

# Assisting gas pipeline users to negotiate better deals and prices

*Richard Owens  
Executive General Manager  
Australian Energy Market Commission*

*Presented at the Australian Domestic Gas Outlook 2018, 1 March 2018, Sydney Australia*

On Tuesday this week, we published our draft report on the review of economic regulation applied to covered pipelines.

This report is part of a package of reforms to the gas market that we have been making over the past two years, including the major reforms that we recommended in our 2016 East Coast gas market review and which are being implemented by Dr Vertigan's Gas Market Reform Group as we speak.

It's also part of the AEMC's broader work program to redesign Australia's energy markets. We are creating new frameworks as the market evolves, offering electricity and gas customers more opportunities and more control, and most importantly keeping costs as low as possible while maintaining security and reliability.

The draft recommendations in our report are designed to make it easier and cheaper to move gas to where it's needed. If implemented, our recommendations will help gas pipeline users negotiate lower prices and better terms. 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 be a more credible back-stop if negotiations fail. This will lead to better prices for manufacturing businesses that rely on gas, gas-fired generators, and ultimately Australian households and businesses.

The recommendations in the draft report apply to all light and full regulation covered pipelines across Australia that are currently regulated by the AER on the East Coast and the ERA in WA.

The AEMC has made a number of targeted reforms to gas pipeline regulation in recent years, but this is the first comprehensive review of the economic regulatory regime for gas pipelines since the original gas access code was introduced 20 years ago. We consulted extensively, including through an issues paper, an interim report, a public workshop and many stakeholder meetings. We also worked very closely with the AER, ERA, ACCC and the Gas Market Reform Group.

The report contains about 30 draft recommendations, across seven key areas which I'll outline today.

The review is part of a broader package of AEMC reforms to achieve the COAG Energy Council's gas market vision. This review complements the AEMC's other recent gas market reforms. In particular:

- Our 2016 **East Coast wholesale gas market and pipeline frameworks review** recommended a set of reforms to redesign wholesale gas markets. It also contained a package of pipeline capacity trading reforms, which are currently

being implemented by the GMRG. And it recommended increasing transparency through improvements to the Gas Bulletin Board. We completed a rule change last year to implement the first part of those bulletin board changes, with further rule changes to follow once the necessary law changes have been made.

- Our 2017 **review of the Victorian declared wholesale gas market** made recommendations for the redevelopment of the Victorian market to make it easier to trade gas and manage risks. We are expecting to receive rule change requests shortly to implement key recommendations from that review.
- We are currently undertaking our first **biennial review of the liquidity** of wholesale gas markets and pipeline trading markets. A key purpose of this review is to monitor the state of implementation and effectiveness of the recommendations from our East Coast market review, and identify whether there is a need for future reforms. Implementation of the complete reform package will take several years, so our first liquidity review this year will focus on providing a baseline for future reviews.
- We will also publish a report later this month on whether our gas pipeline capacity trading reforms from the East Coast market review should apply in the **Northern Territory** once the Northern Gas Pipeline links the Territory and East Coast gas markets for the first time.

These previous AEMC recommendations will make it easier to buy and sell gas in the wholesale markets. The current gas pipelines review adds to those reforms by making it easier and cheaper to move that gas to where it's most valued.

This review of the regulatory regime for *scheme* pipelines also complements the GMRG's new regime for *non-scheme* pipelines under Part 23 of the gas rules, and we have adopted some of the features of Part 23 and applied them to covered pipelines, for example information reporting requirements for light regulation pipelines.

The terms of reference for this review asked us to make recommendations on any amendments necessary to address concerns that covered pipelines are able to exercise market power.

A key driver for our review was the ACCC's gas inquiry report, which found that a number of pipeline operators were engaging in monopoly pricing that has led to higher gas prices for users and affected the efficiency of the East Coast gas market, and upstream and downstream markets. The ACCC also found that the market power of pipelines was not being effectively constrained by the current regulatory regime or the threat of regulation. The ACCC recommended that the COAG Energy Council ask us to review the gas pipeline regulatory regime in Parts 8-12 of the rules.

Key concerns raised by the ACCC and by a number of stakeholders during our consultation were that:

- Various aspects of the rules may enable full and light regulation pipeline operators to charge monopoly prices; and
- Users often consider that they are required to accept unbalanced non-price terms

There are several key causes of these issues under the current regulatory regime:

- Too narrow a set of services on full regulation pipelines are currently classified as **reference services** and have an up-front tariff and non-tariff terms set by the regulator in an access arrangement
- **Expansions** of full regulation pipelines are currently not always subject to full regulation, which creates a risk of monopoly pricing on the expanded capacity
- **Information disclosure obligations** for light regulation pipelines are relatively limited, making it difficult for users to engage in informed negotiations
- The AER and ERA do not currently have **clear enough powers and appropriate levels of discretion** in key areas that impact how tariff and non-tariff terms are set, such as cost allocation and the calculation of depreciation
- **Arbitration** is not currently a sufficiently credible threat to assist effective and balanced negotiations, partly because of the high degree of uncertainty for users regarding the arbitration process and the likely outcome of any arbitration

The current regulatory regime is incentive-based, and built on a foundation of reliance on negotiation and arbitration. Service providers and users negotiate price and non-price terms, informed by access arrangements for reference services on full regulation pipelines, and information disclosure obligations for all covered pipelines. Binding arbitration can be used when negotiations fail to result in an acceptable outcome. Arbitration is not intended to be used regularly, but instead to act as a threat that keeps the parties honest during negotiations.

This regime is markedly different from the electricity network regulation regime, which relies on more direct price setting by the regulator and more prescriptive obligations on service providers in the rules, with very little ability for users to negotiate different prices, terms or service levels.

