its proposal strikes a balance between the objectives of policing negative behaviour by certain service providers, and promoting and developing market-based, open and transparent transmission services with tariffs and access provisions which provide incentives to stimulate and develop the natural gas market.

The current draft of the Code will not work for entrepreneurial pipeline operators and developers because of its pre-occupation with cost of service tariff setting under the watchful eye of a regulator and users with access to detailed financial information about the provision of pipeline transport services. In contrast, PG&E Corporation's suggested regime will promote entrepreneurial pipelines to serve developing markets where the proponent is prepared to take long term market risk with the expectation of long term rewards.

Indeed, PG&E Corporation is convinced that, without that balanced approach, the overall CoAG objectives of free and fair trade in natural gas may well be unattainable. Free and fair trade in natural gas is most likely to take place when there is active competition from multiple suppliers and multiple consumers. This depends on the availability of adequate, reasonably priced transmission infrastructure connecting supply and markets. An objective of GRIG, therefore, should be to establish an Access Code which encourages the development of adequate transmission infrastructure to create the necessary competitive forces for gas reform which maximises the benefits to natural gas consumers.

Further, 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.

PG&E Corporation urges the GRIG to consider seriously the company's proposal to establish an alternative access methodology which would be embodied within the Code. The proposed alternative Competitive Market Code will encourage commercial behaviour by transmission system operators which will facilitate the objective of free and fair trade in natural gas. Most importantly, it will establish incentives for the development of a transmission system infrastructure which is essential to the competitive market in natural gas which is at the heart of the CoAG objectives.

Finally, PG&E Corporation is not convinced that the inclusion of regulation of both transmission and distribution pipelines in the Code is appropriate, since the Code does not recognise the significant differences between them. PG&E Corporation recommends that the regulatory code for distribution pipelines be separated from that of transmission. This would not only expedite the completion of the transmission code, but would allow it to be shaped to facilitate the development of an integrated transmission pipeline infrastructure to serve Australia's incipient growth in gas demand.

1. THE CODE MUST PROMOTE THE DEVELOPMENT OF FREE AND FAIR TRADE IN NATURAL GAS.

The Code should assist in moving the natural gas industry toward a free and fair natural gas trading market and should provide positive reinforcement to commercial behaviour that promotes the development of a pipeline infrastructure which would establish an environment for a dynamic natural gas marketplace. Such a marketplace would exhibit the following characteristics:

- Adequate transmission infrastructure;
- Multiple suppliers and multiple consumers;
- Gas-on-gas competition;
- Diverse methods of trading in natural gas and transmission services;
- Choices in transmission services and delivery methods.

In formulating the access provisions and the framework for regulating transmission services through the basic commercial tools of tariffs, conditions of service and access methods, the Code should provide the basis for defining and establishing parameters to service providers to act to assist the achievement of the dynamic market.

1.1 INFRASTRUCTURE DEVELOPMENT IS ESSENTIAL TO THE COMPETITIVE MARKETPLACE.

The competition essential to free and fair trading in natural gas depends in the first instance on the existence of adequate infrastructure connecting the market centres to competitive supplies. Moreover, for the marketplace to exhibit the characteristics described above, specifically to make available diverse means for trading in natural gas and transmission services, the transmission infrastructure must be established with adequate capacity to enable the development of a spot market and competitive forces within a secondary capacity trading market. Further, the existence of spare capacity is critical to market growth which is unimpeded by the delays and additional costs associated with construction of incremental capacity to meet new market demand.

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.

1.2 PIPELINES SHOULD FACILITATE DEVELOPING A COMPETITIVE MARKETPLACE.

The Access Code, comprising tariff setting principles and access conditions, should be based on:

- promoting maximum economic efficiency;
- providing pipeline access on the lowest commercial terms feasible; and
- facilitating the development of a highly competitive natural gas market.

The code should promote transmission services and transmission system operators that support the development of the natural gas market.

To facilitate the development of the competitive marketplace which underpins market growth, the Code should create a tariff structure for transmission services that improves the crucial link between the market and supply. Several critical elements assist in achieving this objective:

- First, the Code should implement **non-discriminatory** principles for open access to transmission services.

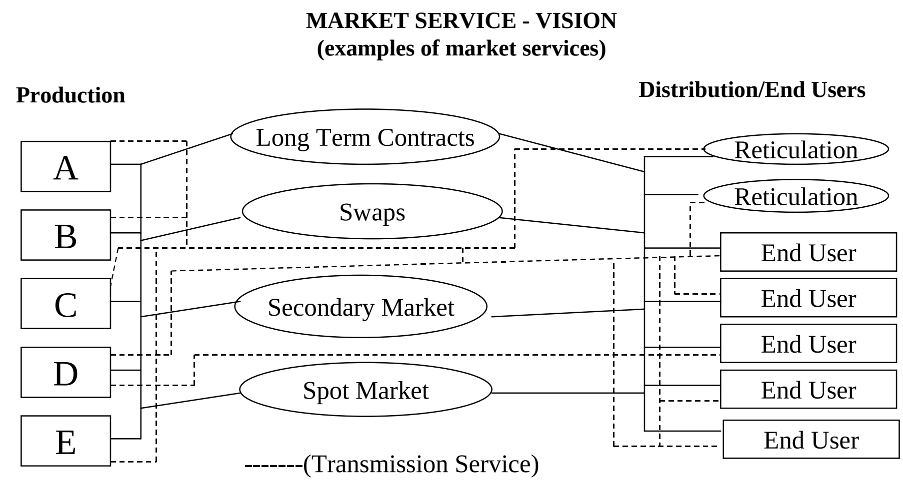
- Second, the Code should establish **tariffs that support effective price signals from market to supply.**

- Third, the Code should provide shippers with the **operational flexibility** to allow shippers to adjust their supply and/or market arrangements periodically to further competition among suppliers.

