FREE AND FAIR TRADE IN GAS:

HOW MUCH HAS BEEN ACHIEVED?

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1 Introduction

When people talk about the benefits of National Competition Policy they tend to focus on how reforms can contribute to lower prices and better quality service delivery. While there is much evidence to support this, the Longford disaster in September 1998 illustrated that the benefits are potentially much wider.

The $50 million Interlink pipeline from New South Wales to Victoria was opened shortly before Longford was immobilised, allowing natural gas trades between the two states for the first time. Implementation of the National Gas Pipelines Access Code (National Code), a centrepiece of NCP gas reform, was a critical factor underpinning the construction of this pipeline, as it created an enforceable right for the pipeline owners and gas producers to access the distribution networks in major markets like Melbourne and Sydney.

The Interlink allowed emergency supplies of gas to flow into Victoria from interstate throughout the crisis. This enabled hospitals to be supplied with gas, and also enabled pressure to be maintained in the Victorian gas network, averting a major collapse of the system which could have shut down gas supplies in the State for several months.

The National Code is an important breakthrough in creating more competitive gas markets as it gives customers greater scope to negotiate with a range of gas suppliers, knowing that it is possible to access a pipeline to carry the gas to the required destination. The added competition is pushing down prices of both gas and gas haulage services.

Although it is still early days, these developments offer the potential to expand the market for natural gas, fuelling the development of new pipeline proposals to link key gas basins with major markets. Some of these proposals – like the AGL-Chevron pipeline from Papua New Guinea to Queensland, and the Eastern Gas Pipeline along the south-eastern seaboard – are well advanced, with significant potential benefits for national and regional economic development.

These reforms – in the downstream sector – are bringing price reductions unimaginable a few years ago. For example:

- in Western Australia, transmission tariffs on the pivotal Dampier-Bunbury pipeline will fall by around 26 percent between 1997 and 2000 under a transitional price path;

- gas prices in the Pilbara fell by 50 percent following deregulation in 1995; and

- gas distribution prices in New South Wales are to fall by up to 60 percent in real terms between 1997 and 2000 under the AGL access undertaking accepted by the NSW regulator in 1997.

Shortly I will look at the gas reform program in more detail. Firstly, however, I should provide some background on the wider NCP program.

2 Background

The Commonwealth and all State and Territory governments adopted the National Competition Policy package in 1995. It encompasses a wide-ranging program of reforms to promote productivity growth and raise the real incomes of Australian households.

In short, the reforms are to:

- extend the reach of the anti-competitive conduct laws in Part IV of the Trade Practices Act (TPA) to virtually all private and public sector businesses;

- improve the performance of essential infrastructure through implementing reform packages in the electricity, gas, water and road transport industries; and establishing third party "access" arrangements for the services of nationally significant infrastructure;

- review and, where appropriate, reform all laws which restrict competition, and ensure that any new restrictions provide a net community benefit; and

- improve the performance of government businesses through structural reform; introducing competitive neutrality so that government businesses do not enjoy unfair advantages when competing with private businesses; and considering the use of prices oversight.

Because of the size of the package, implementation has been phased over several years. The Council assesses each government's progress in meeting its reform commitments at three stages of implementation: in July 1997, 1999 and 2001.

Governments agreed to implement the NCP package because they could see that the reforms could play a major role in enhancing the performance of the economy and the welfare of the community as a whole.

In simple terms, the idea of competition is that two or more producers competing for the same customers are more likely to think of ways to improve efficiency and offer consumers better products, cheaper prices, or both. This may occur, for example, through more efficient work and management practices, greater attention to customer demand and more dynamic innovation.

By lowering prices, competition can raise the real incomes of consumers. This directly improves people's material living standards and provides an impetus for economic growth and sustainable job creation. And by lowering input costs for producers, competition can make the difference between profitability and non-viability, particularly for businesses competing in export markets.

An important part of the NCP package was a comprehensive agenda for reform of major infrastructure covering the electricity, gas, water and road transport industries. The gas reform package has already been responsible for some important reform achievements in the gas industry:

- structural break-up or ring fencing of the old vertically integrated transmission, distribution and retailing monopolies;

- the national third party code for access to transmission and distribution pipelines was signed off by all Australian governments in November 1997. The implementation legislation has been passed in

all mainland jurisdictions[1], although it is not yet operational in all; and

- as noted earlier, we are seeing the beginnings of interstate trade in gas, with New South Wales supplying Victoria's emergency gas needs in the aftermath of the Longford crisis.

