

Australian Energy Market Commission

## INTERIM REPORT

Review into scope of economic regulation  
applied to covered pipelines

31 October 2017

REVIEW

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## **About the AEMC**

The AEMC reports to the Council of Australian Governments (COAG) through the COAG Energy Council. We have two functions. We make and amend the national electricity, gas and energy retail rules and conduct independent reviews for the COAG Energy Council.

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## Summary

The Council of Australian Governments (COAG) Energy Council has requested that the Australian Energy Market Commission (AEMC or Commission) review the economic regulatory framework that currently applies to covered transmission and distribution natural gas pipelines. This framework has not been comprehensively reviewed since the inception of the *National third party access code for natural gas pipeline systems* (code) in 1998.

The review into the scope of economic regulation applied to covered pipelines (review) forms a vital component of the gas market reform agenda. This interim report (report) is intended to set out the issues arising from submissions to the issues paper, and identify those issues that the Commission intends to examine further in its draft report.

The regulatory framework applied to scheme pipelines is incentive-based, with an underlying negotiate-arbitrate premise. Pipeline service providers and prospective users negotiate the terms, conditions and tariff for access to pipeline services. Binding arbitration can be used when the negotiation process fails to lead to an outcome that is acceptable to both parties. To aid this process for full regulation pipelines,<sup>1</sup> the regulator determines or approves a full access arrangement. A full access arrangement sets out one or more reference services and reference tariffs, in addition to reference non-tariff terms and conditions, to inform negotiations.

This framework is intended to constrain the market power of gas pipeline service providers through arbitration (or the threat of arbitration), while placing users and prospective users at the heart of the regulatory process through negotiation.

These fundamental aspects of the framework were established by the code in 1998, and remain in the National Gas Law (NGL) and National Gas Rules (NGR). The Commission does not intend to recommend changes to these fundamental aspects of the regulatory framework in this review.

For a negotiate-arbitrate framework to successfully constrain market power, all of the individual elements of the regime need to function. Through consultation, the Commission has identified elements of the regime that it plans to investigate further through the remainder of this review:

- the forms of regulation that should be applied to pipelines (including expansions and extensions of pipelines), and the tests that determine which form of regulation should apply
- the appropriateness of the reference service definition
- the efficiency of the access arrangement process

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<sup>1</sup> A full regulation pipeline refers to a scheme pipeline that is not subject to a light regulation determination.

- the methodology to assess the efficient costs of providing the reference service(s)
- the role of information disclosure requirements in addressing the bargaining asymmetry between pipeline service providers and prospective users
- credibility of the threat of arbitration, and efficiency of arbitration process and outcomes.

These elements are set out below in Figure 1.

**Figure 1 Overview of issues for consideration in the review**

Framework for pipeline regulation	Regulation of pipeline services	Access arrangements	Determining efficient costs	Negotiation and information	Arbitration
<ul style="list-style-type: none"> <li>▪ Negotiate-arbitrate framework</li> <li>▪ Forms of regulation</li> <li>▪ Coverage of pipeline extensions and expansions</li> </ul>	<ul style="list-style-type: none"> <li>▪ Reference service definition</li> </ul>	<ul style="list-style-type: none"> <li>▪ Access arrangement process</li> <li>▪ Tariff setting</li> <li>▪ Non-tariff terms and conditions</li> <li>▪ Regulatory discretion</li> </ul>	<ul style="list-style-type: none"> <li>▪ Assessment of capital expenditure and operating expenditure</li> <li>▪ Capital base and depreciation</li> <li>▪ Cost allocation</li> </ul>	<ul style="list-style-type: none"> <li>▪ Access arrangements</li> <li>▪ Information requests</li> <li>▪ Key Performance Indicators</li> <li>▪ Capacity information</li> </ul>	<ul style="list-style-type: none"> <li>▪ Process and timeframes</li> <li>▪ Cost of arbitration</li> <li>▪ Incidents that trigger arbitration</li> <li>▪ Pricing principles</li> </ul>

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# 1 Introduction

On 19 August 2016, the Council of Australian Governments (COAG) Energy Council published a gas market reform package in response to the 2016 reports into the east coast gas market by the Australian Competition & Consumer Commission (ACCC) and the Australian Energy Market Commission (AEMC or Commission).<sup>2</sup> Included in the reform package was the requirement for the AEMC to review Parts 8 to 12 of the National Gas Rules (NGR). On 5 May 2017, the COAG Energy Council issued the AEMC with terms of reference for a review into the scope of economic regulation applied to covered pipelines. The terms of reference request the AEMC to:

“make recommendations on any amendments it considers necessary to Part 8-12 of the NGR to address concerns that pipelines subject to full regulation are able to exercise market power to the detriment of economic efficiency and the long term interests of consumers.”

The terms of reference also specify that the review is to consider whether any changes should be made to the dispute resolution mechanism in Chapter 6 of the NGL and Part 12 of the NGR, to provide a more effective constraint on any exercise of market power by service providers. The AEMC is required to work closely with the Gas Market Reform Group (GMRG) in this regard.

Parts 8 to 12 of the NGR set out how scheme gas pipelines are regulated, as follows:<sup>3</sup>

- Part 8: Access arrangements
- Part 9: Price and revenue regulation
- Part 10: Other provisions of and concerning access arrangements
- Part 11: Facilitation of, and request for, access
- Part 12: Access disputes.

Part 23 of the NGR commenced on 1 August 2017. This part sets out an access regime for non-scheme pipelines.

This review covers transmission and distribution pipelines that are subject to economic regulation by either the Australian Energy Regulator (AER) or Economic Regulation Authority of Western Australia (ERA).

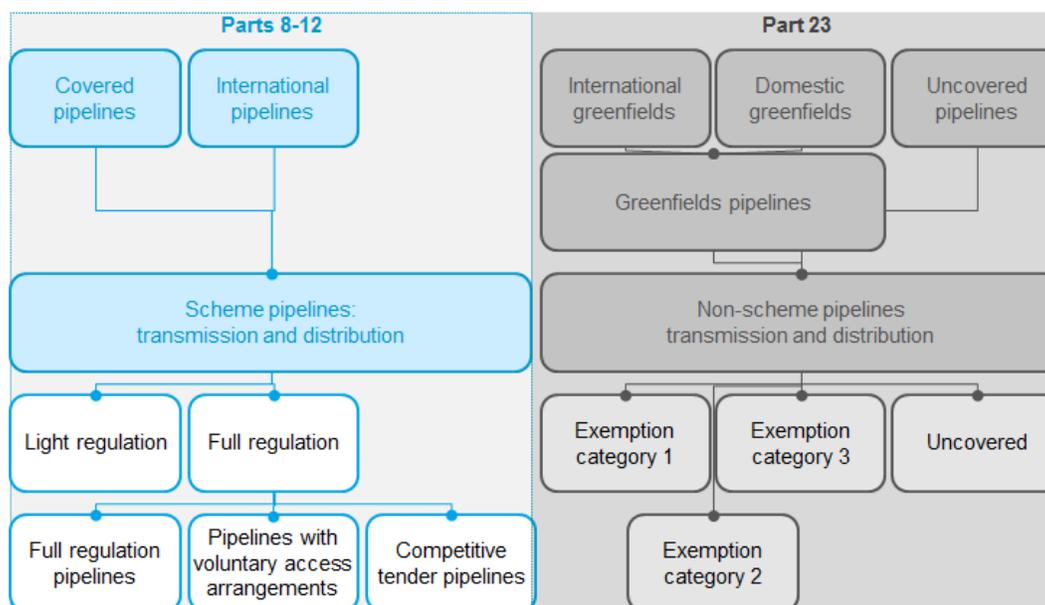
The scope of the review is summarised in Figure 1.1.

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<sup>2</sup> ACCC, *Inquiry into the east coast gas market*, April 2016; AEMC, *East coast wholesale gas markets and pipeline frameworks review, stage 2 final report*, May 2016.

<sup>3</sup> A covered gas pipeline is a pipeline that is covered under the NGL and NGR. Covered pipelines and international pipelines are referred to as scheme pipelines. This review does not include international pipelines.

**Figure 1.1 Scope of review**



## 1.1 Stakeholder engagement to date

On 27 June 2017, the AEMC published an issues paper and received 20 submissions from stakeholders.<sup>4</sup>

The AEMC has also met more than 25 stakeholders including gas pipeline service providers, users and relevant jurisdictional policy bodies. It has also engaged with the ACCC, AER, ERA and GMRG throughout the review.

## 1.2 This report

This interim report provides a summary of stakeholder submissions to the issues paper. The report sets out the key issues in relation to the economic regulation of covered gas pipelines, and identifies the issues that the Commission intends to examine further in the draft report. Each of the following chapters of the report is structured as follows:

- current framework, which provides an overview of the relevant NGL and NGR provisions<sup>5</sup>

<sup>4</sup> Submissions were received from the ACCC, APA Group, Jemena Gas Networks, Lochard and consortium of market participants, WA Energy Disputes Arbitrator, AGL Energy, Central Petroleum, APGA, Dampier to Bunbury Pipeline and Australian Gas Networks, Chemistry Australia, AEMO, AER, EnergyAustralia, NT Power and Water Corporation, AusNet Services, Energy Users Association of Australia, Hydro Tasmania, Energy Networks Australia, Major Energy Users and Public Interest Advocacy Centre. All submissions are published on the AEMC website.

<sup>5</sup> References in this report to the NGL and NGR include the NGL and NGR applicable in Western Australia under the *National Gas Access (WA) Act 2009* unless otherwise stated.

- summary of submissions, which discusses stakeholder submissions on the issues paper
- issues for consideration, which sets out the issues that the Commission intends to examine in the draft report
- other issues, which summarises issues raised by stakeholders in submissions to the issues paper that the Commission does not intend to investigate further in the review

In identifying issues for further investigation in this review, the Commission has considered the following:

- if the issue impedes the achievement of the NGO
- whether the issue can be addressed through the NGL and NGR
- stakeholder views on the issue
- materiality of the potential impact of the issue, by itself or when combined with another issue
- whether the issue is best addressed within this review, or within another current or future project.

### **1.3 Next steps**

The Commission will engage with stakeholders on the issues that this report has identified for further consideration. This will include consultation on any potential recommendations to address the issues.

The Commission will publish a draft report in February 2018. The draft report will set out the Commission's assessment of the issues that this interim report has identified as issues for further consideration. Where relevant, the draft report will set out draft recommendations for further stakeholder consultation.

The terms of reference require the Commission to publish a final report in June 2018.

## 2 Framework for pipeline regulation

This chapter provides an overview of the current regulatory landscape for gas transmission and distribution pipelines.

The chapter sets out the current framework, summarises related stakeholder submissions on the issues paper, and discusses issues that the Commission intends to discuss further in the draft report. The following topics are discussed in this chapter:

- negotiate-arbitrate framework
- forms of regulation
- coverage of pipeline extensions and expansions.

### 2.1 Current framework

#### 2.1.1 Negotiate-arbitrate framework

Fundamental to the economic regulation of gas pipelines in Australia is a negotiate-arbitrate framework. Prospective users and service providers are able to negotiate non-tariff terms and conditions that collectively define the service that is sought, in addition to the tariff for that service. Underpinning these negotiations is the ability of prospective users to take unresolved negotiations to arbitration. In an arbitration to seek access to a pipeline, the arbitrator will determine tariff and non-tariff terms and conditions for the provision of the service in dispute. An arbitrated tariff, or the threat of an arbitrated tariff, is intended to restrict a service provider's ability to price monopolistically. The threat of arbitration is also intended to constrain the service provider from exercising its market power (to the extent that it holds it) in negotiations.

The primary benefits of the gas pipeline negotiate-arbitrate framework include:

- Users and prospective users (producers, retailers and industrial consumers) are at the heart of the regulatory process. Users and prospective users are able to negotiate specific, bespoke services that suit their business models, needs and risk appetites.<sup>6</sup>
- Pipeline service providers are able to adapt flexibly to changing user preferences and developments in natural gas markets.

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<sup>6</sup> Users and prospective users of pipelines can also be referred to as shippers. These parties deal directly with pipeline service providers in order to ship gas through a pipeline. Small gas users are customers of retailers.

- The framework reduces the regulatory burden, particularly in the case of light regulation. For light regulation pipelines,<sup>7</sup> regulated tariffs are only determined if and when a matter is taken to arbitration. For full regulation pipelines, only reference tariffs are determined by the regulator.<sup>8</sup>

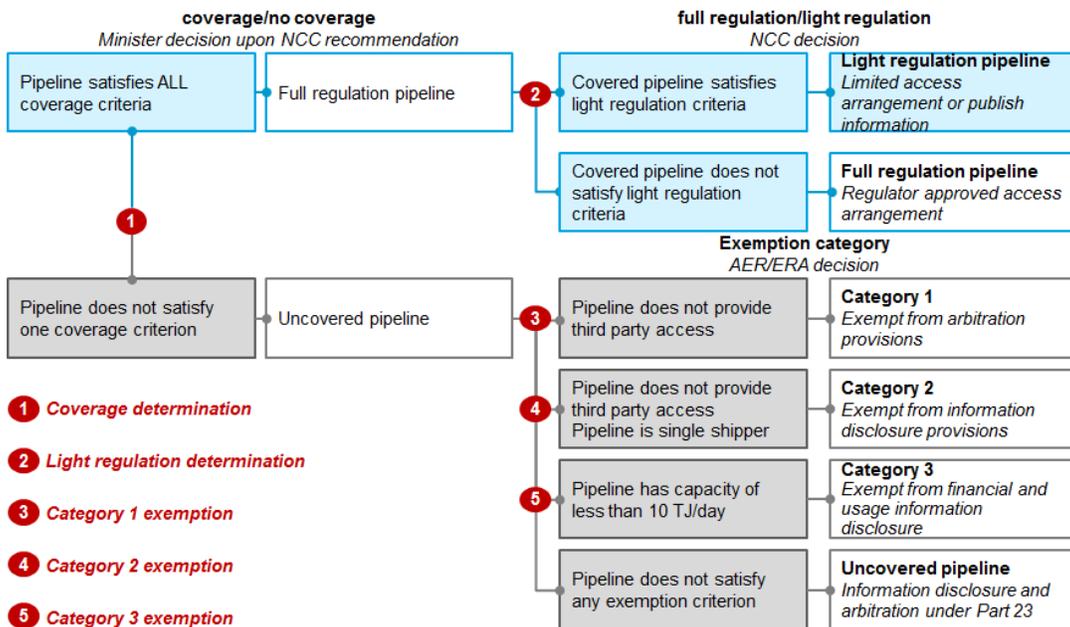
The negotiate-arbitrate framework is central to all forms of economic regulation that currently apply to gas pipelines in Australia – whether they be subject to full regulation, light regulation, or the access regime for non-scheme pipelines under Part 23 of the NGR. These different forms of regulation are briefly outlined below.

### 2.1.2 Forms of regulation

Under the current regime, different forms of economic regulation apply in different circumstances. The original intent of this was to allow for a more tailored level of regulation to be applied based on the extent of the market failure the regulation is intended to address, and the relative regulatory burden of each form of regulation. That is, a fit for purpose approach to the application of economic regulation.

The forms of regulation that apply to a pipeline or part of a pipeline,<sup>9</sup> and the decisions required to determine which form of regulation applies, are outlined in Figure 2.1.

**Figure 2.1 Forms of regulation under the current framework**



<sup>7</sup> A light regulation pipeline refers to a scheme pipeline that is subject to a light regulation determination by the National Competition Council (NCC). See Figure 1.1.

<sup>8</sup> This reduction in regulatory costs should be netted against the cost of the negotiation process, which is borne by the counterparties.

<sup>9</sup> Under the current framework, an extension or expansion of a pipeline may not form part of the covered pipeline in some cases. This is discussed in more detail in section 2.1.3.

The different forms of regulation are:<sup>10</sup>

- Full regulation, requires the regulator undertaking an assessment of, and subsequently approving a full access arrangement or revision to an access arrangement. The purpose of this is to determine at least one reference service, and the corresponding reference tariff and non-tariff terms and conditions for each reference service.<sup>11</sup> The negotiate-arbitrate framework applies to all services, and is informed by the access arrangement.
- Light regulation, where a negotiate-arbitrate framework applies to all services, and no reference services or reference tariffs are determined in an access arrangement. While a service provider may submit a limited access arrangement<sup>12</sup> to the regulator for approval, it may not be required to do so and may publish certain information on its website as an alternative.
- Access regime under Part 23 of the NGR,<sup>13</sup> which is also a negotiate-arbitrate regime and also requires the publication of certain information by the service provider.<sup>14</sup>

The criteria that determine the form of regulation that applies to a pipeline or part of a pipeline are as follows:

- The coverage criteria determine whether the pipeline is a covered pipeline and is included in the regulatory framework as a 'scheme' pipeline.<sup>15</sup>
- If covered, the form of regulation factors determine whether full or light regulation applies.<sup>16</sup>
- If not covered, the access regime for 'non-scheme' pipelines applies, and various exemption criteria determine the particular Part 23 provisions that do not apply:<sup>17</sup>

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<sup>10</sup> The descriptions of full and light regulation, and the access regime under Part 23, in section 2.1.2 are intended to be illustrative.

<sup>11</sup> In effect, ex ante price cap regulation applies to reference services.

<sup>12</sup> Rule 45 states that a limited access arrangement must identify the pipeline, describe pipeline services, state non-tariff terms and conditions, in addition to specified requirements. A limited access arrangement does not include tariffs.

<sup>13</sup> Part 23 of the NGR came into effect on 1 August 2017.

<sup>14</sup> Prior to 1 August 2017, greenfields pipelines were not subject to any economic regulatory obligations under the NGR.

<sup>15</sup> Scheme pipelines include covered pipelines and international pipelines (s. 2 of the NGL). 'Non-scheme' pipelines include uncovered pipelines and greenfields pipelines. Prior to 1 August 2017, international, uncovered and greenfields pipelines were not subject to any economic regulatory obligations under the NGR.