- Fourth, the Code should promote the development of **a secondary market in capacity** by allowing customers to assign their service commitments to promote the efficient balancing of the cost of capacity reservations with the competitive benefits of increased access to suppliers. Properly implemented, capacity brokering will assist in avoiding unnecessary infrastructure investment.

Such an open access pipeline regime, including published, non-discriminatory tariffs; flexible, customer-driven services; and market sensitive rates, will provide the maximum support for the introduction of viable competition which directly benefits the consumers of natural gas.

Most natural gas industrial customers supply products that compete in the international marketplace. Their concerns are focused on lowering production costs, creating the need for more control over energy costs through additional flexibility in their purchases of natural gas. An open access transmission service that promotes competition for market demand among multiple gas suppliers is the most certain way to ensure sustained growth and economic development and address the requirements of market participants. The desired competitive marketplace for a natural gas consumer is illustrated on Figure 1. This multiple-choice marketplace contrasts sharply with the limited choices offered by a transmission system dominated by capacity built to serve foundation customers without regard for market development.



Producers	Market Service Provider	Distribution/End User
A Range of Producers	- Energy Companies - Merchant Banks - Facilitators - Brokers - Production Companies	- Distributors - Commercial - Specialist end users

Figure 1: Market Vision

The key components for success of an access regime from the shipper's perspective, whether they are a consumer or a supplier, are:

- access to multiple supply sources and customers;
- low, market-responsive tariffs;
- flexible operations to accommodate shippers commercial requirements;

- timely and cost-effective expansion to meet market demand;
- reliable service; and
- free and open information exchange.

Competitive forces will prevail when they are supported by an appropriate set of tariff principles that are actively managed by market-focused transmission service providers. The benefits to the natural gas marketplace of market-focused, competitive, open access transmission services should be:

- lower consumer gas prices resulting from multiple suppliers and gas-on-gas competition;
- more consumer choices for suppliers and transmission services;
- greater pipeline and customer operating efficiency; and
- increased economic and industrial development.

1.3 THE CODE SHOULD PROVIDE INCENTIVES FOR PRO-COMPETITIVE ACTIVITIES

The Code should seek to promote positive behaviour and market responsiveness. The Code's prescription for change is based on policing the negative traits of monopolistic behaviour by pipeline operators and will not induce or create incentives for positive market behaviour. Such an approach will continue to reinforce pipeline behaviour of passively participating in market development, being principally concerned with affiliate/foundation customers, offering no flexibility in pricing or operations, maintaining confidentiality in conduct, and possibly directly or indirectly frustrating 3rd party access.

The behaviour for transmission system operators which the Code should seek to encourage is for the operator to act to promote a Competitive Market by:

- actively promoting the growth and development of the natural gas market and increased commodity trading;
- generating greater utilisation, throughput and transactions;
- providing more supply and commodity access choices for users/markets;
- being open and non-discriminatory on capacity utilisation and availability and tariff information;
- offering non-discriminatory tariffs for users;
- encouraging development of an active secondary market for capacity;
- providing price flexibility that is responsive to market and user needs; and
- establishing transparency in financial reporting so that the market has confidence in the tariff framework and can negotiate for transmission services from an informed basis.

These positive market behaviour traits of transparency of conduct, open information access, non-discriminatory service to users, market responsiveness, tradeability of a shipper's spare capacity, and transparency of financial reporting will directly involve the transmission system operator in positively promoting market development and growth.

1.4 THE CODE'S TARIFF SETTING PRINCIPLES WILL DISCOURAGE POSITIVE MARKET BEHAVIOUR BY PIPELINE OPERATORS.

The Code does not provide incentives for the transmission system operator to promote and develop markets. Indeed, the Code does not even envisage such conduct. Rather, the Code is primarily structured around forcing third-party access onto a reluctant provider. This will not promote free and fair trade in natural gas and will not create incentives for development of the natural gas market. Instead, the Code's concentration on highly prescriptive and heavy handed cost of service tariff setting will create conditions for inefficient pipeline management and operations.

Cost of service tariff setting principles will usually encourage pipeline developers to construct only that capacity for which they have contracted demand and to expand only when sufficient contracted incremental demand can be secured. In other words, the service provider has the incentive to produce supply blockages by holding back capacity to the most conservative bankable investment. If the tariff framework rewards low risk investments grounded only in committed capacity, then a lag effect is produced in the delivery of additional capacity which produces price volatility for the commodity as supplies from producer to customer are artificially held back due to inadequate capacity. The windfall in these cases will be taken by the producer or distributor at the expense of the consumer.

Under the cost of service pricing principles in the Code, the tariffs applicable to all services on a pipeline will be set at the highest justifiable incremental cost of service tariff without regard to market requirements or the need for spare capacity for market development. This will lead, in turn, to a shift in management focus from the desired emphasis on market development to the justification and preservation of cost of service tariffs which are as high as possible. Ultimately, the cost of service focus, with a guaranteed (and government sponsored) rate of return, will discourage creativity and market behaviour which would otherwise lead to the free and fair trade in natural gas which underlie CoAG's objectives.

Finally, PG&E Corporation is convinced that the draft Code will create an unintended but significant bureaucracy to meet the ongoing regulatory obligations prescribed by the Code. Many of those ongoing regulatory obligations establish impractical and burdensome regulatory requirements which will be extremely difficult to implement without significant cost both to government and to the pipeline industry. The pipeline industry will not be willing to be levied by Government to cover the cost of the bureaucracy, nor will users be willing to bear both the cost of the bureaucracy <u>and</u> the cost of the administrative, legal and accounting services that will have to be assembled by the pipeliner to meet the demands of the Regulator. Tax treatment of regulatory cost must also be a consideration.

