Central Petroleum

Central Petroleum Limited

Submission in response to the

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

27 March 2018

Introduction

Central Petroleum Limited (Central) is a small cap oil and gas exploration and production company with significant gas exploration acreage located within the southern portion of the Northern Territory. Whilst Central has low cost gas production relative to the cost of production for new gas reserves in the East Coast, it must enter into significant gas transportation agreements in order to sell to domestic customers. For Central, and for many other new gas suppliers into the East Coast market, pipeline tariffs are the single largest cost item for delivered domestic wholesale gas supply.

Following the 2016 ACCC Inquiry into the East Coast Gas Market (IECGM) and the 2016 Examination of the Current Test for the Regulation of Gas Pipeline (Vertigan Examination), two of the most comprehensive independent examinations ever undertaken for the Australian domestic gas market, monopolistic pricing within the pipeline sector is now recognised as a major source of inefficiency within the Australian domestic gas market. This recognition validates what users of gas pipelines have long highlighted as a major distortion in gas price signals which are critical to efficient gas markets by stimulating new gas production and mitigating the magnitude of demand destruction associated with increasing gas production costs.

It is within this context, that Central has considered the AEMC Review into the scope of economic regulation applied to covered pipelines (Draft Report).

Submission Overview

A number of the Vertigan Examination's recommendations were recently implemented for uncovered pipelines. The most critical of which deals with the pricing principles available under a binding arbitration framework. The pricing principles for arbitration of uncovered pipelines now specifically addresses what has essentially been a loophole in the prevailing pipeline regulations – the use of accounting depreciation in determining asset value notwithstanding the much more rapid return of capital investment ingrained within the pipeline tariff pricing regime. This loophole has had the effect of allowing pipeline owners to self-determine pipeline revenue generation year-on-year (i.e. monopolistic pricing power) without having to recognise those excessive asset returns in future pipeline tariff calculations.

Whilst this critical issue appears to now have been addressed for uncovered pipelines through the National Gas (Pipeline Access – Arbitration) Amendment Rule 2017 (section "569 – Pricing Principals"), it does not extend to covered pipelines which must continue to rely on Parts 8 – 12 of the National Gas Rules (NGR) to establish pricing principals for regulated pipelines.

The AEMC's recommendations, specifically as they relate to pricing principles, fall well short of effective economic regulation or even an outcome approaching a workably competitive market. In so doing, covered pipelines that are subject to regulation will continue to engage in monopolistic pricing within a gas market that is already struggling to absorb massive production cost increases and trying to mitigate inevitable job losses associated with demand destruction. Failing to effectively address this flaw within the existing regulations fails to support the National Gas Objectives (NGOs) by allowing a major inefficiency to persist within the gas market.

Submission on the Draft Report

Central is highly aligned with other users of gas pipelines, both gas suppliers and gas customers, on the need for effective economic regulation of pipeline tariffs. This is particularly the case where those gas market participants do not have legacy pipeline capacity positions or significant pipeline capacity portfolios. Central is aligned with the Energy Users Association of Australia (EUAA) and supports their submission on the Draft Report. The following key points of submission, however, should be highlighted:

1) Draft Recommendation 16 seeks to address current pricing principles that fail to recognise full returns from a pipeline in the determination of its asset base. It seeks to do this by simply clarifying that "depreciation" is to become "economic depreciation" under rule 77. The rational for this solution is that it "…gives the regulator or dispute resolution body the discretion to take previous returns into account when setting an opening capital base for a scheme pipeline". As noted in the Draft Report (pg. 109), however, "economic depreciation" is intended to be a high level term that "encompasses a range of approaches…".

   The first critical shortcoming of this proposed solution is that it gives the regulator the discretion to consider a range of alternative approaches, each with significantly different outcomes for market participants. The arbitrator and market participants need to have certainty which in the specific methodology to be used to determine asset values/capital charges so that they can assess the appropriateness of prevailing pipeline charges and merits associated with arbitration. Of particular concern is that AEMC proposal will now allow the regulator or arbitrator to have discretion to take into account past recoveries for pipelines built after 1997. This discretion does not currently exist (it currently must be taken into account) so it is a clear step backward from effective economic reform.

   A second critical shortcoming is that the proposed solution fails to provide an arbitrator or market participant with any specific clarity as to how previous returns will be taken into account in establishing asset values. The GMRG made considerable progress toward this outcome by defining the "depreciated construction cost approach" in their Gas Pipeline Information Disclosure and Arbitration Framework Explanatory Note dated 2 August 2017. The GMRG suggests in this Explanatory Note on page 16 "…that the AEMC or SCO consider this issue as part of their reviews into the regulation of gas pipelines." The AEMC should utilise the significant work already completed by the GMRG to clearly and definitively articulate the methodology, rather than simply relying on a vague definition of economic depreciation and letting market participants figure it out during arbitration.

   The current AEMC proposal to redefine "depreciation" as "economic depreciation" and allow the arbitrator and regulator discretion in how they calculate asset values fails in every way to specify and clearly define a methodology to be used by the regulator to determine asset values/capital charges. As such it does little (if anything) to address the flaws in the existing regulations that have allowed pipeline owners to perpetually engage in monopolistic pricing.

2) There is a material gap between the approach used to determine asset values/capital charges by the GMRG for uncovered pipelines and by the AEMC recommendations within the Draft Report for covered pipelines. This creates a bizarre scenario where pipeline owners are incentivised to get regulatory coverage for their pipelines in order to preserve monopolistic pricing opportunity. The AEMC should align itself with the approach to asset values/capital charges that have been enacted for uncovered pipelines, both because it is far more supportive of the NGOs and to avoid a distortion in incentives for alternative regulatory coverage.

3) Draft Recommendation 17 requires the regulator to calculate an initial capital base for only lightly regulated pipelines that currently have not previously had an initial capital base calculated. Excluding the majority of regulated pipelines from any revised asset value methodology that accounts for previous returns defers into the distant future any market benefit associated with effective economic regulation. In addition, it in essence sanctifies any monopolistic pricing behaviour that occurred prior to the AEMC's review of economic regulation.

4) The AEMC has proposed that an arbitrator would have to take into account the asset value set by the AER. Whilst Central supports this in concept, a change in law could be required before the AER could adopt an asset value methodology that accounts for prior recoveries. If this is the case, it needs to be addressed such that any changes to the regulations can actually be implemented as intended.

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