

Distribution 2001 Conference – Brisbane

**Address by
Greg Martin, Managing Director
Australian Gas Light Company**

“Energy Distribution – the issues ahead”

Good morning.

Today I want to explore some of the key issues facing distribution asset owners.

Well today, I am going to tell you a story about gas, but the message applies equally well to any utility service provider.

Back in the 1950's NSW had a wonderful gas market, in Sydney there were two gas companies, there was one in Newcastle, one in Wollongong, one in Goulburn, and a number of other regional centres.

Almost every home had a gas fridge, a gas copper, instantaneous gas hot water services in the bathroom and kitchen, a gas stove, and a gas heater in the living room.

Gas was the premium fuel, the distribution system was well run and the various companies that owned the systems were profitable. Yes, it was towns gas – not as good as natural gas, but it had been the fuel of choice for over 100 years and 80% of all homes used gas.

Let's fast forward to 1976, the time of the introduction of natural gas into New South Wales. By then, 20 years later, just 30% of homes in Sydney had gas and most had only one or two gas appliances in the home.

The country utilities were broke, the city utilities were almost broke, the distribution system was outdated the technology was old and supply was unreliable.

In 1986, now 10 years into the natural gas era, some things had changed for the better and others had not changed much at all.

Industrially gas had made a big recovery. New primary and secondary mains had been built to carry gas to industry but the domestic system hadn't changed much at all.

By then all the country utilities had folded and had been taken over for peppercorn sums as their networks were, in effect, worthless.

The two networks in Sydney had merged but they leaked as much gas as they sold and the community was still largely unwilling to recognise the benefits of natural gas.

So let me take you through some of the issues that almost saw the death of the New South Wales gas distribution business.

There were commercial issues, there are always commercial issues, capital was short, profits just weren't there and there was constant downward pressure on gas prices and upwards pressure on costs.

Returns were capped at 2% over the bond rate. I can assure you, with all the wisdom of hindsight, that 2% over the bond rate is not a good place to be!

At the local level we saw councils wanting to take profits from utilities instead of encouraging better services for their rate payers.

And then there was interstate political interference – The Victorian Government had effectively banned the sale of Bass Strait Gas outside Victoria. Cross border issues between New South Wales and Victoria effectively stopped natural gas coming to New South Wales.

So instead, AGL planned to build a pipeline from Moomba to Sydney, the East coast Pipeline Company was formed and had actually started the project.

Then in 1973 we saw the nationalisation of the Moomba to Sydney pipeline system. Our plans for the pipeline were completely derailed and we became a purchaser of capacity instead of a pipeliner.

Then we had to deal with a complex bureaucratic system, too much bureaucracy simply slowed the pace for new projects, so growth was slow even where we could afford it.

One has to question whether much has changed?

Then there was no national market and no national utilities. So one blessing was that we needed to deal with just one regulator.

Now we face many regulators, too many! It's almost as if regulation become an industry in itself. But even back then regulatory overkill was on the growth curve.

Together these problems produced a 10 year delay in bringing natural gas to Sydney due in part to competition from alternative fuels and commercial pressures but also due to the difficulties of dealing with an increasingly complex and bureaucratic political and regulatory system.

Who says owning and operating an energy distribution network is a risk free business!

So during the late eighties, the system just had to be restored or we were out of business, so at a cost of over \$350 million, we refurbished the leaky old system turning it around from the worst to the best of gas technology.

And then came another critical factor in the process of recovery. Around 1990 the NSW Government adopted incentive based regulation. This was regulation based on setting fair market prices for natural monopoly services.

So over a decade ago the NSW Government recognised the need to fund growth. The idea was to encourage utility owners to make their systems more efficient then share the benefits with both the owners and the customers. Surely one aim of regulation should be to reward success?

Now, once more we have a high level of regulatory complexity. As an example, for five years we have been trying to build a gas transmission and distribution system in the Central Ranges of New South Wales.

The approval cycle alone has cost us more than three years. Any sensible person would think, for \$120 million project in one small region of New South Wales that one set of rules and one regulator would be adequate.

Particularly as we should all be working in the interests of consumers who are desperately keen to get access to natural gas.

But we have the Federal regulator overseeing the high pressure pipeline system, and perhaps having to debate whether postage stamp pricing or distance based pricing is the most appropriate mechanism.

And while we have the federal regulator oversighting pricing, we have a state regulator to oversight the construction and operating protocols of the proposed pipeline.

And then we have the proposed new gas networks. Here we have a state based pricing regulator.

We plan to service 10 different cities and towns with the project. Without all the towns we have no project yet we run the risk of stranded assets should one or more of those towns prove to be uneconomic.

Alternatively Central Ranges could be treated as one regulated system we could treat the project as part of a state wide distribution system.

Which is the right way? Clearly the financial outcomes are different from all those scenarios and you can immediately see the added regulatory complexities – who should decide which works best? I believe it should be the proponent! the only real risk taker in the project!

So what are the lessons we learn, or should learn?

Good regulation should complement competition. The two must work together in the best interests of all.