3 The Council's Role

The National Competition Council plays a number of roles in the gas reform process, three of which relate to third party access:

- firstly, the Council makes recommendations on applications under Part IIIA of the TPA to declare services provided by significant infrastructure facilities such as gas pipelines. For example, the Council received an application from Futuris in September 1996 seeking access to the AlintaGas high-pressure gas distribution system. The application was later withdrawn following negotiations between Futuris and AlintaGas.

- second, where a State Government wants to avoid the risk of declaration of services in its jurisdiction, it can apply to the Council for certification that an existing State access regime is 'effective' under the Trade Practices Act. Implementation of the National Code is following the certification route, with South Australia, NSW, the ACT, Queensland and Western Australia already having applied for certification. The South Australian regime was certified as effective by the Commonwealth Minister for Financial Services and Regulation in December 1998.

- third, the Council plays a number of ongoing roles under the National Code. In particular, the Council will handle applications for coverage of a pipeline – and revocation of coverage.

  The Council understands the need for certainty as to the likely coverage of new infrastructure and is available to advise investors on whether a proposed new pipeline would meet the coverage criteria. Alternatively, investors may seek coverage prior to construction of a new facility by adopting the Code's competitive tendering principles

[1] Tasmania does not yet have a natural gas industry.

for new pipelines, or by submitting an access arrangement for the pipeline to the regulator.

Conversely, revocation issues will arise from, for example, technological innovation and changing market conditions. The Council has just received its first application for revocation of coverage regarding a number of lateral pipelines in Western Australia, and will shortly run a public consultation process.

- finally, the Council assesses State and Territory progress in implementing competition reforms agreed by the Council of Australian Governments (COAG). The Council must deliver a report to the Federal Treasurer in June of 1997, 1999, and 2001, on progress by each State. This advice will form the basis of the Treasurer's decision to allocate three tranches of competition payments to each jurisdiction from these dates, totaling around $16 billion.

  As far as gas reform goes, the Council's future assessments will focus on two key issues:

  1. effective operation of the National Code, including the phasing out of transitional arrangements in accord with the November 1997 intergovernmental *Gas Pipelines Access Agreement*; and

  2. the review and, where appropriate, reform of all legislative and regulatory barriers to free and fair trade in gas, including barriers in the upstream sector.

4 The National Code

As I have already indicated, one of the central areas of gas reform is third party access at the gas transportation level, and the National Gas Pipelines Access Code has now been passed through legislation by all jurisdictions, although it is not yet operational in some States. The Council regards the effective operation of the National Code as an important second tranche assessment issue.

In short, the National Code provides people with a right to negotiate access to gas pipeline services on reasonable terms and conditions

approved by an independent regulator – with a right to binding arbitration to resolve disputes.

Customers can then buy gas directly from a gas producer or gas retailer of their choice, and purchase gas transportation separately from a gas pipeline company. The aim is to encourage competition between gas producers and retailers – which should result in better service provision and cheaper prices.

Under the national framework, infrastructure owners are required to submit access arrangements complying with the provisions of the Code to the regulator. Access arrangements must include reference tariffs for reference services (benchmark prices for standard services) which comply with specified pricing principles. Reference tariffs may be used to determine access prices or may serve as a basis for negotiation. However, the arbitrator must apply the reference tariffs in a dispute over pricing of a reference service.

The Council's primary function in this area at present is in considering certification under Part IIIA of the TPA of each State's application of the National Code. Once a regime is certified as effective, the relevant services are immune from declaration under Part IIIA.

South Australia became the first jurisdiction to have its access regime certified. This occurred in December 1998. The Council is about to make a recommendation on the NSW and ACT regimes to the Minister.

The South Australian certification process raised only a handful of substantive issues. This was to be expected as the Council examined the effectiveness of the Code in 1997 and recommended a number of amendments to ensure that it satisfied the certification principles. These amendments were all implemented, and included amendments to the pricing principles and the insertion of a wider appeals process. As such, most potential certification issues were addressed back in 1997.

The issues the Council is currently considering for each of the State certifications are essentially:

- whether State regulators are independent of all parties, including governments, and whether they have sufficient resources to fulfill their work. While the ACCC is the regulator for transmission pipelines in all States other than Western Australia, State bodies will regulate distribution networks in most jurisdictions. This has

required the establishment of new regulatory agencies in a number of jurisdictions.

- whether transitional arrangements for phasing in the National Code are consistent with the principles agreed by all jurisdictions in the 1997 *Gas Pipelines Access Agreement*, and have sound policy merit; and

- the implications of any derogations (modifications, variations or exemptions) from the Code for its effective operation.

