

15 October 2015

Ms Shari Boyd
Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Project reference code: GRC0029

Dear Ms Boyd

APA Group (APA) welcomes the opportunity to comment on the Australian Energy Market Operator (AEMO) Rule change request in respect of the Rules for allocating Authorised MDQ and AMDQ Credit Certificates.

APA does not believe that the AEMC has correctly interpreted the current operation of the Rules, and in doing so has concluded that the proposed Rule change substantially changes the allocation process for AMDQ, and associated investment incentives. This is not the case. APA discusses these issues in the attached submission.

APA supports the Rule change as lodged by AEMO in November 2013 as providing for improved clarification of the operation of the current rules for the allocation of Authorised MDQ and AMDQ Credit Certificates.

If you would like any further information, please call Alexandra Curran on 02 9275 0020.

Yours sincerely



Peter Bolding
General Manager Strategy & Regulatory



National Gas Amendment (DWGM-AMDQ Allocation) Rule 2015

APA submission responding to Consultation Paper

1. Introduction

APA Group (APA) welcomes the opportunity to comment on the Australian Energy Market Operator (AEMO) Rule change request in respect of the Rules for allocating authorised MDQ and AMDQ credit certificates (collectively, AMDQ).

APA does not believe that the AEMC has correctly interpreted the current operation of the Rules, and in doing so, has concluded that the proposed Rule change substantially changes the allocation process for AMDQ, and associated investment incentives. This is not the case.

APA supports the Rule change as lodged by AEMO in November 2013 as providing for improved clarification of the operation of the current rules for the allocation of AMDQ, as well as appropriate signals for timely investment in new capacity on injection pipelines.

2. Interpretation of AMDQ allocation Rules

2.1. AEMC's representation of current practice in allocating AMDQ

1. Current practice

(a) Has the current practice relating to the classification of new capacity instruments and the party who undertakes the allocation process been correctly set out above?

(b) If not, please identify any inaccuracies.

As a minor matter, AEMC's description of current practice could be improved by noting that the allocation of AMDQcc is not undertaken directly by the service provider. AEMO allocates AMDQcc on direction by the service provider.

Further, APA GasNet previously determined how it would direct the allocation of spare AMDQcc via a fixed price tender for a set term. The AER has, however, since determined that APA GasNet's role in directing the allocating of spare AMDQcc is a reference service, and has included this service in the access arrangement applying to the VTS.

In doing so, the AER has determined the cost of providing that service by APA GasNet, and has allocated a portion of total revenue to this service and set a tariff. This means that 'proceeds' from the allocation of spare AMDQcc under the access arrangement are part of the total revenue calculation for APA GasNet, and are included in determining the reference tariffs for the two reference services (transportation and spare AMDQcc allocation).

2.2. AEMC's representation of the current rules in allocating AMDQ

APA does not believe that the AEMC has correctly interpreted the current operation of the Rules.

In respect of Rule 329(2), it would appear the AEMC have not considered the timing elements that are part of this subrule and how these impact its operation. The relevant part of this subrule is highlighted in bold below:

Where the declared transmission system service provider undertakes an extension or expansion and the cost of the extension or expansion is entirely added to the declared transmission system service provider's capital base on the basis that **the criteria in rule 79 are met by the time the extension or expansion is commissioned**, additional authorised MDQ which becomes available for allocation as a consequence of that extension or expansion is to be allocated in accordance with rule 330.

Under Rule 77(2), expenditure is added to the capital base at the point of establishing the opening capital base for the next (forecast) period. This is after expenditure has been incurred. Until this time, approved forecast expenditure is part of the *projected* capital base, and does not enter the capital base until the end of the period and the opening capital base for the next period is established (that is, effectively after ex post review).

This is an important element of the gas access regime, and one that differs from the electricity regime. All capital expenditure under the gas regime is subject to review before entering the capital base – it is at this point that the AER determines whether the expenditure actually meets the requirements of Rule 79. This review relates to both the need for the expenditure, and its quantum, noting that it is not uncommon for an approved project to ultimately cost more than any previously approved amount. Further, many projects completed within a period may not have been part of the original approved projected capital base, so may be assessed by the AER for the first time during this ex post approval process.