<sup>16</sup> Section 16 of the NGL.

<sup>17</sup> Rules 585 to 590 of the NGR. If no exemption criteria are met, then the pipeline service provider must comply with all Part 23 requirements.

- Pipelines that do not provide third party access are exempt from the arbitration provisions under Part 23 (category 1 exemption)
- Pipelines that do not provide third party access or single shipper pipelines are exempt from the information disclosure provisions of Part 23 (category 2 exemption)
- Pipelines with a daily capacity of less than 10TJ are exempt from disclosing certain financial, usage and availability information under Part 23 (category 3 exemption).

### **2.1.3 Coverage of pipeline extensions and expansions**

The process for determining the regulatory treatment of an extension or expansion to a pipeline that is already subject to full regulation differs from the process for determining the form of regulation that applies to pipelines as a whole.

As set out in Part 10 of the NGR, full access arrangements must include extension and expansion requirements that:<sup>18</sup>

- may state whether the applicable access arrangement will apply to services to be provided as a result of an extension to, or an expansion of the capacity of, the pipeline
- may outline the basis to later determine whether the applicable full access arrangement will apply to services to be provided as a result of a pipeline extension or expansion
- must specify the impact on tariffs in cases where an access arrangement applies to incremental services as a result of an extension or expansion.

The extension and expansion requirements cannot require the service provider to fund an extension or expansion, unless the service provider agrees.

## **2.2 Summary of submissions**

### **2.2.1 Negotiate-arbitrate framework**

A number of stakeholders suggested that more distinction between how transmission and distribution pipelines were regulated might be appropriate. The AER stated that distribution pipelines had less services that were more standardised, and as such the negotiate-arbitrate framework might be less relevant.<sup>19</sup> APGA noted that transmission and distribution infrastructure had different characteristics.<sup>20</sup> PIAC suggested that the

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<sup>18</sup> Rule 104 of the NGR.

<sup>19</sup> AER, submission to the issues paper, p. 7.

<sup>20</sup> APGA, submission to the issues paper, pp. 3-4.

negotiate-arbitrate framework for distribution pipelines might not be sufficient to promote the long-term interests of some gas consumers, such as households and small businesses.<sup>21</sup>

However, PIAC considered that the framework worked well for transmission pipelines.<sup>22</sup> DBP and AGN highlighted the benefits of the negotiate-arbitrate framework:<sup>23</sup>

- the approach to setting reference services that creates a benchmark service, rather than prescribing a menu of available services that users and prospective users may not be interested in
- the discretion framework that provides additional stakeholder certainty and reduces regulatory costs
- a strong incentive framework.

### 2.2.2 Forms of regulation

A number of stakeholders commented on the various criteria that determine which form of regulation applies. APGA suggested that the introduction of Part 23 to the NGR effectively assumed that market power existed on all pipelines.<sup>24</sup>

Some stakeholders commented on the effectiveness of the current coverage criteria, and suggested changing the coverage criteria to those proposed by the ACCC in its 2016 inquiry.<sup>25</sup> Others suggested that the market power of transmission pipeline service providers was clear, and so that some form of regulation should apply universally.<sup>26</sup>

PIAC also suggested that provisions in the form of regulation factors might not be appropriate.<sup>27</sup>

APGA suggested that additional exemptions should be made to some Part 23 provisions for distribution pipelines.<sup>28</sup>

Stakeholders also commented on the number and spectrum of different forms of regulation. A number of stakeholders supported a range of forms of regulation,

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21 PIAC, submission to the issues paper, pp. 4 & 12.

22 PIAC, submission to the issues paper, p. 12.

23 DBP and AGN, submission to the issues paper, p. 7.

24 APGA, submission to the issues paper, pp. 4 & 6.

25 Submissions to the issues paper: PIAC, pp. 4; EUAA, p. 1.

26 Submissions to the issues paper: Central Petroleum, cover letter, p. 1; MEU, pp. 5-6 & 14-15.

27 PIAC, submission to the issues paper, pp. 4, 12-13 & 24.

28 APGA, submission to the issues paper, p. 4.

allowing the regulatory burden to be tailored to the extent of the market failure.<sup>29</sup> However, Hydro Tasmania raised the prospect of forum shopping by service providers.<sup>30</sup>

Many stakeholders reflected on whether both light regulation and the access regime under Part 23 of the NGR were required, given their apparent similarity.<sup>31</sup> MEU noted that it did not consider that light regulation effectively constrained service provider's market power, and that light regulation pipelines should become full regulation.<sup>32</sup> PIAC highlighted the importance of determining how pipelines would be transitioned to another form of regulation should light regulation be removed.<sup>33</sup>

Some stakeholders expressed the view that some of the provisions in Part 23 should also apply to pipelines subject to light and/or full regulation.<sup>34</sup> In contrast, APGA suggesting applying Part 23 provisions to pipelines subject to light and/or full regulation would not be appropriate.<sup>35</sup>

### **2.2.3 Coverage of extensions and expansions**

The AER and ACCC were of the view that all expansions of a covered pipeline should automatically become part of the covered pipeline. The AER considered that this would be more consistent with expansions to light regulation pipelines (for which there is no limited access arrangement). Such expansions would automatically form part of the covered pipeline, unless the regulator determined otherwise.<sup>36</sup> The ACCC noted that there was no effective competition for the provision of expanded capacity. On the other hand, the ACCC considered that extensions could be built by an alternative service provider, which might warrant separate treatment.<sup>37</sup> MEU considered that partially covered pipelines should become fully covered.<sup>38</sup>

EUAA and MEU considered that the regulator should have full discretion as to whether extensions and expansions become part of the relevant covered pipeline.<sup>39</sup> However, DBP and AGN, APGA and APA noted that current access arrangements typically give the regulator discretion to decide the coverage of extensions and expansions. They also noted that setting the extension and expansion requirements in

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<sup>29</sup> Submissions to the issues paper: AusNet, p. 3; ENA, pp. 10-11; DBP and AGN, pp. 4 & 12; APGA, p. 6; APA, pp. 39-42.

<sup>30</sup> Hydro Tasmania, submission to the issues paper, p. 2.

<sup>31</sup> Submissions to the issues paper: APGA, p. 6; Jemena, p. 4; AGL, p. 2; EnergyAustralia, p. 2; EUAA, p. 1; PIAC, p. 4; APA, pp. 39-42.

<sup>32</sup> MEU, submission to the issues paper, pp. 16-17.

<sup>33</sup> PIAC, submission to the issues paper, p. 4.

<sup>34</sup> Submissions to the issues paper: MEU, p. 17; Hydro Tasmania, p. 2; ACCC, pp. 9-11.

<sup>35</sup> APGA, submission to the issues paper, p. 9.

<sup>36</sup> AER, submission to the issues paper, p. 14.

<sup>37</sup> ACCC, submission to the issues paper, p. 9.

<sup>38</sup> MEU, submission to the issues paper, p. 20.

<sup>39</sup> Submissions to the issues paper: EUAA, p. 6; MEU, p. 19.

an access arrangement is carried out through the access arrangement public consultation process.<sup>40</sup>

## **2.3 Issues for consideration**

### **2.3.1 Negotiate-arbitrate framework**

The Commission considers that there are benefits to the negotiate-arbitrate framework for the regulation of gas transmission and distribution pipelines, as discussed above. Moreover, pipeline users and prospective users are relatively few in number, typically relatively well resourced and well informed with regard to the negotiation process, and may have a degree of countervailing market power.

The ability of users of distribution pipelines to negotiate on the basis of a regulator-approved access arrangement is an important feature, as it provides flexibility to:

- accommodate the needs of prospective users
- adopt a template contract based on the access arrangement.

The negotiate-arbitrate framework used for gas pipeline services differs substantially from the framework in place for the regulation of the large majority of electricity network services.<sup>41</sup> For these electricity services, the regulatory process determines, *ex ante*, both the specific services that are regulated and the total revenue to be derived from the provision of those services. In electricity, for the majority of services, distribution network service providers deliver services to consumers as well as retailers under tripartite arrangements. Hence, there are not just a small number of relatively well-informed and resourced counterparties to negotiate with a network service provider.

The Commission considers that for many gas distribution services, the benefit of being able negotiate specific, bespoke services is positive but more limited than for gas transmission pipelines. The Commission's initial assessment is that:

- there are likely to still be some benefits of the negotiate-arbitrate regime for distribution pipelines
- the benefits of removing the negotiate-arbitrate framework for distribution pipelines appear small compared to the costs of introducing and administering a new framework

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40 Submissions to the issues paper: DBP and AGN, p. 9; APGA, p. 8; APA, p. 21.

41 The majority of electricity network services are classified as standard control services (distribution) or prescribed transmission services (transmission). A small number of services are classified otherwise, including as negotiated distribution and negotiated transmission services.

- there seem to be no issues that are exclusively related to the application of the negotiate-arbitrate framework for distribution pipelines.

Clearly, for the negotiate-arbitrate framework to successfully constrain any misuse of market power, the individual elements of the regime must be functioning adequately. This will be explored in the following five chapters.

### 2.3.2 Forms of regulation

Given the number of stakeholders that have commented on the forms of regulation and the circumstances in which they apply, and its central importance to the regime, this matter will be considered extensively by the Commission in this review.

Specifically, the Commission will consider:

- Whether the different forms of regulation contribute to a regime that achieves the NGO at least cost.

If consolidation is required (for example, by removing or amending the current light regulation regime for scheme pipelines), then the Commission will consider how this could be achieved, including which elements of each form of regulation should be retained and the transitional measures that would be required.

- Whether the tests for determining which form of regulation applies to different pipelines are appropriate.

As set out in Figure 2.1 above, since the introduction of Part 23 of the NGR, there are now six different forms of regulation and five different tests for determining which form of regulation should apply to a pipeline. If light regulation were to be removed, one of these tests could potentially be removed. However, a new test may be needed to determine whether existing light regulation pipelines continue to be covered pipelines and become subject to full regulation, or if these pipelines should change to non-scheme pipelines and be subject to the access regime for non-scheme pipelines under Part 23.

The introduction of Part 23 of the NGR has also meant that all pipelines that provide third party access are now subject to some form of regulation under the NGR. As a result, the key question for the regulatory regime has become which form of regulation should apply rather than whether a pipeline should be regulated.<sup>42</sup>

The current combination of coverage criteria and form of regulation factors also risk unintended and undesirable outcomes. In particular, light regulation pipelines are arguably subject to a lighter form of regulation than uncovered pipelines that do not fall under any of the Part 23 exemption categories. This is even though light regulation pipelines have satisfied all the coverage criteria, and

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<sup>42</sup> The only natural gas pipelines that are not regulated under the NGR are pipelines that obtain an exemption under Part 23 on the basis that they do not provide third party access.

the current tests would imply that market power concerns are greater for these pipelines.

The Commission is conscious that the coverage criteria have recently been considered by the ACCC and Dr Vertigan. The draft report will not seek to revisit the issues considered in that previous work. However, in considering the above issues, it is likely to be necessary for the Commission to consider whether the coverage criteria continue to be relevant and appropriate. These considerations are also likely to include whether the gas access regime should apply a new test for determining the form of regulation.

In making recommendations on these matters, the Commission will consider issues including the following:

- whether the forms of regulation, and the tests that allocate pipelines under them, effectively address the type and extent of market failure that regulation is seeking to remedy
- whether each form of regulation is, and should be, successively more onerous as the potential for market failure that it seeks to address increases.

### **2.3.3 Coverage of extensions and expansions**

Extension and expansion requirements in access arrangements have not been consistent, for example:

- In the current Central Ranges Pipeline access arrangement, the service provider has the discretion to exclude extensions or expansions from being included as part of the covered pipeline.<sup>43</sup>
- In the current Roma to Brisbane Pipeline access arrangement:<sup>44</sup>
  - the service provider will seek a regulatory determination on proposals to cover extensions that are not already forecast and approved in the access arrangement
  - expansions will be covered as a default, however the service provider can seek a regulatory determination on a proposal that an expansion not form part of the covered pipeline.

A consequence is that some pipelines are partially covered pipelines, in that they have uncovered extensions and/or expansions that do not form part of the covered pipeline. An example of a partially covered pipeline is the Goldfields Gas Pipeline in Western Australia. Currently, 45 per cent of the pipeline capacity is provided by uncovered

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<sup>43</sup> Access Arrangement for Central Ranges Pipeline, November 2005, p. 28.

<sup>44</sup> Access Arrangement for Roma Brisbane Pipeline, August 2012, pp. 32-33.

assets.<sup>45</sup> In addition, only one of the extensions (the Newman lateral) is part of the covered pipeline.

Distribution pipelines and market carriage transmission pipelines are typically more likely to include extensions and expansions as part of the covered pipeline.<sup>46</sup> This may reflect the network nature of these pipelines.

The primary body responsible for assessing the coverage of pipelines, in accordance with the coverage criteria, is the NCC. The NCC makes a recommendation to the relevant minister who then makes the coverage decision for that pipeline. For covered contract carriage transmission pipelines, extension and expansion requirements in access arrangements typically allow some discretion in deciding whether extensions or expansions should be part of the covered pipeline. This discretion may be given to the regulator. In effect, this results in the regulator, rather than the NCC, deciding what to regulate.

This issue has been raised by several stakeholders, who consider that this has a material impact on the regulatory framework. In preparing the draft report, the Commission will examine the coverage of extensions and expansions on a covered pipeline, including:

- the regulatory burden of regulating a partially covered pipeline<sup>47</sup>
- rationale for an *expansion* of a covered pipeline not to be covered, and whether an expansion of a covered pipeline should automatically form part of the covered pipeline.
- rationale for an *extension* of a covered pipeline not to be covered, and whether an extension of a covered pipeline should automatically form part of the covered pipeline.
- if discretion on a case by case is merited, the process for determining whether extensions and expansions are covered. This will include whether the criteria for decision making are correct, and are being made by the appropriate party.

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<sup>45</sup> There is 109 TJ/day provided by covered assets, and around 89 TJ/day provided by additional compression that has been invested in since the initial pipeline was built. ERA, Draft decision on proposed revisions to the access arrangement for the Goldfields Gas Pipeline, 17 December 2015, pp. 315 - 318.

<sup>46</sup> Under the market carriage system, which operates only in the Victorian declared wholesale gas market, a user (market participant) is not required to enter a pipeline capacity contract. In this market, facilitated by the Australian Energy Markets Operator (AEMO), a participant's daily gas flow is determined by its bids into the wholesale gas market. For example, in the Victorian Declared Transmission System access arrangement, the regulator decides whether extensions will be covered. Expansions to the pipeline will be covered unless the service provider and regulator agree otherwise.

<sup>47</sup> The allocation of costs across the covered and uncovered parts of a covered pipeline is discussed in more detail in Chapter 5 of this report.

In relation to these issues, the draft report will also include consideration of the coverage of extensions and expansions for distribution and transmission pipelines, and for contract carriage and market carriage pipelines, in order to avoid unintended consequences.

## 2.4 Other issues

Stakeholders raised two other issues with regard to the overarching regulatory framework.

The MEU suggested that the AEMC consider whether all transmission pipelines should operate under the market carriage approach (currently used for the Victorian Declared Transmission System (DTS)) rather than the contract carriage system used outside of the DTS.<sup>48</sup> The Commission has already considered this question at length as part of its review of eastern Australian wholesale gas markets, and has concluded that contract carriage remains appropriate outside of the DTS. For this reason, the Commission does not intend to revisit this question as part of this review.<sup>49</sup>

In addition, a number of stakeholders have suggested that the definition of natural gas in the NGL might be restrictive in that it may exclude various other gases (or mixtures of gases) that might appropriately fall under the regime (such as biogas and hydrogen mixed with natural gas).<sup>50</sup> The Commission recognises the importance of this question, but considers this review of economic regulation is not the most appropriate process to give it due consideration. Nevertheless, given its importance for the future development of the gas industry, it would be relevant to fully consider this issue in the near term. The Commission is in discussions with key policy stakeholders on the best way to take this issue forward.

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<sup>48</sup> MEU, Submission to the issues paper, pp. 9-10.

<sup>49</sup> AEMC, *East coast wholesale gas market and pipeline frameworks review*, Stage 2 final report, 23 May 2016.

<sup>50</sup> Submissions to the issues paper: DBP and AGN, pp. 5-6; Jemena, p. 2; ENA, pp. 5-6 & 12. The definition of natural gas is included in s. 2 of the NGL. The NGL (WA) extends to pipelines hauling gas other than natural gas (s. 6A).

## 3 Regulation of pipeline services

In the current regulatory regime, tariff and non-tariff terms and conditions of access to all services on full regulation pipelines are regulated by reference to "reference services". This chapter sets out the current framework, summarises stakeholder submissions to the issues paper, and discusses issues for further consideration, in relation to determining the reference service(s).

### 3.1 Current framework

Reference services and reference tariffs are a defining feature of full regulation under the NGL and NGR.

For full regulation pipelines, the regulator approves or determines one or more reference services and corresponding reference tariff(s). The reference service(s) and tariff(s) are set out in a full access arrangement for the pipeline, which is typically revised every five years.

Each reference service is defined by a unique set of terms and conditions. A group of broadly similar services may share some characteristics (for example, forward haul, back haul, park and loan), but differ in the specific terms and conditions.

When a prospective user seeks the exact terms and conditions specified by the reference service, it will be charged (at most) the reference tariff.<sup>51</sup> However, commonly, a prospective user will want a different service.<sup>52</sup> Even if the prospective user only wishes to change reasonably minor non-tariff terms or conditions, those changes constitute a different service from the reference service. In these cases, the reference service and corresponding reference tariff provide a benchmark (a *reference point*) for the negotiation process. Where counterparties fail to negotiate a mutually acceptable outcome, the prospective user may seek arbitration. In practice:

- In the case that a prospective user seeks a service that differs only slightly from the reference service, then the reference service would provide a good basis for the negotiation process. In this case, an arbitrator may only need to determine the marginal cost of the change to the non-tariff terms and conditions - as opposed to determining the appropriate tariff from first principles.
- In the case that a prospective user seeks a service that differs substantially from the reference service, then the reference service may provide only limited information to the negotiation process. Consequently, there is greater uncertainty in both the negotiation and arbitration processes.

