HSBC Building
Level 19
580 George Street
Sydney NSW 2000
PO Box R41
Royal Exchange NSW 1225

Telephone 61 2 9693 0000
Fax 61 2 9693 0093
www.apa.com.au

APA Group

Australian Pipeline Ltd
ACN 091 344 704

Australian Pipeline Trust
ARSN 091 678 778

APT Investment Trust
ARSN 115 585 441

Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Project Reference Code: GRC0012

By email: aemc@aemc.gov.au

APA Group welcomes the opportunity to comment on the AER's proposed Rule change regarding the definition of Reference and Rebateable services.

In summary, APA Group considers that:

- The current Rules are well aligned to the characteristics of the industry being regulated and do not require amendment; and
- The AER's proposed Rules have considerable scope for unintended consequences, which would impinge on the ability of service providers to earn the efficient costs of providing services, and distort the risk/reward relationships in existing bilateral contracts.

Bilateral contracting is part of the nature of the gas industry

The gas pipeline industry is founded on bilateral negotiation and agreement. This is a feature of the global industry that pre-dates the Australian access regime.

Bilaterally-agreed foundation contracts have been instrumental in the development of the pipeline infrastructure in place in Australia today. These contracts are carefully crafted to provide for a fair balance of cost, revenue and risk sharing between the pipeline infrastructure provider and the shipper.

This is a key reason why the National Gas Access Regime was designed to recognise the importance of contractual arrangements. Those contracts reflect a careful balancing of risks and returns between investors in long-lived production assets and investors in long-lived pipeline assets.

APA Group submits that the relevant aspects of the current National Gas Rules harmonise effectively with the nature of the industry being regulated. As developed more fully below, the AER's proposed Rule Change changes the relationship between the structure of the industry and its regulatory oversight. It will be critical to assess the implications of this proposed Rule Change in this context.

The negotiate/arbitrate incentive regime

Given the prevalence of bilateral contracting in the gas industry, it is important to remember that the gas access regime is, at its heart, a negotiate/arbitrate regime. In this context, the purpose of the Reference Tariff is to provide a guide around which negotiation can take place, supported by a mandated requirement to provide access to the reference service at the Reference Tariff, and further supported by a rigorous dispute resolution regime in cases where negotiation has not been successful.

It is within this context that the definitions of Reference and Rebateable Services must be considered.

APA Group supports the principle that at least one Reference Service must be defined in the access arrangement.

This is consistent with the nature of the negotiate/arbitrate regime, in which the Reference Service and Reference Tariff act as a guide to negotiation, supported by a rigorous dispute resolution regime. The explanatory material included in the former Gas Code makes this clear where it states:

> *A Reference Tariff operates as a benchmark tariff for a specific Service, in effect giving a User a right of access to the specific Service as the Reference Tariff, and giving the Service Provider the right to levy the Reference Tariff for that Service.*

Definition of Reference Service

APA Group has concerns over the basis of the AER's assertion that the requirement to determine a Reference Tariff for each Reference Service gives rise to regulatory risks where the demand or revenues to be derived from Services are uncertain. It is unclear to APA Group how a Service for which there is uncertain demand could be considered a Reference Service.

By way of example, the AER refers to the ACCC decision to omit backhaul services on the Roma to Brisbane Pipeline (RBP) from the definition of either Reference or Rebateable Services. The ACCC was clear in its decision that allowing the RBP to retain any revenues associated with providing backhaul services would act as a strong incentive to develop the market for that service.

Notwithstanding the strength of this incentive, the RBP does not currently carry contracts for backhaul services. It is therefore clear, in APA Group's view, that backhaul is not a service demanded by a significant portion of the market and can not be classified as a Reference Service.

Further, the proposed Rule change provides the AER with discretion to determine whether a Service is a Reference Service, and thereby require the setting of a Reference Tariff. APA Group is concerned that this discretion is in no way linked to the AER's stated concern over uncertainty as to the demand for the service or the revenues to be earned from providing these Services.

Definition of Rebateable Services

The AER proposes to remove the requirement that a Rebateable Service must be in a substantially different market from the Reference Service. There are sound reasons this requirement was written into the Gas Code and National Gas Rules, and to remove it has scope to undermine the bilateral contracting features of the gas industry.

Many existing contracts, particularly long term foundation contracts, contain a "most favoured nation" clause, providing that, if the price of the pipeline service on offer to other shippers is less than that agreed in the contract, the lower price applies to the foundation contracts.

This is critical to the definition of the Rebateable Service. Were the AER to amend the definition of Rebateable Services, the rebate could trigger the most favoured nation clauses in the foundation contracts and fundamentally change the risk/reward relationship inherent in those contracts.

The definition of "Rebateable Service" was designed to protect the risk/reward relationship embodied in those foundation contracts by requiring a Rebateable Service to be a service in a substantially different market from that for any Reference Service.

It is therefore incorrect for the AER to assert that the Gas Code did not reflect policy intent at the time, and that this error should now be corrected. Instead the AER has failed to recognise the key balance that was struck in the original drafting of the Gas Code between bilateral contracts and the access regime.

At a minimum, the AER's approach to defining Rebateable Services could have the impact of reducing the amount of revenue that can be earned by the pipeline operator below that which is required to meet the requirements of NGL s24(2). At worst, this could have the impact of undermining the foundations of gas infrastructure investment in Australia for many years to come.

