



3 November 2011

Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Via online submission

Reference service and rebateable service definitions
AEMC Project Reference: GRC0012

Dear Commissioners

The Australian Pipeline Industry Association (APIA) is pleased to provide for the Australian Energy Market Commission's (AEMC) consideration the attached submission in response to the rule change proposal by the Australian Energy Regulator (AER).

APIA does not consider that a sufficient case for a rule change has been made.

APIA is particularly concerned the proposed rule change would effectively change the gas regulatory regime from incentive-based price regulation to revenue cap regulation. The AER's proposal to calculate a reference tariff based on its assessment of the revenues earned from the provision of another AER-defined service, rather than from the costs incurred to provide it, create this consequence.

APIA looks forward to working with the AEMC on this matter, and if you have any questions regarding the submission, please contact me on (02) 6273 0577.

Yours sincerely



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Policy Adviser

APIA Response to AER Rule Change Proposal to change the definitions of “Reference Service” and “Rebateable Service”

Introductory comments

Bilateral contracting is a key feature of the global gas industry, and this was recognised in the development of the former National Gas Code, and in the current National Gas Access Regime.

In particular, the appropriate framing and definition of Reference Services, and the definition of Rebateable Services, were and remain key parts of the gas access regime, as they can have a fundamental impact on past and future arrangements that underpin long-lived gas pipeline investments. As discussed more fully below, it will be critical to assess the implications of this proposed Rule Change in the context of the appropriate primacy of bilateral contracts that underpins the National Gas Law. This aspect is not addressed in the AER’s Rule Change proposal.

The Gas Access Regime offers flexibility on the nature of the tariff variation mechanism, in particular the adoption by the service provider of price or revenue control, or a combination of these mechanisms. The AER’s approach focuses on the distribution of revenue outcomes after the calculation of Reference Tariffs, which effectively shifts the regime towards revenue control or a revenue cap regime. This is a fundamental change to the access policy framework and goes beyond the AER’s claims that the proposal merely amends definitions to reflect the intent of the former Gas Code.

It is also important to remember that the gas access regime is, at its heart, a negotiate/arbitrate regime. In this context, the purpose of the reference tariff is to provide a guide around which negotiation can take place, supported by a mandated requirement to provide access to the reference service at the reference tariff, and further supported by a rigorous dispute resolution regime in cases where negotiation has not been successful. The explanatory material included in the former Gas Code makes this clear where it states:

A Reference Tariff operates as a benchmark tariff for a specific Service, in effect giving a User a right of access to the specific Service as the Reference Tariff, and giving the Service Provider the right to levy the Reference Tariff for that Service.

APIA further considers that the AER has not adequately addressed the requirements under the Regulations that a Rule Change proposal contain an explanation of how the proposed Rule will or is likely to contribute to the achievement of the National

Gas Objective.¹ The AER's Rule change proposal supports its claims that the proposed Rule promotes the National Gas Objective by assertion alone. APIA considers that further analysis is required, particularly with reference to the relationship between the Rule change proposal and its impact on bilateral contracts, before such a claim can be verified, and stakeholders must be provided with an opportunity to respond to any such analysis.

The balance of this response is divided into 3 sections:

1. a contextual discussion of the nature of the natural gas industry and the National Gas Access Regime;
2. matters of principle to which the AER's proposal gives rise; and
3. responding to specific issues in the AER's proposal relating to the definition of reference and rebateable services.

Where appropriate, reference is made to the questions posed by the AEMC in its consultation paper.

1. The natural gas industry and the National Gas Access Regime

The gas pipeline industry is founded on bilateral negotiation and agreement. This is a feature of the global industry that well pre-dates the Australian access regime.

APIA submits that the relevant aspects of the current National Gas Rules harmonise effectively with the nature of the industry being regulated.

The AER's proposed Rule Change changes the relationship between the structure of the industry and its regulatory oversight by seeking to amend the definition of rebateable services under Part 9 of the Gas Rules. The AER asserts there was a policy intention under the Gas Code that other pipeline services' revenue could be rebated from reference service revenue. The AER states that this intent was important to regulate the recovery of multiple sources of revenue by pipeline owners for the costs of the same pipeline assets. However, this policy intent was not fully realised either in the previous Gas Code or in Rule 93(4)(b) of the Gas Rules which require that the market for a rebateable service be in a "substantially different market to the reference service".