An interpretation of Rule 329(2) that requires a determination that an expansion has entered the capital base would require the commissioning of a new asset (when AMDQ is created) to be delayed until the end of a regulatory period and after the AER had approved the closing capital base, as this would be the point where it could be determined that the capital expenditure had entered the capital base in full. APA does not believe that this is a workable interpretation of this Rule.

By contrast, an interpretation of this Rule that relates it to the initial capacity of the Longford pipeline, as well as any assets that were included in the initial capital base for the VTS (and therefore were subject to an Authorised MDQ allocation) is a more workable interpretation of this Rule, and one that fits with current accepted practice.

Further, APA considers that the AEMC has concluded that the remainder of Rule 329 offers a clearer allocation methodology than is actually the case.

The areas of uncertainty are as follows:

- Rule 329(3)(a) refers to that part of an expansion that satisfies Rule 79, and contemplates the creation of either authorised MDQ or AMDQcc by that conforming expansion
- Similarly, Rule 329(3)(b) refers to that part of an expansion that does not satisfy Rule 79, and contemplates the creation of either authorised MDQ or AMDQcc by that non-conforming expansion
- There is no guidance under the rules to determine whether authorised MDQ or AMDQcc are created by an expansion under Rule 329(3). This is left to agreement between AEMO and the service provider
- For expansions that fall under Rule 329(3)(a), the allocation is required to be in accordance with Rule 330, however rule 330 only relates to the allocation on authorised MDQ (not AMDQcc)
- Rule 329(4) provides for the allocation of authorised MDQ or AMDQcc by direction of the service provider where subrules (2) or (3)(a) do not apply
- Rule 329(6) refers to AEMO's allocation of authorised MDQ or AMDQcc under Rule 330, where Rule 330 only applies to authorised MDQ
- As Rule 330 only applies to the allocation of authorised MDQ through an AEMO auction process, it follows that any AMDQcc created is allocated on the direction of APA GasNet.

APA considers that current and accepted allocation practice since market start, which differentiates authorised MDQ or AMDQcc between original Longford capacity (authorised MDQ), and capacity added since that time (AMDQcc), is instructive in interpreting the intent in the operation of the rules. This interpretation is also the only one that is capable of practical implementation in the context of the regulatory cycle.



3. Details of the rule change request

3.1. Issues that the rule change request seeks to address

2. Issue identification

- (a) Has AEMO correctly identified the issues relating to the current provisions of the NGR?
- (b) If not, what other issues, if any, do stakeholders see in relation to the NGR provisions as currently drafted?

APA considers that AEMO has correctly identified some of the issues related to the current provisions in Rule 329(3), in relation to their lack of clarity and cross referencing. It is also the case, however, that the rules as currently drafted are not capable of being followed in some circumstances, as they cross refer to clauses that do not apply to the circumstances contemplated.

There are a number of further issues with the operation of the current rules under the AEMC's interpretation of their operation. These relate to incentives to invest and the timing of investment, and are discussed further in section 4.3 below.

3.2. Operation of the proposed Rule

3. Identified solution

- (a) Do you consider the solution identified by AEMO will address all of the issues associated with the classification of new capacity and the party responsible for undertaking the allocation process in the Victorian DWGM?
- (b) Why or why not?

APA supports the rule changes proposed by AEMO. APA considers that the AEMO proposal provides a clear, transparent and easy to administer process for the creation and allocation of both authorised MDQ and AMDQcc, while also providing appropriate incentives for investment in new capacity throughout the regulatory period. The AEMO Rule change therefore represents a preferred methodology compared to that in the current rules.

APA notes that the AEMC's description of proposed rules are not completely accurate, in that the AEMC refers to the new rules providing for a minimum of 20 days' notice for an APA *tender* of AMDQcc. The proposed rules only refer to APA giving a minimum 20 days' notice for Market Participants to *respond to proposals* for the allocation of AMDQcc. This is because the Rules do not require APA GasNet to undertake a tender process, and alternative processes could be adopted in the future.