PG&E Corporation has assembled some detailed responses to specific provisions in the Code and these are set out in Appendix 1

2.0 PG&E'S SUGGESTED SUPPLEMENT TO THE CODE

PG&E Corporation proposes an alternative to the Code's highly prescriptive provisions which are primarily framed at forcing access from reluctant transmission services to users other than the principal service users. PG&E Corporation believes that its suggestion - provisions that actively **promote** open access - can be readily achieved by supplementing the existing Code so that all users are treated equitably and without discrimination, supported by competitive market activities by transmission service providers.

These supplementary provisions would include a benchmark market test for maximum tariffs which provides incentives for the transmission service provider to promote market growth and install sufficient capacity to provide ongoing and long term transmission services for all its customers and achieve an adequate return on its investment. In essence, PG&E Corporation is proposing a "Market Focussed Transmission Service", in contrast to a Cost of Service Transmission Service

The Market Focussed Transmission Service is distinguished from the highest justifiable incremental cost of service tariff discussed above. The commercial risk for the provider of Market Focussed Transmission Services should rest on its ability to increase utilisation rather than on a tariff which the Regulator has underwritten which effectively guarantees a return on a low-risk incremental capital investment.

The tariffs determined for a Market Focussed Transmission Service are open and non-discriminatory. All shippers are offered the same agreement for a particular transportation service. However, if in response to the demands of the market, improved conditions of tariff or other aspects of access are provided to a shipper, all other shippers (or proposed shippers) will be offered the same tariff and conditions for the same service.

This approach provides for a level commercial basis for pipeline transactions among all users. This is enhanced by one of the most important aspects of the Market Focussed Transmission Service - a requirement for the Service Provider to make available, through a screen-based, real-time trading system (probably on the Internet), comprehensive information on contracts, tariffs, spare capacity, bids for capacity and other important technical and commercial data. This allows existing and potential users of service to develop appropriate strategies for gaining maximum efficiency in their service needs and/or negotiating future requirements.

2.1 A MARKET FOCUSSED CODE WILL FACILITATE AND ENCOURAGE PRO-COMPETITIVE ACTIVITY BY TRANSMISSION SERVICE PROVIDERS.

PG&E Corporation's proposal is to create a supplement to the Code which enables a transmission service provider to elect a Market Focussed approach (referred to as the "Competitive Market Code") reflecting open access and non-discriminatory criteria and a pro-market development mindset. This proposed code is in contrast to the limited 3rd Party Access regulatory framework with prescriptive tariff and regulatory provisions currently embodied in the Code. **It is intended to supplement the Code, not replace it.**

This approach achieves the Task Force's objective of regulating negative behaviour to enable compulsory access for 3rd parties, but also provides for a regulatory regime which promotes open access and a dynamic market in which the transmission service provider is a positive influence. A draft of the additions to the current version of the Code which are proposed by PG&E Corporation to accomplish the Competitive Market Code are contained in Appendix 2.

This Competitive Market Code defines and prescribes the attributes of a carrier in both market and service terms and also in terms of management and operational control. The proposal envisages that a service provider must satisfy the Regulator that it has the attributes and non-discriminatory service provision policies and practices that would class it as a "Competitive Market Carrier". In the event that the service provider is unable to demonstrate this, it would be covered by the proposed general 3rd party access provisions embodied in the Code.

In addition to demonstrating the attributes of non-discriminatory service policies and practices, the service provider must satisfy the Regulator that the tariff principles and proposed maximum tariff are fair and reasonable. A Market Benchmark Test is prescribed for the service provider to satisfy the Regulator of its competitive market carrier characteristics and the market appropriateness of the tariff proposals. A diagram illustrating the procedures for implementing the Competitive Market Code is shown in Figure 2.

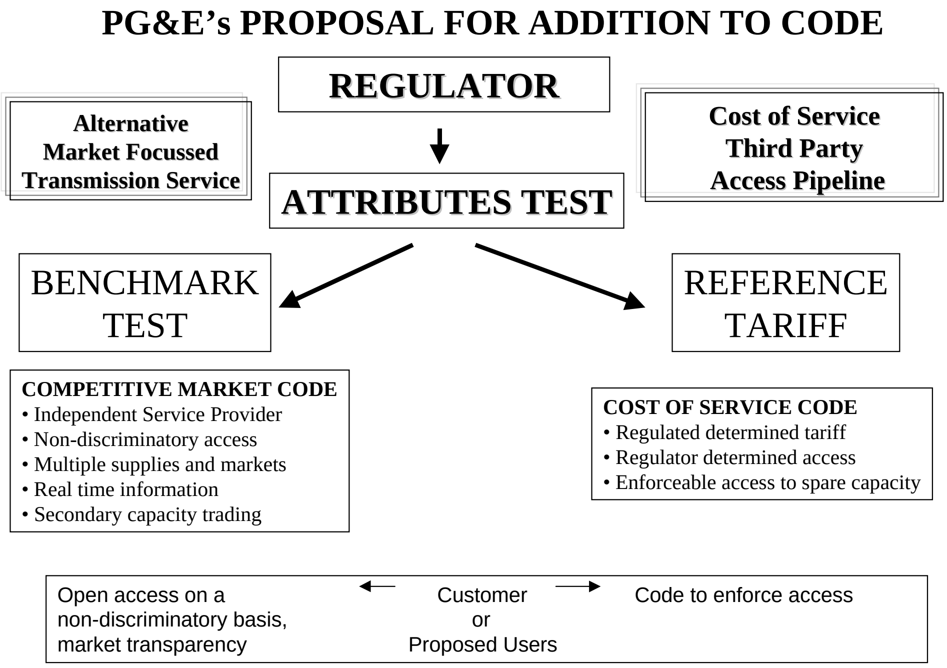


Figure 2: Procedures for implementing the Competitive Market Code

The Market Benchmark Test is formulated around the projected internal rate of return probabilities measured against the development of the market for transmission service and is supported by an independent assessment from a commercial investment advisor such as an investment bank. The risk, and therefore incentive, is placed on the service provider to maximise utilisation, throughput and transactions to achieve reasonable returns. It is not a cost of service methodology, but rather reflects an assessment of the "value" of the transmission service in the marketplace without regard to artificial limitations resulting from depreciation calculations sanctioned by regulatory authorities.