The AER further asserts that this outcome is contrary to policy intent, and has the effect of preventing revenue from other pipeline services being rebated to users, even when it is efficient to do so. The AER therefore seeks to remove the requirement that a rebateable service be in a substantially different market to the reference service.

APIA considers that the AER's statements with respect to policy intent at the formation of the Gas Code are incorrect, as they do not recognise the important balance struck between bilateral contracts and rebateable services made at the time of the Gas Code.

Particularly in Australia's relatively young gas industry, bilaterally-agreed foundation contracts have been instrumental in the development of the pipeline infrastructure in

¹ National Gas (South Australia) Regulations-13.5.2011, section 13(1)(d)

place today. These contracts are carefully crafted to provide for a fair balance of cost, revenue and risk sharing between the pipeline infrastructure provider and the foundation shipper.

This is a key reason why the National Gas Access Regime was designed to recognise the importance of contractual arrangements. Those contracts reflect a careful balancing of risks and returns between investors in long-lived production assets and investors in long-lived pipeline assets.

Many existing contracts, particularly long term foundation contracts, contain a “most favoured nation” clause, providing that, if the price of the pipeline service on offer to other shippers is less than that agreed in the contract, the lower price applies to the foundation contracts.

This is critical to the definition of the rebateable service. Were the AER to amend the definition of rebateable services, the rebate could trigger the most favoured nation clauses in the foundation contracts and fundamentally change the risk/reward relationship inherent in those contracts.

The definition of “rebateable service” was designed to protect the risk/reward relationship embodied in those foundation contracts. Providing a revenue rebate to those contracts distorts the risk/reward balance inherent in those contracts, and result in the service provider being inadequately compensated for the risks undertaken. This is why the definition of rebateable service requires it to be for a service in a substantially different market from that for any reference service.

It is therefore incorrect for the AER to assert that the Gas Code did not reflect policy intent at the time, and that this error should now be corrected. Instead the AER has failed to recognise the key balance that was struck in the original drafting of the Gas Code, which has been carried over into the National Gas Rules, between bilateral contracts and the access regime.

At a minimum, the AER’s proposed change to the definition of rebateable services could have the impact of reducing the amount of revenue that can be earned by the pipeline operator under contract below that which is required to meet the requirements of NGL s24(2). At worst, this could have the impact of undermining the foundations of gas infrastructure investment in Australia for many years to come.

APIA is very concerned about the impact of the AER’s proposed Rule Change on the risk/reward relationship underpinning bilaterally negotiated pipeline contracts and future investment Australia’s pipeline infrastructure.

Implications for the form of regulatory control

Are there other consequences of the Rule change (intentional or unintentional) that have not been identified by the Proponent?

APIA is concerned that one of the consequences² of the proposed Rule Change is to change the gas regulatory regime by moving it towards a revenue cap regulation. This is particularly the case for the AER’s proposal to adjust a reference tariff based

² It is not clear if this is an intended or an unintended consequence.

on the revenues earned from the provision of another AER-defined rebateable service, rather than from the costs incurred to provide the Reference Service.

APIA has not found any evidence of a policy intent to shift regulation of the gas pipeline industry to a revenue-based control mechanism.

2. Matters of Principle the AER Proposal gives rise to

AER assertions on policy intent

One of the reasons that the AER relies on to substantiate the need for the proposal to be approved is to ensure that the NGR maintains the intention of access arrangements under the Gas Code.

On pages 1 and 2 of the formal application, the AER states that the intention of the Gas Code was to have flexibility regarding the contents of an Access Arrangement, that this “framework” should continue under the NGR but that with the current drafting of the definitions of “reference service” and “rebateable service”, this flexibility is not possible and may be hindered by the NGR.

APIA considers that it is inappropriate for the AER to make this assertion that the intention of the Gas Code in relation to access arrangements was to be replicated in the NGR without referencing direct evidence from the MCE to that effect.