APA Group is very concerned about the impact of the AER's proposed Rule Change on the risk/reward relationship underpinning bilaterally negotiated pipeline contracts and future investment in Australia's pipeline infrastructure.

APA Group considers that such a change would run contrary to the National Gas Objective. While users may support the short term reduction in cost associated with such a rebate, in the longer term this approach would have a chilling effect on investment. This would not be in the longer term interests of users.

Introduction of cross subsidies

APA Group considers that defining a Rebateable Service that is similar to an existing Service also has scope to introduce cross subsidies in markets served by gas pipelines. For example, suppose a gas pipeline is serving a brickworks at the Reference Tariff, and commences serving a competing brickworks at a similar tariff, but not as a Reference Service. If the Service taken by the second brickworks were defined as a Rebateable Service, the revenues derived from the second brickworks would be rebated to the first brickworks, its competitor.

This is a key reason for retaining the "substantially different market" test in the Rules. In the absence of this requirement, there is clear scope to introduce subsidies between users in competitive industries.

Retrospective rule-making

In its Rule change proposal, the AER refers to the sale of AMDQ credit certificates (AMDQ CC) as a driver for the need for the Rule change. In particular, the AER wishes to have this Rule in place to guide its assessment of the APA GasNet Access Arrangement revisions to be filed in March 2012.

APA Group notes that the AMDQ credit certificates currently in place were issued within the auspices of the currently existing Access Arrangement, and contractual arrangements then entered into with AMDQ CC holders, with the approval of the AER. APA Group provides details on the policy background and current operation of AMDQ CC arrangements in an attachment to this submission. This includes a discussion of rebates applied by APA Group against the Reference Tariff under those arrangements. The term of current AMDQ credit certificate allocations extend into the next regulatory period.

APA Group considers that imposing a Rule change to confiscate revenues from contracts written under a previous access arrangement regime is tantamount to retrospective regulation. In order to provide certainty to infrastructure investors, it is critical that any such Rule changes be applied prospectively. As a matter of procedural fairness, a Rule should not apply to actions undertaken or contracts entered into before the Rule was in operation. APA Group considers that it is patently inappropriate for the AER to attempt to confiscate these revenues by way of this Rule change.

APA Group would be pleased to discuss any aspect of this submission with the AEMC at its convenience. Please contact Peter Bolding on (02) 9693 0053.

Yours faithfully

3/11/11

Peter Bolding
General Manager Regulatory and Strategy

ATTACHMENT

AMDQ Credit Certificate Allocation and Pricing

AMDQ CC have been allocated by APA GasNet (and its predecessors) since it was introduced in 2002. Initially, AMDQ CC was allocated on a first come first served basis due to the fact that there was not significant demand for the product. At that time the pricing was set in relation to the regulated injection tariff for the relevant injection zone. AMDQ CC was priced at the regulated injection tariff but was charged on a take or pay basis.

Following the change in the wholesale gas market introduced in February 2007 and the unusual market conditions that applied during winter 2007, demand for AMDQ CC increased dramatically. The previous contracts expired at the end of 2007. APA GasNet, after consultation with the ACCC, agreed that it would auction the available AMDQ CC. This consisted of the original 200 TJ/day plus another 65 TJ/day that APA GasNet and AEMO had agreed could be defined on the South West Pipeline due to changes in operational conditions. This would be further increased by another 82 TJ/day on commissioning of the Brooklyn Lara Pipeline (BLP).

The auction for the 265 TJ/day available before the commissioning of the BLP was based on fixed tranches at a floor price of the regulated injection tariff but with both price and term at the shippers' discretion. The pricing was still subject to the requirement under contract that any AMDQ CC revenue was in lieu of the regulated injection revenue. In this auction all 265 TJ/day was sold at prices ranging upwards from the regulated injection tariff and for periods between 3 and 5 years.

The auction of the extra 82 TJ/day created by the BLP was also fully subscribed. This capacity was tendered at a fixed price for the period ending 31/12/2012. Again, the pricing was subject to offset against regulated injection revenue.

Moreover, when the injection volume and revenue are applied in the APA GasNet price control model, which governs the annual regulated tariff adjustments, the volumes and revenues applied are the full take or pay amounts rather than the actual flows and the theoretical revenues from those flows based on the regulated injection tariffs. In addition, any actual injection volumes either in excess of AMDQ CC by AMDQ CC holders or by shippers not holding AMDQ CC are included.

The net effect of this treatment of AMDQ CC volumes and revenues in the price control process is that APA GasNet does not earn any excess revenue from AMDQ CC when it is priced at the reference tariff. Any extra revenue is only earned to the extent that AMDQ CC is priced above the regulated injection tariff.

As can be seen from the history of pricing of AMDQ CC, and in accordance with economic principles, the prices rise as the system approaches capacity. Thus AMDQ CC as presently priced provides a direct signal for investment in the injection pipelines of the DTS.

While APA GasNet earns extra revenue in the short term from constraints in the pipeline system, in the longer term APA GasNet is better off by making efficient investments in the pipeline system. These investments are signalled by the demand for AMDQ CC, as they are not otherwise signalled in the Victorian market carriage system.