EUAA Submission to AEMC Review into the scope of economic regulation applied to covered pipelines

Introduction

The Energy Users Association of Australia (EUAA) is very pleased to make this submission. We are the peak body representing Australian energy users. Our membership covers a broad cross section of the Australian economy including significant mining, 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 EUAA has been very supportive of the various COAG initiatives on gas flowing from the ACCC Inquiry into the East Coast Gas Market (ACCC Inquiry) published in April 2016 – both around increasing the sources of gas supply to the domestic market and removing the monopoly power the ACCC report identified as being exercised by a number of pipeline operators. On the latter, we welcomed the recent final report of the Gas Market Reform Group (GMRG) on the information disclosure and arbitration framework for non-scheme pipelines.

We now welcome this current examination of the regulatory structure applying to covered pipelines and in particular the opportunity to apply the excellent work of the GMRG into this regulatory structure.

In all this reform work, we strongly support COAG's focus on the National Gas Objective – in the long term interest of consumers. So often in the past this has been incorrectly equated with assuring the investment returns of pipeline owners, to the detriment of the NGO. Transportation costs have been inflated above their efficient levels as pipeline owners have been able to extract monopoly profits from shippers. The efficiency of the gas market has suffered with:

- existing consumers having to pay prices that did not reflect a what a prudent and efficient operator would charge,
- these inefficient tariffs acting as a barrier to entry for new sources of gas in the east coast market

Our overall approach is welcome the renewed focus on the National Gas Objective and recommend:

- Changing the coverage test to that recommended by the ACCC in its Inquiry into the east Coast Gas Market
- Improvements in the existing regulatory regime eg application of the forthcoming binding WACC guideline, expanded use of benchmarking and application of incentive mechanisms, rather than move to a new regulatory regime; not because we are opposed to considering a different regime, but because it would take some years to put the new regime in place and we need reform quickly
- Serious consideration be given to replacing the current "light regulation" regime with the recently introduced Gas Pipeline Information Disclosure and Arbitration Framework for non-scheme pipelines

- Have only two categories of discretion “no discretion” and “full discretion” and give the AER full discretion around the building block elements of the access arrangements
- AER to asses both forecast and actual capital expenditure
- AER to have discretion to decide of what expansion and extensions should be included in the covered pipeline
- AWR to ensure that shippers on regulate pipelines are not paying for speculative capital expenditure
- Change the focus of pipelines reporting KPIs to one of ensuring the information gained through the regulatory information notices process is comprehensive and consistent across pipelines to enable benchmarking both performance over time for a particular pipeline and comparative performance among different pipelines.
- Apply the Framework and Approach methodology from electricity networks togas networks
- AER to develop information disclosure standards for pipeline networks
- Apply the recently agreed Arbitration Framework for non-scheme pipelines to regulated pipelines.
- NGF to provide for the AER to assess non-price terms and conditions as part of the overall assessment of the access regime meeting the NGO.

Should you require clarification or further engagement with the EUAA please do not hesitate to contact us.

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CEO EUAA

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Responses to specific questions

Question 1 Purpose of the regulatory framework

(A) What do you think are the objectives of the current regulatory framework? Are the objectives of the framework clear? Has the framework achieved them?

(B) Are the objectives of the current regulatory framework still relevant, or should they focus on different issues such as monopoly pricing?

(C) Has the current incentive-based framework appropriately incentivised the efficient operation, use and investment in pipelines? Should a different approach to incentives be considered?

(D) Are there other third party access regimes (for example, for rail, ports or telecommunications) that would better achieve the purpose of the gas

EUAA Response

The aim of current regulatory framework should be the NGO – in the long term interests of consumers. However, the evidence provided by the ACCC inquiry clearly shows the regulatory framework has failed to achieve this objective given the exercise of market power by gas pipeline operators to extract monopoly rents from consumers.