Further, consistent with the investment analysis necessary to support such an infrastructure investment, the Market Benchmark Test evaluates the market and its likely demand over the entire period for which the tariff will be effective. It is a market-based approach which penalises the service providers for not promoting the market and its development and rewards the service provider for market growth.

PG&E Corporation suggests that additional paragraphs be included in Section 2 of the Code to incorporate the Market Benchmark Test in the form of the attached draft, The Competitive Market Code outlines the framework for the internal rate of return tests and the determination of the maximum tariffs.

An alternative to this Market Benchmark Test which could accomplish the same objective of ensuring competitive tariffs with the right incentives for service providers, could exist when an existing government owned transmission system has been acquired through an open competitive bidding process conducted by a government entity in which the tariff was a major consideration in the process. In this circumstance, the open and competitive bidding process is a surrogate for an assessment of the appropriate tariff levels for the market, enabling the Regulator to accept the results of the bidding process as a substitute for the Market Benchmark Test.

The Competitive Market Code also includes non-discriminatory tariff provisions which ensure that discounts offered to one customer are offered to all similar-situated customers. In addition, the Code requires that the transmission system's operations be transparent with a free flow to the marketplace of:

(1) real-time information regarding system operations and available capacity,

(2) financial reports consistent with the requirements of a listed company

These non-discriminatory tariff and transparency provisions, coupled with the market-based investment return assessment and incentive tariff structure, ensure that the Competitive Market Transporter must be responsive to the market to ensure increased throughput and transactions necessary for reasonable returns on investment.

2.2 TO QUALIFY FOR THE COMPETITIVE MARKET CODE, A TRANSMISSION SYSTEM PROVIDER MUST EXHIBIT SEVERAL PRO-COMPETITIVE ATTRIBUTES.

The draft Competitive Market Code prescribes several pro-competitive attributes which must be affirmatively demonstrated by the transmission service provider to qualify for consideration under the Competitive Market Code:

I. The service provider must demonstrate that it is conducting the business of a Competitive Market transmission service provider independently of a natural gas producer, major consumer or retailer. This attribute is designed to ensure that the service provider's decisions in the marketplace regarding tariffs and capacity expansions are made independent of any pecuniary interests in upstream or downstream activities in the natural gas industry. In other words, this attribute will ferret out those service providers who have an inherent conflict of interest associated with vertical integration.

II. The service provider must demonstrate that it will provide non-discriminatory open access to all available and developable capacity on the transmission system. This attribute is designed to ensure that all parties are given access to the transmission system on a completely non-discriminatory basis, an essential element to market growth.

III. The service provider must demonstrate that circumstances exist, or have the potential to exist, for multiple suppliers and markets. This attribute is designed to ensure that there is at least the potential for the free and fair trade in natural gas which is at the core of the CoAG objectives and which is essential to market forces influencing transmission service tariffs and conditions of service. The combination of several competing supply sources and a number of competing consumers will result in vigorous competition.

IV. The service provider must demonstrate that it will offer non-discriminatory tariffs for equivalent services. This attribute is necessary to ensure that market-induced changes in tariffs or conditions of service are reflected in the transmission services for all similarly-situated customers. This in turn will provide that there will be no arbitrary distinctions in service provided to consumers who are competing in the same world competitive markets.

V. The service provider must provide real time open access to data and information on tariffs, terms and conditions of service, operations, and available capacity. The most likely vehicle for implementing this condition is the Internet, which is used to provide up-to-date information to users, potential users and other interested parties of operating conditions on the pipeline, applicable tariffs and terms and conditions of service, available services, booked and available capacity along the transmission system either from the system operator or in the secondary market, capacity expansion plans, and standard procedures for obtaining access to the transmission system. The on-line information will have a powerful influence on the market because it will act as a clearing house for critical commercial information necessary for existing and potential users of the system, including suppliers and consumers.

VI. The service provider must allow for the development of a secondary market in capacity by allowing shippers to assign contracted capacity on an open access basis. The existence of an active secondary market in capacity is essential to ensuring that competitive forces directly influence negotiations for available capacity, specifically providing for competition for capacity between the secondary market and the transmission system operator. This secondary market will ensure that competitive market forces establish the tariffs and conditions of service applicable to the transmission system .

VII. The transmission service provider must provide financial information to the marketplace in accordance with the requirements for a publicly-listed company under Corporations Law and Australian accounting standards. By providing this information to the commercial marketplace, this requirement will ensure that users and potential users of the transmission system will have the necessary market knowledge to enable meaningful negotiations for tariffs and terms of service. This information would also be published in electronic format on the Internet site.

VIII. The service provider must agree to an undertaking with the Regulator to ensure oversight of the service provider's compliance with the access provisions incorporating the above attributes. This will establish a system for dispute resolution consistent with the market-based oversight inherent in the Competitive Market Code. This undertaking could well be conducted with the Australian Competition and Consumer Commission under Division 6 of Part IIIA of the Competition Policy Reform Act of 1995, an approach which would ensure compliance oversight and dispute resolution under established procedures.