At the time of preparation of this rule change proposal through the AEMO Gas Wholesale Market Consultative Forum, the allocation of AMDQcc by direction of APA GasNet was not a reference service under the VTS access arrangement. Subsequently, the AER classified the allocation of spare AMDQcc as a reference service. Now, the access arrangement, including the queuing requirements, is intended to address the appropriate allocation methodology for spare AMDQcc. This means that the inclusion of proposed new rule 1A may not be necessary under the Rules. Notwithstanding this, APA does not consider that the inclusion of minimum 20 days' notice for Market Participants to respond to proposals for the allocation of spare AMDQcc is unreasonably restrictive on the operation of an efficient allocation methodology under an access arrangement. To the extent that this provision provides some certainty to Market Participants, APA considers that it should be retained.



3.3. Rationale for the proposed rule

4. Cost and benefits

Do you consider AEMO's analysis of the total market costs and benefits include all potential costs and benefits that may result from the proposed rule? If no, why not?

APA agrees that the proposed rule will not increase costs for participants as it represents current practice. The approach provides benefits through clearer rules, but also in providing for clear incentives to invest in new injection pipeline capacity. These incentives have been shown to be effective by the investment that has occurred on pipelines such as the South West Pipeline, and shippers supporting that investment through contractual commitments to purchase new AMDQcc prior to construction of any expansion.

4. Issues for consultation

4.1. Effective allocation process

5. Allocation process

- (a) Is the process and design of the allocation mechanism used by AEMO to allocate authorised MDQ efficient? If not, what improvements are necessary?
- (b) Is the process and design of the allocation mechanism used by APA to allocate AMDQcc efficient? If not, what improvements are necessary?

APA has no comment on the AEMO allocation process for Authorised MDQ.

APA is concerned that the AEMC has chosen to extend discussion on this Rule change proposal into the efficiency of APA GasNet's past processes for allocating AMDQcc. The Rules provide that where the service provider undertakes the allocation, that allocation is a matter for the service provider. The previously adopted tender process, and methodology for treating revenues, was a commercial process adopted by APA GasNet and is not stipulated under the Rules, and is not part of the AEMC's consideration under the Rules. It should also be noted that this process was overseen by the ACCC through their competition functions.

Further, APA GasNet allocation of spare AMDQcc is now subject to the prevailing access arrangement. The AER decision to make the allocation of spare AMDQcc a reference service and subject to the access arrangement noted the existing APA GasNet allocation process via a tender process, but also set a reference tariff for that service. The allocation of revenue to the sale of spare AMDQcc under the revenue model makes the AEMC's discussion of 'volume' and 'price' effects from the allocation of AMDQcc redundant – AMDQcc revenues and tariffs, and how they are reflected in the overall revenue allocation for APA GasNet, are now included in the overall regulated tariff model for APA GasNet. There are no price or volume effects to consider.

The AER decision also means that the method of allocation for spare AMDQcc is a matter for access regulation. In this respect, allocation of spare AMDQcc by the service provider is similar to other firm contracting arrangements for pipeline services on contract carriage pipelines, such that a reference tariff is set, but contracting parties are free to agree to alternative arrangements, and is not a matter for the Rules beyond the current arrangements under Part 9.

4.2. Regulated revenue amount

6. Regulated revenue

- (a) Is the AEMC's understanding of the linkage between the inclusion of costs into the capital base and the opportunity to earn only the regulated revenue amount correct? If not, why not?
- (b) Is the inclusion of the costs associated with an extension or expansion in the capital base an appropriate factor to determine who undertakes the allocation process? Why or why not?
- (c) Is the regulated revenue amount received by APA pursuant to its access arrangement a sufficient investment incentive to ensure efficient



investment in the DTS? Why or why not?

(d) Do stakeholders have a view on the materiality of the issue related to the 'volume effect' and 'price effect' going forward? What is this view based on?

(e) If stakeholders are of the view that neither the 'volume effect' or 'price effect' are material at this time, are there specific market developments that may impact the market resulting in the 'volume effect' or 'price effect' becoming material?

(f) If so, what are these market developments?

