SUBMISSION

AEMC Draft Report - Review into the scope of economic regulation applied to covered pipelines | March 2018

Energy Users Association of Australia

INTRODUCTION AND SUMMARY

The Energy Users Association of Australia (EUAA) is very pleased to make this submission on the AEMC Draft Paper on the economic regulation of covered pipelines (Draft Paper). We are the peak body representing Australian energy users. Our membership covers a broad cross section of the Australian economy including significant retail, manufacturing and materials processing industries.

Our members are highly exposed to movements in both gas and electricity prices and have been under increasing stress due to escalating energy costs. These increased costs are either absorbed by the business, making it more difficult to maintain existing levels of employment or passed through to consumers in the form of increases in the prices paid for many everyday items.

The driver for the AEMC gas work has been the ACCC Inquiry into the East Coast Gas Market (ACCC Inquiry)[1] published in April 2016. This report confirmed the views long expressed by gas users, and long disputed by pipeline operators, as well as large incumbent gas producers/aggregators with legacy pipeline capacity, that pipeline operators exercised monopoly power in setting pipeline charges. The ACCC concluded that this monopoly pricing is enduring, not transitory. [2]

The EUAA has been very supportive of the subsequent related reforms and increased information disclosure by the Gas Market Reform Group, the AEMC and the ACCC to reduce that market power and bring downward pressure on pipeline tariffs. In particular we were very supportive of the Vertigan Committee reforms for unregulated gas pipelines.

As the AEMC notes in this current report, this reform for lightly and fully regulated gas pipelines:

> "… aims to address concerns about potential monopoly pricing by pipeline service providers." (p.i)

and

> "If implemented in full, the package of draft recommendations will help pipeline users negotiate lower prices and better terms for their gas transportation agreements.
> A broader range of services will be subject to access arrangements, prices will be set at more efficient levels, contract terms will be more balanced, and arbitration will act as a more credible back-stop if negotiations fail. (pp ii-iii).

The EUAA welcomes the Commission's recommendations in regarding a greater range of reference services, greater information disclosure and a fast track arbitration regime, including pipeline expansion as part of the pipeline, greater consumer involvement in the AER regulatory process and removal of part of the regulatory discretion framework.

However, there are considerable barriers to this greater consumer involvement that we hope will be resolved with COAG's consideration of funding arrangements for consumer engagement around network regulation. Without this the AEMC's recommendations on this aspect cannot be implemented.

[1] ACCC Inquiry into the East Coast Gas Market April 2016 https://www.accc.gov.au/media-release/release-of-east-coast-gas-inquiry-report-into-the-increasingly-complex-and-uncertain-gas-market

[2] Ibid p.111

While there is much to welcome in the reform package presented in this Draft Report, there is the potential for it to fall short of what is required to meet the NGO in two crucial aspects in Draft recommendation 16:

(i) A failure to make the definition of "economic depreciation" crystal clear and

(ii) The decision to allow the regulator or dispute resolution body discretion in how it takes previous returns (not constrained by the determination of reference services) into account when it sets the opening capital base for a scheme pipeline

Asset values drive tariffs and the ACCC Inquiry[3] identified the lack of consideration of asset values as a prime driver for the exercise of monopoly power by pipeline operators. The result is that end use gas consumers, whether shippers in their own right or consumers purchasing from a retailer who is a shipper, are left with paying tariffs that reflect the exercise of monopoly power rather than the result of good regulatory practice in reflecting the outcome of a 'workably competitive' market.

The AEMC seems to assume that information transparency and disclosure proposals together with reforms in the arbitration process will result in, if not equality in bargaining power between the pipeline operator and the gas user, at least a substantial rebalancing of the existing asymmetry. We think this is too optimistic. The resources available to the pipeline operator, particularly given the concentration of ownership, are going to be significantly greater than those available to an end gas user. While large gas retailers may have more resources for a negotiation and arbitration process, they may have much less incentive to go to arbitration than a specific end sue consumer depending on the retailer's ability to pass through changes in pipelines access terms to the end consumer.
The way to address this remaining negotiation asymmetry is to be very prescriptive in the rules underlying the information disclosure. The key driver of gas transport prices above efficient or workably competitive levels is the asset valuation process that allows pipeline operators to recover their capital costs more than once and this is where a prescriptive rules regime is of most benefit to consumers.