Satisfaction of these attributes provides the service provider with the opportunity to establish through the Market Benchmark Test that it may operate under the Competitive Market Code rather than the more prescriptive requirements specified in the Code.

3.0 CONCLUSION

- PG&E Corporation's proposed Competitive Market Code will provide the support for market behaviour by transmission system providers that assist the development of free and fair trade in natural gas within the context of a dynamic natural gas marketplace.

- The Competitive Market Code will stimulate economic growth and development by ensuring rewards are provided to transmission service providers through market-based tariffs which invigorate development and growth of the market.

- The Competitive Market Code provides for an informed market on an on-going basis with (1) transparency on access to tariffs, terms and conditions of service, capacity, and executed transport agreements and (2) financial reporting on the transmission system in accordance with the standards applicable to listed companies.

- The Competitive Market Code provides for non-discriminatory access to services and tariffs, including a provision that discounts or special service conditions negotiated by the competitive marketplace are offered to all equivalent services.

- Services under the Competitive Market Code are market-responsive because of the incentives from enabling higher returns on investment only through increased throughput and from market-based tariffs which enable discounting and other non-discriminatory practices to reflect variations in the market on an on-going basis.

- PG&E Corporation urges GRIG to consider this supplement to the Code as means of overcoming the requirement by some jurisdictions for extensive derogations and to sponsor a framework where pipeline owners and proponents will be encouraged to build the infrastructure to support Australia's undoubted potential for growth and development. PG&E Corporation contends that the Code in its current form will not provide the proper balance between risk and reward for pipeline proponents and owners, nor will it send the correct signals to the users of natural gas to persuade investors to create economic growth and jobs for Australians.

APPENDIX 1

DETAILED RESPONSES TO SPECIFIC PROVISIONS WITHIN THE CODE

The following comments apply to the July 1997 issue of the National Third Party Access Code for Natural Gas Pipeline Systems ("Code"). The comments use the same nomenclature and numbering system as are used in the Code and Code text is written in italics.

The Code:
INTRODUCTION
This Code establishes a national access regime for natural gas pipeline systems.
The objectives of this Code and the legislation which establishes it are:
to facilitate the open and efficient development and operation of a national gas market, and to safeguard against abuse of monopoly power;
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;
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.

Comment
PG&E contends that the Code does not facilitate the "development" of the natural gas market. It contains aspects which will restrict development and reduce the incentives for investment in pipeline infrastructure. Nor does the Code promote a competitive market; it is more likely that the Code will favour large customers, distribution companies and large producers against the interests of the smaller customers with less market power. It promotes the concept of "foundation customers" who, by Dr Balchin's admission, are allowed to be cross subsidised by the smaller customers on the Reference Tariff .

The Code is unbalanced against Service Providers.

The Code:
The aim of the Code is to provide sufficient prescription so as to reduce substantially the number of likely arbitrations, while at the same time incorporating enough flexibility for the parties to negotiate contracts within an appropriate framework. The Code has also been designed to provide a clear national access regime, with consistency between different jurisdictions.

Comment:
While the Code has a commendable aim to be consistent across all jurisdictions, it does not incorporate flexibility. Presumably, the authors of the Code consider that the Regulator's "discretion" is a means of providing "flexibility". This is not so, since the Regulator's actions are circumscribed by the prescriptiveness of the pricing principles in Section 8, for example. In this case, the Regulator has no option but to apply cost of service tariff methodology – some even disguised as a discounted weighted average tariff (Section 8.7) which was found to be totally inappropriate for the Moomba to Sydney pipeline in the 1970s.

The Code:
1. COVERAGE
This section of the Code describes the kinds of gas infrastructure which are subject to the Code…..

Schedule A lists the Pipelines which are automatically Covered by the Code (section 1.1).

Comment:
The method by which the Code unilaterally determines the all existing pipelines are "Covered" is of concern, particularly if the application of the Code results in revenue reductions. Have the authors of the Code determined whether this action will provoke calls for compensation from existing pipeline owners if their financial position is jeopardised?

The Code:
Revocation of Coverage

1.24 Pipelines listed in Schedule A and Pipelines that have become Covered after the commencement of the Code may cease to be Covered where a person applies to the Council for Coverage of the Pipeline to be revoked and, after receiving a recommendation from the Council, the Designated Minister determines that Coverage of the Pipeline should be Revoked.

And:

1.30 Subject to section 1.26(a), the Council cannot recommend that Coverage of the Pipeline be Revoked, to any extent, if the Council is satisfied of all of the matters set out in paragraphs (a) to (d) of section 1.8, but the Council must recommend that Coverage of the Pipeline be revoked (either to the extent described, or to a greater or lesser extent than that described, in the application) if the Council is not satisfied of one or more of those matters.

Comment:

The method by which the revocation of Coverage is not well defined in the circumstances where a second pipeline is built to serve the same market region. For example, a new pipeline could be built into the South West of Western Australia, resulting in pipeline on pipeline competition. In these circumstances, regulation of both pipelines is unnecessary.

The Code:

2. ACCESS ARRANGEMENTS

The process whereby a compulsory Access Arrangement is approved can be summarised as follows:

The Service Provider submits a proposed Access Arrangement, together with the Access Arrangement Information, to the Regulator.

The Regulator may require the Service Provider to amend and resubmit the Access Arrangement Information.

The Regulator publishes a public notice and seeks submissions on the application.

The Regulator considers the submissions, issues a draft decision and then, after considering any submissions received on the draft, makes a final decision which either:

approves the proposed Access Arrangement; or

does not approve the proposed Access Arrangement and states the revisions to the Access Arrangement which would be required before the Regulator would approve it.

