

AEMC GPR0004

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

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1. Introduction

The Australian Pipelines and Gas Association (APGA) welcomes the opportunity to respond to the Australian Energy Market Commission's Issues Paper for the Review into the scope of economic regulation applied to covered pipelines.

APGA is the peak body representing Australasia's pipeline infrastructure, with a focus on gas transmission, but also including transportation of other products, such as oil, water and slurry. Our members include constructors, owners, operators, advisers, engineering companies and suppliers of pipeline products and services.

APGA's members build, own and operate the gas transmission infrastructure connecting the disparate gas supply basins and demand centres of Australia, offering a wide range of services to gas producers, retailers and users. The replacement value of Australia's gas transmission infrastructure is estimated to be \$50 billion.

1.1 Experience of the NGL and NGR

Since 2000, APGA's members have invested in and built over \$10 billion of infrastructure providing 5,000km of coverage across 13 major new gas transmission pipelines and expansions of existing pipelines in Australia. A similar amount of investment has occurred in maintaining existing infrastructure. This investment has occurred to meet the demand of Australia's gas markets, which has experienced unprecedented change in the last five years.

It is this investment that has created the interconnected East Coast gas grid, provides increased options for gas supply for Australian gas users and will now connect the NT market to the broader East Coast market. This investment has all occurred under the framework provided by the National Gas Law 2008 (NGL) and the National Gas Rules (NGR). Most of the investment has occurred on non-scheme pipelines.

The framework has been working well and delivering for the consumers of natural gas.

1.2 Terms of Reference

As noted in the Issues Paper, On 5 May 2017, the COAG Energy Council issued the AEMC with terms of reference for a review into the scope of economic regulation applied to gas pipelines. The terms of reference request the AEMC to:

"make recommendations on any amendments it considers necessary to Parts 8-12 of the NGR to address concerns that pipelines subject to full regulation are able to exercise market power to the detriment of economic efficiency and the long term interests of consumers."

This Review follows the Australian Competition and Consumer Commission's (ACCC) East Coast Gas Inquiry which identified gaps in the regulatory framework that allow pipeline that are subject to economic regulation are able to engage in monopoly pricing.

The ACCC found specific issues with three aspects of the existing regulatory regime for scheme pipelines:

- Reference services: the current definition of 'reference service' is that the service is sought by a 'significant part of the market'. Not all services are nominated to be reference services. The ACCC suggested that pipeline owners may be able to exercise market power on these non-reference services to the detriment of consumers and economic efficiency;
- Pipeline expansions: when a pipeline that is subject to full regulation is expanded (for example, through the addition of a compressor), the additional capacity is not necessarily included within the definition of the covered pipeline and consequently not subject to economic regulation. As a result, the ACCC noted that pipeline owners may be able to exercise market power on these services provided by the expansion to the detriment of consumers and economic efficiency; and
- Information and dispute resolution: there may be barriers that are preventing participants from using the access dispute resolution provisions in the NGR. The ACCC formed the view that the threat of arbitration was unlikely to be a constraint on the behaviour of pipeline service providers.

1.3 APGA submission

APGA appreciates that the AEMC has covered the above issues and explored a broad range of potential issues in the Issues Paper. Given the number of gas market reform processes underway, APGA will limit its comments in this submission to:

- The differences between gas transmission pipelines and gas distribution networks;
- The challenges that may arise in balancing the pricing principles in the new framework for arbitration on non-scheme pipelines and the current regulatory approach to pricing; and
- the above issues raised by the ACCC, including the role of light regulation in the NGR.

We are happy to engage with the AEMC for further discussion of these issues or other topics raised in response to the Issues Paper.

2. Key issues

2.1 Gas transmission pipelines and gas distribution networks are distinct categories of infrastructure

Gas transmission pipelines connect Australia's gas producing basins to our demand centres of capital centres, industrial zones, mining regions and export facilities. Gas transmission pipelines operate at high-pressure and are made from steel. They traverse long-distances and are, at an asset level, largely point-to-point. A number of transmission pipelines have invested in bi-directional capabilities in response to changing market needs in recent years. There has also been investment in increasing interconnectivity between pipelines, leading to the creation of the East Coast gas grid present today.

