

Opening remarks

- Thank you for inviting me to speak to you today on the Australian Energy Regulator’s view of regulatory challenges facing the Australian natural gas sector. New national gas legislation and new institutional bodies – such as the AER – means that going forward there will be a new regulatory environment. This will present challenges but also opportunities to improve the regulatory process.
- For those in the audience not familiar with the AER’s role I will first briefly outline who the AER is, and the key timelines.
 - The AER is a constituent part of the Australian Competition and Consumer Commission (ACCC). It was established under Part IIIAA of the Trade Practices Act 1974 and operates as a separate legal entity to the ACCC.
 - The AER is to assume responsibility for the economic regulation of the energy sector on a national basis with the exception of Western Australia whereby the Economic Regulation Authority will continue to perform the function of economic regulator. The AER will assume these responsibilities from State regulators on a staged basis over the next two years. Currently the AER regulates the wholesale electricity market and electricity transmission networks in the national electricity market (NEM).
 - The AER is to assume its gas transmission and distribution regulatory functions on 1 July 2007, following passage of new gas legislation by the jurisdictions together with a new gas code, exposure drafts of which will be released in the near future. In the interim, the ACCC continues to regulate gas transmission pipelines, assisted by the AER, and the state and territory regulators continue to regulate access to gas distribution systems.
- The main responsibility of the economic regulator under the gas code is to approve access arrangements proposed by gas pipeline service providers. These set out the terms and conditions – including price – under which services will be made available to third parties. The regulator also monitors compliance with code provisions such as the ring fencing obligations and, if necessary, arbitrates access disputes.
- As the new national economic regulator for the sector with a new regulatory framework the AER is seeking to take a forward looking approach to continue to improve the quality of regulation. However, this will be a two way street. It will require better processes, trust and willingness to engage by both the regulator and regulated gas businesses if we are to make the most of the opportunities available under the new regulatory regime to improve the quality of the regulatory process.

- In my talk I want to outline some of the proposed improvements to the regulatory framework for the gas sector which have been signalled by the policy makers and which may be reflected in revisions of the existing gas law and gas code. I say “may” because we are yet to see the new legislation. I understand that an exposure draft may be released fairly soon. The meeting of the Ministerial Council on Energy on 27 October may shed more light on this.
- I will give my views on the regulatory challenges facing the gas industry and identify some associated opportunities.
- As the AER’s expertise and role is in the field of economic and access regulation, I will generally confine my comments to those fields and not refer to technical or safety regulation.
- I will also talk about how I see the AER its gas regulation role and its expectations about how infrastructure owners will need to participate in the regulatory processes if we are to achieve effective regulatory outcomes.
- To start with, however, I will briefly outline how the gas sector has transformed over the last decade or so, including developments in gas production, transportation and retailing.

Transformation of the natural gas market

- Since the introduction of gas reforms commencing with the *Free and Fair Trade in Natural Gas in 1994*, it is no understatement to say that the gas market has undergone remarkable growth and development.
- The natural gas industry has been transformed from a series of state-based vertically integrated businesses into an increasingly integrated gas market in the southern and eastern states, brought about by the structural separation of transmission and distribution activities and retail contestability.
- There is widespread agreement that the natural gas industry performs better today than it has done in the past and that a decade of reform has clearly benefited consumers and the broader economy.
- This growth has been, and continues to be, driven by new investment in gas production facilities, as well as pipeline infrastructure and competition in the retailing of natural gas. All segments of the gas supply chain are expanding.

Gas production is changing and expanding

- Australia has known gas reserves that are estimated to be capable of meeting domestic demand for more than 100 years at current consumption levels with many major established supply centres in the north west of Western Australia, in central Australia and off the coast of Victoria. Of course, some of this gas will be exported as LNG, but this statistic provides a useful indication of scale of resource available.
- One of the major recent supply side changes to the gas sector is the emergence of Coal Seam Methane (CSM) as an energy source. It is estimated that the reserves of CSM are 10 times greater than all the conventional gas reserves in eastern Australia

combined and has the potential to be a substantial source of gas in the future. CSM development is particularly significant in Queensland with significant corporate activity including major producer Origin expanding its Spring Gully facilities and now Santos announcing a \$606 million take over bid for Queensland Gas Company.