Draft Recommendations in Chapters 2 – 5

The EUAA is generally supportive of the recommendations in these Chapters.
Our focus is on the discussion of the coverage test. In this we support the comments on the test made in the submissions on this matter by the Public Interest Advocacy Centre and the Major Energy Users. In particular we support the PIAC recommendation that all distribution pipelines should be regulated. Our members have informed us of what they consider to be examples of the exercise of monopoly power with their supply of gas through distribution pipelines.

The current coverage test has not supported the NGO in two ways – it has allowed too many pipelines that have the ability to exercise market power to change to being unregulated and it has created too high a barrier for shippers seeking to get an unregulated pipeline regulated.

The ACCC Inquiry [4] described the experience of Kimberly Clarke's unsuccessful attempt to get coverage of the SEPs pipeline. The MEU submission on this matter provides further information. Given this experience, there is simply no appetite for end use consumers to undertake the very time and resource intensive and very costly process to apply for a pipeline to be regulated. As the ACCC Inquiry noted[5]:

> "Not only are few transmission pipelines regulated, but the threat of regulation is also failing to impose an effective constraint on the behaviour of a number of unregulated pipelines. This is because the current test for regulation under the NGL (the 'coverage criteria'), which largely mirrors the declaration criteria in Part IIIA of the CCA, is unlikely to be met by the majority of transmission pipelines on the east coast given the characteristics of the east coast gas market. The criteria are also, as the Productivity Commission has noted,

[3] Ibid Chapter 6
[4] Ibid p. 117
[5] Ibid p. 10

> not designed to address the market failure that has been observed in this Inquiry, which is monopoly pricing that gives rise to economic inefficiencies with little or no effect on the level of competition in dependent markets."

The ACCC Inquiry recommended a change in the coverage test to one that focused on whether the pipeline has market power now, whether this will continue in the medium term and whether the coverage will contribute to the achievement of the NGO. The EUAA supports this form of the test. The ACCC[6] recommended that the AEMC undertake further consultation on the application of this new coverage test.

In response to the AEMC's request (p. 47), the EUAA, on the basis of its members experience and the ACCC Inquiry evidence, believes that these matters are material and should be addressed as part of this review. While we acknowledge the AEMC's argument that the changes to Part 23 have brought these unregulated pipelines under a form of regulation, there is still the risk of "under regulation". The fact that these Part 23 changes are recent, is not a reason for delaying detailed consideration of the ACCC's proposed coverage test.

We agree with the Draft Paper when it says (p. 47) that the implementation of the other proposed changes be prompt and should not be delayed by coverage test considerations. This is why we support the Commission setting out in its final report the process it intends to follow for a review of the coverage test which should start as soon as possible following the final report. While there are obvious connections with the 2019 review of Part 23 reforms, the complexity of the coverage review means an early start is preferable so that results can feed into the 2019 Part 23 review.

As we await the implementation of an effective coverage test, we need to ensure that the remainder of the regulatory framework ensures, as much as possible, the same NGO focussed outcome for consumers irrespective of whether a pipeline is regulated or unregulated[7]. We believe that a combination of the changes proposed in the Draft Paper and increased clarity around calculation of the capital base, which is discussed in the next section, should go a long way to achieving this. We do not want a framework that allows a pipeline to "regulatory shop" between regimes.

A final comment on Recommendation 13:

> **Draft recommendation 13: Remove the limited and no discretion regulatory framework**
> To remove the limited discretion and no discretion framework contained in rule 40 from the NGR.

We are concerned that this may mean the setting of tariffs in a way that does not meet the workable competition objective and this is discussed further in the next section.

Chapter 6 – Determining efficient costs

The ACCC Inquiry concluded that the current negotiate/ arbitrate framework based on published access arrangement information has failed to stop the exercise of monopoly power by pipeline operators. We agree with the AEMC's view that:

> "...for a negotiate-arbitrate framework to successfully constrain the use of market power, all the individual components of the framework need to work together and function well in practice. This has been the focus of the Commission's work for this review." (p. 8)

[6] Ibid p.11

[7] This is the same approach as taken in a number of the Draft Report's recommendations eg Draft recommendation 22 which requires distribution pipeline service providers to disclose
capacity and usage information whether they are full or lightly regulated or unregulated.

We submit that only with a crystal clear approach to the determination of the capital base and efficient costs will all components of the framework achieve the Commission's objective.