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<sup>51</sup> The reference tariff acts as a price cap for the reference service.

<sup>52</sup> In practice, this is more likely to occur in relation to transmission pipeline services.

- For pipelines subject to light regulation, there are no reference services to guide the negotiation and arbitration processes.<sup>53</sup>

Understood in this light, not all services in which a service provider may have market power must be reference services. A reference service acts as an aid to the negotiation process, by narrowing the points of contention and providing greater predictability of the outcomes of any arbitration. In turn, this should reduce the prospect of negotiation leading to arbitration, and reduce the cost of arbitration in the event that it does. Services that are not reference services (including all services on light regulation pipelines) are still subject to economic regulation through binding arbitration (if required), with the threat of arbitration acting as a limit on market power.

Rule 101 of the NGR is designed to reflect this framework:

“(1) A full access arrangement must specify as a reference service:

(a) at least one pipeline service that is likely to be sought by a significant part of the market; and

(b) any other pipeline service that is likely to be sought by a significant part of the market and which the AER considers should be specified as a reference service.

(2) In deciding whether to specify a pipeline service as a reference service, the AER must take into account the revenue and pricing principles.”

The "significant part of the market" test is intended to allow a reference service and reference tariff to be specified whenever this would aid negotiations for a significant number of prospective users.

Full regulation in the context of the gas regime is different to the regime that applies to the majority of electricity services. This is despite the fact that full access arrangements have some similarities to regulatory determinations in the electricity regime. The most notable similarity is the use of the building block approach to determine revenue requirements. However:<sup>54</sup>

- In electricity, the revenue requirements are used to set price or revenue caps that are paid by users of the vast majority of the services provided by the network.
- In gas, the revenue requirement is used to derive reference tariffs for reference services, which form the basis for negotiations for the provision of those services or other services.<sup>55</sup>

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<sup>53</sup> Although most light regulation pipelines publish an indicative rate for a minimum term firm forward haul service.

<sup>54</sup> Refer to section 2.3.1 for a more detailed discussion of the differences between the electricity and gas economic regulation regimes.

<sup>55</sup> A revenue yield reference tariff variation, if approved by the regulator, may act as a revenue cap. Chapter 4 provides a more detailed discussion of tariff setting under the NGR.

## 3.2 Summary of submissions

A large number of stakeholders commented on the concept and effectiveness of reference services.

There was a consensus among stakeholder submissions that the concept of reference services in the context of a negotiate-arbitrate regime was fundamentally sound.<sup>56</sup>

Nevertheless, a number of stakeholders suggested amendments to the definition of reference service.<sup>57</sup> The ACCC and AER suggested that the definition be changed so that for each broad category of service (for example, forward haul, back haul, park and loan) that was non-contestable, the regulator should define at least one reference service and corresponding reference tariff. They suggested that because some categories of services did not have a reference service, prospective users were not aided in the negotiation process by a reference service and reference tariff.<sup>58</sup> AGL also noted the potential for the exercise of market power by pipelines in categories of services that did not have a reference service.<sup>59</sup> PIAC and AEMO suggested a market power or contestability based definition for reference services.<sup>60</sup>

However, APGA cautioned against unduly increasing the number of reference services, or attempting to determine a reference tariff for every possible service. It expressed concern about the consequential regulatory cost and the potential to stifle the development of new services to suit the needs of prospective users.<sup>61</sup>

The AER also commented on the relationship of reference services and rebateable services, which is explored in more detail in Chapter 5.<sup>62</sup>

## 3.3 Issues for consideration

Consistent with stakeholder submissions, the Commission considers that the reference service is a key component of the gas pipeline negotiate-arbitrate regime.

In light of submissions and the 2016 ACCC inquiry, the Commission considers that there is likely to be scope to improve the access arrangement process for determining reference services so as to:

- improve the information that is available to negotiating parties

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<sup>56</sup> Submissions to the issues paper: DBP and AGN, p. 4; ACCC, p. 8; AER, p. 6; APGA, p. 7; PIAC, p. 11.

<sup>57</sup> Submission to the issues paper: MEU, p. 16; ACCC, p. 3; AER, p. 18; PIAC, pp. 5, 34; AEMO, p. 2.

<sup>58</sup> Submissions to the issues paper: ACCC, p. 3; AER, p. 18.

<sup>59</sup> AGL, submission to the issues paper, p. 3.

<sup>60</sup> Submission to the issues paper: PIAC, pp. 5, 23; AEMO, p. 2.

<sup>61</sup> APGA, submission to the issues paper, p. 7.

<sup>62</sup> AER, submission to the issues paper, p. 18.

- equalise bargaining power across pipeline service providers and prospective users in access negotiations
- enhance the credibility of the threat of arbitration
- reduce the necessity for, and costs of, arbitration.

Specifying a greater number of reference services across a range of different types of pipeline services may improve the negotiate-arbitrate process. However, such an approach would also increase the costs incurred by regulators, service providers and other stakeholders in the access arrangement process. Specifying a reference service for every possible combination of terms and conditions is not feasible. Nor is it consistent with the concept of a reference service within the context of a negotiate-arbitrate framework.<sup>63</sup>

The Commission intends to examine the definition and determination of reference services further in preparation of the draft report. In doing so, it will aim to balance the:

- usefulness of reference services as benchmarks for negotiation and arbitration
- regulatory burden of any proposed changes.

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<sup>63</sup> This is particularly the case for transmission pipelines.

## 4 Access arrangements

This chapter considers the issues raised in relation to access arrangements for both light regulation and full regulation pipelines, particularly in relation to:

- the access arrangement process, including:
  - identifying and setting reference services
  - revision and consultation periods
- the tariff and non-tariff terms and conditions of access
- regulatory discretion.

### 4.1 Current framework

#### 4.1.1 Full access arrangement process

Full regulation pipeline service providers are required to submit to the regulator, for approval, a full access arrangement or revision to an applicable access arrangement that is a full access arrangement in accordance with the NGR.

The regulator assesses a full access arrangement proposal under Part 8 of the NGR.<sup>64</sup> The regulator seeks submissions on the proposal, issues a draft decision for consultation, and then makes a final decision to approve or refuse to approve the full access arrangement proposal.

If the regulator approves a full access arrangement proposal, it approves all elements in that proposal including the terms and conditions on which the reference service will be provided.<sup>65</sup>

The consultative process for a full access arrangement proposal or revision is shown in Figure 4.1.<sup>66</sup>

The regulator must make a final decision on a full access arrangement within six months of receipt of the proposal (or revised proposal).<sup>67</sup> The regulator will "stop the clock" on the decision making timeframe where additional information or consultation

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<sup>64</sup> Access arrangement proposal refers to the initial access arrangement. Access arrangements are then periodically revised. The process for a limited access arrangement revision is the same.

<sup>65</sup> Rule 41 of the NGR.

<sup>66</sup> Rules 57-62 of the NGR.

<sup>67</sup> Rule 62 of the NGR.

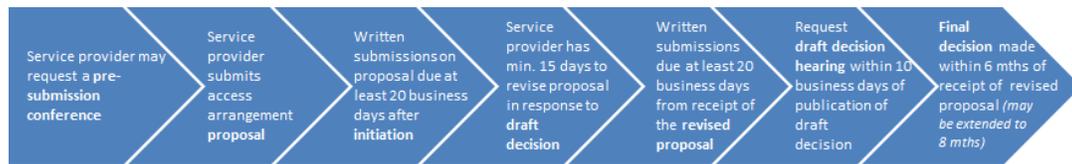
is required,<sup>68</sup> and there is an absolute time limit of 13 months for the entire process to be completed.<sup>69</sup>

Where a revised access arrangement proposal is required, the regulator must provide at least 15 business days for the revision of the proposal.<sup>70</sup> In practice, the regulator often provides a longer time for the revised proposal to be submitted (see discussion in section 4.3.1).

The regulator also has the discretion to make or revise an access arrangement if the service provider fails to do so, or if it does not agree with the service provider's proposal. The regulator may also revoke an access arrangement during an access arrangement period if it finds a material error or deficiency.<sup>71</sup>

Outside the access arrangement review period, a service provider may submit to the regulator an access arrangement variation proposal at any time.<sup>72</sup>

**Figure 4.1 Full access arrangement process**



#### 4.1.2 Limited access arrangement process

A light regulation pipeline service provider may submit a limited access arrangement. If it does, the limited access arrangement must include information on the pipeline services, non-tariff terms and conditions for access to the pipeline services that are likely to be sought by a significant part of the market and other information as set out in rule 45 of the NGR. Notably, a limited access arrangement is not required to include any tariff information. The regulator must assess a limited access arrangement proposal for a light regulation pipeline using the expedited consultative procedure within four months (as shown in Figure 4.2).<sup>73</sup>

<sup>68</sup> AER, *Access arrangement guideline*, March 2009, pp. 17-18.

<sup>69</sup> Rule 13 of the NGR.

<sup>70</sup> Rule 59(3) of the NGR.

<sup>71</sup> Only specified types of errors or deficiencies may trigger revocation of an access arrangement. See rules 63 and 64 of the NGR.

<sup>72</sup> Rule 65 of the NGR. The AEMC understands this has rarely occurred under the code or NGR.

<sup>73</sup> Rules 9, 45 and 55(4) of the NGR.

**Figure 4.2 Limited access arrangement process**



As with a full access arrangement, the regulator has the discretion to make, revise or revoke a limited access arrangement in certain circumstances.<sup>74</sup> A light regulation pipeline may choose to withdraw a limited access arrangement proposal at any time before the regulator makes its final decision.<sup>75</sup>

In the absence of a limited access arrangement, the service provider must publish on its website the tariffs on offer for light regulation services, and the other terms and conditions of access to those services.<sup>76</sup>

### **4.1.3 Tariff setting**

For a full regulation pipeline, the regulator must approve the reference service(s) and associated reference tariff (s).

Once a service provider's efficient costs are determined,<sup>77</sup> tariffs are set for tariff classes (on distribution pipelines)<sup>78</sup> and reference services (for transmission pipelines).<sup>79</sup> As discussed in section 4.1.5 below, regulatory discretion regarding setting of tariffs is limited.

#### **Distribution pipeline tariffs**

A distribution pipeline service provider is required to divide customers for reference services into tariff classes that group these customers based on their characteristics.<sup>80</sup> In most cases, distribution tariff classes differentiate between residential (and small commercial) customers and large industrial customers. Tariff classes and their associated tariffs are designed to recover the revenue associated with providing the reference service to each of those tariff classes, as well as to send signals to customers about the cost impact of their consumption.

<sup>74</sup> Only specified types of errors or deficiencies may trigger revocation of an access arrangement. See rules 63 and 64 of the NGR.

<sup>75</sup> Rule 55 of the NGR.

<sup>76</sup> Rule 36 of the NGR. The light regulation pipeline must report annually to the regulator about access negotiations for light regulation services. See Chapter 6 for further discussion on information provision.

<sup>77</sup> See Chapter 5 for further discussion on the assessment of pipeline costs.

<sup>78</sup> Rule 94 of the NGR.

<sup>79</sup> Rule 95 of the NGR.

<sup>80</sup> Rule 94 of the NGR.

For each tariff class, the revenue expected to be recovered should lie between the cost of providing the reference service to customers in that tariff class, and the stand alone cost of not providing the reference service to those customers.<sup>81</sup>

### **Transmission pipeline tariffs**

A full access arrangement on a transmission pipeline must set reference tariffs in order to generate from the provision of each reference service the portion of revenue applying to that reference service.<sup>82</sup>

For each reference service, a service provider must outline its proposed approach to setting the reference tariff by:

- explaining how revenues and costs are allocated, including the relationship between costs and tariffs<sup>83</sup>
- explaining how the tariffs have been designed to generate the portion of referable total revenue from each reference service and from each user, or class of users<sup>84</sup>
- explaining and describing any pricing principles it employed.<sup>85</sup>

### **Prudent discounts**

Service providers may seek approval from the regulator to apply a tariff discount to a user, or prospective user, or class of users.<sup>86</sup> The regulator may only approve a prudent discount if it is satisfied that the discount is necessary to respond to competition from other service providers or energy sources, or to maintain efficient use of the pipeline. Further, the approval may only be given if the discount is likely to lead to reference tariffs (or equivalent tariffs) being lower than what they would otherwise have been. In the event that the regulator approves a prudent discount, it may also approve the allocation of the cost (or part of the cost) of providing that discount to the costs of providing the service in future access arrangements.<sup>87</sup>

### **Tariff variation mechanism**

Rule 97 provides a mechanism for varying the approved reference tariffs within an access arrangement period. Reference tariffs may vary in accordance with a fixed schedule, as a result of a cost pass through for a defined event (such as changes in taxation arrangements), or in accordance with a formula set out in the access arrangement. The reference tariff variation formula may provide for:

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81 Rule 94(3) of the NGR.  
82 Rule 95 of the NGR.  
83 Rules 93(1)-(2) and 72(1)(j)(i) of the NGR.  
84 Rule 95 of the NGR.  
85 Rule 72(1)(j)(ii) of the NGR.  
86 Rule 96 of the NGR.  
87 Rule 96(3) of the NGR.

- variable caps on the revenue derived from a particular combination of reference services
- tariff basket price control
- revenue yield control,<sup>88</sup> or
- a combination of the above.

#### 4.1.4 Non-tariff terms and conditions

In addition to approving the reference service(s) and associated tariff(s) for a full access arrangement, the regulator must assess the proposed non-tariff elements set out in the proposed access arrangement. These include:

1. Terms and conditions: the access arrangement must set out the other terms and conditions on which the reference service will be provided.<sup>89</sup> There is an overarching requirement for all provisions contained in an access arrangement to be consistent with the NGO, the NGR and any procedures in force when the terms and conditions of the access arrangement are determined or revised.<sup>90</sup>
2. Queuing requirements: these set the process for establishing the order of priority between prospective users of spare or developable pipeline capacity. Queuing requirements must be included in access arrangements for transmission pipelines and in access arrangements for distribution pipelines if required by the regulator.<sup>91</sup>
3. Capacity trading requirements: both full and light regulated pipelines are required to include information on transferring capacity between users.<sup>92</sup>
4. Extension and expansion requirements.<sup>93</sup>
5. Change of receipt or delivery point requirements: these provide for the transfer of receipt or delivery points and specify under what conditions these changes may occur.<sup>94</sup>
6. Review submission date and revision commencement date: access arrangements do not expire,<sup>95</sup> instead they are revised and/or varied. Each access arrangement

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<sup>88</sup> This effectively acts as a revenue cap and decreases the demand risk for the service provider.

<sup>89</sup> Rule 48 of the NGR. In the case of a limited access arrangement, the requirement is for the non-tariff terms and conditions for access to the pipeline services likely to be sought by a *significant* part of the market (rule 45 of the NGR).

<sup>90</sup> Rule 100 of the NGR.

<sup>91</sup> Rule 103 of the NGR.

<sup>92</sup> Rule 105 of the NGR.

<sup>93</sup> Rule 104 of the NGR. See Chapter 2 for further discussion of extensions and expansions.

<sup>94</sup> Rule 106 of the NGR.

must include a review submission date and a revision commencement date, which set when the next proposed revisions to the access arrangement are to be submitted to the regulator and the intended commencement date of the revised access arrangement (which determines the access arrangement period). The date for revisions can be bought forward by the occurrence of a trigger event, as set out in the access arrangement.<sup>96</sup>

#### 4.1.5 Regulatory discretion

Rule 40 of the NGR prescribes three levels of discretion for the regulator on elements of an access arrangement proposal:

- No discretion: The regulator may not withhold its approval to the relevant element of the access arrangement if the proposal meets the specified conditions set out in the NGL or the NGR. This applies to the access arrangement submission review date and access arrangement revision commencement date.<sup>97</sup>
- Full discretion: The regulator may withhold its approval to the access arrangement element if in its opinion, a preferable alternative exists that complies with the NGL and NGR. This applies to most elements of an access arrangement.<sup>98</sup>
- Limited discretion: The regulator may not withhold approval of an element of the access arrangement if the regulator is satisfied that the element complies with the NGL and NGR and is consistent with any applicable criteria in the NGL.<sup>99</sup> The regulator has limited discretion in relation to:
  - conforming capital expenditure<sup>100</sup>
  - the depreciation schedule<sup>101</sup>
  - operating expenditure<sup>102</sup>
  - for distribution pipelines, the setting of tariffs classes to allow service providers to recover the expected revenue<sup>103</sup>

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<sup>95</sup> Rule 49 of the NGR. With the exception of full access arrangements made on a voluntary basis, or through a competitive tender process.

<sup>96</sup> Rule 51 of the NGR. Examples of trigger events may include a re-direction of the flow through the pipeline, a competing source of natural gas becoming available to customers on the pipeline, or a significant extension, expansion or interconnection occurs.

<sup>97</sup> Rule 50(2) of the NGR.

<sup>98</sup> Refer to rule 45 of the NGR for limited access arrangements and rule 48 for full access arrangements.

<sup>99</sup> See rule 41 of the NGR.

<sup>100</sup> Rule 79 of the NGR. See Chapter 5 for further discussion.

<sup>101</sup> Rule 89 of the NGR. See Chapter 5 for further discussion.

<sup>102</sup> Rule 91 of the NGR. See Chapter 5 for further discussion.