If the Regulator does not approve the Access Arrangement, the Service Provider may propose an amended Access Arrangement which incorporates the revisions required by the Regulator. If the Service Provider does not do so, the Regulator can impose its own Access Arrangement.

Comment:

PG&E's considers that the Access Arrangement Information required under this section of the Code is far too complex and comprehensive than is necessary for the purpose intended. In particular, aspects such as gearing, cost of borrowings and other financial aspects vary considerably over the life a pipeline, depending upon the sources of funds, prevailing economic conditions and company financing policy. It is impossible for a new pipeline proponent to assemble the Access Arrangement Information prior to a project go-ahead.

More importantly, the Regulator is able to exercise its discretion over any item in the Access Arrangement Information and accept or reject the figures provided. In this way the Regulator is put in the position having to exercise his discretion on matters more properly decided upon by the Service Provider's Board of Directors. This aspect is untenable for both Service Providers and the Regulator.

The Code:

2.22 If a Service Provider fails to submit a proposed Access Arrangement within the time required under section 2.1, the Regulator may draft and approve its own Access Arrangement. Before approving its own Access Arrangement under this section 2.22 the Regulator must follow the process set out in sections 2.9 to 2.19 as though the Access Arrangement drafted by the Regulator had been proposed by the Service Provider.

Comment:

If the Regulator has the power to create is own Access Arrangement and enforce it on a reluctant Service Provider, again the Regulator is assuming powers that are unacceptable and could also result in a disaffected Service Provider seeking compensation for the actions of the Regulator. This power cannot be exercised without a merit appeal process.

The Code:

Reference Tariffs

3.3 An Access Arrangement must include a Reference Tariff for:

(a) at least one Service that is likely to be sought by a significant part of the market; and

(b) each Service that is likely to be sought by a significant part of the market and for which the Regulator considers a Reference Tariff should be included.

3.4 Unless a Reference Tariff has been determined through a competitive tender process as outlined in sections 3.16 to 3.31, an Access Arrangement and any Reference Tariff included in an Access Arrangement must, in the Regulator's opinion, comply with the Reference Tariff Principles described in section 8.

Comment:
Herein lies the most significant problem to existing and future Service Providers. The Reference Tariff must be, by definition, the lowest tariff available on the pipeline, because it is determined by application of the cost of service methodology in Section 8. The inputs to the derivation of the Reference Tariff will have been determined by the Regulator, using its narrow, and most likely, conservative view of the financial aspects of the pipeline. Any discounts offered on the Reference Tariff will have a direct effect on the Service Provider's rate of return, unless the Regulator permits cross subsidies from the smaller Users with less market power than the larger or foundation customers. If this is the outcome, then the Code has failed in its mission to provide competition and lower prices.

The Code:

3.14 If the period from the date the Access Arrangement is approved to the review date specified under section 3.13 is more than five years, the Regulator must not approve the Access Arrangement without considering whether mechanisms should be included to address the risk of forecasts on which the terms of the Access Arrangement were based and approved proving incorrect. These mechanisms may include:

(a) requiring a review prior to the planned review if certain events occur, for example:

  (i) if a Service Provider's profits derived from a Pipeline exceed a certain amount or if the value of Services reserved in contracts with Users exceeds a certain level;

  (ii) if the type or mix of Services provided by means of a Pipeline changes in a certain way; or

(b) a Service Provider returning some or all profits in excess of certain amount to Users whether in the form of lower charges or some other form.

Comment:
The Authors of the Code must surely be aware that a long term capital investment, such as a pipeline requires long term arrangements to be in place to ensure bankability. A five year agreement followed by potential uncertainty will result in higher costs of funds.

The Code:

Determining Reference Tariffs through a Competitive Tender Process

3.16 Any person who wishes to conduct a tender in relation to a Pipeline that has not been built may make an application to the Regulator (a Tender Approval Request) requesting the Regulator to approve the use of a tender process to determine:

(a) Reference Tariffs for certain Reference Services to be provided by the proposed Pipeline;

(b) other specified items which are required to be included in an Access Arrangement and which are essential to determine the Reference Tariffs concerned (including, without limitation, the review date).

Comment:

The Competitive Tender Process is flawed in that it provides for <u>any</u> party other than the pipeline proponent to call tenders for the construction of a pipeline to serve <u>that party's</u> 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 customer, who could be competitors.

The competitive tender process could be acceptable in the case where a government carries out the process to sell an asset, but in no other circumstances would that be acceptable, since conflicts of interests will always arise. Even where a government perceives a need, 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.

The Code

Notification of a Dispute

6.1 If a Prospective User and a Service Provider are unable to agree on one or more aspects of access to a Service provided by the Spare Capacity or Developable Capacity of a Covered Pipeline, the Prospective User or Service Provider may notify the Regulator that it considers that a dispute exists. A dispute only exists for the purposes of this Code when the Regulator has been notified of the dispute and has agreed that there is a dispute. Without limiting the circumstances in which the Regulator may not agree that there is a dispute, the Regulator may do so if it considers that the claim is made on trivial or vexatious grounds.

Comment:
It is inappropriate for the Regulator to act as the arbitrator, since it participated in setting the rules defined in the Access Arrangement. The Regulator cannot be seen as independent and therefore will not be regarded as impartial by either of the parties to the dispute.

The Code:

Decisions by the Regulator

7.8 If the Regulator is required under this Code to make a draft decision or a final decision, the Regulator must include its reasons in its draft decision or the final decision.

Comment:
Even though the Regulator's decisions are made public, this requirement does not diminish the ability to make decisions that affect the profitability of a pipeline system. The Code does not allow for merit appeals in any but a few minor instances. This gives the Regulator enormous and unrestrained power which is not subject to any oversight. Even the ACCC is subject to appeals though the Competition Appeals Tribunal. The resulting unbalance is unacceptable.