While we can agree in theory with an incentive based regulatory framework based on a prudent and efficient operator, the real measure of its success is how it works in practice to prevent the exercise of monopoly power and pricing. Given this, we see merit in the change in the coverage test to that recommended by the ACCC Inquiry where the focus is on whether[1]:

- "the pipeline in question has substantial market power
- it is likely that the pipeline will continue to have substantial market power in the medium term
- coverage of the pipeline will or is likely to contribute to the achievement of the National Gas Objective (NGO) (for example, by promoting efficient investment, operation and/or the use of natural gas services for the long-term interests of consumers of natural gas)."

As the ACCC notes, this test[2]:

> "…better reflects the characteristics of the market and will provide a more effective constraint on the behaviour of pipeline operators. The test is also consistent with the principles embodied in the NGO and policy makers' original intentions when implementing this regime."

Once a pipeline is covered, it is about how effective are the rules and the Australian Energy Regulator implementing the rules. How robust is the application of benchmarking to measure what a prudent and efficient operator means? How effective is the measurement of rate of return to reflect the risk allocation between pipeline owner and shippers?

While there are other models that could be drawn on eg negotiated settlements, our preliminary view is that recent reforms – particularly the abolition of Limited Merits Review – suggest that the

[1] ACCC Inquiry p.20
[2] ibid

preferred approach is to improve the current model rather than replacing it with a completely new model. This is not because we are opposed to considering a different regime, but because it would take some years to put the new regime in place and we need reform quickly

These improvements would include:

- Application of the results of the forthcoming AER binding rate of return guideline – where it is hoped that a thorough examination of the risk allocation between pipeline owners and shippers will result on a more appropriate WACC
- Expanded use of benchmarking to better understand what is a prudent and efficient operator and how this can change over time eg with productivity improvements
- Application of incentive mechanisms similar to those that operate with electricity networks, and
- Increased AER funding to reduce the information asymmetry between pipeline operators and the AER and shippers in this regulatory process

Question 2 Efficiency of full regulation

(A) Do you consider that the benefits delivered by the access arrangement review process for a full regulation pipeline outweigh the costs?

(B) Is there a regulatory framework that may better achieve the desired objectives compared to the current negotiate-arbitrate framework supported by access arrangements developed under incentive-based economic regulation?

(C) Do you think that the access arrangement process should be amended to be similar to the revenue determination process for electricity service providers? Should there be greater recognition of consumer consultation, particularly for distribution pipelines?

(D) Have the NGR been effective and adaptable to the evolution of the gas industry?

EUAA Response

The EUAA firmly believes that the benefits of full regulation outweigh the costs of that regulation. This will be even more the case in the future with:

- the abolition of Limited Merits Review and the application of the AER's binding WACC guideline substantially reducing the transactions costs of regulation
- the focus on better application of the regulatory rules eliminating the inefficiencies stemming from the pipelines exercising monopoly power.

Our response to Question 1 commented that our view is that fixing the current model is quicker way of getting closer to the achieving the National Gas Objective that going through the lengthy process of getting stakeholder agreement to adopt a new model like negotiated settlements.

The level of consumer consultation in the current round of pipeline revenue rests varies greatly among pipeline operators. When we see the strong commitment of the ENA to putting the customer "at the centre" of the discussion, we would assume that the gas networks would welcome an expansion in and recognition of their customer engagement process. Consideration should be given to the regulatory outcome being influenced by the scope and success of that consumer consultation eg specific monetary rewards for best practice consumer engagement.

Question 3 Efficiency of light regulation

(A) Do the form of regulation factors consider relevant structure, conduct and performance issues to enable the NCC to make an informed decision on the application of full or light regulation?

(B) Do you consider that the light regulation regime has been fully utilised and appropriately enforced to produce benefits to pipeline users and achieve its objectives? If not, why not?

(C) Are there other regulatory requirements that should be applied to light regulation pipelines? Are there current requirements that should not be applied?

(D) Having regard to the new proposed non-scheme pipeline regulatory arrangements on information disclosure and arbitration, is the light regulation regime still relevant? Should it be retained, removed or amended?

EUAA Response

We do have some concerns around the application of the light regulatory framework to distribution pipelines. Consumers of these pipeline services tend to be either retail or small/medium sized businesses which may have no option eg though the nature of their industrial processes, to use any other source of energy. This provides an easy avenue for the exercise of market power by a natural monopoly. The EUAA has heard of a specific case of a regional industrial gas user in Queensland which was unable to switch from gas to another energy source and which was only able to obtain one offer for a new gas contract. This was because the gas supplier has bought all the spare capacity in the distribution pipeline which prevented other potential suppliers from obtaining transport access.