- for transmission pipelines, that reference tariffs recover the portion of total revenue referable to the reference service.<sup>104</sup>

However, it should also be noted that s. 28 of the NGL provides that in making a decision, the regulator may make the decision that it "is satisfied will or is likely to contribute the achievement of the NGO to the greatest degree."<sup>105</sup> In addition:<sup>106</sup>

“(2) In addition, the AER -

(a) must take into account the revenue and pricing principles -

(i) when exercising a discretion in approving or making those parts of an access arrangement relating to a reference tariff; or

(ii) when making an access determination relating to a rate or charge for a pipeline service, and

(b) may take into account the revenue and pricing principles when performing or exercising any other AER economic regulatory function or power, if the AER considers it appropriate to do so.”

## 4.2 Summary of submissions

### 4.2.1 Full access arrangement process

In its submission, the AER recommended introducing an "upfront process to identify reference services, rebateable services, application of incentive schemes and the form of control prior to the commencement of an access arrangement review."<sup>107</sup> As noted in Chapter 3, the AER and ACCC argued that the inclusion of additional reference services in an access arrangement could help address concerns about monopoly pricing of pipeline services.<sup>108</sup> However, the AER also noted that the timeframes set out in the current framework did not provide sufficient opportunity to fully consider the flow on impacts of including additional reference services. As such, it has felt "constrained to accept the design elements proposed by the service provider."<sup>109</sup>

The key elements of the AER's proposed upfront mechanism are:

- the introduction of a non-compulsory process similar to the framework and approach mechanism under the NER to determine reference service(s), certain non-tariff terms and conditions, the form of control and any incentive mechanism

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103 Rule 94 of the NGR.

104 Rule 95 of the NGR.

105 Section 28(1)(b)(iii)(A) of the NGL.

106 Section 28(2) of the NGL.

107 AER, submission to the issues paper, p. 3.

108 Submissions to the issues paper: AER, p. 19; ACCC, p. 8.

109 AER, submission to the issues paper, p. 19.

applying to full access arrangements (see Box 4.1 for an explanation of the NER's framework and approach process).

- one round of consultation, with a final decision made six months prior to the commencement of an access arrangement review.

Related to the above, the AER also noted that rule 57 of the NGR enabled service providers to request a pre-submission conference before submitting the full access proposal, but that the AER itself could not initiate a pre-submission process.<sup>110</sup>

The views of users and service providers on introducing an upfront mechanism were mixed. The inclusion of an upfront mechanism was supported by the ACCC, AEMO and PIAC and the EUAA. However, service providers considered that such a mechanism would increase complexity when sufficient consultation with users and the regulator existed.<sup>111</sup> Specifically in relation to distribution pipelines where there are fewer services, Jemena considered that such a process would be inefficient and unnecessary.<sup>112</sup>

An alternative access arrangement process suggestion was the introduction of a shorter process. DBP and AGN suggested that the introduction of a fast-tracked decision making process could reduce the time and resources directed to access arrangement reviews.<sup>113</sup>

In addition, a number of service providers and users raised concerns with the minimum 15 business day timeframe for submitting a revised access arrangement proposal in response to the regulator's draft decision.<sup>114</sup>

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110 AER, submission to the issues paper, p. 19.

111 Submissions to the issues paper: APA, pp. 12-13; APGA, p. 3; Jemena, p. 3.

112 Jemena, submission to the issues paper, p. 3.

113 DBP and AGN, submissions to the issues paper, pp.16 & 19.

114 Submissions to the issues paper: DBP and AGN, p. 5, 17; ENA, p. 12; Jemena, p. 3; EUAA, p. 3.

#### **Box 4.1 Framework and approach process**

The framework and approach process is the first step in the regulatory process used by the AER to determine and set efficient prices for electricity distribution network services (clause 6.8.1(a) of the NER).

Through the framework and approach process, the AER assesses and proposes an approach on a range of matters, including:

- which services provided by the distribution network will be regulated
- form of regulation that should apply to each service
- service classification: direct control, negotiated or unclassified (unregulated)
- how incentive schemes should be applied.

One of the benefits of the framework and approach process is that service classification decisions drive many other aspects of the subsequent distribution determination process. The distribution determination process may be able to operate much more efficiently if the AER has already made preliminary decisions on which services should be regulated and the form of regulation that should apply to those services. The AER can depart from the framework and approach service classifications during the distribution determination process (clause 6.12.3(b) of the NER), but rarely does so.

#### **4.2.2 Tariff setting**

Pipeline users and consumer groups expressed concern that tariffs for both regulated and unregulated services are too high and do not reflect a service provider's reasonable costs and return on capital.<sup>115</sup>

In contrast, service providers considered that tariffs reflect the efficient costs of providing pipeline services. APA argued that the tariff setting guidelines in rule 95 do not appear to constrain the service provider or regulator from setting cost reflective tariffs.<sup>116</sup> AusNet stated that its tariffs were reflective of the services sought by customers, and that non-reference services were provided at rates set to recover efficient costs.<sup>117</sup>

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<sup>115</sup> Submissions to the issues paper: MEU, p. 16; PIAC, p. 6; Central Petroleum, p. 3.

<sup>116</sup> APA, submission to the issues paper, p. 32.

<sup>117</sup> AusNet, submission to the issues paper, p.3. See Chapter 5 for further discussion on the determination of efficient costs.

DBP and AGN contended that pipeline users could use arbitration if they considered that they were being overcharged for pipeline services.<sup>118</sup>

In its submission, the AER recommended that in order to improve efficiency and consistency of the access arrangement process, service providers should be required to use the AER post tax revenue model (PTRM) and roll forward model (RFM) in preparing their proposed access arrangements.<sup>119</sup> The AER considered that requiring service providers to use consistent models would reduce the chance of errors in decisions, and improve comparability between service providers.<sup>120</sup>

#### **4.2.3 Non-tariff terms and conditions**

Some pipeline users expressed concern that there has been limited focus by the regulators on the non-tariff terms and conditions contained within access arrangements. They suggested that this has resulted in a disconnect between the tariff and non-tariff terms of access to a pipeline.

In particular, AGL noted that "terms and conditions often remove commercial risks from the service providers [and] it is important that the regulator ensure a more balanced outcome between the interests of the service provider and users."<sup>121</sup> Stakeholders identified increasingly restrictive terms and conditions in relation to access to (or the ability to amend) delivery points without penalties, warranty and indemnity clauses<sup>122</sup> and the prices of overruns and imbalances.<sup>123</sup> The EUAA considered that the AER should be more explicit in its assessment of non-tariff terms and conditions against the NGO.<sup>124</sup>

There was a view among some pipeline users that further standardisation of terms and conditions across pipelines (regardless of the regulatory status) and jurisdictions would reduce costs.<sup>125</sup>

However, APA noted that there has been extensive consultation on its standard terms and conditions for regulated pipeline services.<sup>126</sup>

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118 DBP and AGN, submission to the issues paper, p. 10. See Chapter 7 for further discussion on the arbitration framework.

119 AER, submission to the issues paper, p. 15.

120 AER, submission to the issues paper, p. 15.

121 AGL, submission to the issues paper, p. 3.

122 AGL, submission to the issues paper, p. 3.

123 Hydro Tasmania, submission to the issues paper, p. 3.

124 EUAA, submission to the issues paper, p. 2.

125 Submissions to the issues paper: EnergyAustralia, p. 2; AGL, p. 4.

126 APA, submission to the issues paper, p. 36.

#### **4.2.4 Regulatory discretion**

Some stakeholders suggested that limits on regulatory discretion should be removed from rules 79, 89, 91, 94 and 95. Stakeholders noted that if the limited discretion provisions were changed to full discretion, the regulator would be able to make decisions that best met the NGO and the revenue and pricing principles.<sup>127</sup>

AGL suggested that limited discretion could be restricting regulators from responding to changes in market conditions and preventing the establishment of a standardised approach to economic regulation.<sup>128</sup> The AER also raised this concern, noting an example where a service provider proposed that backhaul and derivative services should be a multiple or discount to the firm transportation service. The AER commented that the limited discretion in relation to tariff setting means it is constrained in challenging proposals made by the service provider.<sup>129</sup>

In contrast, APA was of the view that limited discretion was ineffective because regulators interpreted and applied their discretion liberally. APA provided an example where the depreciation method proposed for the Goldfields Gas Pipeline was rejected by the regulator on the basis that it was not in the long term interest of consumers with respect to price (that is, inconsistent with the NGO).<sup>130</sup>

Stakeholders also made specific comments on some of the individual limited discretion rules, which are discussed in Chapter 5.

### **4.3 Issues for consideration**

#### **4.3.1 Full access arrangement process**

##### **Improving engagement in the access arrangement process**

The AER and other stakeholders have stated that the current access arrangement process does not provide sufficient time to appropriately consult on, consider and decide on a proposal where there is a material change to the reference service(s) or to the associated terms and conditions. The Commission also notes concerns about the complexity of the access arrangement process, and the constraints on some stakeholders from active engagement.

In light of the concerns expressed by stakeholders, the Commission intends to consider whether amendments to the NGR are required to:

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<sup>127</sup> Submissions to the issues paper: Jemena, p. 3; EUAA, p. 2; MEU, p. 18; PIAC, p. 17; AER, pp. 10-11.

<sup>128</sup> AGL, submission to the issues paper, p. 3.

<sup>129</sup> AER, submission to the issues paper, p. 10.

<sup>130</sup> APA, submission to the issues paper, p. 9.

- include an upfront process to determine reference services and standardised reference non-tariff terms and conditions<sup>131</sup>
- facilitate more extensive consideration of the access arrangement proposal
- allow for additional customer consultation.

The Commission will also consider whether the pre-submission conference under rule 57 of the NGR is useful, or should be amended to facilitate broader stakeholder consultation. However, in considering these issues, the Commission notes that it may not be necessary for the NGR to address such matters, as stakeholders can arrange such discussions independent of the particular provisions in the NGR. The Commission understands that this already occurs in practice. Accordingly, the Commission will also be mindful that any possible amendments to the NGR do not unnecessarily limit or constrain the assessment of proposed access arrangements.

### **Revision period**

The timeframe for submitting a revised access arrangement proposal in response to the regulator's draft decision is at least 15 business days.<sup>132</sup> In relation to recent draft decisions the AER has set the revision periods as:

- 35 business days for the Roma to Brisbane Pipeline 2017-2022
- 27 business days for AusNet Services 2018-2022
- 30 business days for Multinet Gas 2018-2022
- 30 business days for Australian Gas Networks (Victoria and Albury) 2018-2022 and for the APA Victorian Declared Transmission System 2018-2022.

Similarly, the ERA set the revision periods on the Dampier to Bunbury Natural Gas Pipeline and the Goldfields Gas Pipeline as two months following its draft decisions for the current access arrangements on these pipelines.<sup>133</sup>

Revising an access arrangement proposal can be complex and time is required for service providers to digest and respond to a regulator's draft decision. Furthermore, 15 business days may not provide adequate time to allow service providers to engage with stakeholders on any required changes. However, the Commission notes that the access arrangement process already provides an opportunity for stakeholder feedback on the revised proposal ahead of a final decision.

The Commission is also aware of some concerns that service providers may use the revision period to submit a revised proposal that departs substantially from the initial

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<sup>131</sup> See section 4.3.3 for a more detailed discussion of issues for consideration in non-reference tariff terms and conditions.

<sup>132</sup> Rule 59(3) of the NGR.

<sup>133</sup> The revision period included the Christmas-New Year holiday period 2015-2016.

proposal, rather than be focussed on the additions or amendments required to address matters raised in the draft decision.<sup>134</sup>

In the next stage of the review, the Commission intends to consider whether the timeframe to submit a revised proposal under rule 59(3) should be extended and what may be an appropriate timeframe for the revision period. The Commission will also consider whether the NGR are sufficiently clear about whether service providers may submit a revised proposal that makes changes that are not in response to issues raised in the draft decision.

#### **4.3.2 Tariff setting**

Reference services and reference tariffs form the basis of access negotiations for all services on a full regulation pipeline (for example, backhaul, park and loan, short term services, as available and interruptible services). As such, it is important that reference tariffs:

- are set at the correct level (using the building blocks set out in Part 9 of the NGR)
- correctly allocate costs across pipeline services.<sup>135</sup>

The use of consistent revenue models by service providers may assist the regulator in making its assessment of efficient costs, total revenue and reference tariffs.<sup>136</sup>

The Commission intends to consider whether mandating the use of regulator developed financial models, such as is required under the NER, may improve accessibility and transparency for stakeholders, and address concerns that reference tariffs are set above efficient costs.

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<sup>134</sup> Under rule 60 of the NGR a service provider may submit additions or other amendments to the access arrangement proposal in order to address matters raised in the draft decision.

<sup>135</sup> See Chapter 5 for further discussion on total revenue and cost allocation.

<sup>136</sup> Examples of such revenue models include the AER's post tax revenue model (PTRM) and roll forward model (RFM), and the ERA's pro forma regulatory information statements and forecast cost statements.

#### **Box 4.2           NER revenue models**

Under the NER, the AER is required to prepare and publish a post-tax revenue model (clauses 6.4.1(a) and 6A.5.2(a) of the NER) and roll forward model (clauses 6.5.1(b) and 6A.6.1.(b) of the NER). These models are used to determine the network service provider's annual revenue requirement for each regulatory year within the regulatory control period:

- Post-tax revenue model: calculates the annual revenue requirement for each year of a regulatory control period using the building block approach.
- Roll forward model: is used to calculate the closing regulatory asset base for the regulatory period, which becomes the opening regulatory asset base in the next regulatory control period.

In addition, while rule 97 requires that the regulator must have adequate oversight or power of approval over variation in reference tariffs, it does not specify the process for this approval. The rule is also silent on the particular elements that must be included in a tariff variation mechanism. The Commission intends to consider whether the NGR provides sufficient guidance in relation to the assessment of the reference tariff variation mechanism.

#### **4.3.3    Non-tariff terms and conditions**

Stakeholders are invited to make submissions to the regulator on any aspect of the access arrangement proposal and on any subsequently revised version of the proposal including the appropriateness of the terms and conditions.<sup>137</sup>

The Commission has observed that across access arrangement reviews, users and prospective users have made a variety of submissions on terms and conditions, including seeking to add clauses.<sup>138</sup> Stakeholders have also requested the regulator consider the appropriate allocation and price of risk in the terms and conditions.<sup>139</sup>

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<sup>137</sup> Rules 58(1) and 59(5)(c)(iii) of the NGR.

<sup>138</sup> In the review process for the Multinet Gas access arrangement review 2018-2022, AGL sought to add a new clause to facilitate the creation of commercial agreements differing from the terms and conditions in the access arrangement. In its draft decision, the AER rejected the request on the basis that the NGL and NGR set out the process for negotiating access and resolving disputes (AER, *Multinet Gas access arrangement 2018-2022, Draft decision*, July 2017, p. 7).

<sup>139</sup> In the recent RBP access arrangement proposal stakeholders requested that the AER consider whether the proposed rates for overruns, imbalances and variances were reasonable and whether the tariffs reflected the level of risk borne by the service provider. (Submissions on RBP access arrangement 2018-22 proposal: AEC, p. 2; QGC, pp. 1-2).

In response to such stakeholder feedback, the AER has assessed reference service terms and conditions for consistency with the NGL. In doing so, the AER has considered:<sup>140</sup>

- risk allocation
- legal consistency and clarity
- consistency with the relevant requirements in the NGL, NGR and the relevant procedures in force.

In relation to its assessment process, the AER has stated:<sup>141</sup>

“In some cases, greater prescription or intervention on our part in determining these terms and conditions may impede competitive market outcomes and be inefficient. There are two reasons for this: first, our lower level of information than that of [service providers] and users and second, the user-specific nature of many issues. Accordingly, we will generally avoid proposing amendments in these cases where flexibility to negotiate commercial outcomes is desirable. We expect that both service providers and users will negotiate in good faith on such matters. ”

Nevertheless, there are the following potential issues in relation to non-tariff terms and conditions:

- consistency of non-tariff terms and conditions across access arrangements
- link between tariffs and non-tariff terms and conditions.

Consequently, the Commission intends to consider whether further standardisation of non-tariff terms and conditions is required and how this could be achieved through the NGR.

The Commission also intends to consider whether the NGR provide sufficient guidance for the regulator, service providers and users on the interrelationship between the tariff and non-tariff terms and conditions of a full access arrangement.

#### **4.3.4 Regulatory discretion**

There are currently three levels of regulatory discretion in the NGR. Stakeholders, including the AER, have raised concerns about the purpose and effectiveness of limiting regulatory discretion in relation to conforming capital expenditure, the depreciation schedule, operating expenditure and tariff setting.<sup>142</sup> This is discussed further in Chapter 5.

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<sup>140</sup> AER, *Roma to Brisbane access arrangement 2018-22, Draft decision*, Attachment 12, pp. 19-20; see also AER, *Australian Gas Networks Victoria and Albury gas access arrangement 2018-2022, Draft decision*, July 2017, p. 48.

<sup>141</sup> AER, *Roma to Brisbane access arrangement 2018-22, Draft decision*, Attachment 12, pp. 19-20.

<sup>142</sup> Rules 79, 89, 91, 94 and 95 of the NGR.

Stakeholder submissions have also indicated that there may be some ambiguity surrounding the link between the levels of discretion in the NGR and the manner in which the regulator must perform or exercise its economic regulatory functions or powers under s. 28 of the NGL.

The Commission intends to consider whether the three different levels of regulatory discretion in the NGR effectively promote the NGO, and are consistent with the NGL.

## **4.4 Other issues**

### **4.4.1 Most favoured nation clauses**

In discussions with the AEMC, some stakeholders raised concerns about clauses known as most favoured nation clauses in commercial contracts.<sup>143</sup> These clauses are typically negotiated in relation to a foundation contract and stipulate that the service provider cannot agree to ship gas at a price lower than the amount agreed in the foundation contract. In the event that a service provider does later ship gas at a lower price, that lower price must be offered to the foundation customer.<sup>144</sup>

Relevantly, s. 322 of the NGL states that:

“nothing in this Law is to be taken as preventing a service provider from entering into an agreement with a user or prospective user about access to a pipeline service by means of a scheme pipeline that is different from an applicable access arrangement that applies to that pipeline service.”