Unspent conforming capital expenditure

We agree with retention of the current incentive based framework for regulated pipelines. However, we should not underestimate the incentive the AEMC identifies for service providers:

> "… to try to overstate projected capital expenditure in order to benefit from the return on and of the unspent capital expenditure up to the start of the next access arrangement period." (p. 102)

While the AER is well aware of this risk when assessing regulatory proposals and:

> "…often approve a lower amount of expenditure that they consider satisfies the relevant criteria than that proposed by the service provider." (p. 102)

the risk is still present. The AEMC recommendation for greater involvement of consumers in the AER regulatory will, in principle, allow greater scrutiny of these capex proposals. However, the lack of funding for consumer engagement is a huge barrier to this participation. The issue of funding has been under lengthy consideration by COAG Energy Ministers and it is hoped that it will be finalised at its April meeting in favour of increased funding. Without it the AEMC's objectives will not be achieved.

Contingent project mechanism

We agree with the concept of introducing a contingent projects mechanism as suggested by the AER. They can be a useful mechanism when there is uncertainty around future demand and they are being increasingly used by electricity networks in their revenue proposes to the AER.

However, it will need to be introduced in a form that reflects the shortcomings of the existing contingent projects mechanism – tightening of the triggers under which they are approved and increasing the level of consumer engagement in project evaluation.

Using contingent projects should not be a backdoor method of getting a higher capex during a regulatory period in the absence of the appropriate level of scrutiny that would come if the same project were part of the ex-ante capex proposal. Contingent projects should not be a way for networks putting capex projects into the "contingent projects" bucket and then claim that "prices will only risk by x" over the 5 year regulatory period because the impact of the contingent projects has been excluded.

Capital base

The core issue here is how operators of pipelines that are not fully regulated can set tariffs without regard to the return of past capital recoveries. As the ACCC Inquiry found in its analysis of two pipelines where the operator had already recovered the cost of construction, prices were[8]:

> "…2-5 times higher than they would be likely to be if they were subject to full regulation."

where prices would be based on the forward looking cost of operating and maintaining the pipelines, as the NGR require. This "over recovery" of the costs of providing the service is not consistent with the regulatory aim of a workably competitive outcome.

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[8] Ibid p. 108

As the ACCC Inquiry noted[9]:

> "…if the pipeline was subject to full regulation under the NGL and NGR, the scope to charge prices that 'over recover' the cost of providing the service would be limited because one of the more fundamental principles in the NGR is that an asset should only be depreciated once over its economic life. In effect, this means that once the value[10] of the asset has been recovered from users, regulated prices would be based on the forward looking cost of operating and maintaining the pipeline (including the cost of carrying out any future capital works)."

It is for this reason that the EUAA strongly supports the concerns expressed by Central Petroleum around the access arrangements it has been presented with for the Carpentaria and Amadeus pipelines and how the asset value determinations under rule 99 in Part 9 of the NGR are inconsistent with the provisions of rule 579 of Part 23 of the NGR.

The EUAA agrees with the Draft Paper on the importance of having an initial capital asset base for every pipeline where one does not exist now. Central to the calculation of this capital base is inclusion of past recoveries that are unconstrained by the determination of reference services. The AEMC seems to agree with this. However, in its acknowledgement of the confusion between the terms "depreciation" and "return of capital" that arose in 2017 during debate on the Vertigan reforms to Part 23:

> "For some stakeholders, the use of different language in referring to "depreciation" in calculating initial capital bases under rule 77 in Part 9 of the NGR and "return of capital" in asset value determinations by an arbitrator under rule 569 of Part 23 of the NGR has raised the question of whether a different meaning is intended." (p. 108)

the AEMC seems to have gone only part of the way to clear up this confusion. Yes, it has made clear that depreciation refers to "economic depreciation" over the asset life:

> The Commission's view is that the correct interpretation of depreciation as it is used in rules 77(1) and 77(3) is as a high-level term that refers to economic depreciation (not accounting or tax depreciation) as would be expected in economic regulatory frameworks and models." (p. 109)

which is consistent with the ACCC's Inquiry comment cited above. To emphasise its intentions, the AEMC says:

> "To clarify the situation, it is recommended that the term "depreciation" when used in the calculation of an initial capital base in rules 77(1) and 77(3) of the NGR be defined such that it is clear that this is a broad term that refers to economic depreciation." (p. 109)

Yet the AEMC seems to give scope for there to be ways, other than set out in the AER's interpretation of Part 23, to determine "economic depreciation":

> "Economic depreciation encompasses a range of approaches *including* the AER's interpretation for Part 23 financial reporting purposes." (emphasis added) (p.109)

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[9] Ibid p. 107

[10] Recognising the different approach pre and post the commencement of the Gas Code in 1998.

