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## **NGPAC – Proposed Change to Gas Code for New Pipelines**

Hastings Funds Management (Hastings) is making this submission as a specialist infrastructure fund manager with extensive experience with regulation in Australia. Hastings has a 11.1 per cent equity interest in Epic Energy through its funds.

### **Introduction**

In February 2001, the National Gas Pipelines Advisory Committee (NGPAC) released an Information Memorandum which considers an amendment to the National Third Party Access Code (the Code). The amendment has been put forward by the Australian Pipelines Industry Association (APIA), on behalf of Epic Energy in the context of its proposed new gas transmission pipeline between Darwin and Moomba (the DMP). The proposal seeks to remove regulatory uncertainty on the basis that if an access undertaking is accepted under Part IIIA of the Trade Practices Act (TPA Act), the DMP will be exempt from application of the access regime of the Code for the duration of the undertaking. We note that this pipeline will bring substantial benefits of basin on basin competition and play a significant role in bringing competitively priced gas into the eastern-shore markets, where shortage of gas out of the Cooper Basin is becoming an issue.

Our submission relates to the fundamental problem arising from the ACCC's interpretation of the Code and the uncertainty this creates for new and existing pipelines. While we are not saying that the Code in its present form cannot provide the necessary result, we believe that there is a high level of uncertainty surrounding its interpretation by the ACCC.

In this submission, we demonstrate how the ACCC has 'shifted goal-posts' between reviews, leading to continuing regulatory uncertainty, loss of equity, a lack of demand for regulated assets, and a real hazard that new investment will be stranded because the ACCC has a track record of changing the rules ex-post. In light of this evidence, we argue that the Code must be amended so that Epic can successfully obtain an access undertaking for the pipeline.

As we stated earlier, we do not believe that the policy underlying the Gas Code is flawed although we are not convinced that the Code adequately deals with new pipelines. Further, we believe that the regulator's discretion in applying the Code is fundamentally flawed. As an investor, we need certainty that this discretion will not be abused. We invest in a number of regulated assets across infrastructure and in our experience, the ACCC has paid no heed to government policy as set out at the time of sale. It has overturned undertakings upon which assets were sold to private investors. It has ignored Commonwealth representations to restate these undertakings. Its conduct to date provides us with no certainty that capital invested in the DMP will not be at unacceptable regulatory risk. We are not prepared to accept this regulatory risk as we can invest in unregulated assets with better risk/return trade-offs (Hastings currently has a policy of not investing in regulated assets in Australia where the percentage of regulated revenues exceeds 50%).

To the extent possible, we have kept our comments to questions raised in the Information Memorandum.

**1. Are the reasons provided by APIA for urgently progressing this potential amendment reasonable?**

We believe that if the DMP access regime cannot be finalised quickly, the opportunity to develop the DMP will be lost. Customer demands to have gas supplies by 2004 require us to commit to the pipeline within the first half of this year. If the amendment relating to the access regime for the DMP is not finalised within the deadlines, the pipeline may not be built.

As an investor, we are prepared to take volume risk on DMP, however, we are not prepared to accept regulatory risk. A few examples of how regulatory risk has damaged investment in Australia will suffice to illustrate our point:

*Electricity and Gas*

When the gas and electricity businesses were privatised, regulation was executed on a pre-tax, real weighted average cost of capital (WACC) basis. Prices paid to the government were calculated on the premise that this approach would continue. Subsequently, the ACCC changed its methodology and moved to a post-tax approach. This approach was subsequently followed by the Office of the Regulator

General (ORG) in Victoria. As the revenue requirement for a business falls under the post-tax basis, businesses were effectively penalised for past investment decisions. Assets evaluated in a post-tax regime are under threat of being stranded since new investors, who will assume post-tax modelling in their valuation, would pay less than the initial investors, who modelled on a pre-tax basis. We see evidence of this trend in the sale of GPU PowerNet to Singapore Power last year, in which GPU suffered an equity write down of \$450 million over less than three years, primarily due changes in regulation during the three years. In addition, the failure of GPU to sell GasNet at the time of writing clearly demonstrates that there are few buyers in the market for regulated assets at anywhere near their previously assessed prices.