(g) If the party who undertakes the allocation process was determined based on the inclusion or exclusion of costs in the capital base in comparison to the current practice of AEMO undertaking the allocation process for authorised MDQ and APA undertaking the allocation process for AMDQcc:

- what, if any, impact would this have on parties participation in the market?
- what parties are likely to be affected either positively or negatively?
- how would these parties be affected?
- will market participants' behaviour be affected? If so, how?
- if so, what are the consequences or outcomes of these behavioural changes on efficiency in the market and/or the long-term interests of consumers?

As noted above, APA does not agree that the current rules provide that APA does not receive additional revenue from the allocation of authorised MDQ or AMDQcc when the costs of the extension or expansion are included in the capital base. APA believes that the current rules refer only to capacity in place at the time of establishing the initial capital base at Longford, and later extensions and expansions are not made part of the capital base until after they are commissioned (that is AMDQcc is allocated).

Notwithstanding this position, APA provides the following in response the AEMC's questions, which assume the alternative interpretation.

Role of the revenue cap (AEMC question a)

The AEMC have articulated a 'problem' with APA GasNet collecting revenue in addition to the AER approved regulated revenue amount. This reflects a misunderstanding of the scope of regulation, as well as the operation of a price cap regulatory regime.

The AER approved regulated revenue amount for the VTS relates to cost of the provision of pipelines services on regulated pipeline infrastructure. Prior to the most recent access arrangement decision, the allocation of AMDQcc was not included as a pipeline service, and therefore was not part of the scheme of regulation for the VTS. In this respect, the allocation of AMDQcc was akin to the provision of any other unregulated services by a pipeline business.

This makes the AEMC's conception of 'over recovery' of revenue for AMDQcc compared to the regulated revenue approved under the access arrangement incorrect – there was no actual or necessary relationship between the two.

Now that the allocation of spare AMDQcc is classified as a reference service, this process is within the scheme of the access arrangement, however the concept of over-recovery is still not relevant as the reference tariff set for the allocation of spare AMDQ is included in the AER's revenue allocation for APA GasNet.

Further, under a price cap form of regulation, regulated service providers can earn more than the regulated revenue decision through outperformance, including through volume and price outperformance. Shippers and service providers are free to agree arrangements that are alternatives to the regulated outcome, including arrangements that result in the service provider earning more revenue than the regulated revenue amount, and these agreements are not relevant to the access regime.

Inclusion of expenditure in the capital base and investment incentives (AEMC questions b and c)

APA does not believe that inclusion of the costs of expansion in the capital base is an appropriate consideration in relation to the allocation of AMDQ.

A key issue that arises from this linkage is one of timing.

Under the Rules, AMDQ is created and allocated immediately prior to the new capacity coming into service through a change to the Service Envelope Capacity under the Service Envelope Agreement. This can occur at any stage in the regulatory cycle, and may not coincide with a regulatory decision. This means that new capacity completed within a regulatory period is not added to the capital base until the next review (when the opening capital base for the next period is established). In this context, it will not be known if the capacity will satisfy Rule 79 as conforming capital expenditure.

This circumstance occurred with the recent completion of the South West Pipeline capacity expansion (installation of the Winchelsea compressor). In response to shipper demand that emerged after the regulator's decision, APA GasNet has chosen to install a larger compressor, thereby creating more capacity, than that approved in the regulatory decision. This was made possible in part through commitments from shippers to purchase new AMDQcc.

APA believes that the additional capacity on the South West Pipeline is conforming capital expenditure, however the additional expenditure associated with installing a larger compressor is subject to regulatory decision, and in any case, none of the expenditure on this project (even that already assessed by the AER) will be actually added to the capital base until the start of the next regulatory period (1 January 2018).

The new capacity for the South West Pipeline came into operation in the first half of 2015, including the additional capacity beyond the most recent regulatory approval. It is difficult to see how this capacity would be treated for the purposes of determining which party would undertake the allocation of any Authorised MDQ or AMDQcc created under the AEMC's conception of the Rules. This creates uncertainty for both the service provider and shippers.