The EUAA agrees that replacing the light regulation regime with the recently introduced Gas Pipeline Information Disclosure and Arbitration Framework for non-scheme pipelines, could bring improved outcomes in terms of the NGO and removal of the exercise of market power by pipeline operators. Shippers will have substantially more information available than they currently have and will have a robust arbitration system if they are unable to reach a negotiated outcome. However it should be emphasised that while the Framework decreases the information asymmetry, a negotiation asymmetry may still remain given the relative resources available to the pipeline operator vs the shipper.

Question 4 Efficiency of regulatory discretion

Do you consider that the three levels of regulatory discretion in approving the elements within an access arrangement are useful and assigned appropriately?

EUAA Response

The EUAA agrees with the AEMC that there is uncertainty around interpreting the level of discretion in Part 9 of the NGR. Our general approach is to:

- simply have two categories of AER discretion – “no discretion” and “full discretion”
- that, given the role of the regulation is to meet the NGO and prevent the exercise of monopoly power, that the AER should have full discretion around the building block elements of the access arrangements

The latter allows the application of a consistent approach to issues such as depreciation schedules to prevent over recovery of costs from consumers.

Question 5 Conforming capital expenditure

(A) Do you consider it beneficial that both forecast and actual capital expenditure are assessed by the regulator?

(B) Does an appropriate level of regulatory scrutiny on investment occur if the regulator's discretion is limited?

(C) Can the same capital expenditure criteria apply to both market carriage and contract carriage pipelines? And to both transmission and distribution pipelines?

EUAA Response

Yes, we consider it beneficial for the AER to assess both forecast and actual capital expenditure. It is central to the NGO that the AER can assess whether the actual capital spent was consistent with what a prudent and efficient operator would have spent.

As we noted in our response to the previous question, it is important for the AER to have full discretion on any matter associated with the building blocks in the access arrangements – of which capital is a key part. This scrutiny is not possible under the existing regime of limited AER discretion. There should be consideration of the application of the RiT-T and RiT-D tests used in electricity networks to gas networks. This would apply, given the recent AEMC rule change for electricity networks, to both new and replacement capital.

Question 6 Extension and expansion requirements

(A) Should there be discretion regarding which extensions and expansions are to be included as part of a covered pipeline? On which basis do you consider that such discretion should be exercised?

(B) If a pipeline is partially covered, does this impact on the application of the cost allocation and tariff setting rules? Does it impact on other aspects of an access arrangement?

(C) Should the same extension and expansion requirements apply to both market carriage and contract carriage pipelines? And to both transmission and distribution pipelines?

EUAA Response

The aim of the regulation should be to ensure the shippers of the regulated part are not paying for a component of the unregulated part. The AER should have the discretion to decide on what expansion and extensions should be included in the covered pipeline.

Question 7 Investment in excess capacity

(A) In your opinion, why has the speculative capital expenditure account rarely been used?

(B) Should the regulatory framework support more or less investment of a speculative nature? If more, how could it do so most efficiently and effectively? With which party(s) should the risk of speculative investments reside?

(C) If the regulatory framework permits speculative investment, should it also allow for the management of redundant assets?

EUAA Response

It is reasonable to conclude that this section has not been used because of the ability of pipeline operators to include the capital in the regulated asset base. The expended ability of the AER to exercise full discretion proposed above should limit this occurring.

The key issue for shippers is that they are not paying for speculative capital in a regulated asset base which should be borne by the pipeline operator, not whether the regulatory regime encourages or discourages the use of a speculative capital account.

If this principle is followed then if speculative capital becomes redundant the pipeline operator meets the costs of that decision.

Question 8 Capacity available under an access arrangement

(A) Does the current regulatory framework offer appropriate incentives for a service provider to offer spare capacity of a covered pipeline where it is efficient to do so?