We submit that to avoid further confusion, the AEMC should provide a precise definition of "economic depreciation" consistent with the Part 23 definition around "depreciated cost of construction" which is consistent with the workably competitive market objective. [11]

Further, the wording of the relevant recommendation, rather than prescribing the use of "economic depreciation" leaves it to the discretion of the dispute resolution body on whether to take previous returns into account:

> **Draft recommendation 16: Clarify the term depreciation when used in capital base valuations**
> To amend the NGR to clarify that the term "depreciation" when applied in calculating an opening capital base in rule 77 refers to economic depreciation. This gives the regulator or dispute resolution body has the discretion to take previous returns into account when setting an opening capital base for a scheme pipeline. (p. 111)

The EUAA's submission is that the methodology under NGR rules 77(1) and 77(3) needs to be exactly the same as in Part 23 and exactly reflect the intention of the regime described in the ACCC Inquiry:

- The asset base is its original capital base plus capital spent since commissioning, less the component of the tariff users paid since commissioning that related to capital recovery – this includes any monopoly returns
- once the value of the asset has been recovered from users, regulated prices would be based on the forward looking cost of operating and maintaining the pipeline (including the cost of carrying out any future capital works).

and that there should be no discretion available to the regulator or dispute resolution body in applying this methodology.

Summary

We agree with all the draft recommendations except 16 where we propose the following amendments:

> **Draft recommendation 16: Clarify the term depreciation when used in capital base valuations**
> To amend the NGR to clarify that the term "depreciation" when applied in calculating an opening capital base in rule 77 refers to economic depreciation [insert specific definition related to deprecated cost of construction to be consistent with Part 23]. This ~~gives~~ requires the regulator or dispute resolution body to follow this specific definition in how it ~~has the discretion to~~takes previous returns into account when setting an opening capital base for a scheme pipeline. (p. 111)

Chapter 7 – Information disclosure

The EUAA strongly supports the recommendations around increased information disclosure for light and fully regulated pipelines to replicate what is now required under Part 23 for unregulated pipelines. The benefits of this

[11] Gas Pipeline Information Disclosure and Arbitration Framework Initial National Gas Rules Explanatory note 2 August 2017 p. 5 and 15
http://gmrg.coagenergycouncil.gov.au/sites/prod.gmrg/files/publications/documents/Final%20Explanatory%20Note%20-%202%20August.pdf

disclosure are potentially significant compared to the costs the pipeline operators may pass on to consumers to provide the information. We would assume this information is mostly already available internally as part of normal business practice and from the pipeline operator determining its negotiating strategy with any shipper. So, the additional costs of publication should be very low.

However, we would caution the AEMC on its enthusiasm for the benefits of this disclosure:

> "For prospective users, removing information asymmetries should facilitate negotiation of access at the lowest price that is commensurate with efficient levels of capital and operating investment. Where a negotiated outcome is not achieved, the availability of an appropriate level of information will assist parties to decide whether to initiate a dispute and if so will allow prospective users to put forward their case." (p. 119)

The process of negotiation and arbitration can have significant transactions costs. Information can give leverage to the shipper and the more information the better leverage and reduction in the current information asymmetry. However, this only works if it is based on key underlying principles.

For example, lots of information on current asset values is of limited use in a negotiation/arbitration process if it does not reflect a very clear understanding of economic depreciation and if the arbitrator is not bound to follow that principle. Provision of this clear information is also crucial where the negotiation is between a service provider and a shipper that is an aggregator for a large number of customers eg retail customers. In this case the aggregator may have less incentive to negotiate if there is an expectation that any tariffs can simply be passed on. This is where cost based tariffs consistent with the capital values calculation described above offer some protection to all end consumers.