Outside of the access arrangement, parties are able to reach agreement on terms and conditions that best suit their circumstances, subject to the requirements of law, including competition law. As such, the Commission does not consider that it is appropriate to examine a regulatory response to this issue in the draft report.

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<sup>143</sup> See also Power and Water NT, submission to the issues paper, pp. 4-5.

<sup>144</sup> NERA, *Foundation contracts and greenfields gas pipeline developments: experience from the United States and other jurisdictions, a final report for the ACCC*, March 2002, p. 31.

## 5 Determining efficient costs

This chapter sets out the issues that submissions have raised with regard to determining the efficient costs of providing pipeline services. It includes:

- an overview of the current regulatory framework related to determining efficient revenue for full regulation pipelines
- stakeholder feedback on issues that should be considered
- the broad issues that the Commission will consider further in this review
- other issues raised.

### 5.1 Current framework

#### 5.1.1 Monopoly pricing

The NGL's revenue and pricing principles set out that a service provider should be provided with a reasonable opportunity to recover efficient costs in line with a regulatory obligation or requirement. The full list of principles is set out below:<sup>145</sup>

“(1) The revenue and pricing principles are the principles set out in subsections (2) to (7).

(2) A service provider should be provided with a reasonable opportunity to recover at least the efficient costs the service provider incurs in -

(a) providing reference services; and

(b) complying with a regulatory obligation or requirement or making a regulatory payment.

(3) A service provider should be provided with effective incentives in order to promote economic efficiency with respect to reference services the service provider provides. The economic efficiency that should be promoted includes -

(a) efficient investment in, or in connection with, a pipeline with which the service provider provides reference services; and

(b) the efficient provision of pipeline services; and

(c) the efficient use of the pipeline.

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<sup>145</sup> Section 24 of the NGL.

(4) Regard should be had to the capital base with respect to a pipeline adopted -

(a) in any previous -

(i) full access arrangement decision; or

(ii) decision of a relevant Regulator under section 2 of the Gas Code;

(b) in the Rules.

(5) A reference tariff should allow for a return commensurate with the regulatory and commercial risks involved in providing the reference service to which that tariff relates.

(6) Regard should be had to the economic costs and risks of the potential for under and over investment by a service provider in a pipeline with which the service provider provides pipeline services.

(7) Regard should be had to the economic costs and risks of the potential for under and over utilisation of a pipeline with which a service provider provides pipeline services."

Under rule 79 of the NGR, the regulator determines capital expenditure that "would be incurred by a prudent service provider acting efficiently, in accordance with accepted good industry practice, to achieve the lowest sustainable cost of providing services." The efficient costs form the "total revenue" for the pipeline, which is calculated using the building block approach:<sup>146</sup>

- return on the projected capital base
- depreciation on the projected capital base
- estimated cost of corporate income tax
- increments or decrements resulting from the operation of an incentive mechanism
- forecast operating expenditure.

### **5.1.2 Capital expenditure and operating expenditure**

Capital expenditure is assessed ex-ante and ex-post by the regulator:

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<sup>146</sup> Rule 76 of the NGR.

1. Ex-ante: at the beginning of an access arrangement period, the regulator determines whether projected capital expenditure is 'conforming'. Conforming capital expenditure is added to the opening capital base to calculate the projected capital base for the access arrangement period. The return on this expenditure is included in the calculation of total revenue and reference tariffs for that period.
2. Ex-post: prior to the start of the next access arrangement period, the regulator determines whether actual capital expenditure for the current period is 'approved'. Approved capital expenditure is rolled into the opening capital base. Together with the projected capital expenditure for the next access arrangement period, this forms the projected capital base for the next access arrangement period.

Operating expenditure is only assessed once by the regulator (ex-ante). Prior to the start of an access arrangement period, the regulator determines whether forecast operating expenditure for that forthcoming period is approved.

To be approved by the regulator, capital expenditure and operating expenditure must be at a level that would be incurred by a prudent service provider acting efficiently, in accordance with accepted good industry practice, to achieve the lowest sustainable cost of delivering pipeline services.<sup>147</sup>

In addition, capital expenditure must satisfy one of the following criteria:<sup>148</sup>

- the overall economic value of the expenditure directly accruing to the service provider, gas producers, users and end users is positive
- the present value of the expected incremental revenue to be generated as a result of the expenditure exceeds the present value of the capital expenditure
- the capital expenditure is necessary to maintain and improve the safety of services, maintain the integrity of services, comply with a regulatory obligation or requirement, or maintain the service provider's capacity to meet levels of demand for services existing at the time the capital expenditure is incurred.

These rules on forecast operating and capital expenditure illustrate the incentive based regulatory regime that is applied to gas pipelines. Specifically, in the context of capital expenditure, service providers are incentivised to proceed with a more efficient option than the forecast capital expenditure, or to not proceed with the investment if it is no longer efficient. Under the current incentive framework, if an investment is no longer required, then the service provider initially benefits by not undertaking the investment. However, at the next access arrangement period, the benefit is shared with users

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<sup>147</sup> Rules 79(1)(a) and 91 of the NGR.

<sup>148</sup> Rule 79 of the NGR.

through the removal of the return on and of capital expenditure from total revenue and reference tariffs.<sup>149</sup>

### **Limited discretion in assessing expenditure**

Regulatory discretion is limited in carrying out the assessment of capital and operating expenditure.<sup>150</sup> This means that the regulator may not withhold its approval if it is satisfied that the proposal complies with the applicable requirements of the NGL.<sup>151</sup>

### **Capital contributions**

Capital expenditure can also be fully or partially funded by users through capital contributions. The regulator may approve that the capital expenditure be rolled into the capital base subject to the extent of the capital contributions made. Regulatory approval of including the capital expenditure may be subject to the access arrangement including a condition that the service provider cannot benefit from the capital contribution through increased revenue.<sup>152</sup>

### **Non-conforming capital expenditure**

The regulator may approve that a service provider recover non-conforming capital expenditure through a surcharge. Expenditure recovered through a surcharge cannot be rolled into the capital base.<sup>153</sup> Alternatively, the service provider may set it aside in a speculative capital expenditure account, and roll it into the capital base only if and when the regulator re-classifies it as conforming expenditure in the future.<sup>154</sup>

## **5.1.3 Capital base and depreciation**

The initial opening capital base for a covered pipeline is determined under rule 77 of the NGR:

- for a covered pipeline commissioned before the commencement of the NGR in 2008: with reference to the relevant provisions of the code
- for a covered pipeline commissioned after the commencement of the NGR in 2008: the cost of construction of the pipeline and pipeline assets incurred before commissioning of the pipeline (including easement and real property costs), plus

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<sup>149</sup> Likewise, service providers are not required to proceed with forecast operating expenditure and will benefit from any efficiency gain during the access arrangement period. While operating expenditure is not assessed ex-post, the regulator would consider efficiencies gained in assessing forecast operating expenditure for the next access arrangement period.

<sup>150</sup> Rules 79(6) and 40(2) of the NGR.

<sup>151</sup> Also see s. 28 of the NGL that requires consideration of the NGO and revenue and pricing principles. Refer to Chapter 4 for further discussion on limited discretion.

<sup>152</sup> Rule 82 of the NGR.

<sup>153</sup> Rule 83 of the NGR.

<sup>154</sup> Rule 84 of the NGR.

the amount of capital expenditure since the commissioning of the pipeline, less depreciation and disposed assets.

The capital base for a non-scheme pipeline is determined under rule 569 of the NGR as: the cost of construction of the pipeline and pipeline assets incurred before commissioning of the pipeline (including easement and property costs), plus the amount of capital expenditure since the commissioning of the pipeline, less return of capital and disposed assets.

The opening capital base for a subsequent access arrangement period for a scheme pipeline is also determined under rule 77. It is to be the opening capital base for the previous period (or notional previous period if there was no full access arrangement), plus conforming capital expenditure, less depreciation and disposed assets. As discussed in section 5.1.2, only conforming capital expenditure and approved depreciation are rolled into the capital base.

The depreciation schedule may list assets by asset or asset class. It assigns a value and life for each asset or asset class. As a result, the asset value for an asset at any point in time can be calculated based on the depreciation methodology approved by the regulator.<sup>155</sup> Along with asset lives, the depreciation methodology defines the time profile of depreciation. The time profile provides a tool for the service provider to manage assets, cash flow and the revenue path across access arrangement periods.

The NGR also set out that a depreciation schedule should be designed such that:<sup>156</sup>

- reference tariffs vary over time, in a way that promotes efficient growth in the market for reference services
- each asset or group of assets is depreciated over the economic life of that asset or group of assets
- an asset is depreciated only once
- the service provider's reasonable needs for cash flow meet financing, non-capital and other costs.

This rule is applied by the regulator with limited discretion. As a consequence, service providers are able to submit, and obtain approval for, depreciation schedules that have been calculated using different methodologies, provided they comply with the requirements set out above.

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<sup>155</sup> For example, historical cost accounting or current cost accounting.

<sup>156</sup> Rule 89 of the NGR.

#### **5.1.4 Cost allocation**

##### **Reference services**

Rule 93 of the NGR includes provisions that require the allocation of total revenue across reference services and other services to reflect the allocation of direct costs and other costs across reference services and other services:

- Direct costs of providing reference services are allocated to reference services, and direct costs of providing non-reference services are allocated to non-reference services.
- Other costs are allocated between reference and non-reference services on a basis that is determined or approved by the regulator, in line with the revenue and pricing principles.

##### **Rebateable services**

Rule 93 also permits the regulator to allocate costs of rebateable services to reference services as long as the regulator is satisfied that the service provider will apply an appropriate portion of the revenue generated from the sale of rebateable services to provide price rebates (or refunds) to the users of reference services. Rule 93 defines rebateable services as non-reference services whose:

- markets are substantially different from markets for reference services
- demand, or the revenue to be generated from the service, is substantially uncertain.

Rule 93 allows for the re-allocation of costs associated with rebateable services to these services from reference services on an ex-post basis. Under the NGR, rebateable services are services that have uncertain demand at the outset of the access arrangement period. This is the basis for an ex-post rebate rather than an ex-ante cost allocation. The NGR also require rebateable service markets to be substantially different from reference service markets.

## **5.2 Summary of submissions**

### **5.2.1 Monopoly pricing**

Pipeline users and consumer groups considered that the tariffs for regulated services were too high, and did not reflect the service provider's reasonable costs and return on capital. The MEU considered that service providers relied on "unconstrained monopoly power" to set tariffs above efficient costs. PIAC noted that the AEMC should consider why the approved tariffs are resulting in higher than efficient cost recovery.<sup>157</sup>

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<sup>157</sup> Submissions to the issues paper: MEU, p. 16; PIAC, p. 6.

In contrast, service providers considered that tariffs reflected the efficient costs of providing pipeline services. APA argued that existing provisions of the NGR were "designed to direct the service provider and regulator to be efficient in each of the component costs from which reference tariffs are determined". APA also considered that the tariff setting guidelines in rule 95 did not appear to constrain the service provider or regulator from setting cost reflective tariffs.<sup>158</sup>

## 5.2.2 Capital expenditure and operating expenditure

A number of stakeholders raised concerns that the criteria for assessing efficient capital expenditure (rule 79) might not be achieving the NGO. Specifically, stakeholders considered it an issue that service providers were not required to proceed with approved forecast capital expenditure.<sup>159</sup> In their view, this allows a service provider to recover the costs of the "approved capital works" (through reference tariffs during the access arrangement period) without completing the work.<sup>160</sup> These stakeholders also considered that system security and integrity could be diminished if the capital works did not proceed, because the service provider did not consider it to be prudent.<sup>161</sup>

Stakeholders made a number of suggestions that could address this issue, including:

- introducing a regulatory investment test<sup>162</sup>
- changing the new capital expenditure criteria in rule 79 to more thoroughly assess the deferral of capital expenditure projects<sup>163</sup>
- introducing a mechanism to claw back any revenue gains from reference tariff increases associated with the unspent conforming forecast capital expenditure<sup>164</sup>
- allowing the regulator to recover all of the administrative costs associated with assessing unspent conforming forecast capital expenditure<sup>165</sup>
- requiring the service provider to spend all conforming forecast capital expenditure on the basis of ensuring safety and integrity<sup>166</sup>

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<sup>158</sup> APA, submission to the issues paper, pp. 31-32.

<sup>159</sup> Lochard et al, submission to the issues paper, p. 1.

<sup>160</sup> As noted in section 5.1.2, this would only be the case during the access arrangement period and users would benefit through lower reference tariffs in subsequent access arrangement periods.

<sup>161</sup> Submissions to the issues paper: Lochard et al, p. 1; EnergyAustralia, p. 2; NTPWC, p. 4.

<sup>162</sup> Submissions to the issues paper: PIAC, p. 5; EUAA, p. 6. Regulatory investment tests apply to electricity network service providers under the NER. Differences in the electricity and gas regulatory regimes mean that if a regulatory investment test were to be included in the NGR, it is likely that it would need to be significantly different from the tests in the NER.

<sup>163</sup> EnergyAustralia, submission to the issues paper, p. 2.

<sup>164</sup> AGL, submission to the issues paper, p. 2.

<sup>165</sup> Lochard et al, submission to the issues paper, p. 2.

<sup>166</sup> Lochard et al, submission to the issues paper, p. 2.

- only rolling approved (spent) capital expenditure into the capital base<sup>167</sup> or introducing a contingent project mechanism for significant but uncertain capital expenditure.<sup>168</sup>

### 5.2.3 Limited discretion in assessing expenditure

There were a number of stakeholder comments on whether the regulator's assessment of efficient capital expenditure (rule 79) should be limited discretion.<sup>169</sup> The AER considered that it should be allowed to assess the efficiency of proposed or actual expenditure with full discretion. It also noted that investments proposed or made on the basis of rule 79(2)(c) are a particular concern, as the economic benefit of the investment was not assessed.<sup>170</sup> The AER suggested that rule 79 should not be limited discretion, and that the regulator should be able to propose a more efficient investment.<sup>171</sup> The EUAA also considered it important for the AER to have full discretion on any matter associated with the building blocks, including the assessment of both forecast and actual capital expenditure. In its view, this would allow the AER to prevent the exercise of monopoly power.<sup>172</sup>

NTPWC considered that the current (limited) level of discretion in expenditure assessment was reasonable. In its view, this approach does achieve what it considers to be essential - that both forecast and actual expenditure are rigorously assessed to prevent 'gold-plating'.<sup>173</sup>

DBP and AGN and APA also considered the regulatory discretion in rule 79 should remain limited. DBP and AGN noted that it would not be appropriate to apply hindsight through full regulator discretion in the ex-post assessment.<sup>174</sup> APA considered that the AER does not seem influenced by the limited discretion of rule 79, and has carried out thorough expenditure assessments.<sup>175</sup>

APA noted that forecast costs were best estimates made at the time, and that during the period between proposal of the forecast expenditure and execution of the relevant capital project, changes in market conditions and in the price of materials and services

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<sup>167</sup> Lochard et al, submission to the issues paper, p. 2.

<sup>168</sup> AER, submission to the issues paper, pp. 11-13. A contingent project mechanism is available to electricity network service providers. It can be used where the need for a project (subject to a trigger event) or the costs are uncertain. If the trigger event occurs, the service provider applies to the AER to amend the revenue determination. See rules 6A.8 (transmission) and 6.6A (distribution) of the NER.

<sup>169</sup> Refer to Chapter 4 for further discussion on regulatory discretion.

<sup>170</sup> These are investments related to safety, security or a regulatory obligation or requirement.

<sup>171</sup> AER, submission to the issues paper, p. 12.

<sup>172</sup> EUAA, submission to the issues paper, pp. 5-6.

<sup>173</sup> NTPWC, submission to the issues paper, p. 4.

<sup>174</sup> DBP and AGN, submission to the issues paper, p. 20.

<sup>175</sup> APA, submission to the issues paper, p. 19.

might lead to changes in both project scope and cost. APA considered the ex-post assessment of investment to be beneficial for pipeline users.<sup>176</sup>

DBP and AGN also considered that the current framework provided incentives for investments to be efficient.<sup>177</sup>

#### **5.2.4 Speculative investment**

Stakeholders generally considered that the current framework did not encourage speculative investment. APA noted that rule 84 did not provide an incentive to finance speculative investment as it was unclear when or whether the expenditure would be included in the capital base, and which rate of return would be applied. APA noted that only capital expenditure with some certainty of recovery, for example through long term contracts, would be approved internally. If the regulatory regime were to be amended to encourage speculative investment, this risk would need to be borne by users.<sup>178</sup> DBP and AGN noted that rule 84 was not well tested. They also noted that to be used by service providers, the rule would need to provide a commercial rate of return that acknowledged the additional risk associated with the speculative investment.<sup>179</sup>

While PIAC and EUAA supported greater incentives for speculative investment in principle, they considered that users should not have to bear the costs of the additional risk.<sup>180</sup>

#### **5.2.5 Capital base and depreciation**

Stakeholders raised a range of concerns related to depreciation.

Central Petroleum considered that economic asset lives were generally too long, and suggested that the capital base valuation under rule 569 of the NGR should apply to scheme pipelines.<sup>181</sup>

The AER expressed concern about the issue of inconsistent capital base indexation across service providers.<sup>182</sup>

Hydro Tasmania considered that the current framework for depreciation resulted in inequitable and inefficient outcomes for pipelines facing declining demand.<sup>183</sup>

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<sup>176</sup> APA, submission to the issues paper, p. 18.

<sup>177</sup> DBP and AGN, submission to the issues paper, p. 20.

<sup>178</sup> APA, submission to the issues paper, p. 23.

<sup>179</sup> DBP and AGN, submission to the issues paper, p. 24.

<sup>180</sup> Submissions to the issues paper: EUAA, p. 2; PIAC, pp. 5 & 19.

<sup>181</sup> Central Petroleum, submission to the issues paper, pp. 1-4.

<sup>182</sup> AER, submission to the issues paper, pp. 15-16.