The Code:
Principles for determining the costs of delivering a Reference Service
The costs which the Reference Tariff Principles allow to be recovered are:
a return (Rate of Return) on the value of the capital assets (Capital Base) employed in providing the Reference Service;
depreciation of those assets (Depreciation); and
the operating, maintenance and other non-capital costs (Non-Capital Costs) associated with providing the Reference Service.
Any Reference Tariff - regardless of how it is derived - may be expressed in this form. However, it is intended that a Reference Tariff be acceptable if it meets the Reference Tariff Principles when it is expressed in this form.

Comment
The slavish preoccupation with the use of Cost of Service as a means of calculating the Reference Tariff is the most serious and objectionable aspect of this Code. Cost of Service Methodology is not appropriate to transmission pipelines, particularly entrepreneurial pipelines which are built in anticipation of a market. Very little of Australia's existing pipeline infrastructure would have been built if this Code had been in place from 1969. It is only on established infrastructure where cost of service might have application, but this too, would be flawed, since most existing infrastructure has already been depreciated and hence the revenue received would be variable cost only and the pipeline owner would have little incentive to operate the pipeline efficiently or reliably. This effect is already being felt throughout North America and it is only through innovative (but clearly economically inefficient) pipeline refurbishment and expansion plans that many companies can maintain their "rate base".

Specifically, the rigid application of a cost of service methodology ignores significant issues regarding financing and developing new pipeline systems by concentrating on policing negative behaviour by pipeline operators. By effectively providing only 5 years of tariff certainty, the Code operates to limit the means by which pipeline developments may be financed and the Code's treatment of "redundant" capacity discourages investment decisions with a view toward future growth.

The proponent of an entrepreneurial pipeline must set its tariff for transport services at a level which will encourage its potential customers to invest in new industrial developments, particularly for mineral processing, where international competitiveness is vital. The proponent must also set tariffs which facilitate significant market growth to justify the very large up-front investment in the pipeline. As a result, a pipeline may be proposed to be built with significant excess capacity which will be progressively utilised as the market grows. If cost of service tariff setting methodology were applied to PGT Australia's proposals strictly in accordance with Section 8 of the Code, either the tariff would be so high as to prevent any gas sales or the rates of return on the total invested capital would be so low (with no prospect of recovery in later years) that no project proponent would proceed with the pipeline.

For an entrepreneurial pipeline, the rate of return on invested capital may have to vary considerably over the life of the asset – from lower levels in early years while the market is being established to quite high levels in later years when most of the capacity is being used, if the market grows as predicted. The risk to the pipeline developer is high. Because the Code's pricing methodology has no means of matching risk and reward over a period (15-20 years) which approximates the investment-driven time horizon, its application in its current form will establish a regulatory regime which will discourage investment.

It may be a surprise to the authors of the Code, but its insistence upon cost of service tariff methodology will actually create conditions for inefficient pipeline management and operations. There is a significant body of evidence from North America that these principles often encourage pipeline developers to construct only that capacity for which they have contracted demand and to expand only when sufficient contracted incremental demand can be secured. In other words, the service provider has the incentive to produce supply blockages by holding back capacity to the most conservative bankable investment.

Under the cost of service pricing principles in the Code, the tariffs applicable to all services on a pipeline will be set at the highest justifiable incremental cost of service tariff without regard to market requirements or the need for spare capacity for market development. This will lead, in turn, to a shift in management focus from the desired emphasis on market development to the justification and preservation of cost of service tariffs which are as high as possible. Ultimately, the cost of service focus, with a guaranteed (and government sponsored) rate of return, will discourage creativity and market behaviour which would otherwise lead to the free and fair trade in natural gas which underlies the most basic of CoAG's objectives for the natural gas industry.

In addition to distracting management's focus from market development, the cost of service methodology prescribed requires the imposition of detailed record-keeping and information-reporting requirements which will impose a significant cost burden on pipeline operators. Essentially, the complexity of Section 8 of the Code will require a separate set of "regulatory" books to be maintained and will encourage the development of a business (with a plethora of lawyers and advisers) whose sole focus is on assisting parties in tariff proceedings before the Regulator.

The Code:
New Facilities Investment
8.15 The Capital Base for Relevant Pipeline Assets may be increased from time to time to recognise additional capital costs incurred for the purpose of providing the Reference Service.
Comment:
The Code allows for "incremental pricing" which is a technique which usually prevents new Users from gaining access to the Pipeline at the same rates as the incumbent users. This process is manifestly unfair and if the Service Provider is able to balance its revenue growth and its associated requirement for additional capital with market growth in setting its initial tariffs, then such distortions do not occur.

The Code:
Capital Redundancy
8.23 A Reference Tariff should provide for the Capital Base for Relevant Pipeline Assets to be reduced from time to time to recognise assets which cease to contribute in any way to the delivery of a Reference Service (Redundant Assets).

Comment:
The introduction of the aspects of Capital Redundancy and Speculative Investment in the Code beggars belief and has no application to the way in which a prudent pipeline owner and operator manages his business unless forced to do so by the inappropriateness of the Code. Pipelines must be built to accommodate a growing market – see comments above.

The Code:
Allocation of Costs between Services
Subject to sections 8.37 and 8.40, to the maximum extent that is commercially and technically reasonable the costs comprised in the return on the Capital Base, Depreciation and Non Capital Costs should be allocated to a Reference Service for the purposes of section 8.4 in accordance with the following principles:

Comment:

This requirement imposes an enormous bureaucratic load (with associated costs) on the Pipeline owner and the Regulator, who must audit them, which will have to transferred to Users. Is this fair?