- At the same time reserves have declined in some of the older production areas such as the Cooper Basin and the Gippsland Basin.
- In response to changes in Queensland supply and demand, Epic Energy recently signalled that it may reverse the physical flow of the Ballera to Wallumbilla pipeline later this year.
- In Victoria, new, smaller fields are being developed off-shore.
- In addition to CSM, there are a range of other possible future supply options in Papua New Guinea, off the coast of Western Australia and in the Timor Sea.
- The changes to the gas production and gas pipeline industries reflect the growth in domestic demand for natural gas which has increased from 750 PJ in 1994-95 to 951 PJ in 2001-02 and is forecast to reach 1,747PJ in 2019-20. Production capacity has increased in a corresponding manner.

The size of Australia's gas pipeline network has increased

- As delegates will be aware, there has been substantial growth in the size of the gas pipeline network since the full commencement of gas industry reforms in 1997.
- In total, some 15 new pipelines and several spur lines have been constructed. This infrastructure includes the SEA Gas Pipeline, the Tasmanian Gas Pipeline, the Northern Queensland Gas Pipeline and Telfer Gas Pipeline. None of these pipelines is subject to access regulation.
- Meanwhile the distribution networks in the major cities have continued to grow and gas usage has expanded into regional Australia, mainly in Victoria, New South Wales and Tasmania.

Retail competition has developed

- The introduction of full retail contestability for all classes of gas users has also played a part in increasing demand for natural gas. Full retail competition has been introduced or announced in all states and territories with the exception of the Northern Territory. This has exposed incumbent monopoly retailers to competition and has expanded the scope for competition to drive innovation in products and services.
- The unleashing of commercial and competitive pressures has encouraged separate gas and electricity retailers to converge into energy retailers offering bundled products and services. In total there are around 15 businesses operating in the small customer retail market. This is in contrast to the previous state and territory monopoly gas retailers.

The gas regulatory framework

- The gas reform program has accommodated and facilitated the transformation of the industry. Importantly, new players could have confidence that they would be able to gain third party access to existing transmission and distribution infrastructure on fair and reasonable terms and conditions.
- Perhaps not unexpectedly given their scale and complexity, there were some teething problems with the introduction of a new regulatory regime in 1997 and the period since is peppered with tensions between regulators and pipeline businesses over regulatory outcomes.
- The threshold issue for regulation under the gas code is whether an individual pipeline is covered as this determines whether it is subject to economic regulation. The gas code sets out a set of criteria that must be met for a pipeline to be covered and the means for coverage to be revoked if the criteria are not met. However, when the gas code was implemented in 1997 all major, and most minor, existing natural gas pipelines were automatically covered.
- Since then, coverage of 14 of these pipelines has been revoked following application of the relevant criteria. In retrospect, it seems clear that too many pipelines were subjected to regulation in 1997.
- The investment in pipeline infrastructure I mentioned earlier has provided increased competition between basins which has placed more competitive pressure on some gas transmission services. This can reduce the need for regulation. For example, competition from the Eastern Gas Pipeline was a major factor in the Minister's decision that the Moomba to Marsden section of the Moomba to Sydney Pipeline (MSP) no longer needed to be covered; and competition from the SEA Gas pipeline was a major factor in the NCC's recommendation that the Moomba to Adelaide Pipeline System (MAPS) no longer needed to be covered.
- For those pipelines that are covered, the most important consideration is the level at which reference tariffs are set. These are generally set by adding together the regulatory building blocks of return on capital, depreciation and non-capital costs to give total benchmark revenue, which is then divided by forecast demand to calculate the reference tariff.
- As pipeline businesses are very capital intensive, the key determinants used in setting tariffs are the size of the regulated asset base – referred to as the capital base in the gas code – and the rate of return.
 - The initial setting of the capital base is the most crucial single aspect of tariff setting. It is a one-off process. Once set, the capital base can be rolled forward at the start of subsequent regulatory periods by adding capex and removing depreciation, but it can't be redetermined from the ground up. So, for a given pipeline, the main focus is on the setting of the initial capital base when it first becomes regulated, but that focus then falls away.
 - On an on-going basis, the focus is on the benchmark rate of return.

