The Australian Gas Association
ACN 004 206 044

4 November 1998

Mr John Cosgrove
Presiding Commissioner
Impact of Competition Policy Reforms Inquiry
Productivity Commission
PO Box 80, Belconnen ACT 2616

Dear Mr Cosgrove

The Australian Gas Association (AGA) welcomes the opportunity to comment upon the Issues Paper *Impact of Competition Policy Reforms on Rural and Regional Australia.*

The Australian gas industry has undergone considerable structural change in the 1990s, and reform of the industry initiated by the National Competition Policy launched in 1993 is continuing. As an active participant in gas reform process, the AGA believes it brings a valuable perspective to this inquiry. Please find enclosed the AGA's submission to the Productivity Commission's inquiry.

The AGA remains available to offer further comments or information, should the Productivity Commission have any issues it wishes to discuss.

Yours sincerely

Peter Dalkin

Peter Dalkin
Chief Executive

National Office
Level 3, 7 Moore Street, Canberra ACT 2600
GPO Box 323, Canberra ACT 2601
Telephone: (02) 6247 3955 Facsimile: (02) 6249 7402
Email: canberra@gas.asn.au URL: http://www.gas.asn.au.

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IMPACT OF COMPETITION POLICY REFORMS ON REGIONAL AUSTRALIA

Submission to the Productivity Commission

4 November 1998

Executive Summary

The Australian Gas Association (AGA) believes that National Competition Policy related reforms have the potential to deliver positive outcomes for natural gas development in regional Australia. Through promoting the growth of regional natural gas pipeline infrastructure through the 1990s, the industry has aided in delivering economic and environmental benefits to regional communities, including those facing declining services in other areas.

The benefits which natural gas pipeline investments can bring to regional communities can be further assisted by several means. Firstly, economic regulators established under the competition reforms must allow adequate rates of return, which are necessary for pipeline infrastructure expansion. Recent regulatory outcomes thus far have led the industry to question whether this expansion will be achieved. Secondly, competition could be enhanced by increasing the degree of regulatory certainty in the application of the National Gas Access Code. Another area in which government action could contribute to the delivery of the benefits of natural gas infrastructure to regional Australia is by reducing the delays in the pipeline approvals process.

Natural gas brings substantial economic and environmental benefits to regional Australia. However, measures taken in the Prime Minister's November 1997 Statement, *Safeguarding the Future*, particularly the mandatory two percent renewable target for power generation may have an adverse impact on the development of natural gas, and the wider economy. This being the case, the AGA would argue that such measures need to be scrutinised carefully for their economic and environmental effects. This is especially the case given the proven benefits of natural gas, which has major greenhouse benefits compared to other fossil fuels.

It is also important that governments recognise that energy market reform in the electricity sector has produced a decline in Australia's greenhouse performance. Government owned enterprises have created an oversupply of inexpensive power generation facilities, which have high levels of sunk costs. This has led to price outcomes for power generation that are unsustainable. Participation in the National Electricity Market by power generators that are still largely government trading enterprises has the potential to inhibit future competition from competing energy sources such as natural gas. This occurs principally by their distortion of pricing signals, through a perverse ability to operate at rates of return below that found in the private sector.

Distributional Effects of Gas Market Reform

Natural gas market development has significantly benefited regional Australia. The distributional impact of pipeline development undertaken mainly by private sector participants is overwhelmingly positive.

Natural gas pipelines in regional Australia are typified by long cost recovery profiles, low initial customer load, and a consequent reliance on returns based on investment in future market development opportunities. Competition arrangements have required that gas transmission, distribution, and retail companies are 'ring-fenced', rather than operate as vertically integrated structures. This means that at least two separate bodies are generally involved in the pipeline construction process and the local distribution of gas to residential and commercial customers. In most circumstances, it is the pipeline constructor who bears the cost of the low initial demand, and indeed it is likely that many recently constructed regional pipeline assets will make losses in their initial years.

The pricing structures adopted in regional Australia reflect, to a large degree, the need to compete with other energy sources. This has the effect of improving the competitiveness of existing regional enterprises, and encouraging the greater decentralisation of significant value adding industries. Reduced energy costs which natural gas delivers to regional Australia can thus serve important social, as well as economic and environmental objectives.

Enhancing Competition and Regulatory Outcomes

Competition in regional Australia will be enhanced markedly by increasing the degree of regulatory certainty in the application of the National Gas Access Code. The current level of discretion in the Code adds considerably to the compliance costs of the competition based model. It is important to note that only regulatory outcomes that deliver an appropriate rate of return for investors will continue to encourage the growth of gas pipeline infrastructure into regional Australia.