The direct customers of gas transmission pipelines tend to be large corporate entities, covering gas producers, users, retailers and gas-fired power generators (GPG). Each gas transmission pipeline has a unique demand profile influenced by its major customers. Some pipelines largely serve GPG and experience high summer peaks. Others serve mining or industrial regions and have largely flat loads. Those that transport gas to colder regions tend to experience winter peaks as the demand for space heating increases.

Customers on gas transmission pipelines had demonstrated a clear preference for bespoke packages of services to take into account the specific requirements of their demand profile.

Gas transmission pipelines face varying levels of competition depending on their customer base and particular circumstances.

Gas distribution networks transport gas with Australia's cities and towns, providing gas connections to small and medium businesses, homes, schools and hospitals. They operate at low pressure and tend to be made from PE pipe. The direct customers of gas distribution networks tend to be energy retailers, who utilise the network to provide gas to their customers.

Customer on gas distribution pipelines are typically able to have their needs met through standardised services.

Natural gas is a fuel of choice. This means it is in constant competition with electricity and other energy sources. This is particularly true at a distribution level, where some governments actively encourage a move away from gas to renewable sources of energy. In many regional towns, gas distribution networks also face direct competition with bottled gas.

The findings of the ACCC East Coast Gas Inquiry that have led to this Review were made with reference to gas transmission pipelines. However, from a regulatory perspective, there is little difference in the treatment of scheme-pipelines whether they are classified as transmission or distribution.

With the range of gas market reforms underway, several of which are focussed on transmission pipeline capacity markets, it is appropriate to consider whether there should be a greater distinction in treatment of gas transmission and distribution pipelines in the NGR.

The implementation of the new information disclosure and arbitration framework for non-scheme pipelines highlighted a number of issues that can arise with a lack of distinction between gas transmission and distribution pipelines. In particular, it was evident during the process that the threshold at which reporting (or other) obligations apply should not be the same for both types of infrastructure. The proposed threshold of 10TJ/day throughput was deemed appropriate for gas transmission pipelines but would have caused several regional distribution networks to be subject to the obligations with little benefit for consumers.

2.2 Arbitration for non-scheme pipelines and scheme pipelines

Now that the new information disclosure and arbitration mechanism, it is appropriate to consider the arbitration mechanism that is applied to non-scheme and scheme pipeline and explore the potential for great consistency.

The new arbitration mechanism for non-scheme pipelines presents many attractive features for access seekers and APGA anticipates there will be submissions to this Review calling for the mechanism to apply to scheme pipelines also.

There is a key issue that will present a challenge to the direct application of the arbitration mechanism for non-scheme pipelines to apply to scheme pipelines; that of pricing principles.

2.2.1 Pricing principles

Rule 569 (3)(a) sets out the primary pricing principle that an arbitrator must follow when making an access determination on a non-scheme pipeline:

The price of access to a pipeline service on a non-scheme pipeline should reflect the cost of providing that service, including a commercial rate of return that is commensurate with the prevailing conditions in the market for funds and reflects the risks the service provider faces in providing the pipeline service

Of most significance is the requirement for the arbitrator to determine a price of access that reflect the cost of providing that service.

The arbitrator's focus on the actual cost of providing the service on non-scheme pipelines stands in contrast to the regulator's focus on finding the efficient cost of providing a service for scheme pipelines and providing incentives for a service provider to achieve costs lower than the efficient cost. The revenue and pricing principles set out in the section 24 of the NGL require the regulator to provide that:

(2) A service provider should be provided with a reasonable opportunity to recover at least the efficient costs the service provider incurs in—

- (a) providing reference services; and*
- (b) complying with a regulatory obligation or requirement or making a regulatory payment.*

(3) A service provider should be provided with effective incentives in order to promote economic efficiency with respect to reference services the service provider provides. The economic efficiency that should be promoted includes—

- (a) efficient investment in, or in connection with, a pipeline with which the service provider provides reference services; and*
- (b) the efficient provision of pipeline services; and*
- (c) the efficient use of the pipeline.*

Any attempt to apply the new information disclosure and arbitration mechanism for non-scheme pipeline to scheme pipelines will have to reconcile the two fundamentally different approaches to tariff setting during an access determination.

