

Choose your path: the future for Australia's gas market

By Jeff D. Makhholm, Senior Vice President, NERA Consulting

Around the turn of the millennium, regulatory and judicial authorities confronted several forks in the road ahead regarding Australia's gas market. The choices they made forged the present reality in eastern Australia – an illiquid and opaque gas market with pricing problems and consumer discontent from Queensland to Tasmania.

In 1996, the Australian Competition Tribunal (ACT), in a highly contested case, rejected the Australian Competition and Consumer Commission's (ACCC) claim that anticompetitive detriments outweighed the original public benefits of producer joint marketing agreements.

As a result, the Cooper Basin joint venture continues to effectively dominate the sale of that gas through pipelines to Sydney and Adelaide.

In 1998, the Victorian Treasury, over the public objections of gas producers (whom I spoke for), borrowed from its recent electricity market design to impose 'market carriage' (a truly Orwellian label) on the Victorian gas transmission system with the privatisation of gas and fuel of Victoria. Market carriage socialised pipeline costs, dissolved pipeline capacity rights and created a regulatory barrier to gas shipments at Victoria's borders and deterred investment.

In 2001, the Australian Capital Territory, in another highly contested case, limited the ability of the National Competition Council (NCC) to recommend regulatory coverage for new pipelines, finding that the Eastern Gas Pipeline did not meet the National Gas Law criteria for coverage (I testified for the NCC in that case: we lost). The ACT set the bar for coverage so high that it effectively deregulated all new gas pipelines and set the stage for the subsequent removal of coverage from most other significant transmission pipelines.

These past choices – in isolation and surely unconsciously – undermined Prime Minister Keating's 1995 call for "free and fair trade in natural gas".

Each body, dealing with narrow questions at different times, would not have known the effect of their decisions on a broader competitive public policy. But the cumulative outcome of these choices, among others, created a gas market in eastern Australia beset with large-scale private arbitrations, a lack of competitive price discovery and barriers to competitive entry – not "free and fair trade".



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Today, Australian authorities face a new fork in the road ahead. Right now, the Australian Energy Market Commission (AEMC) is drafting reform recommendations to the Energy Council. This time, we all can anticipate the broader consequences of their choices, for we have a definitive international perspective on the possible paths ahead.

Since the last time Australia considered major regulatory change, the United States' (US) gas market has adapted to its competitive new regulatory regime to tremendous effect – embracing advanced technology to spur the entry of shale gas; tilting the competitive electricity generation mix away from coal; pouring investment into new competitive pipeline links; driving the competitive gas price away from oil prices – down to lows not seen since the 1970s (AU\$2/gigajoule).

Rather than Australia's patchwork of over- and under-regulation, the US chose to regulate broadly and fairly with a masterpiece of restraint: 282 federal employees in the gas division of the Federal Energy Regulatory Commission (FERC) and a 2015 budget of AU\$87 million – all in – dealing with licensing and ratemaking for three quarters of the world's gas pipelines.

The US system reflects a brilliant paradox – each interstate pipeline mile is, and has been for more than 75 years, subject to ultra-transparent licensing and skilful cost-based regulation of pipeline prices.

However, capacity rights in those pipelines trade among shippers in unregulated 'sublet' markets. Gas producers can reach any buyer on the interstate pipeline system simply by acquiring capacity rights at the going price – no regulator involved.

As such, simply reaching any interstate pipeline ends the competitive journey to market for producers, hence the veritable explosion in technologically driven competitive innovation and the financial industry capital to support it. And at the same time, US gas pipelines, with their federal licenses and regulated prices, are more profitable as a group than ever (certainly more so than their Australian counterparts). »

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European Union (EU) regulators chose an uncompetitive path, burdened by political and institutional endowments that inherently obstruct gas markets: sovereign internal borders; resistance to independent regulation or transparency; and protectionism for individual member-state ‘gas champions’.

While seemingly calling for competition, EU gas legislation has put a competitive gas market further out of reach. It forbids transparency, outlaws physical-path pipeline prices, interposes an EU-wide electricity market design and promotes an explosion of new regulatory intervention.

As a result, EU gas prices remain closely linked to oil spot equivalents (about AU\$5.64/gigajoule), new pipeline construction in Western Europe is the slowest in the world, US coal heads to Europe where it can compete, evident shale gas remains firmly in the ground, and the financial industry shows no interest in forming futures markets in the business.

The results for European gas consumers are terrible. Europeans

have paid a stupefying AU\$692 billion – yes, billion – more than Americans in the past six years for the gas that flows through European pipelines.

Those who observe Europe have reason to be dispirited. Europe’s institutional path dependency is a powerful force. It is hard to foresee the reform of that system anytime soon, despite the evident cost.

But Australia is not beset by the EU’s institutional baggage. It has reason to be hopeful as it faces the next fork in the road. The Federal Government, in collaboration with the states, could turn to a continental gas market regime that so evidently works, visible in North America now if not 15 years ago.

Such reform could rescue Australia’s gas market from its illiquidity and opacity, embrace regulatory restraint, invite the financial markets in, create competitive price discovery and pursue the type of competitive and technological dynamism regrettably lacking in Europe but on full display in the US. **P**

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