Because of this uncertainty, linking the type of AMDQ created to a decision as to whether the expenditure associated with the extension or expansion is added to the capital base is likely to delay investments in capacity to even more closely coincide with the regulatory control period (something that is already a problem with the current regulatory arrangements).

It should be noted that seeking up front agreement from the AER to the expenditure under Rule 80 would not address this issue, as this decision does not add the expenditure to the capital base; it only binds the regulator to add the expenditure at the next review. A process that required the service provider to seek this type of within period approval would also delay any investment further.

There is also an issue in relation to incentives to invest.

For other regulated pipelines (that is, those not operating under the Victorian declared wholesale gas market rules), extensions and expansions can be included in the capital base as conforming capital expenditure, without the shippers that requested or which use the additional capacity associated with that extension or expansion necessarily paying the reference tariff for those services. As noted above, shippers and service providers are free to agree arrangements that are alternatives to the regulated outcomes, and these agreements are not relevant to the access regime. This ability to agree alternative arrangements is key to supporting investments in additional capacity for these pipelines, and is also contemplated under approved extensions and expansions policies for other APA regulated pipelines.

Requiring the allocation of AMDQ by AEMO where the extension or expansion is included in the capital base would remove the ability of shippers and service providers to agree alternative arrangements for access to AMDQ created through an expansion. This is important as the ability to agree alternative arrangements has been critical to securing investment in the VTS in the past.

The recent expansion of the South West Pipeline was underpinned by shipper commitments to AMDQcc prior to the expansion being built. This preceded a decision by the regulator as to whether the investment was conforming capital expenditure.

These shipper commitments allowed APA GasNet to accurately forecast the demand for the expansion, but also gain certainty over the tariffing arrangements as the agreement with shippers in relation to AMDQcc created a take or pay arrangement for the service. This certainty of demand is critical under the VTS as shippers do not need to commit to their demand under the market-carriage framework. Without the commitment to AMDQcc by shippers,



APA GasNet would not be able to be certain that it would receive a return on its investment in additional capacity, or even assess whether the expansion was likely to be conforming capital expenditure.

The shipper commitment to AMDQcc also allowed APA GasNet to commence work on the expansion prior to the regulatory decision, which was important as it was serving pent up demand for the expansion. Linking the method of allocation of AMDQcc to the regulatory decision making process means that the timing of this investment is similarly tied, and capacity will not become available to the market will not proceed until this decision is made.

Materiality of the price and volume effect (AEMC questions d, e and f)

As noted above, the AEMC's discussion of the volume and price effect is not relevant to the rules or scheme of access regulation as these questions relate to pricing of a service that was not a pipeline service at the time. In any case, the classification of the allocation of spare AMDQcc as a reference service means these arrangements are no longer in place.

Impact of change of allocation process on the market (AEMC question g)

A change in practice of this type would have a significant impact on incentives to invest in new pipeline capacity that creates AMDQcc. As determined by the AEMC in other policy processes, the market carriage framework has very poor incentives for investment. This is because a shipper cannot gain direct access to the capacity it may want to underwrite, and the service provider cannot gain certainty over the demand for services that may justify a capacity expansion. This problem is particularly pronounced for injection pipelines (where AMDQ is relevant), as a shipper's intentions in relation to injection are subject to commercial considerations (in particular the shipper's gas supply arrangements) and the shipper has a number of alternatives for injection into the system. An expansion could be built in good faith on the basis of anticipated demand and then not used. This creates a strong risk of asset redundancy which means that the service provider requires a level of certainty of demand before investment.

Under the DWGM, the only current mechanism for the service provider to gain confidence on intended flows, and for a shipper to ensure access to capacity that it underwrites, is through the allocation of AMDQcc by the service provider. This certainty is not provided through the allocation of Authorised MDQ by AEMO.

A change in allocation approach is very likely to lead to less investment in the VTS, and where investment does occur, that investment is delayed and involves very conservative expectations of demand (that is, it is likely to be undersized for the market). This outcome would impact competition in the VTS, as shippers with access to gas may not be able to access the market as there is insufficient pipeline capacity, and ancillary payments are likely to be higher as this will create more deviations between the operating and pricing schedules (congestion uplift).