The AER incorrectly states that this problem has arisen simply because of a “drafting error” on the part of the parliament and that its proposal is seeking to address this.

In fact, this is not the case. In the SCO response to submissions made by industry on this point in the consultation on the development of the NGL, SCO was clear that it was the intention for all pipeline services to be included. In this regard, regard should be had to SCO response to stakeholder consultation on the National Gas Rules.³ In particular, SCO responded:

The NGR requirements for the specification of reference services in access arrangements will return to a future-looking approach, where access arrangements must specify as reference services all services "that are likely to be sought by a significant part of the market".

Unsubstantiated need for a Rule Change

Is the Rule change proposal likely to contribute to the achievement of the NGO, particularly in respect of promoting efficient investment in and use of pipeline services? If so, on what basis?

Many of the AER’s assertions about meeting the key rule change criterion – ie contributing to the achievement of the national gas objective - are unsubstantiated. The Rule Change proposal includes no supporting analysis or commentary to

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<http://www.ret.gov.au/Documents/mce/ documents/SCO Responses to Stakeholder Consultations on the National Gas Rules20080430104644.pdf>

indicate how the proposed Rule Change will promote achievement of the NGO more than the existing Rules.

APIA considers that it is incumbent on the Rule Change Proponent to provide substantiation and evidence as to how this rule change criterion is met. Failure to provide this substantiation would cause the proposal to offend clause 301(1)(a)(ii) of the National Gas Law. It is critical that any argument or evidence provided by the AER at later stages of the Rule change process are subject to adequate scrutiny and interested parties are given the opportunity to make submissions on the substantiation or evidence. Failure to provide an opportunity to respond would, in APIA's view, constitute a denial of natural justice.

Failure to identify a problem

Do you agree that the problem identified by the Proponent has the potential to limit the regulator's ability to set an efficient tariff? If so, why?

Is the Rule change proposal likely to effectively address the problem identified by the Proponent?

In light of the discussion on the alignment of the current Rules with the key characteristics of the industry, the AER has not clearly identified that a "problem" exists.

The AER purports that one of the key "problems" with the existing Rules is the lack of regulatory oversight on some services.

APIA submits that this assertion is simply not correct. The AER states a concern that the current requirement that a rebateable service be in a substantially different market to the reference service means a pipeline service that meets neither of the definitions for reference or rebateable services will be unregulated. The AER states:

The current definition on rebateable service which requires that a rebateable service be in a substantially different market from the reference service may lead to some services of a service provider (where they are not otherwise a reference service and subject to a reference tariff) being unregulated.

This is not the case. All pipeline services provided by means of a scheme pipeline are covered by the access regime and subject to access dispute provisions. In the case of a non-reference pipeline service, this means that where a service provider and user are unable to agree on an aspect of access to the pipeline service (including the tariff), either party may notify the AER (or the WA Arbitrator in WA) of a dispute.

Where the matters under dispute satisfy the requirements of section 186 of the National Gas Law (for example the dispute is not vexatious, trivial or misconceived), the AER can make an access determination requiring the service provider to provide access to a user in accordance with specific terms and conditions, including price. This provides an overriding protection for users and incentive on service providers to ensure that all pipeline services provided by means of the scheme pipeline are offered on a fair and reasonable basis, even where a reference tariff has not been set for that particular service. The lack of access disputes notified in respect of non-

reference services suggests that the AER's concerns are not shared by users or prospective users and that the regime is working as intended.

APIA submits that the AER has failed to demonstrate that the key "problems" that it is seeking to address through the rule change proposal can not be addressed through other provisions of the current version of the NGR (ie version 11).

Inappropriate examples

One of the arguments that the AER has used to substantiate its proposal is that the NGR lacks the flexibility as to what services should be reference services. The AER uses the circumstances of three pipelines as examples of where, if the NGR definitions were to apply, it would lead to certain services being included as reference services which, in turn, would lead to an outcome that is in conflict with the NGO and also the RPP.