<sup>183</sup> Hydro Tasmania, submission to the issues paper, pp. 2-3.

Some stakeholders considered that the current framework for depreciation resulted in an over recovery of costs. These stakeholders supported the introduction of clear criteria and a standardised approach to depreciation.<sup>184</sup> EUAA suggested that allowing the AER to exercise full discretion in assessing depreciation would allow a consistent approach to be applied.<sup>185</sup>

### **5.2.6 Cost allocation**

With regard to cost allocation between the covered and uncovered parts of a partially covered pipeline,<sup>186</sup> EUAA was concerned that users of the regulated part of the pipeline should not subsidise users of the unregulated part.<sup>187</sup> PIAC suggested that the NGR could recognise that this situation can occur and provide specific guidance on consistent cost allocation methodologies.<sup>188</sup>

APA considered that having parts of a pipeline that were not part of the covered pipeline did not affect the application of cost allocation or tariff setting rules for the covered part of the pipeline. APA gave the example of the Goldfields Gas Pipeline in Western Australia to support its views.<sup>189</sup>

## **5.3 Issues for consideration**

### **5.3.1 Monopoly pricing**

The Commission considers that a number of issues have resulted in stakeholder concerns that tariffs may not reflect efficient costs. Some of these issues relate to the assessment of efficient costs, and are discussed in this chapter. Other stakeholder concerns relate to reference service definition, tariff setting and the effectiveness of the arbitration regime, and are discussed in other chapters as relevant.

### **5.3.2 Capital expenditure and operating expenditure**

Stakeholder submissions regarding unspent conforming capital expenditure were related to investment in the Victorian Declared Transmission System (DTS). In the 2008-2012 access arrangement period, APA did not spend the conforming forecast capital expenditure at the Brooklyn compressor station. APA carried out other expenditure that it considered to be more prudent. DTS users disagreed with this decision, and considered that the conforming capital expenditure would better address their constraint issues in the DTS.

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<sup>184</sup> Submissions to the issues paper: PIAC, p. 25; DBP and AGN, p. 16.

<sup>185</sup> EUAA, submission to the issues paper, p. 5.

<sup>186</sup> Refer to section 2.3.3.

<sup>187</sup> EUAA, submission to the issues paper, p. 6.

<sup>188</sup> PIAC, submission to the issues paper, pp. 25-26.

<sup>189</sup> APA, submission to the issues paper, p. 22.

The DTS operates under a market carriage arrangement, and as a result has different drivers for investment to contract carriage transmission pipelines. The operation of the market carriage approach on the pipeline means that there are no pipeline capacity rights for users as there are on a contract carriage pipeline. Consequently, DTS users have fewer incentives to underwrite capital expenditure (through capital contributions, paying surcharges or supporting capital expenditure that will not be rolled into the capital base). As a result, the DTS service provider (APA) focusses on capital expenditure that it considers is likely to satisfy rule 79 and be rolled into the capital base.

In practice, distribution pipeline service providers are also more likely to focus pipeline capital expenditure on that which can be approved through the regulatory processes and rolled into the capital base. However, no concerns have been identified by stakeholders in this regard.

Given stakeholder interest in this issue, and its materiality in the building block approach, the Commission intends to consider whether the test in rule 79 remains appropriate for both ex-ante and ex-post assessment of capital expenditure in the context of distribution and transmission pipelines. The Commission will also examine the adequacy of rule 91 in assessing forecast operating expenditure.

### **5.3.3 Limited discretion in expenditure assessment**

As discussed in Chapter 4, the Commission intends to consider limited discretion further in the draft report. This will include the concerns and suggestions raised in relation to the limited discretion in assessing capital and operating expenditure under rules 79 and 91.

### **5.3.4 Speculative investment**

The speculative investment account under rule 84 has been rarely used.<sup>190</sup> In addition, stakeholder submissions indicate that service providers are not interested in making speculative investments. Service providers wish to have some certainty over the return on investment in order to attract finance to the project. For contract carriage transmission pipelines, this means having long term contracts in place to underwrite any additional pipeline capacity. For the DTS and distribution pipelines, this means having robust demand forecasts that support the planned investment.

It is important that the current framework is to not deter efficient investment in spare capacity, while keeping the investment risk with the service provider. Equally, the framework should not encourage inefficient investment that creates additional costs for users.

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<sup>190</sup> In the 2000 access arrangement for the Central West Pipeline, \$2.78 million was placed in the speculative investment fund under section 8.19 of the code. This portion of the investment was expected to be rolled into the capital base once the pipeline was extended to Tamworth.

The Commission will consider whether rule 84 is still relevant to the regulatory framework, and if so whether any amendments could better achieve or clarify its objective.

### **5.3.5 Capital base and depreciation**

The objectives of an efficient depreciation time profile are efficient investment, access to financing and efficient cost recovery across current and future customers. The depreciation criteria under rule 89 of the NGR refer to a service provider's financing needs and efficient growth in the market for reference services. The regulatory discretion is limited in relation to assessing a service provider's proposed depreciation for a full access arrangement.

Potential issues in relation to depreciation include:

- insufficient clarity in the reference to financing needs
- regulator's limited discretion to assess and make a decision regarding a service provider's depreciation proposal
- difference between the economic asset lives and the actual or tax asset lives.

In the draft report, the Commission intends to explore:

- the assessment of depreciation, in line with the NGO and objectives of an efficient depreciation schedule
- whether the regulator should have limited discretion in relation to depreciation
- valuation of assets to roll into the capital base, and valuation of the initial capital base for newly covered pipelines - including the estimation of depreciation.

### **5.3.6 Cost allocation**

Cost allocation provisions in the NGR are perceived as ambiguous and inconsistent.

Rule 93 of the NGR provides for the allocation of total revenue across reference services and other services. The rule does not specify:

- allocation across covered and uncovered parts of a pipeline
- allocation of assets, and rolling of allocated assets into the capital base.

In addition, it is unclear whether the total revenue calculated under rule 76:

- refers to the pipeline as a whole, and includes any revenue from extensions or expansions that do not form part of the covered pipeline, or

- refers only to the covered pipeline, and excludes any revenue from extensions or expansions that do not form part of the covered pipeline.

If total revenue in rule 76 refers to the covered pipeline only, then it is likely that rule 93 cannot refer to allocation across covered and uncovered parts of the pipeline. Even if this is not the case, rule 93 is ambiguous in relation to allocation across covered and uncovered parts of the pipeline. There may also be a possible constraint of a regulator's information gathering powers to covered parts of the pipeline, which may affect the ability of the regulator to assess cost allocation across covered and uncovered parts of the pipeline and to ultimately, set an efficient reference tariff.<sup>191</sup>

As discussed in Chapter 2, Part 23 of the NGR may apply to uncovered parts of a covered pipeline. As a consequence, cost allocation across covered and uncovered parts of a pipeline may be further complicated, as the capital base valuation could be different under Parts 9 and 23.

Another issue is that rule 79 does not allow the regulator to assess capital expenditure that may be associated with an uncovered extension or expansion in a previous period, as conforming capital expenditure. Rules 77 and 78 restrict capital expenditure rolled into the capital base to conforming capital expenditure. There is no mechanism to include capital expenditure related to uncovered extensions or expansions in the capital base at a later date. Even if the uncovered portion of the pipeline was later covered, it is unclear how the expenditure would be rolled into the capital base.

Rule 93 also allows for the re-allocation of costs associated with rebateable services to reference services. Stakeholder submissions have illustrated uncertainty in relation to the concept, application and relevance of rebateable services. For example, there is some uncertainty around how revenue from rebateable services would be rebated. The provisions of the rule refer the rebate to users, rather than the reference tariff itself. The Commission will investigate these issues, in addition to examining the role of rebateable services in the framework for economic regulation of covered pipelines.

In general, an imprecise allocation of costs to the reference service could mean that users of some services may be cross-subsidising users of other services. This has the potential to distort incentives for the efficient investment in, and operation and use of a pipeline. The Commission will investigate the issues noted above in relation to cost allocation. This will include considering the alignment of cost allocation provisions with the NGR, in addition to the fair and transparent distribution of scheme pipeline costs across users. It will also consider the implications of Part 23 of the NGR for cost allocation between covered and uncovered parts of a pipeline and whether any amendments or clarifications are required.

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<sup>191</sup> Chapter 6 includes a more detailed description of the information gathering powers of the AER and the ERA under the NGL and NGR.

## 5.4 Other issues

### 5.4.1 Redundant assets

Rules 85 and 86 of the NGR provide a mechanism for the classification of assets as redundant, and allows redundant assets to be re-classified as conforming capital expenditure (and included in the capital base) if they are no longer redundant. The redundant asset provision was supported by PIAC and MEU to avoid the costs of unutilised investment being borne by consumers.<sup>192</sup>

The AEMC is aware of only one instance where a pipeline asset has been declared as redundant. In 2005, the Independent Pricing and Regulatory Tribunal of New South Wales (IPART) declared that part of the Wilton to Wollongong pipeline was redundant due to decreased utilisation. IPART removed the asset from the capital base under section 8.27 of the code.<sup>193</sup> The service provider sought to have that part of the pipeline rolled back into the capital base in the 2010 access arrangement review. The AER rejected the proposal on the grounds that the redundant asset was not contributing to the delivery of pipeline services.<sup>194</sup>

Regardless of its limited use, there is a view that the redundant asset provision provides an incentive for service providers to make efficient investments. Stakeholders supported retaining the provision to avoid consumers bearing the costs of unused investments.

The Commission does not intend to examine the redundant asset provisions of the NGR in any further detail in the remainder of this review.

### 5.4.2 Technical and reliability standards

State and territory governments are responsible for the regulation of gas transmission and distribution pipelines within the jurisdiction. This may take the form of:

- laws and regulations that set out safety and technical requirements for the pipeline infrastructure and supply of gas, administered by a state regulator<sup>195</sup>

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<sup>192</sup> Submissions to the issues paper: PIAC, p. 5; MEU, p. 22.

<sup>193</sup> IPART, *Revised access arrangement for AGL Gas Networks, Final Decision*, April 2005, pp. 36-41, 78-89.

<sup>194</sup> AER, *Jemena Gas Networks, Access arrangement proposal for the NSW gas networks, Final Decision (public)*, June 2010. pp. 45-46.

<sup>195</sup> The state technical regulators are: the Division of Energy Water, Regulation & Portfolio Strategy in NSW; the Office of the Technical Regulator in SA; Energy Safe Victoria in Victoria; the Department of Energy and Water Supply in Queensland (with the Queensland Competition Authority administering industry codes); EnergySafety WA in WA; Office of the Tasmanian Economic Regulator in Tasmania; Department of Primary Industry and Resources in Northern Territory.

- a requirement for the service provider to be licensed, which can then require:
  - the operator to develop management plans to comply with the relevant laws, regulations and industry codes<sup>196</sup>
  - ongoing monitoring and reporting by a state regulator<sup>197</sup>
- compliance with certain Australian standards, such as:
  - AS/NZS 4645: gas distribution networks
  - AS 1697: installation and maintenance of steel pipe systems for gas
  - AS 3723: installation and maintenance of plastic pipe systems for gas.

These jurisdictional requirements can change over time. Where a regulatory obligation or requirement changes, rule 79(2)(c) (capital expenditure criteria) provides that this will be conforming capital expenditure provided the expenditure is also prudent.

AEMO suggested that a statutory reliability and planning standard could be introduced in Victoria for the DTS. AEMO considered that a planning standard would provide a framework for what constitutes security and reliability, and would allow for investment to maintain and improve the safety of services or the integrity of services.<sup>198</sup>

The Commission notes that service reliability standards are the responsibility of state and territory governments.<sup>199</sup> Therefore, this review will not consider introducing reliability and planning standards into the NGR. However, the Commission is in discussion with key policy stakeholders regarding how best to take this issue forward.

Nevertheless, as discussed above, as part of this review, the Commission will consider whether the capital expenditure criteria in rule 79 remain appropriate, including in relation to their application to the DTS.

### 5.4.3 Allowed rate of return

Rule 87 of the NGR requires the regulator to publish non-binding rate of return guidelines. These guidelines set out proposed methodologies to estimate the allowed rate of return; and the estimation methods, financial models, market data and other

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<sup>196</sup> In New South Wales, operators must have a safety and operating plan. In South Australia, operators must have a safety, reliability, maintenance and technical management plan. In Victoria, operators must have a safety management plan.

<sup>197</sup> Licencing is administered by: the Division of Energy Water, Regulation & Portfolio Strategy in NSW; Essential Services Commission South Australia in SA; the Essential Services Commission in Victoria; the Department of Energy and Water Supply in Queensland; ERA in WA; Office of the Tasmanian Economic Regulator in Tasmania; Department of Primary Industry and Resources in Northern Territory.

<sup>198</sup> AEMO, submission to the issues paper, pp. 1-2.

<sup>199</sup> See Australian Energy Market Agreement, Annexure 2.

evidence to estimate the return on equity, return on debt and the value of imputation credits.

Stakeholders provided a number of different comments on the allowed rate of return. EnergyAustralia considered that while the allowed rate of return for regulated pipelines was transparent, it has been too high.<sup>200</sup> MEU stated that a pipeline service provider should be rewarded for risks greater than the regulatory bargain. However, MEU also considered that service providers received rewards that were greater than their risks.<sup>201</sup> PIAC stated that the allowed rate of return for the covered and uncovered sections of the pipeline should be calculated using a comparable approach, and that a binding rate of return guideline would reduce access arrangement costs.<sup>202</sup> Jemena considered that the discount rate under rule 119M(2)(a) did not afford the service provider with the desired flexibility.<sup>203</sup>

On 14 July 2017 the COAG Energy Council agreed to introduce a binding rate of return guideline, to be developed by the AER and ERA.<sup>204</sup> This decision was made in light of the Commonwealth announcement to abolish the limited merits review regime.<sup>205</sup>

This review will not examine the determination of the allowed rate of return, as this matter is currently being considered through another review as noted above. However, as part of this review the Commission may consider the application of the allowed rate of return to the capital base, speculative account and arbitration. It may also consider the linkages between the allowed rate of return and other elements of a full access arrangement, including non-tariff terms and conditions of access. For example, that certain non-tariff terms and conditions of access should be amended to align with a binding allowed rate of return.

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<sup>200</sup> EnergyAustralia, submission to the issues paper, p. 1.

<sup>201</sup> MEU, submission to the issues paper, pp. 14-15.

<sup>202</sup> PIAC, submission to the issues paper, pp. 12 & 27.

<sup>203</sup> Jemena, submission to the issues paper, p .3.

<sup>204</sup> The Commission understands that the guideline will apply to covered gas pipelines.

<sup>205</sup> COAG Energy Council, *Meeting communique*, 14 July 2017, p. 2.

## 6 Negotiation and information

This chapter sets out the issues regarding information available to and accessible by prospective users in negotiations with pipeline service providers. It also discusses issues regarding information available to the regulator in carrying out its functions. It includes:

- an overview of the current information disclosure requirements
- stakeholder feedback on the availability and accessibility of information, its adequacy and the adequacy of the regulator's information gathering powers
- the issues that the Commission intends to consider further in this review.

### 6.1 Current framework

#### 6.1.1 Access arrangements

##### Full access arrangements

Where an access arrangement exists for a full regulation pipeline, the service provider is required to publish the access arrangement as approved by the regulator, along with access arrangement information relating to that access arrangement.<sup>206</sup>

Access arrangement information is defined as:<sup>207</sup>

“Access arrangement information for an access arrangement or an access arrangement proposal is information that is reasonably necessary for users and prospective users:

(a) to understand the background to the access arrangement or the access arrangement proposal; and

(b) to understand the basis and derivation of the various elements of the access arrangement or the access arrangement proposal.”

If, in the regulator’s opinion, the access arrangement information submitted is not sufficiently comprehensive or is otherwise in any way deficient, then the regulator can require the deficiency to be corrected.<sup>208</sup>

Access arrangement information must include information on expenditure and utilisation for the previous access arrangement period by category, in addition to other information relevant to pricing of the reference service.<sup>209</sup>

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<sup>206</sup> Rules 107 and 44 of the NGR.

<sup>207</sup> Rule 42(1) of the NGR.

<sup>208</sup> Rule 43(3) of the NGR.

## Limited access arrangements

A service provider providing pipeline services by means of a light regulation pipeline must publish on its website the prices on offer for light regulation services and the other non-tariff terms and conditions of access to these services.<sup>210</sup>

The service provider must also report to the regulator on access negotiations at least annually, and in doing so, set out the results of those negotiations and provide any other information that the regulator requires. The regulator may publish this information.<sup>211</sup>

A service provider providing pipeline services by means of a light regulation pipeline can elect to submit a limited access arrangement for that pipeline.<sup>212</sup> If a limited access arrangement is in force and is accessible on the service provider's website, the non-tariff terms and conditions of access need not be separately published on the website.<sup>213</sup> The information provision requirements are less onerous for limited access arrangements than for full access arrangements, reflecting the overarching objective of this form of regulation.<sup>214</sup>

### 6.1.2 Information requests

#### Prospective users

Prospective users of scheme pipelines can request the regulator to issue a notice to a scheme pipeline service provider requiring the service provider to provide information that the prospective user reasonably requires to decide whether to seek access to a pipeline service, and how to apply for access.<sup>215</sup>

Where there is no published tariff, the scheme pipeline service provider must, on request, notify a prospective user of the tariff for a service, provided the scheme pipeline service provider is in a position to provide the service.<sup>216</sup>

#### Regulatory information notices and orders

Sections 45 and 46 of the NGL provide two instruments for the regulator to gather information from scheme pipeline service providers. Regulatory information orders (RIOs) and regulatory information notices (RINs) can be served on scheme pipeline

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209 Rule 72(1) of the NGR.

210 Rule 36(1) of the NGR.

211 Rule 37 of the NGR.

212 Section 116 of the NGL.

213 Rule 36(2) of the NGR.

214 Rule 45 and 36(2) of the NGR. Chapter 2 includes further discussion of the forms of regulation under the current regime.