Chapter 8 Arbitration

We agree with the AEMC when it says, in the negotiate-arbitrate regime under the NGL and NGR, that:

> "…an efficient and effective dispute resolution framework is integral in providing a credible threat to stakeholders to engage in successful access negotiations. (p. 141)

The EUAA believes that the absence of any disputes under the current dispute resolution for scheme pipelines is indicative of its ineffectiveness. End use gas consumers simply do not have the resources to engage with pipeline operators in a process they consider biased against them at the start. As the ACCC Inquiry noted[12]:

> "The threat of arbitration under the NGL in these cases appears to be having little influence on the behaviour of these pipelines, with some shippers informing the Inquiry that the costs and resources associated with an access dispute, coupled with the uncertainty surrounding how the AER would approach certain issues and the final outcome, 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'."

For the threat of arbitration to work, it has to be seen as credible. This will only occur if:

- the party with fewer resources ie end consumers who are shippers, have the appropriate level of transparency around information based on a workably competitive outcome that is considered fair, and

[12] Ibid p. 101

- the party with the greater resources ie the pipeline operator, cannot influence the arbitration process to move away from a workably competitive outcome

While the EUAA welcomes the AEMCs draft recommendations on arbitration, they will not create a credible threat during the negotiation process because of the shortcomings in Draft Recommendation 16.

Dispute resolution body and role of dispute resolution expert

We appreciate the AEMC supporting our reasoning at the December forum on the why the AER (and the Energy Disputes Arbitrator in Western Australia) should be retained as the disputes resolution body. We can understand the potential contribution of experts to the process but would see the use of these experts to be at the discretion of the disputes resolution body and not something that a party to the dispute can influence.

Reference framework for the dispute resolution body

The EUAA agrees with the AEMC when it proposes:

> "For light regulation pipelines, and because there is no full access arrangement, the Commission considers that the dispute resolution body requires clear guidance for tariff disputes in relation to the following:
>
> - calculation of an initial capital base, in case the light regulation pipeline does not have an initial capital base determination" (p. 150)

and then describes the recommendations in Chapter 6 around calculation of the initial capital base for all light regulation pipelines.

We also agree with the AEMC's recommendation that:

> "… the dispute resolution framework for scheme pipelines lay out a clear reference framework for decisions made by the dispute resolution body. The framework should refer to applicable access arrangements, regulatory determinations, revenue and pricing principles, in addition to general principles in line with the examples noted above. This would enhance the predictability of arbitration outcomes and the threat of arbitration in encouraging successful negotiations."

And yet, as we commented on the language in Draft Recommendation 16, the definition of "economic depreciation" is not crystal clear and dispute resolution body will have discretion on whether it uses "economic depreciation" in its decision making. As the AEMC notes:

> "It is worth noting that, as with non-scheme pipelines, in settling an access dispute, a dispute resolution body is not bound by the published financial information. However, the comprehensive underlying data will provide significant useful information for both negotiations and arbitrations. (p. 134)

Given this uncertainty, we doubt the ability of the Commission's recommendations to achieve their objective of an overarching reference framework. If there is a chance of the arbitration process using an asset valuation approach that does not accord with the proposal discussed above in Draft Recommendation 16, then shippers will not feel confident that the proposed framework will provide clear guidance on tariff disputes and will feel that arbitration is not a credible threat during negotiations.

What assurance has the shipper that, even if the information disclosure in the course of the negotiation process is based on a clear definition of economic depreciation, that this same definition will be applied during the arbitration? The discretion given to the dispute resolution body will provide an opportunity for the pipeline operator (which has much greater resources) to make submissions in favour of an alternative approach that is more favourable to them and may be contrary to the information disclosure it made during the negotiation process.

In the absence of this framework then the Commission has concluded that it would:

> "…make(s) the basis of the decisions of the dispute resolution body unclear in these circumstances. This may increase the uncertainty of arbitration outcomes, which reduces the credibility of the threat of arbitration. (p. 149)

The EUAA agrees.

Summary

As currently drafted, the EUAA submits that if se have correctly interpreted Draft Recommendation 16, the recommendations will not achieve the desired overarching reference framework that will give shipper confidence that arbitration will act as credible threat during the negotiation process. While the other recommendations do contribute to lowering the transactions costs of arbitration, shippers will continue to be very sceptical of entering into the arbitration process.

Two simple changes are proposed to ensure the process does achieve the framework's objective:

- as recommended above in the recasting of Draft Recommendation 16, and
- remove the discretion of the dispute resolution body in how it can assess a pipeline's capital base so that it is the same as in the information disclosure during the negotiation phase

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