- Since 1997, the initial capital base has been set for almost all the pipelines that are still covered. The exceptions are four Queensland pipelines that are subject to derogations from the gas code by the Queensland Minister, part of the Moomba to Sydney pipeline which is still under appeal and the Dawson Valley pipeline which only recently became covered.
- Looking forward, whilst the values attached to the metrics composing the weighted average cost of capital will be an ongoing issue, there is now I think a level of common ground about the methodology for setting the rate of return. Additionally, the recent MSP decision of the Full Federal Court has clarified the nature and scope of regulatory discretion. This should provide greater certainty to regulators and industry about what aspects of a regulatory decision would provide grounds for appeal. I note however that the service provider has sought special leave to have that decision reviewed by the High Court.

Improvement to the gas access regulatory regime are on the way

- The gas industry played a leading role in the debate of the past few years about regulation and infrastructure which led to major reviews of regulatory policy. In the gas industry there has been the Productivity Commission Review of the Gas Access Regime followed by the Expert Panel on energy regulation generally and broader consideration by policy makers of regulatory consistency across gas and electricity distribution.
- The new regulatory framework for gas will incorporate the MCE response of 9 May 2006 to the Productivity Commission Review of the Gas Access Regime and the MCE's response to the report by the Expert Panel. These outcomes will be contained in the draft legislative package of the proposed National Gas Law and related rules which, as I said earlier, is expected to be released soon for public consultation. It is intended that all State Parliaments will consider this legislation by mid 2007.
- What is publicly known is that there will be some considerable changes to the gas access regulatory regime. Firstly, the coverage test for gas transmission and distribution pipelines will be aligned with the coverage test in Part IIIA of the *Trade Practices Act 1974*. This will increase the threshold test for coverage of a gas pipeline and reduce the test for revocation.
- There will be a new light form of regulation, involving ring fencing and information disclosure obligations as well as access dispute resolution measures. This will be an alternative to an access arrangement with a reference tariff approved by the regulator.
- The test for determining the application of the light form of regulation will be prescribed in the national gas legislation and the Australian Energy Markets Commission (AEMC) will apply the test in consultation with the AER. This assessment will occur at any time (and take effect at the end of an access arrangement period) for a pipeline that is already covered, and prior to the submission of an access arrangement for a newly covered pipeline.
- The scope of gas pipeline regulation will be further reduced by measures to remove greenfield pipelines from regulation. There will also be the regulatory option for new pipeline proponents to seek a binding ruling that a pipeline does not meet the

coverage test. If a pipeline is found not to meet the coverage test, the exemption from coverage will remain for 15 years after the pipeline commences operation, irrespective of whether market circumstances change.

- An exemption from price regulation for international greenfield transmission pipelines will also be introduced. These pipelines would need to originate in another country and bring gas to Australia from outside of Australian territory and not be covered by an existing access arrangement.
- In relation to regulated pipelines, new time limits for regulatory decision makers are likely to be introduced and would be consistent with the recommendations of the Council of Australian Governments agreement on a national approach to the regulation of significant infrastructure. Gas access decisions will have to be made within six months, subject to stop-the-clock provisions to deter gaming, with one two month extension of time available. The merits review body, the Australian Competition Tribunal, will also be subject to a six month time limit.
- To enable the AER to undertake its regulatory functions effectively, the gas framework will confer on the AER information gathering powers and will make provision for the issuance of information guidelines to the gas industry.
- The gas reforms will also revise the operation of the merits review process for gas regulatory decisions. The new criteria include strict time limits for decision making and an option for the Tribunal to either re-determine a matter or to send complex matters back to the original decision maker for re-determination. This model also is to be applied to the electricity industry. The Tribunal is to be the merits review body for the electricity and gas industries.
- In aggregate, these changes should make a substantial contribution to the operation of economic regulation of the gas industry through reducing the scope of regulation, allowing for the correction of regulatory error and fostering a better environment for pipeline investment.
- Another important part of the MCE reform agenda is the development of a National Gas Market Development Plan by industry representatives through the Gas Market Leader's Group. The Plan is an ambitious and positive attempt to develop and improve the operation of Australia's gas wholesale and retail markets. The Plan has been released for public consultation. The AER has been and will continue to follow the important work of the Gas Market Leaders Group.