215 Rule 107 of the NGR.

216 Rule 108 of the NGR.

service providers to require them to provide the regulator with, or prepare and maintain, the information specified in the RIO or RIN.

RINs are served on a particular service provider and RIOs are general orders imposing obligations on a service provider class(es).

The regulator may disclose information provided in compliance with a RIN or RIO unless a claim of confidentiality has been made.<sup>217</sup> Confidential information can be disclosed in certain forms and under certain circumstances,<sup>218</sup> including if the regulator is of the opinion that the public benefit of disclosure outweighs the detriment.<sup>219</sup>

### **Regulator's general information gathering powers**

Section 42 of the NGL grants the regulator a broad and general power to require the production of any information that it requires for the performance or exercise of a function or power conferred to it under the NGL or the NGR.

This general power is not fettered by the limitations applying to RINs and RIOs,<sup>220</sup> but the regulator must "require" the information "for the performance or exercise of a function or power."<sup>221</sup> By comparison, the regulator may issue RINs and RIOs "if it considers it reasonably necessary for the performance or exercise of its functions or powers."<sup>222</sup>

#### **6.1.3 Key performance indicators**

Access arrangement information must include key performance indicators (KPIs), to be used by the service provider to support expenditure to be incurred over the access arrangement period.<sup>223</sup>

#### **6.1.4 Capacity information**

##### **Spare capacity**

Service providers for all transmission scheme pipelines and some distribution scheme pipelines are required to publish a register of current and prospective spare capacity for the pipeline on their websites.<sup>224</sup>

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<sup>217</sup> Section 57B of the NGL. There is no such provision in the NGL (WA).

<sup>218</sup> Chapter 10, Part 2, Division 1 of the NGL. New reporting and registration arrangements for the bulletin board will commence on 30 September 2018. See AEMC, *Improvements to Natural Gas Bulletin Board, Rule Determination*, 26 September 2017.

<sup>219</sup> Section 329(1)(b) of the NGL.

<sup>220</sup> Section 47 of the NGL.

<sup>221</sup> Section 42(1) of the NGL.

<sup>222</sup> Section 48(1) of the NGL.

<sup>223</sup> Rule 72(1)(f) of the NGR.

A user must also provide information about its own unutilised contracted capacity, including whether capacity is likely to become available and if so when and how much, to any person that requests it.<sup>225</sup>

### **Bulletin board**

Some scheme transmission pipelines are also bulletin board pipelines, and are therefore required to provide certain information to AEMO for publication on the bulletin board. The bulletin board provides information on pipeline capacity outlooks, user details and nominations.<sup>226</sup>

The requirement to be a bulletin board pipeline is unrelated to whether a pipeline is covered.<sup>227</sup>

### **6.1.5 Non-scheme pipelines**

Part 23 of the NGR has recently introduced requirements for non-scheme pipeline service providers to publish and maintain specific information relating to non-scheme pipelines, unless the non-scheme pipelines are subject to an exemption.<sup>228</sup> Part 23 of the NGR may apply to extensions or expansions of a covered pipeline, which do not form part of the covered pipeline.

## **6.2 Summary of submissions**

### **6.2.1 Access arrangements**

APGA saw little need for additional information reporting requirements. It noted that comprehensive information is published as part of a full access arrangement assessment process.<sup>229</sup> APA also considered that no changes were required for information reporting in regard to light regulation pipelines, and that more information reporting requirements on these pipelines would unnecessarily increase the cost of regulation.<sup>230</sup>

DBP and AGN believed that users have access to comprehensive cost information, stating:<sup>231</sup>

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224 Rule 111 of the NGR.

225 Rule 110 of the NGR.

226 Part 18 of the NGR. Many non-scheme transmission pipelines are also bulletin board pipelines. The reporting arrangements for the bulletin board will change on 30 September 2018, resulting in more transmission pipelines having reporting obligations, and more information being reported. See AEMC, Improvements to Natural Gas Bulletin Board, Rule Determination, 26 September 2017.

227 See rules 147 and 149 of the NGR for the requirements to register as a bulletin board pipeline.

228 See Chapter 2 for further discussion on Part 23 exemptions.

229 APA, submission to the issues paper, p. 9.

230 APA, submission to the issues paper, p. 43.

231 DBP and AGN, submission to the issues paper, p. 10.

“It is also unclear in what scenario a shipper could not determine how much they are being 'overcharged' when it has access to:

- all building block cost information relevant to that pipeline;
- forecast demand reviewed and approved by the regulator; and
- prevailing tariffs for equivalent or near equivalent services to use as benchmarks.”

Conversely, there was strong support among users for greater cost transparency and consistency in information provision.<sup>232</sup>

### **6.2.2 Information requests**

The ACCC considered that the AER had existing powers that it could use more widely.<sup>233</sup>

The AER stated that information disclosure by pipeline service providers was inadequate. The AER also considered that it lacked the discretion to collect information, and that it would be better if prospective users were able to seek information directly from pipeline service providers rather than using the AER as an intermediary.<sup>234</sup>

The AER had particular concerns regarding rules 107 and 108, under which the AER considered that information gathering for light regulation pipelines could only be carried out at the request of a third party.<sup>235</sup>

### **6.2.3 Key performance indicators**

Both users and service providers considered KPIs to be of limited value to users and regulators in their current form.<sup>236</sup> AusNet did however see some benefit in the use of KPIs for benchmarking purposes.<sup>237</sup>

### **6.2.4 Capacity information**

Stakeholders questioned the usefulness of some disclosed capacity information. APA suggested that spare capacity registers were seldom used. Moreover, APA suggested

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<sup>232</sup> For example, PIAC, submission to the issues paper, p. 23.

<sup>233</sup> ACCC, submission to the issues paper, p. 10.

<sup>234</sup> AER, submission to the issues paper, p. 22.

<sup>235</sup> AER, submission to the issues paper, p. 22.

<sup>236</sup> Submissions to the issues paper, APA, pp.27-29; EUAA, p. 2.

<sup>237</sup> AusNet Services, submission to the issues paper, p. 4.

that the day ahead capacity market and national trading platforms that were under development by the GMRG could address perceived problems.<sup>238</sup>

### **6.2.5 Non-scheme pipelines**

A number of users, as well as the AER and ACCC, supported adopting the information disclosure provisions in Part 23 of the NGR for scheme pipelines, in order to improve consistency and to increase the amount of information made available.<sup>239</sup>

## **6.3 Issues for consideration**

### **6.3.1 Access arrangements**

Full access arrangements provide reference tariff and non-tariff terms and conditions, and are published accompanied by access arrangement information. Light regulation pipelines may provide limited access arrangements, and publish certain information on their websites. A number of stakeholders have raised issues with these requirements.

Accordingly, the Commission intends to consider whether access arrangements provide sufficient and timely information for users and prospective users to enable informed negotiations for access to pipeline services. The Commission will also consider whether the information allows users and prospective users to make informed decisions about whether to seek arbitration.

### **6.3.2 Information requests**

Prospective users are able to obtain information from a variety of sources. These include:

- full access arrangements (including access arrangement information), limited access arrangements and other information on light regulation pipelines<sup>240</sup>
- published responses to RINs and RIOs
- spare capacity register and bulletin board<sup>241</sup>
- information requests on behalf of users.

The AEMC understands that the AER uses both RINs and RIOs,<sup>242</sup> while the ERA has not.

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<sup>238</sup> APA, submission to the issues paper, pp. 24-26.

<sup>239</sup> Submissions to the issues paper: Hydro Tasmania pp. 2-3; EnergyAustralia, p. 2; AER, p. 22; ACCC, p. 3.

<sup>240</sup> Refer to sections 6.1.1 and 6.3.1 of this report.

<sup>241</sup> Refer to sections 6.1.4 and 6.3.4 of this report

A number of issues have been identified in relation to the regulator's information gathering powers as well as information gathered for users.

In preparing the draft report, the Commission intends to examine whether the potentially available information and the information gathering mechanisms address the requirements of prospective users.

### **6.3.3 Key performance indicators**

There appears to be general consensus among stakeholders that the current KPI provisions in the NGR are not specific and have resulted in pipeline KPIs that have been of limited use.

In contrast, in Great Britain, pipeline service providers report on a number of defined output metrics to assist in assessing the quality of their performance and the health of their assets.<sup>243</sup>

The Commission intends to consider whether KPIs should be retained for reporting and benchmarking purposes. If so, it will also consider how the NGR could be amended to increase the relevance of KPIs to regulators and users. In doing so, the Commission will consider the appropriateness of related NER provisions<sup>244</sup> as well as international examples. The Commission notes that there may be potential duplication of information gathering in the NGR. For example, KPI reporting obligations may be unnecessary because the same information can be obtained through RINs and RIOs. This issue will be included in further considerations of this topic.

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<sup>242</sup> AER, *Annual compliance order 2008*, 7 November 2008 and AER, *Expenditure forecast assessment guideline 2013*, 29 November 2013.

<sup>243</sup> Gas distribution networks, *Network output measures health & risk reporting methodology & framework*, version 2.0, 30 September 2015, p. 56.

<sup>244</sup> For example, rule 6.27 of the NER on annual benchmarking reporting.

**Box 6.1 Asset health: Ofgem**

RIIO (Revenue = Incentives + Innovation + Outputs) is the current Ofgem price control framework for gas distribution networks in Great Britain.

One RIIO output is a measure of the health of and risk posed by the assets. The output is also used to measure the impact proposed investments have upon asset health and risk over the regulatory period.

Gas distribution networks report on six key performance measures for each of 19 asset groups and asset sub-groups. The six performance measures are provided in the table below.

**Table 6.1 Examples of Ofgem asset health KPIs**

ID	KPI	Description	Units
1	Length/ Number of assets	The total length or number of assets in each asset grouping	km, number
2	Asset health	The failure frequency. A measure of the overall health of the network for each asset group	Failures/km/year; failures/number/year
3	Customers risk	Monetised value of customer risk normalised by length or number of assets	£/km/year; failures/number/year
4	Health and safety risk	<Monetised value of all health and safety risks normalised by length or numbers of assets	£/km/year; failures/number/year
5	Carbon risk	Monetised value of all reactive carbon risks normalised by length or numbers of assets	£/km/year; failures/number/year
6	Monetised risk	Monetised total risk normalised by length or numbers of assets	£/km/year; failures/number/year

Source: Gas distribution networks, *Network output measures health & risk reporting methodology & framework*, version 2.0, September 2015, p. 56

### 6.3.4 Capacity information

Submissions indicate that there may be potential duplication of capacity information requirements across the NGR. Recent changes to the bulletin board, day ahead markets and trading platforms may make reporting of capacity utilisation required by Part 11

of the NGR unnecessary for some pipelines. The Commission intends to consider ways to minimise such duplication.

### **6.3.5 Non-scheme pipelines**

Some stakeholders supported greater harmonisation of the disclosure requirements for scheme pipelines with those contained in Part 23 of the NGR. Parts 8 to 12 of the NGR provide significantly greater discretion to the regulator on the information sought and disclosed. These rules also establish that regulator approved terms and conditions of access to a full regulation pipeline will be published.

The Commission intends to consider the potential for the information provision aspects of Parts 8 to 12 of the NGR harmonising with the relevant rules in Part 23 of the NGR. However, in doing so, the Commission will have regard both to the different types of information produced under the different access regimes and to the different context of scheme and non-scheme pipelines.

## 7 Arbitration

This chapter outlines the current arbitration framework in the NGL and NGR, and summarises submissions to the issues paper on arbitration as well as issues for further consideration in this review.

### 7.1 Current framework

Section 2 of the NGL defines the dispute resolution body as the AER, for pipelines that fall under all Australian jurisdictions outside of Western Australia. Under the *National Gas Access (WA) Act 2009* (NGL (WA)), the Western Australian Energy Disputes Arbitrator (EDA) is the dispute resolution body for Western Australian scheme pipelines.<sup>245</sup>

Chapter 6 of the NGL outlines the dispute resolution process for scheme pipelines as follows:<sup>246</sup>

- the prospective user or service provider notifies the dispute resolution body of an access dispute
- the dispute resolution body informs the other party of the access dispute
- the dispute resolution body can terminate the dispute, or make a determination in writing with clearly stated reasons
- the dispute resolution body may require the parties to mediate, conciliate or engage in another alternative dispute resolution process
- the dispute resolution body must, in making an access determination, give effect to the access arrangement that applies to the services of the access dispute pipeline
- each party bears its own costs in a dispute hearing.

Part 12 of the NGR sets out additional requirements for the resolution of certain access disputes between a scheme pipeline service provider and user or prospective user conducted under Chapter 6 of the NGL.

Part 12 of the NGR details particular provisions for the arbitration process in a limited number of specific instances:

- If an access dispute arises as a consequence of a refusal of access on safety grounds.<sup>247</sup>

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<sup>245</sup> Section 9 of Schedule 1 to the National Gas Access (WA) Act 2009.

<sup>246</sup> Sections 181 - 207 of the NGL.

<sup>247</sup> Rule 115 of the NGR.

- If an access dispute raises the question of an expansion or funding of an expansion, or an extension.<sup>248</sup>

Part 12 of the NGR does not contain specific provisions on arbitration processes in regard to other instances where a dispute may arise.

Chapter 6A of the NGL outlines the dispute resolution process for non-scheme pipelines.<sup>249</sup> Part 23 of the NGR includes information disclosure requirements, and sets out the negotiation and arbitration processes for access to non-scheme pipelines.<sup>250</sup>

## 7.2 Summary of submissions

The ACCC stated that it does not consider the threat of arbitration to be an effective constraint on service providers from charging monopoly prices. In its view, the costs and resources that are associated with access disputes, in addition to the uncertainty of the outcome, act as a disincentive for market participants to enter into arbitration.<sup>251</sup>

AGL also stated that arbitration can be costly and time consuming. It perceived the arbitration process as unclear, and outcomes as uncertain. Moreover, AGL considered that Part 12 of the NGR is focussed on safety and capacity expansions only, to the exclusion of all other causes of disputes.<sup>252</sup>

The EDA also commented that an arbitration regime should be uniformly applied, and that the instances that trigger arbitration should be clear.<sup>253</sup>

However, the AER considered that the arbitration provisions do not need to be amended. It has suggested that as an alternative, it could amend its voluntary guidelines on arbitration with the view to reducing uncertainty around the timeframes and methodologies that would be used in an arbitration process.<sup>254</sup>

The ACCC, EUAA and Hydro Tasmania considered that the arbitration regime under Part 23 should be available for all pipelines.<sup>255</sup> In particular, the ACCC considered that the regime under Part 23 provides an appropriate framework for scheme pipelines as well as non-scheme pipelines. This, the ACCC considered, would make arbitration outcomes more certain and make arbitration more accessible to users. However, APGA commented that applying the Part 23 arbitration provisions to scheme pipelines would require the reconciliation of two fundamentally different approaches to tariff setting.<sup>256</sup>

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<sup>248</sup> Rules 117 - 119 of the NGR.

<sup>249</sup> As at the publication of this interim report, Chapter 6A has not been instated in the NGL (WA).

<sup>250</sup> Non-scheme pipelines include greenfield pipelines and uncovered pipelines.

<sup>251</sup> ACCC, submission to the issues paper, p. 9.

<sup>252</sup> AGL, submission to the issues paper, p. 4.

<sup>253</sup> EDA, submission to the issues paper, pp. 1-2.

<sup>254</sup> AER, submission to the issues paper, pp. 23-24.

<sup>255</sup> Submission to the issues paper: Hydro Tasmania, p. 2; EUAA, p. 4; ACCC, pp. 10-11.

<sup>256</sup> APGA, submission to the issues paper, p. 5.

### 7.3 Issues for consideration

The AEMC notes that some issues in relation to the arbitration provisions in the NGL and NGR seem to have the potential to materially impact the credibility of the threat of arbitration on scheme pipelines, or the efficiency of making access arrangements.

Indications are that the arbitration procedure for scheme pipelines as set out in the NGL and NGR does not:

- include a timeframe limitation
- set out public disclosure requirements
- outline a mediation process
- readily provide for joining of disputes
- list the instances that trigger arbitration, as the NGR only explicitly refer to disputes in relation to safety of access, expansions and extensions<sup>257</sup>
- provide sufficient clarity on the pricing principles that an arbitrator would apply.

On this last point, the NGL refers to the access arrangement process, which results in the setting out of tariff and non-tariff terms and conditions for reference services on full regulation pipelines. However, there is a perceived uncertainty on the pricing of non-reference services on full regulation pipelines, and in relation to all services on light regulation pipelines. Relevant to both full and light regulation pipelines, there is little or no guidance provided to the arbitrator on a number of elements, including:

- whether the NGO, revenue and pricing principles or other principles would guide the arbitrator<sup>258</sup>
- asset valuation and depreciation methodology
- determination of other building block components, in the case that pricing is cost-based.

The Commission also understands that some users or prospective users may be reluctant to enter into arbitration as they are concerned that the service provider may later negotiate less favourably with them. This concern is heightened when the user is uncertain of the outcome, as it would not know whether the outcome would be favourable enough to outweigh this risk.

The Commission will investigate these issues, and propose relevant draft recommendations in the draft report. This will include consideration of the provisions

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<sup>257</sup> The NGL refers to access determinations on tariff and non-tariff terms and conditions, but the NGR do not include any specific related provisions.

<sup>258</sup> The access regime for non-scheme pipelines applies a different objective to the NGO under rule 546(1), and different pricing principles under rule 569.

in relation to factors such as timeliness, cost efficiency, transparency, certainty and flexibility.

The Commission will consider whether further guidance should be provided, either in the NGR or through guidelines made by the regulator.

The Commission intends to examine whether there are benefits in the alignment of aspects of Part 12 of the NGR with the arbitration regime of Part 23. In considering this issue, the Commission will have regard to information that the arbitration regime in Part 23 of the NGR was intended to be a form of "commercial" rather than "regulatory" arbitration to apply to non-scheme pipelines. As such, the regime was purposefully designed to be different from Part 12 in some respects.

