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Mr John Pierce  
Chairman  
Australian Energy Market Commission  
PO Box A2449  
Sydney South NSW 1235

16 March 2018



Dear Mr Pierce

**Re: AER submission to Draft Report: Review into the scope of economic regulation applied to covered pipelines**

The AER welcomes the opportunity to respond to the AEMC's draft report of its review into Parts 8-12 of the NGR.

Please find attached our submission to the AEMC's Draft Report.

We broadly support the AEMC's draft recommendations to improve the economic regulation of scheme pipelines, and the intention of the package to strengthen parts of the regulatory framework. This should lower prices and improve service terms and conditions for pipeline users and gas consumers.

We see merit in the AEMC suggestion of a review of the form and spectrum of regulation to which pipelines are subject. We consider such a review will supplement, and maximise the benefits flowing from the AEMC's improvements to scheme pipelines regulation. The objectives of such a review should be to ensure pipeline regulation is fit for purpose. This will ultimately ensure the long term-interests of consumers are met.

The AER looks forward to continuing to work closely with the AEMC on this review, in further developing the reform package in any way it considers helpful.

Should you wish to discuss any aspect of this submission, please contact Kami Kaur on (02) 9230 9163 or at [kami.kaur@aer.gov.au](mailto:kami.kaur@ aer.gov.au).

Yours sincerely



Cristina Cifuentes  
AER Board Member



# **AER submission**

## **Draft Report Review into the scope of economic regulation applied to covered pipelines**

March 2018

## Introduction

We thank the Australian Energy Market Commission (AEMC) for the opportunity to comment on its draft recommendations. We also appreciate the consultation the AEMC has undertaken in the lead up to its draft report, including releasing an interim report in October 2017, and holding a workshop with stakeholders in December 2017.

Persuasive arguments for the need to enhance the economic framework for scheme pipelines have been made by the Australian Competition and Consumer Commission (ACCC) in its East Coast Gas Inquiry 2015,<sup>1</sup> by Dr Vertigan's examination in 2016,<sup>2</sup> in the AEMC's East Coast Wholesale Gas Market and Pipeline Frameworks Review,<sup>3</sup> and the AEMC issues paper and position paper for this current review.<sup>4</sup>

Australia's domestic gas market is increasingly linked to the international gas market, causing tightening gas supply and increasing price volatility. Australia's gas market of the future needs flexible, affordable and accessible pipeline transportation to enable gas users to respond to the price signals in the market. The frameworks for regulating gas need to support this evolution and provide for the efficient investment in, and use of, pipeline infrastructure for the long term interests of consumers.

We broadly support the AEMC's draft recommendations to improve the economic regulation of scheme pipelines, and the intention of the package to strengthen the regulatory framework for scheme pipelines. This should lower prices and improve service terms and conditions for pipeline users and gas consumers.

In addition to any modifications that might result from the AEMC's final recommendations, we consider it will be important for the Australian Energy Regulator (AER) to update and review its arbitration guideline. We would propose to do this at the conclusion of this Review. This will support modification to the arbitration provisions in the rules, and ensure gas users and pipelines operators have a clear description of how the AER interprets the arbitration provisions.

There are specific recommendations in the package that we are particularly interested in continuing to work through the details with the AEMC, and these are set out in the **Attachment** to this paper.

## The overarching framework for pipeline regulation

The AEMC is currently seeking stakeholder views on the different forms of economic regulation that apply to gas pipelines, and the process by which a form of regulation applied to a pipeline is determined. We see this as a critical issue. The different forms of economic regulation that apply to pipelines set out in the National Gas Rules (NGR) are full access regulation, light regulation and the Information and Arbitration regime (henceforth referred to

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<sup>1</sup> ACCC, *ACCC Inquiry into the East Coast Gas Market*, April 2016, p. 110.

<sup>2</sup> Dr Michael Vertigan AC, *Examination of the current test for the regulation of gas pipelines*, 14 December 2016, p. 35.

<sup>3</sup> AEMC, *East Coast Wholesale Gas Market and Pipeline Frameworks Review*, July 2016.

<sup>4</sup> <https://www.aemc.gov.au/news-centre/media-releases/lower-prices-and-better-deals-gas-pipeline-users>

as Part 23) - a comprehensive overview of the existing regulatory regime is at Chapter 3 of the AEMC Report, and will not be repeated here.