The issue of *derogations* is of particular significance. In general, the Council cannot recommend certification in respect of services which are the subject of a total 'derogation' (exemption) from an access regime.

Where a pipeline service is derogated from a specific section of the Code, rather than the Code as a whole, the Council must examine whether the derogation alters the effectiveness of the Code as it applies to the pipeline service. This will be an issue the Council must consider in regard to the Queensland application of the Code, which contains a number of derogations affecting several existing and proposed transmission pipelines.

In particular, the Queensland Regime derogates, for a period, the application of the National Code's pricing principles (including the regulatory approval process) with respect to five transmission pipelines:

- Wallumbilla to Brisbane.

- Ballera to Wallumbilla.

- Wallumbilla to Rockhampton via Gladstone.

- Gatton to Gympie.

- Ballera to Mt Isa.

Under section 58 of the *Gas Pipelines Access (Queensland) Act 1998*, these pipelines may have their tariff arrangements approved – once only – by the Queensland Minister by gazette notice. The Minister-approved tariffs will remain in force until the revisions commencement date, when the tariffs become subject to the regulatory framework of the National Code.

Queensland's certification application argues that the derogations are necessary to protect the commercial interests of pipeline owners with regard to pre-existing access principles negotiated prior to the development of the National Code:

The Council is unable to consider that the National Code applies to the five affected pipelines in the same way as it applies to other pipelines in that the derogations alter a number of fundamental processes in the Code.

Instead, the Council proposes to consider whether the regulatory processes for the derogated pipelines – including tariff outcomes – provide a *reasonable proxy* for the National Code, and if not, whether discrepancies are significant.

In order to process the Queensland application, the Council has sought the advice of the ACCC – in its role as national gas transmission regulator – on whether the Queensland Regime as it applies to the five affected pipelines is broadly consistent with the National Code, and the extent to which any differences are significant.

The Council expects to shortly launch a public consultation process on the Queensland Regime.

5 Upstream Reform

With significant downstream reform now accomplished or in train, greater attention is being given to the 'upstream' sector. The Longford disaster illustrates that upstream monopoly structures have implications not only for gas prices, but also for the security of supply for one of our most essential services.

Australian gas markets were traditionally – and to a large extent, still are – characterised by highly integrated supply chains in each State supported by long-term exclusive contracts between producers, pipeliners and retailers. Consumers typically have had little choice but to buy a bundled package of gas and gas haulage services from a monopoly distributor supplied by other, 'vertically integrated' monopolies. It is difficult to assess the extent to which this structure has impacted on gas prices due to the lack of price transparency in the Australian market. It

is frequently argued that well-head prices in Australia are very competitive by international standards. But the same used to be said about electricity prices prior to reform, while gas prices reportedly fell by two-thirds in Canada after upstream gas monopolies in that country were disaggregated.

The National Code addresses some of the key barriers to competition in gas markets. Principally, by opening up the natural monopoly bottleneck of gas transportation to third party access, it has created the impetus for a number of new gas transmission pipelines, encouraging moves towards a national gas pipeline grid. Once major gas users are interconnected to two or more gas basins or gas suppliers, the scope for upstream competition becomes real.

But the introduction of more competitive structures in the upstream sector is also crucial, in that this would allow greater access by aggregators, pipeliners, retailers and consumers to a range of suppliers. In this sense, upstream reform is the 'missing link' to achieving cheaper gas prices and sustained growth of the gas industry.

That said, upstream reform is a difficult issue. Victoria's gas distributors, for example, have been locked into long-term contracts with a monopoly supplier, and this position is not unusual nationally. Perth, Adelaide, Brisbane and Sydney are other major markets which essentially rely on a single processing plant and a single transmission pipeline. This is one sense in which electricity reform has advanced ahead of gas reform. Several States now have competitive generators, and interstate trade between the south-eastern states is broadening options for supply at competitive prices. This evolving structure in electricity markets is creating greater scope to manage regional supply disruptions.

The Upstream Issues Working Group (UIWG), an intergovernmental group on which the Council is an observer, examined upstream gas reform issues in 1998 and recently finalised a report to COAG on its findings.

The report focussed on three key upstream reform issues:

- barriers to competition arising from acreage management systems;
- third party access to upstream facilities; and
- contractual and marketing arrangements.

The Council's focus in the area of upstream reform relates to its assessment role – specifically, in relation to regulatory reform.

The issue of legislative and regulatory barriers to competition arises in two contexts of the National Competition Policy framework. Firstly, the 1994 COAG agreement on gas reform requires the removal of legislative and regulatory barriers to free and fair trade in gas.