2.3 The role of light regulation under the NGR

With a new information disclosure and arbitration mechanism in place for non-scheme pipelines, there is now consideration of the purpose and continuing relevance of existing provisions under light regulation for scheme pipelines.

Both mechanisms provide the opportunity for an independent third-party to adjudicate disputes arising during commercial negotiation. However, light regulation does more than simply provide access to arbitration.

When looking at the role of light regulation, it is necessary to consider the form of regulation factors set out in section 16 of the NGL and how they are applied in a form of regulation decision.

In particular, 16(d) sets out the requirement that the NCC must consider:

the extent to which any market power possessed by a service provider is, or is likely to be, mitigated by any countervailing market power possessed by a user or prospective user;

The National Competition Council's (NCC) Gas Guide sets out:

4.09 The principal concern under the NGL is to ensure that the form of regulation that is appropriate for a particular pipeline service is proportionate to the degree of market power that is involved. More costly forms of regulation should be adopted only where there is the potential for significant inefficiencies to arise from the exploitation of market power (Expert Panel Report 2006, p 44).

The application of light regulation to a scheme pipeline requires a specific finding from the NCC that a scheme pipeline does not have sufficient market power to justify the expense of full economic regulation.

It is in the best interest of consumers that the gas access regime continue to provide for an alternate treatment of pipelines that have been found to not have excessive market power. Where the costs of regulation can be reduced, they should be. Minimising the burden on regulation where appropriate will minimise the cost to the end user.

This is particularly true for pipelines that are, or have been, subject to full economic regulation. It is appropriate that there is a mechanism in place that allows for such pipelines to be subject to a lower level of regulation if circumstances change such that full regulation no longer delivers net benefit to consumers.

The new information disclosure and arbitration mechanism has been applied to all non-scheme pipelines on the assumption that market power exists on all pipelines. This is a false assumption. The level of market power varies on every pipeline and can vary across service offerings on a single pipeline. It is highly desirable that a mechanism continues to be available that allows for pipelines that have been found to lack market power to be treated differently to pipelines that do have market power.

2.4 Matters raised in the ACCC East Coast Gas Inquiry

2.4.1 Reference services

In its East Coast Gas Inquiry, the ACCC stated that:

For example, the AER is currently only required by the NGR to approve on an ex ante basis the price of access to the 'reference service(s)' offered by the pipeline. In the NGR, a reference service is simply defined as a service sought by a significant portion of the market. By contrast, the electricity regulatory regime identifies regulated services by an assessment of the contestability of the services. The 'reference service' approach used in the NGR has resulted in a number of non-contestable services being excluded from the AER's ex ante review, whereas non-contestable services are arguably a primary target for regulation (because there is no competitive constraint on the pipeline operator's provision of those services).¹

Essentially, the ACCC claimed that pipeline service providers are able to sidestep regulation as a large number of services offered are not reference services. The ACCC's statement that a number of non-contestable services are being excluded from the AER's ex ante review, suggests that access seekers and/or the AER have actively tried to have additional services included and have failed. In reality, every access arrangement process includes an engaged discussion between service providers, access seekers and the regulatory on the reference services that should be defined.

There is also ample evidence that reference services evolve over time as the needs of the market change.

APGA notes that the ACCC did not present any evidence that non-reference services are being monopoly priced. This is not surprising, any attempt to do so would simply see access seekers asking for the service in question to be made a reference service at the earliest opportunity.

The role of reference services

As the AEMC states in the Issues Paper:

The reference service serves as a benchmark for negotiating a gas transport agreement (GTA) with a full regulation transmission pipeline.²

This purpose is entirely appropriate.

It is not feasible, or helpful to access seekers, for the reference service to attempt to cover the full range of services potentially offered by a pipeline service provider. To attempt to define all services offered would be a substantial increase in complexity for the regulatory decision-making process and would stifle the ability of pipeline service providers to develop new services in response to market needs.

A number of reference services that provide benchmarks for key services is sufficient. If the regulator or access seekers believe there are reference services missing from an access arrangement, they should take the appropriate steps to have them considered. For access seekers, this would be asking for their inclusion during the public consultation phase of an

¹ p162, ACCC East Coast Gas Inquiry

² p53, AEMC Issues Paper

access arrangement. For the regulator, this would be setting out the additional services expected in the draft determination and, if the service provider does not respond appropriately imposing them in the final determination.