The recent ORG/ACCC decision to set the weighted average cost of capital at 7.75 percent for Victorian distributors does not provide sufficient incentive or scope to improve customer service quality, or pipeline networks. The rate of return offered may not meet potential investors internal hurdles for capital, leaving the gas industry limited in its range of investment sources. Moreover, customer savings which have been alluded to by regulatory bodies may be illusory. Regulatory decisions may limit the expansion of infrastructure and in turn the customer base, eventually leading to higher prices. Regulatory decisions ought to reflect not only the fact that different gas markets have unique features, but also that in international terms, no gas market in Australia can be considered a low risk, mature market.

The pipelines approval process is another area of concern to the gas industry. Currently, there is a complex pattern of State and Commonwealth legislation, relating to environmental and planning issues. A consistent national approach, based on a commitment to reducing the time required for the granting of State or Territory approvals would assist regional development.

An example of the unreasonable obstacles to pipeline development is the lengthy approvals process which followed East Australian Pipeline Limited's application for the 151 km Wodonga to Wagga pipeline. The pipeline route is mainly over agricultural land, or near regional centres that will benefit from the availability of natural gas. Applications for pipeline permits in Victoria and New South Wales were made on 4 April 1996 and 6 December 1995 respectively, while licenses were issued on 8 January 1998 and 1 October 1997. The eventual regional benefits of the Wodonga to Wagga interconnection are detailed in Information Box 1.

Gas Market Reform and Gas Supply to Regional Australia

An integrated and competitive gas market brings substantial security and reliability of supply benefits to both regional and metropolitan Australian communities. These benefits also relate to the price of natural gas supply, and in the greater availability of natural gas as an energy source to regional Australia.

Since 1973-74 the average residential price of natural gas has fallen by around one-third in real terms.[1] Over the same period, residential electricity prices have remained at approximately the same level. Importantly, prices for gas paid by commercial and industrial customers have also fallen in real terms over this period.

The competitive pressures which may emerge as a result of the 1997 Natural Gas Pipelines Access Agreement have yet to be realised. The fact is that many of the pipelines presently nearing completion have been planned and proceeded with on price and cost assumptions from the pre-competition era. However, the emergence of the capacity for third-party access to transmission and distribution pipelines can significantly enhance the potential for competition in natural gas markets. This competition will benefit consumers, as well as maintain the reductions in energy costs many regional industrial and commercial customers already enjoy through having switched to natural gas.

Competition is also expected to increase the availability, that is the quantity, of natural gas supply to regional Australia. Due to the extremely long lead times involved in major pipeline construction, the effects of competition policy reforms may not manifest themselves in the short-term. Significant expansion in pipeline infrastructure is planned for the future. The AGA has estimated that at present pipeline proposals totaling 11 000 km are under consideration.[2] These projects would have strongly positive regional effects. The pipeline projects identified by the AGA entail estimated investment of around $6 billion over the next several years.

Gas Market Reform and Alternative Energy

The AGA believes that environmental outcomes should be considered as a 'public benefit' issue under the competition reform agenda. This aspect is, at best, poorly understood by government. As a 'bridge fuel', the gas industry believes that natural gas will play crucial role in ensuring Australia meets its international greenhouse obligations in a cost-effective manner with minimal negative impacts on Australia's international competitiveness.

The AGA does not believe that the evolution of a competitive, national market in gas has operated to the detriment of alternative energy suppliers. Indeed, alternative energy suppliers are free from many of unreasonable regulatory obstacles which natural gas pipelines now face in their development, construction, and market development phases.

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[1] *AGA Gas Statistics Australia 1998*

[2] *AGA Research Paper No 8: Gas Transmission Pipelines: Development and Economics*

An important factor in the growth of alternative energy will be the two per cent renewable target introduced as part of the Prime Minister's November 1997 Statement, *Safeguarding the Future*. However its implementation is determined, it is estimated that this will lead to a growth in renewable energy of around twice the power generating capacity of the entire Snowy Mountains Hydro-Electric Scheme. This will have a considerable disruptive effect on the competitive energy market.

The report to the Victorian Department of Treasury and Finance *Mandatory Target for Renewable Energy in Power Supplies*, prepared by ACIL, NIEIR and Redding Energy Management, points out that the effect of mandating renewable energy will be to defer relatively carbon dioxide (CO_2) efficient gas fired power generators. The study makes clear that alternative approaches to emissions reduction, including a major emphasis on fuel switching to natural gas, would be far more efficient, at a cost far less to the overall economy. The major alternative approach to emissions reduction outlined in the study involves fuel switching to natural gas, increased energy efficiency measures, and the use of existing renewables. The study estimates the cost of the alternative approach, achieving the same emissions reduction, in welfare costs at $44 a tonne of CO_2 compared to $418 a tonne for the two percent renewable energy target.[3]

Thus it can be argued that this iniative, currently the subject of implementation planning, is a potentially costly distortion of competitive pressures within the energy market. Moreover, it does not represent a 'least cost' option to the Australian community.