Another example of ACCC intrusion can be found within Epic Energy. Epic's Moomba to Adelaide pipeline is fully contracted for a term of four to five years. As such, there is no spare capacity on the pipeline for which a regulated reference tariff could be applied. Nevertheless, Epic has to submit a formal access undertaking to the ACCC under the Code. During its regulatory review last year, the ACCC not only reduced the rate of return that Epic would get on third party tariffs (if there were any spare capacity) but it also attempted to break the commercially negotiated contracts on this pipeline so that the market-determined tariffs could be reset by the ACCC. We find this kind of behaviour extraordinary.

### *Airports*

When the Australian airports were sold to the private sector, investors were forced to make critical assumptions on the extent to which major expenditures needed to develop the airports would be recoverable from airlines. These assumptions were incorporated into the bid prices for the airports. Consistent with bid business plans, Westralia Airports Corporation (WAC), the owner of Perth International Airport, applied for price increases to recover the costs of some 37 aeronautical projects. The ACCC released its criteria for reviewing new airport investment two and a half years later and subsequently approved only 12 of these projects, rejecting expenditure in respect of approximately \$6.4m of projects. These projects had to be funded from other revenue sources or cancelled, resulting in degradation of returns to airport shareholders.

Another example of the ACCC paying no heed to government policy is that at the time of the airport sales, the Commonwealth made clear representations to buyers

that airports would be regulated on a 'dual-till' basis. Subsequently, the ACCC turned over this policy for its pricing decision on Sydney Airport and adopted a corrupted 'dual-till' approach, by seeking to include aeronautical related revenues which it was only required to monitor under the Price Surveillance Act (PS Act) into the regulated aeronautical revenue of the airport.

### *Conclusion*

The main lesson to be learnt from current regulation is that the process is not transparent and there is a continual risk of procedural uncertainty. Since the ACCC has tended towards ever decreasing rates of return for regulated businesses, we must have perfect foresight of all future regulatory decisions to model cash flows accurately. Since it is quite impossible to do so, we would require an access undertaking that the pipeline's pricing parameters are set at the outset and not tampered by the regulator during the period of the undertaking. Without clear signals on pricing at the outset, we will not make an investment decision.

The NPGAC may be interested to note that we are also an investor in Melbourne Airport. Given the uncertainty of the overall investment process at airports which is overseen by the ACCC, we will now seek pre-approval from the ACCC on all investment prior to making any commitment. If we do not get an adequate response from the Commission, investment will either be restricted or postponed.

## **2. Could regulatory overlap cause problems for prospective Pipelines and deter or delay infrastructure investment that would otherwise go ahead?**

There is no doubt in our mind that regulatory overlap already exists. It has jeopardised the \$450 million investment made by Duke Energy in its Eastern Gas Pipeline. To explain in some detail, Duke Energy invested in this pipeline on the basis that they would negotiate terms with foundation customers and obtain an undertaking under Part IIIA of the TPA Act. In November 1999, Duke submitted an undertaking to the ACCC, proposing the terms and conditions under Part IIIA to provide access to the transport and other services of the pipeline. In January 2001, AGL applied to the National Competition Council (NCC) to have the pipeline 'covered' by the Code. If the Eastern Gas Pipeline was covered under the Code, Duke would be required to submit an access arrangement to the ACCC that met the requirements of the Code.

The example of AGL asking for the pipeline to be declared is a classic example of the ‘free-rider’ problem where businesses which have a vested interest in low tariffs will not negotiate tariffs with pipeline owners at the outset but would rather wait to have the pipeline built and then get it declared, because they believe that they would get more favourable terms through an ACCC determined access regime than through a privately negotiated contract with pipeline owners. The risk is exacerbated by the fact that the foundation customers who did negotiate tariffs at the outset would not want to be ‘out of the market’ and may want to renegotiate their contracts on the same basis as the regulated tariffs. Although the ACCC may argue that if it can achieve favourable terms for consumers, it is fulfilling its mandate, we would argue that such behaviour distorts investment decisions. It creates a massive risk for investors because there is no price certainty of tariffs, since the tariff can be changed by regulatory fiat at any point. We are not prepared to commit Epic Energy to such risks.