There is a need for regulators to balance the short and long term run interests and demands of users. Too much emphasis on the short term can result in a lack of long term investment.

Investors have the right to expect to earn fair returns, so the level of returns that must take into account all of the short and long term risks ahead we must regain balance in energy regulation. I believe it is irresponsible to argue that returns calculated as increases in capital value to fully franked dividends, from funds invested in a vast portfolio of shares in hundreds of public

companies have any relevance to the complexities and risks involved of investing in a large new project or for that matter in the shares of just one public company.

So where do we go from here?

What we need is one clear, easily understood set of rules, fair to all without regard for fuel type or location and one, just one, national energy regulator – a dedicated single purpose regulator of a genuinely national energy market. Let's stop playing games between states and let's stop playing political games with energy.

Let's have instead a collaborative effort to make Australia more competitive, to foster and encourage profitable growth while at the same time protecting our environment and the values of our community.

And let's have long term certainty – with our current mismatch of rules and high levels of regulatory uncertainty can you imagine any company entering into a 30 year supply contract such as AGL did, to bring natural gas to Sydney in 1976, I can't!

So let me come back to gas and electricity distribution assets for a moment? What are they worth and how should they be regulated? Is it via some theoretical calculation, however soundly based, which becomes a regulatory starting point to calculate a fair price for transport charges.

Is it what the market will bear? Is it the value of the cash flows of the business based on its through put? Is it what someone else will pay for these assets? And what is the right price for transport? Who decides the right value for the electricity or gas to be delivered? Who decides the transmission charges and rules? Who decides the retail margin? In a competitive market, should anyone?

And who decides the final selling price for the energy delivered? Perhaps the market?

Is energy worth more to one buyer than another and who should profit if that is the case?

Who decides whether gas is more valuable than electricity, or coal than oil?

Lots of questions aren't there?

So let me be bold enough to set an agenda. Develop a new National Energy policy the last comprehensive policy was way back in 1991.

Encourage the Productivity Commission get on with completing its review of the 3rd Party Access Code for Pipelines.

I'm hoping for words like "access arrangements should encourage regulators to lean more towards facilitating investment than short term consumption of services when setting terms and conditions" and "a strong in principle case to 'err' on the side of investors".

No, I'm not dreaming, these were ideas aired earlier this year in the Productivity Commission draft review.

And speaking of investment just where does the responsibility rest to encourage investment?

Surely it is the role of the government to decide if it wishes to encourage investment, it isn't the role of the regulator.

Yet the post tax model proposed by the ACCC seems to have the effect of confiscating from infrastructure owners the benefits of tax incentives.

One may well ask is the federal treasury aware of the effect that the ACCC's post tax model has on the range of economic tools available to manage the economy?

An area of concern is the trend to highly prescriptive, intrusive and inefficient regulation, pushing up the costs of compliance. The cost of regulation must not outweigh the benefits to the community.

It also concerns me that the language of regulation has moved away from incentive based regulation aimed to provide a fair balance to those nasty words Rate of Return. This is where Australia was on regulation 20-30 years ago – are we really going back to the past – back to regulated monopoly systems?

The ACCC recently commented “Arguments suggesting that regulation is “chilling” investment are clearly motivated by a desire to earn the sort of pre-regulation returns enjoyed by regulated firms”.

I can assure you that AGL certainly doesn't want to go back to the old days when we were a regulated firm - earning “pre-regulated” returns. Let me assure you ACCC , we have never, never been “pre-regulated”.

And just what sort of regulation would I like to see? Let's look at a very simple model of how regulation might work.

The government sets the rules to ensure fair play. The players play the game. The referee keeps an eye on the games and the players to ensure fair play.

Too simplistic? Maybe so but we cannot, must not, allow our society to be so stitched up that it assumes everyone playing the game deliberately sets out to cheat! We don't need a corporate cop – all we need is a referee.

In general terms, if we can accept the fact that competition does actually work and surely it does in many other industries with light handed regulation, so why can't we accept that a free enterprise energy market will produce proper competition outcomes?

In summary, free markets work because competition works. Yes - the government target must be to keep energy prices down but not at any price and not where they or the regulators back winners.

Ten years ago we embarked on a journey from a restricted narrow view of the Australian energy market.

At the time AGL saw some things we didn't like, we were a monopoly and the Hilmer report threatened our cosy corner of the energy market.

But we also saw it gave us the opportunity to grow into a national energy company and I'm proud to say that, despite significant obstacles, we have.

But now, please, let's not lose the benefits that open competition has already demonstrated and will continue to do so.

So, what do we want? I think we'd all agree on; Efficient energy markets and competitive energy costs. A regulatory environment that nurtures innovation. Emphasis on end use energy efficiency. A Government focussed on environmental responsibility.

So how do we get it? Where competition can work then let it. When regulation is essential, then please make sure the focus is on efficiency and the regulations are simple to understand and simple to administer and use correctly targeted incentives to get the right outcomes. And that there's a constant focus on a fair balance for all the interested parties.

Thank you.