In its draft report the AEMC makes recommendations that attempt to create a spectrum of regulation in terms of “strength”, from full regulation (most intensive form of regulation involving the AER as regulator who determines reference tariffs and assesses terms and conditions of access), to light regulation, to Part 23 (least intensive, where the AER is an administrator of this form of regulation).<sup>5</sup>

In 2016 the ACCC inquiry clearly articulated that the coverage test is not delivering outcomes that address market power.<sup>6</sup> This finding was also confirmed by Dr Vertigan’s subsequent examination of the coverage test for the regulation of gas pipelines.<sup>7</sup> Part 23 is an attempt to tackle the market power issue by imposing an information disclosure obligation on pipeline owners covered by the regime, and a commercial arbitration mechanism subject to strict timeframes. Part 23 has also resulted in near universal coverage of all pipelines by some form of regulation.

With the implementation of Part 23, we agree with the AEMC, that the question is no longer whether a pipeline is regulated, but which form of regulation applies to it (full access regulation, light regulation or Part 23). Part 23 attempts to address market power through increasing transparency and providing for a time constrained commercial arbitration. This can be contrasted with the historic architecture for pipeline regulation, which is largely focused on addressing denial of access by vertically integrated firms. We consider that given the changes in the gas market operating environment since the access regime was last reviewed, it is timely to consider whether in fact the historic architecture remains fit for purpose.

We therefore support a review focused on the overarching objectives of gas pipeline regulation to ensure that the layers of pipeline regulation are fit for purpose. The review should also consider whether pipelines can be appropriately designated to a form of regulation, which would require a review of the coverage test. Objectives of the review should ensure that the benefits of regulation outweigh the costs and that the regime of pipeline regulation does not lead to under regulation (insufficiently addressing the identified market failure that regulation is attempting to address) or over regulation (direct and indirect costs) – both of which result in higher prices for consumers.

Therefore, in addition to Part 23 being reviewed in 2019, we see merit, consistent with the thinking set out in the AEMC Draft Report, that COAG Energy Council develop Terms of Reference (TOR) for a review of the forms of regulation and the coverage test.<sup>8</sup>

While we consider a more fundamental overarching review of the regulatory framework and spectrum of regulation is required, the AEMC’s draft recommendations work to strengthen the existing regulation for scheme pipelines. We consider the package responds to stakeholders’ concerns with the current process for regulating scheme pipelines, in particular

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<sup>5</sup> AEMC Draft Report, p. 51.

<sup>6</sup> ACCC, *ACCC Inquiry into the East Coast Gas Market*, April 2016.

<sup>7</sup> Dr Michael Vertigan AC, *Examination of the current test for the regulation of gas pipelines*, 14 December 2016.

<sup>8</sup> AEMC Draft Report p. 40-47.

by making more information available, increasing the clarity and efficiency of the arbitration process, and by ensuring more effective reference services are identified.

We understand that some stakeholders have called for light regulation to be removed now.

Until this more holistic assessment and vision of the future of gas regulation is developed, the AER is of the view that light regulation should remain a form of regulation within the existing regulatory spectrum.

### **Information requirements for light regulation should be enhanced**

Both the ACCC Inquiry and Dr Michael Vertigan's Examination highlighted that information asymmetry is at the heart of market power and consequently, monopoly pricing. Information asymmetry gives rise to a power imbalance between shippers and pipeline operators in negotiations. Shippers are unable to identify the extent of market power because they do not have access to cost of service information. Shippers are therefore unable to assess the reasonableness of the tariffs and terms offered. Access to information levels the playing field and allows for more effective negotiation.

The obvious gap between the light regulation regime and Part 23 is in information disclosure. Part 23 requires pipeline operators to publish the information that shippers need to make an informed decision about whether to seek access to a pipeline service and to assess the reasonableness of an offer made by the pipeline operator. The publication and exchange of this information is intended to facilitate timely and effective commercial negotiations in relation to access to non-scheme pipelines.<sup>9</sup> Light regulation provides a limited amount of information for potential users. We therefore support the AEMC recommendations to improve light regulation for users by increasing information disclosure obligations.

While these changes bring light regulation and Part 23 regulation closer in terms of regulatory impact, the regimes still differ in critical respects, including their specific legislative objectives and the applicable arbitration framework.<sup>10</sup>

We also note that Part 23 has only just been introduced, and that its behavioural impact, price effects and regulatory costs are not yet clear.<sup>11</sup>

### **Arbitration for light and full regulation**

The ACCC Inquiry found that market power is not being effectively constrained by the threat of arbitration on scheme pipelines. It argued that shippers are discouraged from triggering the access dispute provisions due to:

- uncertainty around the potential costs and resources involved, and

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<sup>9</sup> NGR, Part 23.