4.3. Investment signals

7. Investment signals

- (a) Are the allocation processes currently used in the Victorian DWGM efficient mechanisms to provide investment signals in the market? If no, why not?
- (b) Does AEMO's auction process for authorised MDQ provide any investment signals to the market? If no, why not? If yes, how?
- (c) Does APA's tender process for AMDQcc provide investment signals to the market? If no, why not? If yes, how?
- (d) Are there other mechanisms, under the current market design, that provide investment signals in the Victorian DWGM? What are these other mechanisms?
- (e) If there are other market mechanisms, how do they interact with the price determination and allocation processes currently used by AEMO or APA?
- (f) Would the same investment signals exist if AEMO undertook the allocation process for AMDQcc? If no, why not?

As described above, the currently adopted allocation methodology, which deems that extensions and expansions only create AMDQcc allocated by the service provider, provides investment signals by allowing shippers to directly invest in, and secure, new AMDQcc associated with an expansion prior to investments proceeding. Along with ensured access to AMDQcc for the shipper, this process provides certainty to the service provider that the demand



that justifies the expansion will eventuate, which minimises the inherent investment risks in the DWGM. In this way, demand for new AMDQcc provides a signal for new investment in the DWGM.

The currently adopted allocation methodology also addresses issues that arise in relation to the timing of investments in new capacity and the access arrangement cycle by not linking the two processes. This ensures that new capacity can be created throughout the access arrangement period, and need not coincide with expenditure associated with that capacity being added to the capital base, and AMDQcc can still be created and allocated in accordance with the Rules.

Importantly, allocation by the service provider is key to managing these risks, and it provides for certainty of volume and demand for new AMDQcc. This does not occur under the AEMO allocation process.

The currently adopted allocation methodology is also clear, simple, and easy to administer.

APA considers there are very limited alternative signals for investment in the DWGM. As described by the AEMC, demand for existing AMDQ, and the price paid for that AMDQ, can signal constraints in the existing system (by providing tie breaking rights) as well as shippers' perceptions of the risk of uplift payments. As an investment signal, these prices can precede an actual increase in uplift charges, and therefore may give an earlier signal for investment in the system. This is important as investment in new capacity can have long lead times.

4.4. Information provision

7. Information provision

- (a) Has the current practice of allowing AEMO or APA to determine the notice period associated with their respective allocation process impacted market participants' ability to fully participate in the allocation process? If so, how?
- (b) Would the inclusion of a mandatory minimum notice period prior to the allocation process occurring allow parties to make more informed decisions?
- (c) What may be the benefits for the market of market participants making more informed decisions in relation to the allocation process?
- (d) Would inclusion of a mandatory minimum notice provision alter the way parties participate in the market? If so, how?
- (e) Is twenty business days' notice the appropriate minimum notice period? If not, what is and why?
- (f) Is there a need for a maximum notice period? If so, what should it be?

APA does not believe that notice periods for the allocation of AMDQ have been a material issue in the past. The inclusion of minimum notice periods may increase market certainty in ensuring access to opportunities to secure AMDQ, and to that extent are supported by APA.

4.5. Regulatory certainty

7. Regulatory certainty

- (a) Do the provisions of the NGR at issue in this rule change request result in a perception of regulatory uncertainty in the market? Why or why not?
- (b) Does the proposed rule address any regulatory uncertainty in the current provisions? If no, why not?
- (c) Are there other appropriate ways to address any regulatory uncertainty present in the market as a result of the operation of the NGR provisions? If so, what are they?
- (d) In your view, is your alternate approach more appropriate than (a) the current provisions as set out in the NGR; and (b) AEMO's proposed rule? Why?
- (e) If the current provisions are considered to result in regulatory uncertainty:
 - what, if any, impacts does this have on efficient investment in the Victorian DTS and by whom?
 - what, if any, impacts does it have on market participants in relation to their participation in the market?

The rule change proposal presents a clear, transparent and simple approach to determining the type of AMDQ created, as well as the party that will allocate that AMDQ. In doing so, the proposed rules would replace a mess of rules that are difficult to interpret, and in some cases not able to be followed. This has created uncertainty.