

9 February 2000

Mr Ed Willett
Executive Director
National Competition Council
Casselden Place
Level 12, 2 Lonsdale Street
Melbourne, Vic

Dear Mr Willett

Re: Request for an extension of time in responding to the Council's Issues Paper on the application for coverage of the Eastern Gas Pipeline under the National Gas Access Regime

Duke Energy International (DEI) appreciates the time that you and your staff have made available to us over the past two weeks to explain the coverage process under the *National Third Party Access Code for Natural Gas Pipeline Systems* (the *Code*). In particular, we note from our discussions the expressed relevance to the Council of certain information in the decision process. We understand that with regard to section 1.9 of the *Code*, the Council is likely to find information on the following matters pertinent to the final decision.

- As the process is currently structured, the decision to recommend coverage is, in effect, a recommendation that the pipeline be regulated under the specific provisions of the *Code*. Thus the basis for the current decision making process is a simple dichotomy: coverage and regulation (under the *Code*) against no coverage and no regulation under the *Code*. In this context the Council is particularly interested in information relevant to the criteria in section 1.9 that addresses the question of whether or not the pipeline should be covered by the *Code*.

We agree with the Secretariat of the Council that information pertaining to the question of whether or not to regulate is relevant at all stages of the decision process. However, as was discussed at our last meeting, the precise standing or influence of this information in the process is not well defined. This is an issue of some concern for us and, as will be discussed later, forms part of our suggested work program.

- Under the *Code*, the Council's decision making is constrained to making a recommendation to the Minister on the issue of coverage. This constraint does not prevent the Council from considering the ramifications of regulation under the *Code*, or to consider possible outcomes engendered by alternative regulatory processes.

DEI believes that to arrive at the institutional structure with the potential to produce the greatest net social benefits, the Council should consider the effects of the voluntary undertaking submitted under *Division 6 Part IIIA* of the *Trade Practices Act* to the ACCC by DEI. While DEI understands the Council's concern with the absence of a specific statutory provision that enables them to choose between coverage under the Code or regulation through *Division 6 Part IIIA*, we believe that a different approach can be adopted within the decision making process and our suggested work program is designed to accomplish this. The Secretariat indicated the Council might find information on this issue relevant to its decision making.

With respect to these two points, we make a general observation regarding the legislative structure under which coverage decisions are made. While DEI understands the interpretation of the Council under the limited decision tree imposed by the *Code* (coverage/regulation (under the *Code*) versus no coverage/regulation) we are not convinced this interpretation is either immutable or likely to deliver the most appropriate outcome.

A decision not to cover a pipe does not necessarily imply the absence of regulation – nothing prohibits the pipeline owner from voluntarily submitting an access arrangement or an undertaking. In this case the firm's (voluntary) commercial decision to be regulated is consistent with the economic rationale for regulation developed by Stigler¹, ie that market failure or monopoly are not the only reasons why both customers and suppliers may seek regulation.²

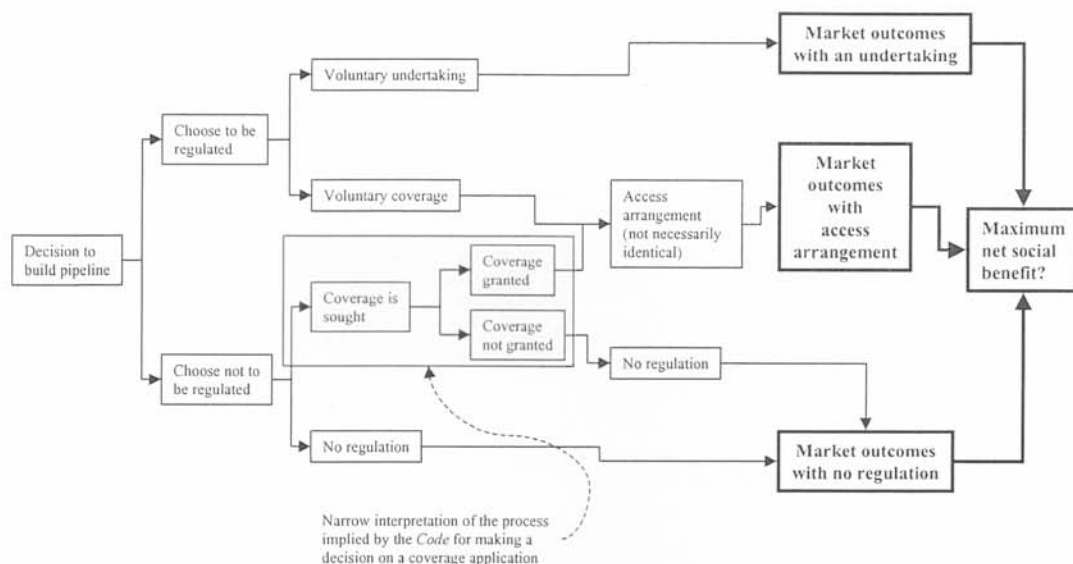
The Council will appreciate that the structure and process by which DEI reached the conclusion to pursue a voluntary undertaking was substantially different than what the Council will follow in making its recommendation to the Minister. In particular DEI, as a matter of commercial responsibility, focused primarily on expected outcomes under different institutional structures, necessarily concentrating our attention on not simply what could happen or what might be allowable, but rather on what is most likely to eventuate. Thus DEI believes the more appropriate decision tree is:³⁴

¹See George J. Stigler, "The Theory of Economic Regulation", *Bell Journal of Economics and Management*, 1971. An overview of the topic can be found in George L. Priest, "The Origins of Utility Regulation and the "Theories of Regulation" Debate", *Journal of Law and Economics*, 1993.