## Abbreviations

ACCC	Australia Competition & Consumer Commission
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
COAG	Council of Australian Governments
Code	National third party access code for natural gas pipeline systems
Commission	See AEMC
DBP	Dampier to Bunbury Pipeline
DTS	Declared Transmission System
EDA	Western Australian Energy Disputes Arbitrator
ERA	Economic Regulation Authority of Western Australia
GGP	Goldfields Gas Pipeline
GMRG	Gas Market Reform Group
GSH	gas supply hub
IPART	Independent Pricing and Regulatory Tribunal of New South Wales
KPI	key performance indicator
NCC	National Competition Council
NEM	national electricity market
NER	National Electricity Rules
NGL	National Gas Law
NGL (WA)	National Gas Access (WA) Act 2009
NGO	national gas objective

NGR	National Gas Rules
PTRM	post tax revenue model
RBP	Roma Brisbane Pipeline
Report	interim report
Review	Review into scope of economic regulation applied to covered pipelines
RIN	regulatory information notice
RIO	regulatory information order
RFM	roll forward model

## A Summary of issues

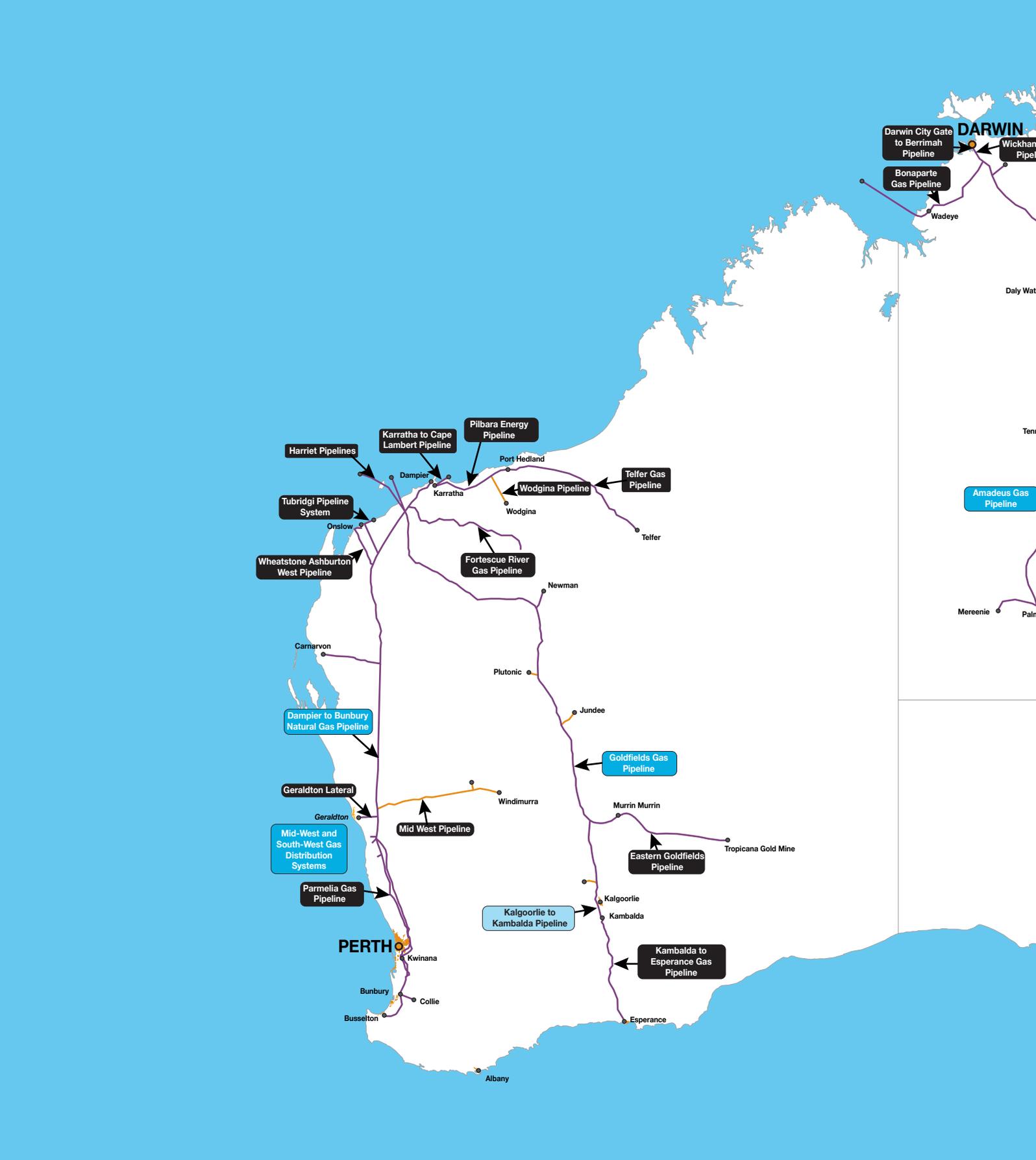
Table A.1 provides a summary of the issues the Commission intends to consider further in preparing the February 2018 draft report.

**Table A.1 Table of issues for further consideration**

Chapter	Issues for consideration
Chapter 2: Framework for pipeline regulation	<ul style="list-style-type: none"> <li>• Whether the different forms of regulation contribute to a regime that achieves the NGO at least cost</li> <li>• Whether the tests for determining which forms of regulation applies to different pipelines are appropriate</li> <li>• Whether each form of regulation is, and should be, successively more onerous as the potential for market failure that it seeks to address increases</li> <li>• Coverage of extensions and expansions for distribution and transmission pipelines, contract carriage and market carriage pipelines (rule 104).</li> </ul>
Chapter 3: Regulation of pipeline services	<ul style="list-style-type: none"> <li>• Definition and methodology for determination of reference services (rule 101)</li> </ul>
Chapter 4: Access arrangements	<ul style="list-style-type: none"> <li>• Stakeholder involvement in the access arrangement process and the potential for an upfront process (rules 57-62)</li> <li>• Adequacy of full access arrangement revision periods (rules 59-60)</li> <li>• Whether the tariff variation provisions are sufficient (rule 97)</li> <li>• Whether further standardisation of non-tariff terms and conditions is required (rule 100)</li> <li>• Whether the NGR provide sufficient guidance for the regulator, service providers, users and prospective users on the interrelationship between tariff and non-tariff terms and conditions of the access arrangement (rule 48)</li> <li>• Whether the three levels of discretion in the NGR promote the NGO, and are consistent with the NGL (rule 40).</li> </ul>
Chapter 5: Determining efficient costs	<ul style="list-style-type: none"> <li>• Whether the capital expenditure criteria remain appropriate for the assessment of proposed forecast and actual capital expenditure (rule 79)</li> <li>• The adequacy of limited discretion in assessing proposed capital and operating expenditure (rules 79 and 91)</li> <li>• Whether the provision for a speculative capital expenditure account is still relevant, and whether any amendments could better achieve or clarify its objective (rule 84)</li> </ul>

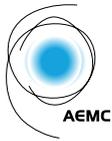
Chapter	Issues for consideration
	<ul style="list-style-type: none"> <li>• Assessment of depreciation, in line with the NGO and objectives of an efficient depreciation schedule (rule 88, 89 and 90)</li> <li>• Whether the regulator should have limited discretion in relation to depreciation (rule 89)</li> <li>• Valuation of assets to roll into the capital base, and valuation of the initial capital base for newly covered pipelines - including the estimation of depreciation costs (rules 77, 78 and 90)</li> <li>• Alignment of cost allocation and related provisions with the NGO, in addition to the fair and transparent distribution of scheme pipeline costs across users (rules 76, 77, 78, 79 and 93)</li> <li>• Implications of Part 23 of the NGR for cost allocation between covered and uncovered parts of a pipeline, and whether any amendments or clarifications are required (rule 93)</li> <li>• Perceived uncertainty in relation to the concept, application and relevance of rebateable services (rule 93).</li> </ul>
Chapter 6: Negotiation and information	<ul style="list-style-type: none"> <li>• Whether full access arrangements and access arrangement information, limited access arrangements and light regulation service information provide sufficient and timely information to users and prospective users (rules 36, 37, 42, 44, 45, 72 and 107)</li> <li>• Whether regulators and prospective users can access relevant information (rules 107 and 108)</li> <li>• Whether some form of KPIs should be retained and, how existing provisions could be improved (rule 72)</li> <li>• Whether reporting of capacity utilisation remains relevant under related reforms to the bulletin board and market information (rules 110, 111)</li> <li>• Potential harmonisation with the information provision rules in Part 23 of the NGR.</li> </ul>
Chapter 7: Arbitration	<ul style="list-style-type: none"> <li>• Assessment of arbitration provisions in relation to factors such as timeliness, cost efficiency, transparency, certainty and flexibility (rules 113-119, Chapter 6 of the NGL).</li> <li>• Whether further guidance should be provided, either in the NGR or through guidelines made by the regulator (rules 113-119)</li> <li>• Whether there are benefits in the alignment of aspects of Part 12 of the NGR with the arbitration regime of Part 23.</li> </ul>

**B Map of transmission and distribution pipelines in Australia**



**LEGEND**

- Transmission pipelines
- Proposed transmission pipelines
- Distribution pipelines
- Full regulation pipeline
- Light regulation pipeline



The information contained in this document, including the pipeline names and locations, has been prepared by the Australian Energy Market Commission (AEMC) as general guidance and for information purposes only. The information is based on publicly available sources, and has not been independently verified by the AEMC, and therefore, may not be complete, accurate or up to date.



## **C Terms of reference**

Mr John Pierce  
Chair  
Australian Energy Market Commission  
PO Box A2449  
SYDNEY SOUTH NSW 1235

Dear Mr  Pierce

You would be aware that the Australian Competition and Consumer Commission (ACCC) East Coast Gas Inquiry report released in April 2016 made a suite of recommendations including:

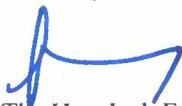
*The COAG Energy Council should ask the AEMC to review Parts 8-12 of the NGR and to make any amendments that may be required to address the concern that pipelines subject to full regulation may still be able to exercise market power to the detriment of consumers and economic efficiency. In carrying out this review, the AEMC should also consider whether any changes can be made to the dispute resolution mechanism in the NGL and NGR to make it more accessible to shippers, so that it provides a more effective constraint on the behaviour of pipeline operators.*

Energy Ministers released a consolidated response to both the AEMC Review and the ACCC Inquiry in August 2016 committing to implement a comprehensive package of reforms. In particular, the Energy Council agreed to task the AEMC to review parts 8-12 of the NGR in line with the ACCC's recommendations.

Accordingly, I am writing to you in my capacity as Chair of the Energy Council, requesting the AEMC to undertake a review into the scope of economic regulation applied to covered pipelines, as per the attached Terms of Reference. I request that the review commence no later than May 2017 and a draft report be released by February 2018, with publication of a final report by June 2018.

I encourage you to collaborate with the Gas Market Reform Group to ensure that the review considers the concurrent work on the development of the gas pipeline information disclosure and arbitration framework and the transportation capacity trading reforms.

Sincerely



The Hon Josh Frydenberg MP  
Chair  
COAG Energy Council  
May 2017

Encl.

## TERMS OF REFERENCE

### Australian Energy Market Commission

#### Review into the scope of economic regulation applied to covered pipelines

##### Background

- Under the National Gas Law (NGL), natural gas pipelines may be subject to different levels of economic regulation: Light regulation: a negotiate-arbitrate model that focusses on commercial negotiation and information disclosure, supported by a dispute resolution process.
- Full regulation: the Australian Energy Regulator (AER) approves a full access arrangement for the pipeline, which sets out the terms and conditions (including prices) for 'reference services', which under the National Gas Rules (NGR) are services that are sought by a significant part of the market. The negotiate-arbitrate model and dispute resolution framework also apply to reference and non-reference services offered by way of pipelines subject to full regulation.

The National Competition Council (NCC) may make a recommendation whether or not a pipeline should be "covered" (i.e. subject to full economic regulation) and the relevant Minister makes a decision on this recommendation.

The NCC may determine that a pipeline should be subject to full or light regulation. In forming a view as to whether a pipeline should be subject to full or light regulation, the NCC has regard to (amongst other things) the 'form of regulation factors' set out in the NGL, which are indicators of the extent of market power a pipeline service provider can exercise.

Parts 8-12 of the NGR govern the economic regulation of pipelines subject to full and light regulation:

- Part 8 sets out the requirements for pipelines subject to full regulation to provide access arrangements (and pipelines subject to light regulation to provide limited access arrangements).
- Part 9 applies to full access arrangements and sets out how prices and revenue are determined (i.e. the building block approach).
- Part 10 includes other provisions relating to access arrangements, such as extension and expansion requirements.

- Part 11 provides that the applicable access arrangement and other information must be made available to prospective pipeline users and sets out the process for parties to seek access to pipeline services.
- Part 12 sets out certain requirements for the resolution of access disputes (the process for dealing with access disputes is additionally set out in Chapter 6 of the NGL).

In April 2016, the Australian Competition & Consumer Commission (ACCC) provided the Australian Government with its report on its inquiry into the east coast gas market.<sup>1</sup> The ACCC's inquiry examined the competitiveness of wholesale gas prices and the structure of the upstream, processing, transportation, storage and marketing segments of the east coast gas industry.

The ACCC's report included a number of recommendations to the Council of Australian Governments (COAG) Energy Council (the Council) to address issues it had identified that related to the exercise of market power by gas transmission pipeline service providers, to the detriment of consumers and economic efficiency.

Of particular relevance to these terms of reference, the ACCC raised concerns that:

1. even if a pipeline is fully regulated, the service provider of that pipeline may still be able to exercise market power to the detriment of consumers and economic efficiency; and
2. the dispute resolution framework may not be providing an effective constraint on the behaviour of pipeline service providers.

Specifically, the ACCC identified the following potential issues with the current economic regulatory framework:

1. Reference services: the current definition of 'reference service' is that the service is sought by a 'significant part of the market'. As a result, some non-contestable services are not subject to regulated terms and conditions (including prices). The ACCC suggested that pipeline owners may be able to exercise market power on these services to the detriment of consumers and economic efficiency.
2. Pipeline expansions: when a pipeline that is subject to full regulation is expanded (for example, through the addition of a compressor), the additional capacity is not necessarily included within the definition of the covered pipeline and consequently not subject to economic regulation. Again, the ACCC noted that pipeline owners may,

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<sup>1</sup> ACCC, *Inquiry into the east coast gas market*, April 2016

as a result, be able to exercise market power on these services provided by the expansion to the detriment of consumers and economic efficiency.

3. Information and dispute resolution: there may be barriers that are preventing participants from using the access dispute resolution provisions in the NGR. As a result, the ACCC commented that the threat of arbitration was unlikely to be a constraint on the behaviour of pipeline service providers.

While the ACCC identified the above potential issues with Parts 8-12 of the NGR in its report, it was not the focus of the ACCC inquiry to carry out a comprehensive assessment of Parts 8-12 of the NGR. Therefore there may be other related issues with Parts 8-12 that were not identified by the ACCC.

Energy Ministers released a consolidated response to both the AEMC Review and the ACCC Inquiry in August 2016 committing to implement a package of comprehensive reforms that address the priority areas of gas supply, market operation, gas transportation and market transparency. In particular, the Energy Council agreed to task the AEMC to review parts 8-12 of the NGR in line with the ACCC's recommendations.

In December 2016, the Council agreed to the development of an Arbitration Framework designed to address the negotiation imbalance between pipeline customers and operators by providing for binding arbitration where commercial negotiations fail.

### **Purpose**

The AEMC is requested to make recommendations on any amendments it considers necessary to Parts 8-12 of the NGR to address concerns that pipelines subject to full regulation are able to exercise market power to the detriment of economic efficiency and the long term interests of consumers.

The AEMC should also consider whether the access dispute resolution mechanism set out in the NGL and NGR should be amended to provide a more effective constraint on the exercise of market power by pipeline service providers, including making dispute resolution more accessible to shippers.

The AEMC should examine the issues identified by the ACCC in its inquiry in relation to Parts 8-12 of the NGR, as well as any other related issues identified by the AEMC, including through stakeholder consultation.

The AEMC is requested to work closely with the GMRG to ensure consistency with all future gas market reform measures and avoid duplication of efforts, particularly in relation to the development of a framework for binding arbitration.

In carrying out this review, the AEMC should have regard to the National Gas Objective, the form of regulation factors and also consider the Council's Vision for Australia's future gas market.

### **Scope**

The review is to focus on transmission pipelines. However, the review will need to consider the implications of any recommendations on distribution pipelines. For example, if the definition of a 'reference service' is changed to address an issue related to transmission pipelines, the AEMC should consider the impacts on, and suitability of that change for, distribution pipelines.

Once a decision has been made that a service is a reference service, the 'building block' approach in Part 9 of the NGR is used to determine regulated prices and revenue. The appropriateness or otherwise of using the building block methodology to determine regulated prices and revenue in respect of reference services are outside the scope of this review. However, it may be necessary for the AEMC to consider consequential changes to the building block methodology in Part 9 as a result of recommendations related to other chapters. For example, if changes are made to the pipeline capacity expansion provisions, the AEMC should consider any implications for the 'new capital expenditure criteria' in Part 9.

### **Consultation, timeframes and deliverables**

The AEMC should carry out the review through a consultative process with jurisdictions, industry members, consumer groups and energy market bodies.

The AEMC is to publish an issues paper in the first half of 2017 and draft report for consultation in early 2018, with a final report and recommendations provided to the Council by June 2018.

<b>Milestone</b>	<b>Timeframe</b>
Terms of reference received	May 2017
Issues paper for consultation	June 2017
Draft report for consultation	February 2018
Final report to COAG Energy Council	June 2018

5 May 2017