Specific AER/APIA issues

- The AER consults with APIA on a range of matters. This includes a planned on-going series of meetings at staff level to discuss regulatory issues which commenced in March 2006.
- The AER also consults with individual members of APIA who are service providers under the gas code about their regulatory obligations. Access arrangement reviews are typically held every five years and involve extensive consultation with the service provider and interested parties. Ring fencing compliance assessments are carried out annually and generally involve a more limited amount of consultation. In addition, some pipelines have annual CPI-X tariff adjustments that require some liaison.

- The development of the Draft regulatory reporting guidelines for gas pipeline service providers is an example of extensive consultation with APIA and its members. The guidelines are designed to provide assurance to the regulator that service providers are meeting their regulatory accounting obligations under the gas code.
- The ACCC released its draft guidelines in May 2004 for consultation with industry and other stakeholders and after considering submissions held a roundtable discussion in September 2004. APIA expressed a number of concerns about the draft to the AER and subsequently developed its own version of the guideline to be implemented by its members on a voluntary basis.
- Earlier this year the AER advised APIA that it had decided not to finalise the draft guidelines at that time. The process is now on hold while the gas and electricity regulatory frameworks are being revised.
- The AER has also consulted with APIA about the further development of the Access arrangement process guideline which was released by the ACCC in December 2005. The purpose of that guideline was to outline the process the ACCC and AER will employ to make timely decisions when assessing proposed access arrangements. Further development of that guideline will also await finalisation of the new regulatory framework for gas pipelines.
- More broadly, there has been a dialogue about information provision. The AER has consistently expressed the need to have access to adequate and timely information to inform best practice regulatory decision making. I am pleased that this need is recognised by members of APIA – I note that Mick McCormack acknowledged this requirement at a recent CEDA lunch at which we were both speaking.
- The AER considers APIA to be an important stakeholder body and looks forward to effective engagement on gas regulation matters.

Regulatory challenges

- From the AER's viewpoint, the main regulatory challenges in the natural gas sector will come from bedding down the new regulatory regime and revised institutional arrangements, and preparing for the transition to the national regulatory regime in general has been a major focus of our agency.
- The MCE announced recently that it now expects that 1 July 2007 will be the implementation date for various changes including the transfer of economic regulation of gas transmission and distribution systems to the AER. The AER is working to this timeline.
- This will require that all jurisdictions pass the new gas law. The MCE will consider this draft legislation its meeting on 27 October after which the exposure draft of the new national gas law is expected to be released for a six week period of consultation.
- The new legislation will include transitional arrangements to smooth the introduction of the new regime – for example, to ensure that regulatory processes can be undertaken without disruption due to the transfer of

responsibilities to AER. Nonetheless, the AER will face a range of administrative issues in taking responsibility for the regulation of distribution networks and this is a serious body of work. We are working with the jurisdictional regulators on a range of handover matters.

- The AER will also have responsibility for regulation of the retail sector, other than for pricing. This role is due to pass to the AER from January 2008, but the detailed framework is not yet known. Governments have agreed that retail gas and electricity price controls will be phased out as workable competition grows in that sector.
- **Opportunities**
 - While there are still challenges facing regulation of the natural gas sector in Australia, in my view there are many positives.
 - After various reviews of access regulation and of the gas access regime in particular, the period of uncertainty is almost over, with the new arrangements due to be implemented in July 2007.
 - The new regime and institutions will provide collective Governments' response to earlier concerns within the sector regarding aspects of regulation—this provides the opportunity to make a new start.
 - We also now have more guidance in terms of precedents from the Courts and the Tribunal about how the gas code should be interpreted and about the nature of the regulator's discretion
 - Almost all initial capital bases have been set.
 - As the network grows there is more competition which can lead to less prescriptive regulation. Fourteen pipelines have had their coverage under the gas code revoked
 - The scope of regulation will be reduced with the introduction of light-handed regulation, 15 year no-coverage rulings for greenfield pipelines and exemptions for international pipelines.
 - Convergence can be reflected in consistent regulation of electricity and gas transmission and distribution.

