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## MEDIA STATEMENT

*Address by Nevenka Codevelle, General Counsel and Company Secretary, APA Group to the ACCC/AER Regulatory Conference 2016, 4 August 2016.*

# **How should regulation address the possible market power of non-vertically integrated monopoly infrastructure?**

## **Introduction**

What I would like to share is a real world perspective on how commercial decisions are made and the impact of regulatory settings on those decisions. I'll stick to the industry I know best, which is gas transmission, although I suspect many of my observations may be equally relevant to other infrastructure industries.

## **So, what is the role of regulation?**

Regulation is but one tool in the tool box that we as a society have, to achieve desired economic outcomes. I would caution against defaulting to a view that regulation is the answer to solving all problems in all circumstances. It simply isn't.

Other tools include most obviously, Government policy, market design but also most importantly, commercial negotiation. The power of the market if left alone, even if not perfect and even if dealing with natural monopolies, to deliver better outcomes cannot be disregarded.

I don't think the question that we should be asking ourselves is "How should regulation address market power concerns?" Rather, the question should be "Which of the tools or combinations of tools in society's very large tool box, should we use to achieve the economic outcomes we are looking for?"

That inquiry must start by being clear about the outcomes we want to achieve. Typically, this is articulated in terms of economic efficiency.

The point though, is that market power is only a problem if, when exercised, it adversely affects the economic outcomes we (as a society) are after. In those circumstances, and only in those circumstances, should there be a follow on question, which is "Given the range of options available of which regulation is but one, how can the problem be fixed most effectively?"

## **Gas transmission as the case study**

In terms of topical industries at the moment, energy is right up there. Recent high electricity prices and concerns about back up for intermittent renewable generation have put the focus on gas as the transition fuel of choice as we move to a cleaner energy future.

This, at the very time that the three LNG projects at Gladstone are ramping up to full production, effectively trebling gas demand on the east coast in just a 3 to 4 year period. This of course has put upward pressure on the delivered price of gas with domestic prices increasingly reflecting LNG export netback pricing.

Government and industry stakeholders agree that what is needed is more gas supply and more gas suppliers. While the answer is simple, it is not easy. The unconventional gas production moratoria in Victoria and restrictions in NSW are cases in point that show the challenges in bringing new gas to production.

Now onto gas transmission. By and large, gas transmission pipelines are natural monopolies. The industry is not vertically integrated. It makes its money by selling capacity for the transportation of gas from production field to end user under

long term bilaterally negotiated contracts. The customers are wholesale gas suppliers, large miners and industrials and LNG producers. With a couple of early exceptions, transmission pipelines have always been privately developed, owned and operated.

Pipelines are regulated based on certain coverage criteria set out in the National Gas Law, which are largely consistent with the Part IIIA general access regime declaration criteria. There is a mix of unregulated, light regulated (essentially a negotiate/arbitrate model) and fully regulated pipelines.

### **So, how has this regulatory regime worked?**

The answer, on the whole, is "very well".

The industry's commercial success is critically linked to that of our customers. That means investing and innovating to give them the services they need now and into the future. It also means reaching agreement on commercial terms that work for both parties. It is simply bad business to insist on unreasonably high prices or other onerous deal terms that kill off projects or harm customers.

Here are some facts and figures for you:

- \$30 billion invested by the pipeline industry over the past 15 years – without any Government financial support.
- Of this, APA alone has invested some \$12 billion on acquiring and developing infrastructure, systems and technology including some 15,000 kms of interconnected pipelines. This has resulted in the creation of APA's East Coast Gas Grid – a transmission pipeline network linking all major east coast production basins to all major demand centres. Gas can now be moved seamlessly from any source of supply to any demand centre making basin on basin competition a reality.
- Global economic consulting firm, The Brattle Group, recently estimated direct quantifiable efficiency benefits to the market associated with formation of APA's East Coast Gas Grid since 2012 to be \$120m to \$150 million to date, and \$15m to \$32m annually going forward.
- Most significantly, notwithstanding a trebling of gas demand almost overnight, there have been no material pipeline infrastructure bottlenecks. Contrast this with the coal industry a decade ago where it was estimated that supply chain bottlenecks resulted in over \$10bn of lost export revenue.

When it comes to price:

- Gas transmission charges on the east coast have not increased in real terms since 2002, notwithstanding an increase of over 65% on the delivered price of gas.
- Tariffs are, by and large, out workings of competitive processes run at the time of project development with subsequent users effectively "piggy backing" off the tariffs negotiated by foundation customers.
- To put some perspective, gas transmission tariffs make up only 5 to 10% of the delivered price of gas for retail customers.

### **So what would the consequence be of more heavy-handed regulation for the industry?**

In short - less risk taking, less incentive to grow the market and less incentive to innovate.

At regulated returns, pipeline owners will take risk commensurate with those returns. The \$800 million South West Queensland Pipeline, which is the crucial link in the East Coast Gas Grid, simply would not have proceeded at the time at regulated returns, given the risks involved. It was committed to at the height of the GFC with considerable financing, construction and execution risk. The contracted tariffs and terms were arrived at following a competitive process and reflected the risks taken.

Similarly, at regulated returns, pipeline owners have little incentive to take a risk on building spare capacity in anticipation of future demand, or of agreeing to projects that may not otherwise be fully underwritten. Bringing together the East Coast Gas Grid pre-empted market demand for flexible and seamless services expected to be required for the LNG projects. That incentive to take risk and invest and innovate ahead of market demand would be diminished under heavy-handed regulation.

### **So how do we fix the market's problems?**

Government and stakeholders agree that the market needs more gas supply and gas suppliers. Ongoing pipeline investment and service innovation is critical to achieving this objective. Gas, once produced, needs to get to market.

Increasing the risk of heavy-handed regulation, such as the ACCC's proposed change to the coverage criteria, will undermine this objective. It is simply the wrong tool to use.

Rather, the tools in the tool box that are better suited to dealing with gas market challenges include first and foremost, Government policy. There is no substitute for getting these settings right.

Second, measures designed to enhance existing market mechanisms and let the market work better are to be encouraged.

The AEMC Gas Market Frameworks Review report was released last Thursday and contains a number of good market design initiatives. Improving transparency, liquidity and facilitating secondary market trading are examples of such initiatives.

It is only by working with industry in the design and implementation of market enhancing initiatives that better outcomes can be achieved. APA looks forward to continuing to play its part.

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#### **About APA Group (APA)**

APA is Australia's largest natural gas infrastructure business, owning and/or operating around \$19 billion of energy infrastructure assets. Its gas transmission pipelines span every state and territory on mainland Australia, delivering approximately half of the nation's gas usage. APA has direct management and operational control over its assets and the majority of its investments. APA also holds minority interests in a number of energy infrastructure enterprises including SEA Gas Pipeline, Energy Infrastructure Investments and GDI Allgas Gas Networks.

APT Pipelines Limited is a wholly owned subsidiary of Australian Pipeline Trust and is the borrowing entity of APA Group.

For more information visit APA's website, [apa.com.au](http://apa.com.au)