The Code:
Prudent Discounts
8.40 …..some or all of any discount given to, or to be given to, that User or Prospective User (where the discount is the difference between the Reference Tariff (or the other Tariff that would have been determined by the Regulator) and the Tariff actually paid or to be paid by the User or Prospective User) may either be:
(c) allocated to other Users of the Reference Service under section 8.39; or
(d) allocated to the Reference Service or some other Service or Services under section 8.35.

Comment:
This provision means that special deals given to some customers – usually those with market power, or even affiliates – can be subsidised by other customers. Is this fair and does it promote competition?

APPENDIX 2

AMENDMENTS TO CODE TO ADD COMPETITIVE MARKET TRANSMISSION SERVICE OPTION

The following amendments to Section 2 of the July 1997 issue of the National Third Party Access Code for Natural Gas Pipeline Systems will be required to implement a competitive market type of access arrangement, entitled Access Arrangement (Competitive Market), through the Market Benchmark Test:

Submission of Access Arrangements

If a pipeline is Covered, the Service Provider must submit a request, with the necessary supporting documentation, to the Regulator for the Regulator to determine, by means of a "Market Benchmark Test" whether the Service Provider will be required to submit an Access Arrangement in accordance with this Section 2 and comply with the tariff setting principles set out in Section 8 or submit an Undertaking generally in compliance with Clause 6 of the Competition Principles Agreement and Section 2.2 (a) to (h) for a pipeline which would then be designated a Competitive Market Transmission pipeline. The Undertaking for a Competitive Market Transmission Pipeline would be known as an Access Arrangement (Competitive Market).

If the Regulator determines that the Service Provider does not meet the criteria listed below to qualify to provide Competitive Market Transmission Services in the Market Benchmark Test, the Service Provider must submit a proposed access Arrangement together with the applicable Access Arrangement Information for the Pipeline to the Regulator:

(a) within 90 days after the Pipeline becomes Covered under Section 1.19 or 1.21 if the Pipeline is not described in Schedule A; or
(b) within 90 days after the commencement of the Code if the Pipeline is described in Schedule A.

If a Pipeline is not covered, the Service Provider must submit a request, with the necessary supporting documentation, to the Regulator for the Regulator to determine, by means of a Market Benchmark Test whether the Service Provider will be required to submit an Access Arrangement in accordance with this Section 2 and comply with the tariff setting principles set out in Section 8 or submit an Undertaking generally in compliance with Clause 6 of the Competition Principles Agreement for a pipeline which would then be designated a Competitive Market Transmission pipeline. The Undertaking for a Competitive Market Transmission Pipeline would be known as an Access Arrangement (Competitive Market).

If the Regulator determines that the Service Provider does not meet the criteria listed below to qualify to provide Competitive Market Transmission Services, the Service Provider must submit a proposed Access Arrangement together with the applicable Access Arrangement Information for the Pipeline to the Regulator.

The criteria to be applied by the Regulator to determine whether the Service Provider will provide competitive Market Transmission Service and meet the market Benchmark Test will be those set out in Clause 6 of the Competition Principles Agreement and a requirement for the Service Provider to commit to the following attributes:

(a) conduct the business of a transmission service independently of a natural gas distributor or producer;
(b) operates its pipelines under an open access regime;
(c) the transmission service is provided from more than one producer, or basin(s) or sources of gas with more than one producer, or in the foreseeable future more than one producer;
(d) the transmission service is provided to market(s) with more than two end users;
(e) provides a non-discriminatory basis for service provision and tariffs;
(f) provides an open access billboard system to Tariffs, conditions of service, capacity usage, availability information and Transmission Service Agreements;
(g) provides for non-discriminatory trade in a users' spare capacity for transport services;

(h) the transmission service shall provide to the Regulator, interested parties and publish in an easily accessible electronic form, financial reports on the Competitive Market Transmission Service substantially in accordance with requirements of public companies.

Having determined that the Service Provider has complied with the above attributes and qualifies as a provider of Competitive Market Transmission Services, the Regulator will require the Service Provider to submit a "Base Commencement Tariff" which will be assessed by the Regulator. The Base Commencement Tariff shall comply with the following:

(a) the low volume scenario of throughput, with a weighted likelihood of probability by the weighted probable internal rate of return on a geared and ungeared basis;
(b) the medium volume scenario of throughput, with a weighted likelihood of probability by the weighted probable internal rate of return on a geared and ungeared basis;
(c) the high volume scenario throughput, with a weighted likelihood of probability by the weighted probable internal rate of return on a geared and ungeared basis;
(d) the weighted average internal rate of return brought about by the circumstances described in paragraphs (a) to (c);
(e) The Regulator shall have the Base Commencement Tariff and tariff proposal reviewed by an independent investment bank or merchant bank, acceptable to the Service Provider, who shall review and evaluate the proposal and advise the Regulator on the proposal;
(f) In considering the Base Commencement Tariff the Regulator shall assess the Base Commencement Tariff and use the advice of the adviser to determine if the Base Commencement Tariff is fair and reasonable and meets the requirements of the Market Benchmark test;
(g) The Regulator shall provide reasons in writing for any variation proposed to the Base Commencement Tariff and the reasons and decision of the Regulator shall be appealable by the Service Provider.

Upon a determination by the Regulator that the Service Provider meets the requirements of the Market Benchmark Test, the Service Provider shall submit to the Regulator, for approval, an Access Arrangement (Competitive Market) which defines all aspects of the Service Provider's on-going methods of compliance with the Market Benchmark Test criteria.

Note: a form of Access Arrangement (Competitive Market) has been developed and can be made available to the reader on request to PG&E Corporation. The draft takes the form of the Access Principles and Indicative Tariff Document for the PGT Queensland Pipeline, which are available at PG&E Corporation's Web site http://www.pgt.com.au/