Secondly, clause 5 of the Competition Principles Agreement requires the review, and where appropriate, reform of all anti-competitive legislation and regulation by the year 2000. In short, legislative and regulatory barriers to competition can only be justified if:

- there is a demonstrated net public benefit, following an independent and rigorous assessment; and

- the objectives of the legislation can only be achieved by restricting competition.

In addition, jurisdictions must assess new legislation imposing barriers to competition against the same criteria.

These principles also apply, of course, to regulatory barriers to competition in downstream markets.

5.1 Acreage management issues

In the area of acreage management, the broad issue for the Council is whether the legislative framework – under the various State, Territory and Commonwealth Petroleum Acts – creates conditions for the issue of exploration permits that are conducive to competition. The kinds of issues here include the size and duration of permits, relinquishment and retention arrangements, the allocation criteria used when issuing permits, and publication of exploration data.

The Council accepts that there are issues of balance here. For example, if the size of permits is too small, especially for highly speculative sites, explorers may be reluctant to commit resources to exploration. But the danger of issuing large permits is that market dominance may be conferred upon the successful permit holder in the event of a discovery.

The UIWG report to Ministers highlights a number of critical issues in this area, including the need for greater transparency in acreage bidding

processes. The Group identified one necessary condition as being to ensure that details of winning acreage bids are published or made readily available to interested parties.

The Council would expect that any acreage issues identified by the UIWG – or identified at a later date – as regulatory barriers to competition be reviewed under the States' legislation review program. The Council would regard these reviews as important assessment issues. The Council is aware that a number of States have reviews in train of their Petroleum legislation and would expect that the principles endorsed by UIWG be reflected in the outcomes, unless an independent review panel finds that the costs of reform outweigh the benefits, and that there are no better ways to achieve the objectives of anti-competitive provisions.

5.2 Third party access to upstream facilities

Another potential barrier to competition is the monopoly ownership and control of upstream production facilities like gas processing plants, gathering lines, satellite stations and offshore platforms. Bottlenecks can arise in the gas supply chain where these facilities are uneconomic to duplicate – that is where there are significant economies of scale and/or scope.

The UIWG identified a need for progress on access to upstream facilities, and recommended the development of a set of best practice principles. APPEA is to draft the principles, which will then be considered by the UIWG, prior to a recommendation to the Minister. The Group noted that it would remain open to individual jurisdictions to take these principles further, through, for example, legislation to provide a basic right for third party access and binding dispute resolution. There are strong indications that some jurisdictions may adopt this option.

The Council is aware that South Australia's NCP review of the *Cooper Basin (Ratification) Act 1975* suggested that certain aspects of the Cooper Basin joint venture arrangements excluded third parties from the benefits of economies of scale in gas processing. The review suggested that regulated third party access be used to deal with this matter.

5.3 Marketing issues

The review of the *Cooper Basin (Ratification) Act 1975* also addressed the third area of upstream reform considered by the UIWG – the issue of marketing arrangements.

The review group found that separate marketing by the Cooper Basin producers is effectively precluded under the Act, and this is imposes restrictions on competition whose costs outweigh benefits. The review group recommended that these restrictions be removed.

The Council has held discussions with South Australia on an appropriate response to the review of this Act, and regards this as an important second tranche assessment issue

More generally, the UIWG report found that the present immaturity of Australia's gas markets would make *mandatory* separate marketing by partners in joint ventures premature at this stage. However, the UIWG also found that separate marketing would enhance intra-basin competition, and targeted this as the longer-term goal. In the meantime, it argued that the ACCC should continue to assess the actions of gas joint ventures on the basis of the public interest test, and that the ACCC should be mindful in its ongoing reviews of authorisations of the desirability of requiring separate marketing as soon as this becomes feasible.

As a possible sign of things to come, the recent ACCC authorisation of joint marketing provisions in the *North West Gas Development (Woodside) Agreement Act 1979* was limited to seven years due to indications that the gas market in Western Australia was evolving to the point where wider use of separate marketing may soon be in the public interest.

6 Retail Competition

Reform at the 'retail' end of the market is the final link in achieving competitive gas prices. The Gas Reform Implementation Group reported on this issue in February 1999, noting that retail competition is closely linked to upstream reform. For example, while a number of retailers have been granted licenses in NSW, some have reported difficulties in sourcing competitively priced gas. The problems include that the contestable end of the market is already under contract, and difficulties in acquiring competitively priced gas from producers.

The opening of the Interconnect pipeline and the Eastern Gas Pipeline will promote inter-basin competition and should enable retailers in NSW, Victoria and South Australia to purchase gas from alternative interstate suppliers.