APIA submits that the circumstances of two of these examples – the SWQP and the Roma to Brisbane Pipeline – are invalid as examples to justify its proposal. Their circumstances would not be any different if the AER's proposal were to be implemented. In these examples, there is uncertainty about the likelihood of the demand for pipeline services. On that basis, these services would never have been declared as reference services, either under the existing provisions of the NGR or the AER's proposal. Again, the AER has failed to demonstrate the need for a change to the existing Rules.

There is only one example the AER has put forward as evidence of the lack of flexibility and the resultant conflicts with the NGO and RPP – the Victorian DTS.

Notwithstanding questions around the AER's assertions on whether these arrangements are consistent with the NGO, it would seem inappropriate to implement a proposal which is aimed at overcoming circumstances that appear to be particular to only one pipeline in a way that could have unintended consequences for other pipelines.

APIA is concerned that, given the inappropriateness of the AER's examples in this Rule Change proposal, there is a real risk of unintended consequences arising from approving the proposed Rule Change.

3. Response to specific matters in AER's proposal relating to the reference service definition

Issue #1

In its opening letter, the AER states on page3:

The proposed rule change to the definition of reference service will allow the AER to exercise discretion as to whether to set a reference tariff in circumstances where there is a high level of uncertainty of revenue/demand for a pipeline service, such that determining an efficient tariff for some services may not be possible.

Even under clause 3.3(b) of the previous Gas Code, the regulator had discretion to require a particular service to be classified as a reference service. That discretion is only tempered under the Rules by the requirement to specify a reference tariff for each reference service (Rule 48(1)(d)). As it is not possible to determine a reference tariff for a service which has a high level of uncertainty of revenue / demand, it can not be a reference service.

APIA submits that the requirement to establish a reference tariff for each reference service is a key element of the gas access regime. The current Rules contain a clear methodology for determining the reference tariffs. Moreover, the Rules currently contain a framework for dealing with those services for which there is a high degree of uncertainty on the demand for a service or the revenue to be derived from providing it – a rebateable service.

APIA is concerned that this change would also impose additional volume risk on the service provider, depending on how the rebateable service mechanisms is implemented. A portion of revenue could be deemed to be recovered through the new “Reference Service”, even where the volumes and revenues are highly uncertain. This would have the effect of confiscating revenues that have not been earned, and indeed may never be earned. This would not give the service provider a reasonable opportunity to recover at least the efficient cost of providing pipeline services.

APIA supports one aspect of the AER’s proposed Rule Change – the requirement that at least one service be specified as a reference service. As discussed above, the gas access regime is a negotiate/arbitrate regime. The purpose of a reference tariff is to provide guidance to the negotiation process, supported by a rigorous dispute resolution regime.

Issue #2

The AER states on page 11 of its submission that a benefit of the rule change is that the AER will be able to approve the treatment of emerging or developing pipeline services of uncertain demand and revenue as non reference services. It then states that this may provide service providers with greater certainty of cost recovery if its revenue does not have to rely on reference tariffs for pipeline services of uncertain demand.

APIA submits that the current provisions of the NGR already enable the AER to approve the treatment of emerging or developing pipeline services of uncertain demand and revenue as non reference services. In fact, the provisions compel this outcome. A service for which there is uncertainty of demand or revenue of itself means that it is a service which is not likely to be sought by a significant part of the market and is therefore not a reference service.

APIA considers that under the existing version of the NGR, services for which there is no reference tariff (ie a non reference service) are capable of being classified as rebateable services, provided they are offered in a substantially different market to the Reference Service(s).

On this basis, the proposal cannot be argued to promote the NGO more than the current Rules.

Summary

In summary, APIA submits that:

- The AER has not established a clear requirement to amend the Rules from the existing Rules.
- The existing Rules harmonise much more closely with the circumstances of the industry than the AER's proposed changed Rules.
- The AER's proposed Rule Changes have scope to fundamentally change the gas access regime from a flexible, incentive based, negotiate/arbitrate price cap regime to a revenue cap regime. This is a foundational change to the gas access regime.
- The AER's proposed Rules potentially have unintended consequences for existing contracts, which could undermine the opportunity for the service provider to recover the efficient costs of providing pipeline services.