The Australian Energy Regulator's approach to regulation

- The AER wants a cooperative relationship with the gas industry as a means of ensuring quality regulatory outcomes. We understand that there will always be some asymmetry of interests, but given a new gas regulatory framework and a fresh AER approach we are looking at better regulatory processes. If the AER and industry are unable to develop professional, trustworthy relationships then this will increase regulatory costs and lead to delays in regulatory assessments.
- During this transition period the AER has been careful not to let its processes get ahead of the MCE's policy development. However we have already committed to:

- Not revisiting regulatory decisions by our predecessors once the AER assumes all of its gas industry regulatory functions.
- Not putting regulatory processes on hold if coverage is being disputed. Rather we will continue with the regulatory process if it is effective to do so and seek the support of infrastructure owners in ensuring regulatory work continues to progress pending the resolution of coverage issues
- As the reform program progresses, the AER will also clearly indicate its view on key issues and consult before it implements any changes to its regulatory approach. As the AER becomes more established we will consult and issue new guidelines on a range of issues such as the transition to the AER's role in distribution regulation. We are already advanced in some of these processes for the electricity sector.
- The AER has also sought to give effect to the spirit of the gas reforms in undertaking recent regulatory assessments.
- As I mentioned earlier, as an interim response to concerns about the timelines for decisions the AER/ACCC released the *Access Arrangement Process Guideline* late last year. This guideline was followed by the AER while assisting the ACCC with its Roma to Brisbane Pipeline access arrangement assessment. The draft decision was completed in a reasonable time of around four months, once all relevant information was received. The South West Queensland Pipeline assessment was more limited, and the draft decision was released within three months.
- It is the AER's view that the regulatory assessment process should be characterised by extensive consultation with the gas pipeline business prior to the lodgement of the relevant access arrangement to identify up front the major issues. This process was followed with success by the AER in the current reset for Powerlink, the Queensland electricity transmission business.
- Indeed, the AER seeks an ongoing relationship with regulated businesses outside the regulatory reset process. This is the best way to identify and resolve issues before the regulatory reset period commences and is a practical means of building understanding on issues.
- The AER will also engage in meaningful consultation, through industry roundtables with key stakeholders, on key regulatory issues such as guidelines to improve the quality of input into regulatory process and policy. This will of course include the APIA. As much as possible we want to eliminate the surprise element in regulatory decisions by announcing or at least signalling our policy or views ahead of the decision being made.
- A key aspect of the regulatory compact is provision of information. Quality regulatory decisions depend on adequate information. The regulator is entitled to that information necessary for decisions to meet the objectives of the gas code. This does not mean however that the regulator should be simply mining information for ill defined purposes. More clinical processes for the provision of information are necessary if we are to avoid costly delays and draft regulatory decisions that can have adverse commercial impacts on the regulated business.