Regional Australia: Business Costs and Locational Decisions of Major Energy Users

The process of gas reform, through improving the accessibility of natural gas as a clean, efficient and competitive energy source, has already influenced the locational decisions in favour of, and lowered business costs in, regional communities.

Natural gas pipeline infrastructure allows major energy users to invest in regional communities, and benefit from the economic and environmental advantages of natural gas. These are usually sizeable community investments, with substantial economic flow on effects in local employment. An example of the form of these benefits is detailed in Information Box 1.

In this respect, natural gas allows enterprises in regional Australia to compete more effectively with businesses located in major urban areas, encouraging the decentralisation of facilities of production and distribution.

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[3] *Mandatory Target for Renewable Energy in Power Supplies: A Report to Victoria Department of Treasury and Finance Energy Projects Division – June 1998*

Information Box 1- Regional Benefits of Wodonga to Wagga Wagga Pipeline

Assessment of the economic impacts of the expansion of gas supply in recent years to the Riverina and Dubbo/Parkes regions has shown a positive impact on regional economic development.

This has been tested in the case of the Riverina region, where natural gas was connected in 1993. Some of the benefits attributed to gas supply in the Riverina, for example, have been increased levels of employment and economic activity in existing industries, and the establishment of new industries. In fact, assessments have indicated that a high number of these new industries relocate in order to access cheaper energy. This in turn, reduces the growth of outlying industrial and commercial areas, which are placing an increasing environmental strain on Australia's urban areas.

Long-term economic benefits in the Riverina region would accrue from the reticulation of natural gas to the towns along the pipeline route, and there is scope for this to occur. Experience elsewhere suggests that potential large-scale users of reticulated gas could be attracted to the region based on access to gas, low cost land and labour, and existing transport infrastructure. For example, there is scope for the energy intensive food processing industry moving or expanding from Wagga Wagga along the route of the pipeline.

Lasting economic benefits will also accrue from the competition that alternative gas suppliers will foster, both for existing and new gas users in the region.

Finally, the local employment and economic effects associated with the ongoing maintenance of the pipeline and the operations of the associated compressor station will be noticeable and beneficial to the community.

Source: ACiL Economics and Policy Pty Ltd, Interconnection of Victorian and NSW Natural Gas Pipelines – An Economic Assessment, A Report to East Australian Pipeline Ltd, May 1996

Competitive Neutrality and Gas Market Reform

The aim of competitive neutrality is to improve economic efficiency and welfare by removing artificial advantages enjoyed by government business and exposing them to normal commercial requirements. A usual commercial requirement is for companies to deliver profits and dividends for their owners. In the energy market, the participation of corporatised publicly owned power generators has not operated in accordance with this principle. This has resulted in unsustainably low electricity prices acting as a disincentive to investment in switching to less carbon intensive forms of energy such as natural gas or renewable energy technologies. In this regard, it is noteworthy that carbon dioxide emissions from electricity generation increased 26 million tonnes over the period 1990-96, at a rate significantly higher then general energy sector emissions.[4] Government owned power generators do not appear to

[4] *National Greenhouse Gas Inventory 1996*

behave 'commercially', and this represents a significant distortion in the National Electricity Market. The current electricity market is delivering short-term price benefits to customers, but acts to the detriment of new energy investments, discourages energy efficiency, and is leading to undesirable greenhouse outcomes.

The development of a national market in electricity and interconnection between the States has revealed there exists significant over-capacity in power generation in both New South Wales and Victoria. These large power generation facilities generally have low costs, and because they are embedded assets there is an incentive for corporatised government agencies to offer electricity at below cost price. A result of this is that electricity consumers in Sydney and Melbourne now enjoy the lowest prices in the developed world, according to one recent survey.

The AGA is concerned that the effect of artificially low electricity prices, derived from a lack of a requirement to achieve a commercial rate of return on assets, will be to undermine future pipeline infrastructure development. One of the key drivers of pipeline developments are large industrial and commercial customers. As the Productivity Commission itself has recognised, large energy consumers have been able to benefit most from extremely low electricity prices. The AGA is specifically concerned that although electricity prices have reached very low levels, older government owned electricity assets have not been decommissioned because of political considerations relating to adverse employment outcomes. The current trend, if continued, would lead to continuing distortions in the national electricity market, a significant slowing in the rate of new pipeline development as well as the use of existing assets.