We consider that these fundamental features of the gas rules remain sound and continue to have benefits in promoting efficient investment and enabling users to negotiate deals that suit their needs.

Our draft recommendations do not move away from this reliance on a negotiate-arbitrate regime, and will not result in the gas rules becoming more prescriptive like the electricity rules. But for a negotiate-arbitrate regime to successfully constrain the use of market power, all of the individual elements of the framework need to work together and function effectively in practice.

Our draft report therefore makes a number of recommendations for significant changes to parts of the rules to improve how this high-level framework operates.

A key recommendation is a **new approach to determine which pipeline services should be specified as reference services** in a full access arrangement. This new approach responds to concerns from many stakeholders that additional services should be specified as reference services so that the regulator sets the efficient tariff for each of those services to assist prospective users.

The new approach includes new criteria for reference services. This reflects that recent changes in the dynamics of the East Coast gas market have resulted in services such as bi-directional transport becoming more important for many users. The new approach will also provide users with greater opportunity for engagement regarding this decision,

as well as providing regulators with a specific framework to focus on this important question at an early stage of the access arrangement process.

We have also **reduced the ability for service providers to exercise market power over pipeline expansions**. This is delivered by including all pipeline expansions as part of the relevant covered pipeline. In addition, existing extensions may also be incorporated into an existing access arrangement, bringing related pipeline assets under one regulatory framework. These changes will also reduce the regulatory burden and support improved decision-making.

We're recommending a set of reforms to achieve **more efficient tariffs and non-tariff terms and conditions**. This will be achieved by amendments and clarifications regarding depreciation, capital expenditure, cost allocation, rebateable services, and linkages with non-tariff terms and conditions. Within 6 months of commencement of the recommended new rules, the regulators will also be required to calculate an initial capital base for the two light regulation pipelines that don't already have one.

We have significantly **strengthened the information reporting obligations** on full and light regulation pipeline service providers. These changes adopt many of the information provision obligations that currently apply to Bulletin Board pipelines and to non-scheme pipelines under Part 23 of the rules. Full and light regulation transmission pipelines will be required to disclose the same capacity and usage information that would be disclosed if they were Bulletin Board pipelines. Full and light regulation distribution pipelines will be required to disclose the same capacity and usage information as non-scheme pipelines. Light regulation pipelines will also be required to disclose the same financial and offer information as non-scheme pipelines.

The AEMC's **Scheme Register** will also be expanded to be a single source of useful information on all scheme and non-scheme pipelines. These changes will result in more relevant, timely and accessible information for users and prospective users to inform their negotiations with service providers.

We've **improved regulatory decision making through the removal of the limited discretion and no discretion framework** that currently restricts the AER and ERA's discretion in relation to certain elements of an access arrangement. This change will make it clearer that the regulators always have the power to make decisions that best contribute to the national gas objective.

To support these changes, we're also **facilitating greater stakeholder engagement** in the access arrangement assessment process. Adjustments to the process will provide more time for stakeholder engagement, in addition to the introduction of the new separate reference service process I mentioned earlier.

Backing all this up is **a more credible threat of arbitration** to constrain the use of market power. We recommend clarifying the bases for arbitration determinations, improving the arbitration process and enhancing its transparency. For the first time, the rules will set out clear steps and timeframes that are to be followed by each party during the negotiation process, with a clear trigger for the arbitration process if the parties fail to agree within these set timeframes. A new fast-tracked arbitration process is also recommended to be available to users and prospective users under certain circumstances. There will also be greater clarity regarding what information must be

published following an arbitration process to improve its usefulness as a precedent for other parties, and an improved ability for multiple users of a pipeline to undertake joint dispute resolution hearings.

The draft report also explores whether the current processes and tests for determining which form of regulation applies are still appropriate. The original purpose of the coverage determination process was to assess whether regulation should apply to a pipeline. But the introduction of Part 23 means that some form of regulation applies to *all* pipelines that provide third party access. As a result, the key question is now what *form* of regulation should apply, not *whether* regulation should apply.

The current tests may not be the most appropriate means for determining this question. This is not just an academic issue, and could lead to a risk of under-regulation under the current tests, as it may be difficult for a pipeline to meet the criteria to be fully regulated.

That risk would likely be increased if the coverage criteria in the gas law were amended to match recent amendments to the criteria in Part IIIA of the Competition and Consumer Act. That could mean that we do all this work on making improvements to the regulation of covered pipelines under Parts 8-12, but may find that no new pipelines ever become subject to Parts 8-12 and some of the current full regulation pipelines become uncovered.

But we are mindful that issues related to the coverage test have been considered recently by the ACCC and by Dr Vertigan, and that it's difficult to assess the magnitude of this issue until we have some experience with the application of Part 23. We also appreciate how complex this issue is and that any change would require significant law changes and some changes to the NCC's role, and we don't want any extended debate on this issue to delay the implementation of the rest of our important recommendations.

Accordingly, the draft report does not contain recommendations on this issue, and instead seeks stakeholders' views on the materiality of the issue, potential solutions to it, and whether it should be considered further as part of this review or as part of a separate future process such as the scheduled review of Part 23 in 2019.

These draft recommendations are designed to make it easier and cheaper for users to move gas to where it's most valued, complementing our earlier reforms that will make it easier to buy and sell gas in the wholesale market.

If implemented in full through law and rule changes, they will help pipeline users negotiate lower prices and better terms for their gas transportation agreements, with those price savings flowing through to gas consumers. They will also benefit gas-powered electricity generation and electricity consumers.

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 be a more credible back-stop if negotiations fail.

These recommendations are currently only draft recommendations though, and we value feedback from stakeholders. Submissions are due by 27 March, with a final report due to the COAG Energy Council by the end of June.