- The regulator needs to be clear on what information is required and why.
- We are already well advanced in developing standard information templates for revenue resets and annual reporting in the electricity sector. We propose to do the same for gas. This will signal our information requirements well up front and allow business sufficient time to adapt data storage systems to meet requirements.
- The AER is hopeful the gas sector will respond positively to the request to use regulatory information templates as a means of providing timely information to the regulator. The AER believes that there is also room to improve the information disclosure framework by ensuring the accuracy of the data, the standardised presentation of the data and the certification of the data by a regulated business.
- The AER will be seeking to work with the sector to develop these templates to ensure that the regulatory process runs smoothly for industry, stakeholders and to meet the community expectation of timely regulatory decisions.
- Finally, I'd like to say something on rates of return.
- Industry in general appears to consider regulatory returns as insufficient. Financial market activity suggests otherwise.
- The sale and acquisition of regulated businesses, such as MurrayLink, GasNet and Allgas put these matters in the market place for its judgement. The price paid for each of these asset was 1.5 or more times the regulated asset value. Indeed, significant premiums over RAB are a common feature of acquisitions in the sector.
- I suggest that it is not possible for 'synergies' such as expected savings in operating expenditures to explain this occurrence. A more plausible explanation is that regulatory returns are being perceived by financial markets as high relative to risk.
- However, the AER believes that regulators need to be cautious at this time in moving from established positions in relation to the cost of capital for regulatory decisions.
- Once the new legislative framework is settled, the AER will need to determine an approach to reviewing the WACC elements in consultation with the sector and other stakeholders.
- The recent Roma to Brisbane Pipeline draft decision observed that policy makers are seeking to balance consistency and certainty in regulatory decisions with the need to allow for a degree of flexibility to recognise changes in financial market conditions and developments in finance theory and practice.
- In the draft decision for the Roma to Brisbane Pipeline each of the parameters that determine the weighted average cost of capital was considered in detail. The AER in reaching its conclusion on the cost of capital cited evidence that some of the parameters currently used to determine the WACC are above prevailing market rates. It was felt however that in view of the ongoing changes to the regulatory framework it was not appropriate at this time to change parameters for setting the WACC to better reflect market data.

- In the case of electricity transmission, the AEMC has proposed to 'lock in' WACC parameters for the next five years. The AEMC's proposal is that these parameters be reviewed by the AER at least 12 months prior to change.
- In this environment investors can expect on-going review of financial parameters for gas transmission and distribution businesses but that adjustments to financial parameters will be measured and incremental.

The gas industry continues to change

- Against the background of the ongoing energy reform program, the gas industry has continued to change and following years of restructuring and active merger and sale activity in the electricity industry, this year signifies a similar trend for the gas industry. Delegates will be aware of the AGL/Alinta asset swap and the purchases of GasNet and Allgas as well as Alinta's purchases of APT units. A fortnight ago Santos made a take over bid for Queensland Gas Company.
- The gas industry is clearly in the process of attempting to restructure to meet competitive and commercial pressures. Based upon publicly available information, the ACCC is informally reviewing a substantial number of gas industry related mergers and acquisitions.
- From the AER's perspective, the proposed mergers and acquisitions point to increasing industry consolidation of gas producers and infrastructure businesses.
- Consolidation in the gas production sector can be pro-competitive – it all depends on the circumstances. In any event the ACCC will assess proposed mergers for any substantial lessening of competition.
- Mergers between infrastructure operators tend to reinforce the need for third party access arrangements particularly given the increasingly interconnected nature of the pipelines in eastern Australia.
- These developments highlight the likely ongoing interaction between the sector and the regulator.
- My expectation is that governments are looking for improved regulatory outcomes. For the new gas access regulatory framework to be effective the gas industry and the regulator will need to work together in an effective manner.

Concluding remarks

- This transformation of the gas industry has benefited consumers and the broader Australian economy. This has been possible because the industry has been able to grow and develop against a background of reform.
- While the reform delivered benefits, calls for improvements to the gas access framework emerged and were a key driver for the wave of reform which is being progressed by the MCE. A study by ACIL Tasman determined that gas access regulation would contribute between \$200 million and \$1.1 billion to Australia's Gross Domestic Product over the next ten years from 2002-03.

- The current regulatory reform program and commercial changes in parts of the gas supply industry clearly indicate we are entering a new phase for the industry and it represents an opportunity for a clean start for regulators and infrastructure owners.
- Over the last year the AER has met much of the industry, government ministers and officials for the purpose of discussing the best way to implement and bed-down energy reforms. To provide further certainty in this area I have outlined in a broad sense the AER's approach to its gas regulatory tasks and indicated that the AER will also be seeking the support of industry to make the new regulatory processes operate effectively.
- I look forward to working with industry as we meet the challenges and seize the opportunities to improve the regulatory process and deliver quality regulatory outcomes.