<sup>10</sup> AEMC Draft Report, Table 3.2, p. 50.

<sup>11</sup> Part 23 was implemented in August 2017 without a Regulatory Impact Statement (RIS). Financial information disclosure will not commence until late 2018.

- uncertainty about the final outcome due to a lack of clarity around the methodologies relied on by the AER and information asymmetry between parties to the dispute.<sup>12</sup>

The negotiate/arbitrate model adopted in gas regulation, provides for arbitration by the AER in the event of an access dispute on a scheme pipeline. Chapter 6 of the National Gas Law (NGL) provides for the arbitration of access disputes by the AER, with a few small additional provisions on access disputes, outlined in Part 12 of the NGR. The AER has a non-binding guideline to arbitration of access disputes for scheme pipelines that was last revised in 2008.<sup>13</sup>

The AEMC has made a number of draft recommendations that clarify and strengthen the arbitration process for scheme pipelines, by outlining specific timeframes for negotiation and creating more certainty around the arbitration process. These changes will improve arbitrations under both full and light regulation.

While we are supportive of the direction of these draft recommendations the AER would like to engage in further discussion with the AEMC to ensure that these recommendations meet the objective of reducing uncertainty, and are achievable.

In light of the ACCC findings and at the conclusion of the AEMC review we consider it will be important for the AER to update and review its arbitration guideline. Our amended guideline will seek to address the key concerns raised by stakeholders such as minimising uncertainty, costs and time in the arbitration of an access dispute. The aim is to make the arbitration mechanism more accessible so that it becomes a more effective constraint on pipeline operators. This will support modification to the arbitration provisions in the rules, and ensure gas users and pipelines operators have a clear description of how the AER interprets the arbitration provisions.

### **Summary of the AER position**

We support the AEMC draft recommendation that the information requirements on light regulation should reflect those in Part 23. We caution against making other specific changes to light regulation as it currently stands, until a more comprehensive review of the forms and spectrum of regulation is undertaken.

We see merit in the AEMC suggestion of a review of the form and spectrum of regulation pipelines are subject to. The review could be undertaken at the time of the COAG Energy Council review of Part 23 in 2019, or at another suitable time.

Consistent with the submission to the AEMC issues paper we made last year, we support changes to the arbitration framework to increase certainty and provide clarity on timelines for arbitration to all scheme pipelines.<sup>14</sup>

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<sup>12</sup> ACCC, *Inquiry into the east coast gas market*, April 2016, p. 101.

<sup>13</sup> AER, *Guideline for the resolution of distribution and transmission pipeline access disputes under the National Gas Law and National Gas Rules*, November 2008 <<https://www.aer.gov.au/system/files/Access%20dispute%20guideline.pdf>>.

<sup>14</sup> [https://www.aer.gov.au/system/files/AER%20submission%20-%20Review%20into%20the%20scope%20of%20economic%20regulation%20of%20covered%20pipelines%20-%2022%20August%202017.\\_0.pdf](https://www.aer.gov.au/system/files/AER%20submission%20-%20Review%20into%20the%20scope%20of%20economic%20regulation%20of%20covered%20pipelines%20-%2022%20August%202017._0.pdf)

## Attachment

While making the case for the need for a holistic examination of the framework and spectrum of regulation for pipelines, we broadly support the AEMC's draft recommendations. They should contribute to improving the economic regulation of scheme pipelines and support the intention of the package to strengthen the regulatory framework, and in so doing lower prices and improve service terms and conditions for pipeline users and gas consumers.

In this attachment we identify areas for further discussion with the AEMC on specific recommendations. We also look forward to working with the AEMC on the drafting of recommendations into rule changes.

### **Extensions and expansions (Draft Recommendations 1-3)**

We agree that the current regulatory discretion as to whether extensions and expansions to a covered pipeline are included in the access arrangement has led to inconsistent treatment.

We support the AEMC's recommendations that all existing and future expansions to a covered pipeline be included in the access arrangement, and that extensions be treated on a case-by-case basis.

### **Reference services (Draft Recommendations 4-7)**

Given market dynamics, the AER supports changes that further determine and define reference services.