But greater *intra-basin* competition is also necessary to address barriers to field sales of gas. This highlights the importance of the acreage management, upstream access and marketing issues I spoke of earlier.

One retail issue to have been drawn to the Council's recent attention is Victoria's Significant Producer legislation. A number of parties claim that the legislation imposes restrictions on significant producers in both the wholesale and retail markets, with adverse consequences for competition.

The legislation enacts anti-discrimination provisions requiring significant producers to sell gas on consistent terms to all purchasers. The legislation also limits the entry of significant producers in the retail market to customer sites using more than 500TJ per annum (about the largest 35 gas consumers in Victoria). The justification for the restriction appears to be an attempt to limit Esso-BHPP's ability both to place other retailers in a 'price squeeze' (by offering a retail price to customers that is low relative to the wholesale price offered to retailers) and to strategically target the customers of 'aggressive' retailers.

Esso-BHPP have argued that the legislation may have the effect of prohibiting legitimate price discrimination, forcing them to offer standard terms and conditions to all retailers, regardless of circumstances. The companies also argue that the legislation may have the effect of restricting competition and the development of interstate trade.

The Council is now seeking additional information from Victoria on the legislation. In particular, the Council is seeking information on the costs and benefits of the restrictions to the community, as well as evidence that the objectives of the legislation could not have been achieved in a less restrictive manner.

Other retail issues arise in the areas of franchises and the contestability roll-out.

6.1 Exclusive retail franchises

Exclusive retail franchises constitute an obvious barrier to retail competition, and jurisdictions agreed under the 1997 *Natural Gas Pipelines Access Agreement* to phase out existing retail franchises by 1 September 2001 (with the exception of a 10-year franchise for the Kalgoorlie-Boulder system in WA). Governments also agreed to restrict new exclusive retail franchises to a limited period and only for certain 'greenfields' projects. The Council regards this commitment as an ongoing assessment issue.

6.2 Contestability Roll-Out

Under the 1997 *Natural Gas Pipelines Access Agreement*, jurisdictions agreed to introduce full retail contestability by 1 September 2001 (1 July 2002 in Western Australia). The timetable varies across jurisdictions, with the roll-out occurring fastest in NSW, the ACT and the Northern Territory. Jurisdictions' timetables are affected by a range of factors including the extent of embedded cross-subsidies in transport tariffs that need to be unwound.

The Council understands that the roll-out program raises some practical challenges for jurisdictions, especially given the relatively short period of time remaining to complete the transition to full retail contestability.

For example, NSW notified the Council in March 1999 that it had amended its contestability timetable. Under the revision, access has been delayed by three months for around 2,600 medium sized customers and by twelve months for around 750,000 small customers.

The NSW Government argues that the change is necessary because AGL Networks – the principal gas distributor in NSW – has not yet finalised the necessary technical and procedural framework to handle a range of issues that arise in a fully contestable market. NSW argued that keeping to the original timetable could result in system failure and other serious problems, offsetting any benefits of introducing contestability at this time.

In addition, NSW noted that the revised timetable helps to address imbalances between the contestability timetables in gas and electricity markets. Full contestability is not proposed in electricity until 2002.

In general, the Council regards transitional arrangements as imposing delays in competitive arrangements, with the potential to impose price penalties on consumers who would otherwise be contestable at an earlier

stage. For this reason, the Council's approach has been that while an effective access regime may incorporate transitional arrangements in response to public policy issues, the arrangements should be phased out as early as possible.

The Council accepts that there may, in some circumstances, be sound reasons to revise contestability timetables. However, the Council will need to be convinced of the policy merit of such changes, and notes that any revisions should be consistent with the final date for transition given in the 1997 *Intergovernmental Gas Pipelines Access Agreement*.

7 Conclusion

The gas industry is undergoing dramatic change. To date, the focus of change has been on the transmission, distribution and retail sectors.

The early outcomes of reform have been impressive. An NUS International survey released in January 1999 revealed that Australia is now one of the cheapest gas suppliers to domestic consumers in the world, with only the fully deregulated markets of Canada and the UK delivering lower prices.

At the same time, recent privatisations in Victoria have revealed ongoing buoyancy and confidence in the industry.

But this is no time to rest on the achievements to date. There is obvious scope for greater competition upstream, and this is the key to achieving further reductions in prices. Recent trends indicate that the share of gas in Australia's energy mix has declined since 1995 from 18.2% to 17.7%, probably due to a more competitive electricity sector.

The opportunity for relative growth in the use of gas has been identified. Ongoing and serious reform – especially upstream – is the key to achieving this.