(B) Do you think that scheme pipeline service providers maintain useful spare capacity registers? Does this rule need to be amended in light of expected market reforms?

(C) Are the rules on defining a service provider interacting with ownership and operational structures in a way that impacts on disclosure of potentially available pipeline capacity?

EUAA Response

This matter is being address through the GMRG work and the AEMC can draw on the conclusions of this review. As a general principle, we support total transparency around the availability of spare capacity on all pipelines and that this be available at an efficient price reflecting marginal costs.

Question 9 Extensions to the pipeline

(A) Does the ability of service providers to exclude extensions from an access arrangement raise concerns for pipeline users?

(B) Would service providers and users benefit from the NGR including a negotiation framework for the connection of separately owned assets to covered pipelines?

EUAA Response

To the extent that extensions are specific purpose eg to supply a particular customer rather than customers generally, then we do not see an issue with excluding extensions for access arrangements. Shippers on the existing regulated part of the pipeline should not bear the risk of a potentially speculative extension built for a particular user eg if that user goes bankrupt and is unable to meet its obligations under its transport contract.

Question 10 Performance indicators

(A) Do the requirements to provide key performance indicators as part of an access arrangement result in useful information to users and prospective users of a pipeline?

(B) Should the rules allow for the regulator to be more specific on which key performance indicators for distribution and transmission pipelines should be reported? Would this provide for better comparisons across pipelines and over time? If not, how could greater consistency be achieved?

EUAA Response

The lack of consistent metrics across pipelines for reporting KPIs means they are of very limited use.

Our preference is to ensure the information gained through the regulatory information notices process is comprehensive and consistent across pipelines to enable benchmarking both performance over time for a particular pipeline and comparative performance among different pipelines.

Question 11 Purpose and definition of reference services

(A) Is the purpose of a reference service as an aid to negotiation for pipeline services a relevant purpose for both transmission and distribution pipelines? Has this been a successful approach? Should access arrangements cover a broader range of services?

(B) Should reference services continue to be defined in relation to market demand? Is there a more appropriate approach to defining reference services?

(C) Does the access arrangement process limit the ability of the regulator and the service provider to make changes to the reference services for an access arrangement? If so, how could this be resolved? Is there merit in adopting the framework and approach process for access arrangements?

EUAA Response

As the ACCC Inquiry argued[3], the current regulatory system for fully regulated pipelines enables a fully regulated pipeline to exercise market power given it only requires the AER to approve a "reference service" offered by the pipeline - defined as a service bought by a significant portion of the market without any requirement about whether the service is contestable. The resultant exclusion of a number non-constable services from regulation has provided the opportunity for the pipeline operator to exercise its monopoly power for these services.

By contrast the regulation of electricity networks uses the Framework and Approach process to identify whether a service is non-contestable and hence subject to regulation. The EUAA supports the extension of this F&A process to gas network regulation to assess contestability and hence regulatory coverage. This will result in a broadening of the number of services that will be subject to regulation and hence reduction in the ability of the pipeline operator to exercise market power.

While the current gas regulatory regime allows a shipper to go to arbitration to determine the price of these non-contestable services, there are strong incentives not go down the arbitration path eg costs, information asymmetry between the pipeline operator and shipper and uncertainty about the outcome.

Question 12 Light regulation and limited access arrangements

(A) Does the light regulation regime achieve its objectives of providing relevant information to users and prospective users on access to a pipeline?

(B) Should the information reporting requirements and the limited access arrangement provisions specified for light regulation pipelines be amended to better achieve the regime's purpose?

EUAA Response

As commented above in our response to Question 3, the EUAA sees benefit in replacing the light regulation regime with the recently introduced Gas Pipeline Information Disclosure and Arbitration Framework for non-scheme pipelines. This will bring the shipper substantially more information than is currently available under the light regulation regime and seems to be a more effective approach to improving information disclosure than amending seeking to expand the information reporting requirements specified in the light regulation regime.

[3] Op cit p. 135

Question 13 Providing information

(A) Do access arrangements and access arrangement information documents contain relevant and accessible information for users and prospective users seeking access to a covered pipeline? Is consistency in the provision of information important to aid in its understanding?