Regulatory discretion with regard to reference services

Rule 101 (b) sets out that an access arrangement must include:

(b) any other pipeline service that is likely to be sought by a significant part of the market and which the AER considers should be specified as a reference service.

This rule provides the regulator broad discretion in the specification of reference services.

The use of the word 'likely' indicates a low threshold for the regulator to decide if a service should be a reference service or not.

The use of the word 'significant' has been signalled as problematic for the regulator, setting a high threshold to include a reference service. APGA does not believe this is the case. Certainly, the word 'significant' should not be deemed to require the regulator establish that a majority of access seekers seek the service. In the current supply constrained East Coast gas market, 'significant' could be taken to mean a single new producer seeking to supply a market.

2.4.2 Regulatory treatment of expansions

In its East Coast Gas Inquiry, the ACCC stated that:

Another gap in the regulatory framework, outside the DTS in Victoria, stems from the discretion that currently exists under the NGR to exclude expansions of a full regulation pipeline from the definition of the covered pipeline. This has resulted in tranches of capacity on some full regulation pipelines not being subject to regulation. While a decision to exclude expansions must be approved by the AER, there is little guidance in the NGR on the matters the AER is to consider when making such a decision. More problematic, however, is the fact that if the AER allows the investment to be excluded from the covered pipeline, the only remedy that users have if the pipeline operator engages in monopoly pricing is to apply to the NCC for the expansion to be covered. For the reasons set out above, this is unlikely to be successful. Knowledge of these difficulties means that pipeline operators may be able to engage in monopoly pricing on the expanded capacity in a relatively unconstrained manner.³

As the ACCC states, the regulator has discretion over whether expansions are to be subject to regulation or not. Presumably, if the regulator is concerned a pipeline operator will engage in monopoly pricing on the expanded capacity, it would not allow the expansion to be excluded from regulation.

The AEMC raises the example of the Goldfields Gas Pipeline in its issues paper. The circumstances of this particular pipeline appear to be the exception, with no other scheme

³ p163, ACCC East Coast Gas Inquiry

pipeline having such a large portion of unregulated capacity. Indeed, APGA understands that existing regulatory practice is to set out in an access arrangement that expansions are to be automatically included in the regulated asset base unless a specific application is made by a service provider. This would lead to consultation and deliberation by the regulator which should ensure the specifics of each circumstance can be considered appropriately.

There are numerous decisions in the NGR that provide the regulator discretion. Where specific guidance is not provided, the National Gas Objective and the Revenue and Pricing Principles should guide the regulator. If the regulator is not confident in exercising discretion, the problem does not lie with the NGR.

2.4.3 Information and dispute resolution

In its East Coast Gas Inquiry, the ACCC stated that:

While the threat of arbitration should in principle impose a constraint on the pipeline operator's behavior when determining the prices of these services, the Inquiry has been informed by market participants that the costs and resources associated with an access dispute, coupled with the uncertainty surrounding the final outcome, can discourage shippers from triggering these provisions. Information asymmetries may also be contributing to this reluctance to trigger these provisions because shippers are unable to determine how much they are being 'overcharged'. One market participant also noted that there is little utility in being able to trigger a dispute in relation to an existing contract, because any access determination would be bound by the pre-existing contractual rights between the parties, which are protected under the NGL. These limitations mean that operators of full regulation pipelines may still be able to engage in monopoly pricing when setting the price of non-reference services, which is what has been observed in this Inquiry⁴

APGA is not certain how these nebulous concerns can be managed. Any dispute resolution process will create costs for participants. An effective dispute resolution process must also have uncertainty, if the outcome from such a process is certain then it will always be used by the party that benefits.

Further, the fact that the ACCC is suggesting that is a 'limitation' that a regulatory dispute resolution process cannot override existing pre-existing contracts is highly inappropriate.

APGA does acknowledge that the new information disclosure and arbitration mechanism for non-scheme pipelines introduces major new information requirements that access seekers will find desirable to be applied to scheme pipelines. However, it should be considered that regulators have access to the large amounts of data during the regulatory process. Once a reference service and tariff is set for a scheme pipeline, it is difficult to see what additional benefit the new information publishing obligations would deliver to access seekers.

⁴ P163, ACCC East Coast Gas Inquiry