² Not the least of which may be that it is easier to capture a single regulator than deal with the entire market. However, there are also positive reasons such as the minimisation of transactions costs associated with contract negotiations. Firms voluntarily submit to regulation quite frequently – whenever the marginal benefits outweigh the marginal costs.

³ To keep the diagram simple we have not included the possibility that a pipeline may voluntarily choose to be regulated after having originally decided not to do so but then having had a request for coverage denied. As there are no provisions in the *Code* dealing with how further requests for coverage will be dealt with, a firm may choose to be regulated to avoid the uncertainty surrounding future coverage applications.

⁴ It is conceivable that an access arrangement submitted voluntarily would have different services and prices than one that results from a coverage process. Under a voluntary filing, the pipeline becomes covered *after* the relevant regulator approves the access arrangement. Presumably a pipeline owner, voluntarily submitting an access arrangement, could withdraw the application if the likely outcome is less beneficial than would result from no regulation. Thus the risks associated with voluntary and compulsorily submitted access arrangements need not be the same. The differential risk may translate into different prices and even services.



While it may have seemed that during our discussions, the Secretariat and DEI were at cross-purposes on certain issues, this is not necessarily the case. Ultimately we are both interested in establishing a commercial structure, with appropriate regulatory outcomes, that maximises the potential net social benefits of exchange in the gas market. Similarly we both agree that this will be best accomplished through the introduction and maintenance of competitive forces at all stages of the value chain.

To the extent that there has been some confusion in the debate, the underlying basis for this uncertainty reduces to a single factor. DEI believes the decision to either grant or deny coverage under the *Code* should flow from an evaluation of the expected welfare implications arising from outcomes engendered by different potential institutional arrangements (eg no regulation, an access arrangement or an undertaking). In our view the stated objectives of the *Code* provide the appropriate benchmark from which to test the different structures. While we note that the objectives, which are contained in the introduction, do not form part of the *Code*, section 10.5 provides the necessary scope for their inclusion in the decision making structure. In accordance with this section we contend these objectives and, more generally, those of National Competition Policy provide the context from which provisions of the *Code* must be interpreted. Thus, any evaluation of the criteria in section 1.9 should be undertaken within the context of these objectives.

The decision tree presented above raises some issues that will have to be resolved. In particular we note the following:

- The Council, in its Statement of Reasons for the Decision to Accept the AGL Application for coverage states that “the intention of the Gas Access legislation, expressed in the Explanatory Memorandum to the Commonwealth legislation, is to create a single process of coverage and access rather than a number of different schemes for access.” This would seem to indicate that the Council does not believe a pipeline owner has a choice to be regulated under *Division 6 Part IIIA*. However, as has been mentioned earlier, this is a matter where additional work may prove useful to the Council.

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- Assuming an undertaking remains a viable option, then this has obvious implications on the regulatory decision process for pipelines. Specifically, the process has to be structured so that relevant information about alternative institutional arrangements can be included in way that has direct effect on decisions made by the Council or the ACCC in relation to either coverage or undertaking applications.

With respect to the points raised by the Council in its Issues Paper we believe there are two significant areas where comments will provide potentially useful information to decision processes;

- Issues related to access, competition, efficiency and pricing; and
- The relationship between the undertaking and the *Code* with respect to the criteria of section 1.9.

These are areas of fundamental importance not only to DEI and the Council but also to stakeholders in the gas and energy markets as well the wider economy. To address these issues we propose a work program leading to:

- The preparation of a detailed comparison of the differences between the likely market outcomes if the EGP were covered under the *Code*, regulated under *Division 6 Part IIIA* through an access undertaking or in the absence of regulation. Specific and detailed attention will be paid to the:
 - requirements of section 8 in setting prices for new pipelines with significant excess capacity for the foreseeable future;
 - effect on prices and market growth from the risks and incentives imposed by regulation;
 - effect on incentives and market growth under different institutional arrangements; and
 - relevance of potentially restricting market outcomes for the sake of legislative and apparent regulatory consistency.
- A legal and economic analysis of why the undertaking is relevant to the decision making of the Council; and
- An economic analysis of the appropriateness of the legislative/regulatory structure in achieving outcomes that maximise net social benefits.

Because of its importance to the industry and the market, DEI, in association with East Australia Pipeline Ltd has agreed to retain Network Economics Consulting Group to perform the work outlined in the first bullet point (eg the comparison between the *Code* and the undertaking). DEI has retained Law and Economics Consulting Group to provide help with the analysis in the second and third points.

This is a significant work program that we hope will provide useful information to the Council in reaching its decision. The Council's deliberations on this matter represent an important decision for the future of the Australian gas industry and we believe the process will be enhanced by this information. However, the nature of the work as

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well as prior commitments by the consultants, means the analysis cannot be completed until mid-April. We therefore request an extension of time to make our submission until the close of business on 14 April.

We look forward to working with the Council in completing this program and arriving at a decision that maximises the benefits of exchange in the gas market.

Yours sincerely

Michael J McDanold
Managing Director
Duke Energy Australia Pty Ltd