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EAST COAST GAS PIPELINES –
IS PRICE CONTROL WARRANTED?

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Key Points

- The ACCC says that pipeline operators are using this market power to derive excess profits, which in the ACCC's view leads to higher retail gas prices for Australian households, reduced profits to gas producers and inefficient investment incentives for producers to develop new sources of gas, i.e. perceived economic inefficiencies in downstream and upstream markets.

- During the period of the inquiry, east coast gas prices have been affected (and continue to be affected) by growth in demand for export LNG, volatility in oil prices (against which export LNG prices are pegged), and static domestic demand for gas, leading to shortages and higher prices for domestic users.

- The ACCC conclusion is based on anecdotal evidence, and the inquiry did not conduct a forensic investigation into prices, costs and profits, leading some industry participants to contest the findings that pipeline charges (rather than other market forces) have adversely affected household gas prices.

- The ACCC considers that current competition law does not address the inefficiencies they perceive, since they have concluded that east coast gas markets are competitive. The ACCC has proposed changes to the gas pipeline access regime because the ACCC considers that the regime does not adequately control what it considers to be excessive pipeline charges.

- In questioning the ACCC's conclusions and recommendations, this paper advocates: *first*, that further investigation be undertaken to ensure that competition policy development is based on solid empirical evidence concerning prices, costs and profits and on adequate analysis of the reasons for short term effects on domestic gas supply and prices; *second*, that appropriate consultation be undertaken before accepting the ACCC's recommendations that undermine the current focus of competition policy on competitive markets, and change the policy focus of the gas pipeline access regime from 'access' to 'price control'; and *third*, that adequate analysis be undertaken of the possible consequences of regulatory intervention that alters the balance of returns to gas producers and pipeline operators, since regulatory error in favour of one or the other is almost certain to impede overall efficient investment in the sector.

East coast gas pipelines – is price control warranted?

There is current pressure on gas supplies for domestic users in the east coast gas market arising from development of LNG export markets. It is reasonable to expect that, given flat projected domestic demand, producers will pursue growth markets overseas. It is also reasonable to assume, as the Productivity Commission suggested in its 2015 report on the east coast gas market, that domestic prices will tend towards net-back prices. While recent record low oil prices have adversely affected export LNG prices, the future cannot confidently be predicted, as witness the current oil price rally. In circumstances of increasing price volatility, the trend to short term contracts and increased uncertainty for users is a worldwide phenomenon.

In 2015, the Productivity Commission recommended against regulatory policy responding to short run market phenomena due to the risk that market forces would overtake the perceived benefits of regulatory intervention. The ACCC appears in its recent report to have come to the opposite conclusion. While the ACCC noted with approval the announcement of a new pipeline linking the Northern Territory gas fields to the east coast network, with completion expected in 2018, the impact on market dynamics needs to be considered, as does the impact of regulatory change on that and future decisions to invest in pipelines.

Based on the price analysis in the ACCC's report of its inquiry, it can be inferred that gas prices for households would be in a range of 11%-22% higher in areas of south east Australia as a result of excessive charges by pipeline operators. This requires further explanation, given that pipeline charges are only a small component of retail gas prices. More significantly, if LNG export prices are competitively determined, it would seem unlikely that pipeline charges could be passed on (or, if reduced following regulatory intervention, could result in a benefit to consumers). The ACCC report recognised this issue but expressed no opinion on it. Clearly this is a critical issue that requires further investigation, as it bears on the perceived need for regulatory intervention (i.e. if competitive pressure is transmitted from global LNG markets to domestic gas markets, that may effectively constrain the power of pipeline operators to affect gas prices) as well as the possibility of intervention having any effect whatsoever.

Importantly, the ACCC found that excess profits by pipeline operators are not associated with exclusionary conduct, and that there is little or no effect on the level of competition in upstream or downstream markets. That is, there is no infringement of competition law under the current 'purpose' test or the 'effects' test proposed by the Harper Review. The ACCC nevertheless argued that the public interest is harmed due to perceived adverse effects on the economic efficiency of upstream and downstream markets. In so far as this requires a judgment as to the distribution of economic surplus between e.g. producers and consumers, or between gas producers and pipeline operators, this is something that the Productivity Commission in its earlier report dismissed as too subjective. It also appears to change the ground rules of competition policy by imposing regulatory intervention even where markets are competitive and conduct is consistent with competition law.

The ACCC recommended a more interventionist access regime similar to the EU and US. However, the different contexts of gas markets in each jurisdiction need to be fully considered. The EU is a net importer of gas, whereas Australia is a net exporter. Our energy markets lack the scale and development of EU and US markets, which may well increase investment and regulatory risks here. While the US has long experience in competition law and policy, our own competition law is only 40 years old, and our regime for third party access to essential facilities dates back only 20 years – less than that in the case of our gas pipeline access regime. US energy laws regulate prices for pipelines using a fair and reasonable standard, which may well be responsible for current perceived under-investment in pipeline capacity. While Australia's gas pipeline access regime uses a cost-based standard, neither that nor the US approach fit well with the ACCC's proposed 'economic efficiency' standard. The policy implications of countering the trend in Australia of de-regulating price controls, by imposing controls on gas pipeline charges, need to be properly thought through.

The ACCC proposed that implementation of its recommendations be left to Australian Energy Market Commission, which is expected to consult further with market participants. However, in questioning the ACCC's conclusions and recommendations, this paper first suggests that further investigation is required to ensure that perceived need for policy change is based on solid empirical evidence concerning prices, costs and profits and on adequate analysis of the reasons for short term effects on domestic gas supply and prices.

Secondly, further consultation is required before accepting and acting on the ACCC's recommendations that effectively undermine the current focus of competition policy on competitive markets, and change the policy focus of the gas pipeline access regime from 'access' to 'price control'. It has been accepted, ever since the1993 Hilmer Review recommended a formal access regime, that the policy objective should be 'access' to facilitate competition in dependent markets, not to impose price control. That approach has been endorsed by the various Productivity Commission reports on gas markets in recent years. The ACCC recommendations, if implemented, would radically alter this policy setting.

Finally, adequate analysis is required of the possible consequences of regulatory intervention that proposes to alter the balance of returns to gas producers and pipeline operators, since regulatory error in favour of one or the other is almost certain to impede overall efficient investment in the sector.

About the Author

Dr George Raitt *is a consultant in the Melbourne office of the national law firm Piper Alderman, where he specialises in corporate and commercial law including competition law. George is also a chartered accountant. He is a sessional lecturer in the Faculty of Law at Monash University and currently engaged in research at Deakin University into market power.*