(B) Do the Part 11 information requirements result in the provision of information that is relevant to users and prospective users seeking access to a covered pipeline? Is there other relevant information that could be provided? How do these requirements compare to the reforms for non-scheme pipelines?

(C) Could the Bulletin Board, or the scheme register, play a greater role in making available information regarding covered pipelines?

EUAA Response

As a general principle, the more information available to the shipper and the more transparent is the regulatory process, the more likely it is to achieve a better outcome in terms of the NGO. This information needs to be presented on the consistent basis and agreed standards so there is no misunderstanding about what it means and to enable comparisons between pipelines. This information disclosure provides a good, but not perfect way, of reducing the information asymmetry between pipeline operator and shipper.

Given the AER is about to begin a process for developing the information disclosure standards to apply to non-scheme pipelines, there is perhaps merit in following a similar course – AER developed information disclosure guidelines – to apply to regulated pipelines.

Question 14 Arbitration

(A) If there is uncertainty about how the current arbitration framework operates, how could this be resolved? Should Chapter 6 of the NGL and/or Part 12 of the NGR be amended with regard to the information and/or the processes?

(B) Are there aspects of the arbitration framework for non-scheme pipelines under development by GMRG that could also apply to scheme pipelines?

(C) Which pipeline services should be subject to arbitration? Are there any pipeline services that should be excluded?

EUAA Response

The limitations of the current arbitration framework for regulated pipelines has been well documented in recent reports.

The EUAA strongly supports the application of the recently agreed Arbitration Framework for non-scheme pipelines to regulated pipelines. This should apply to all services provided by regulated pipelines.

Question 15 Tariffs

(A) Do you consider that the reference tariffs for transmission and/or distribution pipelines reflect the efficient costs of providing those reference services? If not, which provisions of the NGL or the NGR are contributing to that outcome?

(B) Should the NGR recognise partially covered pipelines and provide specific guidance on cost allocation in this context?

(C) Do the tariff setting requirements in the NGR provide the appropriate balance between discretion and guidance to achieve cost reflective tariffs? Should the discretion of the regulator be limited?

(D) Why do you think that distribution pipeline service providers tend to charge the reference tariffs as the prices for the services that they provide?

(E) Is the balance between prescription and discretion for the reference tariff variation mechanism appropriate? Would more guidance in the NGR or from the regulator better support the development of these mechanisms?

EUAA Response

The EUAA has no confidence that the reference tariffs reflect the efficient costs of providing these reference services. This is due to several factors:

- the information asymmetry between pipeline operators and the AER
- the lack of agreed guidelines on the allocation of indirect costs between various service the pipeline provides
- the inability to applying benchmaking
- the rates of return that have been achieved by some pipeline operators as shown by the ACCC research supporting monopoly returns

However, we see potential improvements for consumers with the removal of Limited Merits Review and the application of the soon to be developed binding WACC guideline. Further improvements would be:

- development of a binding AER guideline on cost allocation between the covered and non-covered parts of a pipeline
- more sophisticated consideration of the tax component of the building block which recognises the particular network situation eg whether domestically or overseas owned
- the ability of the AER to exercise more discretion on the conditions under which reference tariffs can be varied during an access arrangement period

Question 16 Non-tariff conditions

(A) Do the non-tariff requirements for access arrangements result in relevant information being provided to users and prospective users of covered pipelines? Are there other non-tariff requirements that would be relevant?

(B) Should the NGR or the regulator provide more guidance on which non-tariff requirements should be included in an access arrangement? Is there a need to provide greater guidance regarding the regulator's assessment of non-tariff requirements?

EUAA Response

The EUAA's key concern here is how the pipeline operator may use restrictive non-price terms to increase the effective price above what might be justified by the AER's cost analysis. Shippers look at the combined impact of price and non-price terms to assess whether to enter into a transport contract and it is important that the NGO apply to all terms.

There is a strong case for the NGR to specifically provide for the AER to assess non-price terms and conditions as part of the overall assessment of the access regime meeting the NGO. This would then require the AER to develop detailed guidelines of how this assessment would be undertaken.

EUAA

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