**3. Is it appropriate for the Code to attempt to remove the potential for regulatory overlap?**

We do not believe that there is any other option. The only viable solution to remove the risk of double jeopardy (that an access undertaking granted under the TPA Act could later be overtaken by a coverage decision under the Code) is to amend the Code so that it prohibits the NCC recommending and the Industry Minister deciding that the pipeline should be covered (ie., the exact situation currently facing Duke’s Eastern Gas Pipeline). Alternatively, the Code should provide that an access arrangement does not need to be submitted to the regulator for approval if an access undertaking under Part IIIA of the TPA Act is in effect.

**4. Does the APIA proposed amendment achieve its stated objectives? Are there any alternatives which could better achieve those objectives?**

There are a number of approaches that Epic Energy could follow with respect to third party access arrangements. However, as we explain below, none of these approaches fulfil our investment requirement of mitigating regulatory risk:

1. Epic Energy could file an access undertaking with the ACCC under Part IIIA of the TPA Act, essentially following the footsteps of Duke. In doing so, Epic

Energy exposes itself to the risk of being hijacked by customers who would get the pipeline declared and obtain a regulatory tariff on its spare capacity rather than negotiate tariffs with Epic at the outset. This risk is not acceptable to us. We would need a fixed tariff for new and foundation customers alike, for a considerable period to recoup the value of our investment.

2. Epic Energy could file an access arrangement with the ACCC under the Code. In doing so, Epic Energy exposes itself to five-yearly reviews. Without perfect knowledge of all cost of capital assumptions that the regulator would apply over the life of the project, we bear the risk of pricing in future regulatory assumptions in our returns which may or may not materialise. For example, if we assume that the regulator will determine a pre-tax real cost of capital of 7.75% for the pipeline at the first regulatory review, what certainty is there that this figure will be retained at the next review? All evidence indicates that the regulator can and has changed gearing level and beta assumptions to lower returns. To illustrate our point, the ACCC determined a pre-tax real WACC of 7.75% for the Transmission Pipeline of Australia (now GPU GasNet) in 1998. In August 2000, it recommended a WACC of 6.7% for Epic Energy's Moomba to Adelaide pipeline. In February 2001, it determined an (effective) pre-tax real WACC of 6.45% for the Snowy Mountains electricity transmission business. These precedents suggest that the WACC for GPU GasNet at the next reset will be substantially lower than 7.75%. GPU would have priced in an assumption relating to the regulatory WACC in its bid to the government. Clearly, if its assumptions are proven wrong by regulatory fiat, it would have to find other sources of funding, resulting in degradation to equity. As an investor in Epic Energy, we are not prepared to accept this type of unmanageable risk.

**5. Which option or options best meet the objectives of the Code?**

We accept that the Code is a well-designed policy instrument, and ideally it should be possible for new pipelines to be dealt under the provisions of the Code. However, as we have noted above, the regulator's interpretation of the Code causes us grave concern. We believe that the ACCC has abused its regulatory discretion and as long as we perceive a risk that it can abuse its mandate and usurp Commonwealth policy intent, we will not support Epic Energy investing in a new pipeline which could be exposed to regulatory change. Under these circumstances, the only option is to use a regime that appears to have a less prescriptive nature than the Code. In doing so,

we are not avoiding the ACCC. We understand that we have to satisfy the ACCC that Epic's proposed access undertaking satisfies the principles of the TPA Act. We are fully prepared to meet with the ACCC as investors, and discuss the regulatory arrangements which should be approved and binding upon all parties in advance of actual investment funding. However, as we have seen considerable volatility in regulatory decisions between periods, and our funding and investment requirements have a longer term, we will seek an access undertaking of 15 to 20 years. Only this period of regulatory certainty, without any re-openers would provide us with the certainty to invest in the DMP.

#### **4. References**

- National Gas Pipelines Advisory Committee, Proposed Amendment to the National Third Party Access Code for Natural Gas Pipeline Systems, Information Memorandum, 1 February 2001.
- National Access Code for Gas Pipeline Systems – Amendment Proposal, Epic Energy, 20 November 2000.
- ACCC Draft Decision on Epic Energy's proposed access arrangement for the Moomba to Adelaide Pipeline System, 16 August 2000.
- ACCC Final Decision on Transmission Pipelines Australia's proposed access arrangement, 6 October 1998.
- ACCC Final Decision on Snowy Mountains Hydro-electric Authority Transmission Network Revenue Price Cap, 7 February 2001.
- ACCC Draft Decision, Sydney Airports Corporation, Aeronautical Pricing Proposal, February 2001.