We believe further discussion is required on the criteria that would guide the regulator in determining the number and type of reference services - in particular, the criteria relating to cost allocation where services such as backhaul are a proportion of the cost of the forward haul service.

### **Access arrangements (Draft Recommendations 8-13)**

The AER assesses access arrangements and supports the majority of the recommendations. However, we would like to have further discussions on the matters mentioned below.

In the AER submission to the AEMC issues paper, recommendation 3 was that the rules provide for explicit indexation of the capital base as part of the requirement for pipeline operators to use AER models (PTRM/RFM) in access arrangement reviews. This approach provides consistent treatment with the electricity rules.

The AER notes that the AEMC accepted that AER models should be developed and used for access arrangement reviews, but it did not adopt the full AER submission on this issue. This was on the basis that the AER's approach on indexing the capital base is not the only appropriate approach that could be used in a regulatory model and that the current rules do not prevent the AER from implementing its preferred approach. The AEMC stated that a more prescriptive method would prevent the development of different approaches over time should the regulator consider it necessary.<sup>15</sup>

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<sup>15</sup> AEMC draft report, p. 111.

However, the AER is concerned that by not explicitly requiring indexation of the capital base, the AEMC may be undermining the improved efficiency and consistency considerations in respect of financial models development/use that is sought to be achieved by draft recommendation 8. Draft Recommendation 8 provides that the AER should be required to develop and publish financial models which the service providers would then be required to use. If there is uncertainty around capital base treatment in the rules, a key aspect of the framework cannot be consistently determined in the development of the financial models.

We would also like to better understanding the purpose and objective of Draft Recommendation 10 (relating to risk sharing arrangements in relation to non-tariff terms and conditions, and the reference tariff variation mechanism), in particular how the AER might practically apply it, and how it might impact on the way the AER undertakes its access arrangement assessments. We believe there are practical difficulties in implementing this draft recommendation.

### **Determining efficient costs (Draft Recommendations 14-20)**

The determination of efficient costs is a key to the setting of efficient reference tariffs.

Draft Recommendation 16 of the AEMC report is that the term 'depreciation' in the NGR be clarified as referring to 'economic depreciation'. This is on the basis that the new Part 23 refers to 'return of capital', which allows the arbitrator to consider any previous returns by the service provider in calculating the value of pipeline assets under rule 569.

The AER considers that further discussion of this recommendation is necessary since the changes may create uncertainty for pipeline service providers. This uncertainty is in terms of whether the AER would ever include previous over recoveries in the calculation of an opening capital base. There is also legal uncertainty if it is unclear whether existing tribunal interpretations of the terminology still apply.<sup>16</sup>

The AER questions whether the existing rules are insufficient to allow discretion for the regulator or dispute resolution body to consider previous returns in setting an opening capital base for a scheme pipeline. Our view is that the current definition of depreciation in the NGR seems to already provide for this possibility.

While we support information disclosure for lightly regulated pipelines being the same as those regulated by Part 23, we caution against recommendation 17 (require an initial capital base valuation for light regulation pipelines) as this represents a more fundamental change to the existing regime. Again, we believe this is an area where further discussion is required.

### **Negotiation and information (Draft Recommendations 21-26)**

The importance of information and its ability to address market power has been established and enacted through Part 23. We support the changes that increase information disclosure to facilitate access negotiation in respect of light regulation pipelines.

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<sup>16</sup> See for example, Application by APA GasNet Australia (Operations) Pty Limited (No 2) [2013] ACompT 8; Application by ATCO Gas Australia Pty Ltd [2016] ACompT 10.

### **Arbitration (Draft Recommendations 27-33)**

We agree with reviewing the arbitration regime in light of time, cost and uncertainty.

The AEMC is proposing to introduce a fast-tracked dispute resolution process for certain disputes.<sup>17</sup> This would require the AER to resolve disputes within 50 business days. While the AER agrees that the arbitration process in Parts 8-12 requires reform, the AER considers that this timeframe is insufficient for a comprehensive arbitration process.

We are concerned the 50 business day timeframe proposed by the AEMC is inadequate. Arbitration decisions made by the AER under Parts 8-12 are subject to judicial review.

The AER therefore recommends a timeframe of at least 180 business days and “stop the clock” provisions. We also believe that the AER needs to have discretion over the criteria for determination of the fast-track arbitration criteria, this could be achieved via development of these criteria by a guideline rather than rule changes.

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<sup>17</sup> AEMC draft recommendation 30.