PIAC submission to the AEMC Review into the scope of economic regulation applied to covered pipelines Draft Report

28 March 2018
Introduction

The Public Interest Advocacy Centre

The Public Interest Advocacy Centre (PIAC) is an independent, non-profit legal centre based in New South Wales. Established in 1982, PIAC tackles systemic issues that have a significant impact upon disadvantaged and marginalised people. We ensure basic rights are enjoyed across the community through litigation, public policy development, communication and training.

Our work addresses issues such as:

- homelessness;
- access for people with disability to basic services like public transport, education and online services;
- Indigenous disadvantage;
- discrimination against people with mental health conditions;
- access to energy and water for low-income and vulnerable consumers;
- the exercise of police power;
- the rights of people in detention, including the right to proper medical care; and
- government accountability, including freedom of information.

PIAC is funded from a variety of sources. Core funding is provided by the NSW Public Purpose Fund and the Commonwealth and State Community Legal Services Program. PIAC also receives funding from the NSW Government for its Energy and Water Consumers Advocacy Program and from private law firm Allens for its Indigenous Justice Program. PIAC also generates income from project and case grants, seminars, donations and recovery of costs in legal actions.

Energy and Water Consumers’ Advocacy Program

The Energy and Water Consumers’ Advocacy Program (EWCAP) represents the interests of low-income and other residential consumers of electricity, gas and water in New South Wales. The program develops policy and advocates in the NSW energy and water markets. PIAC receives policy input to the program from a community-based reference group whose members include:

- NSW Council of Social Service;
- Combined Pensioners and Superannuants Association of NSW;
- Ethnic Communities Council NSW;
- Salvation Army;
- Physical Disability Council NSW;
- Anglicare;
- Good Shepherd Microfinance;
- Financial Rights Legal Centre;
- Affiliated Residential Park Residents Association;
- Tenants Union; and
- Mission Australia.
Review into the scope of economic regulation applied to covered pipelines

PIAC welcomes the opportunity to respond to the Draft Report for the AEMC’s Review of the scope of economic regulation applied to covered pipelines (the Draft Report).  

Given their centrality to the natural gas supply chain, efficient operation and use of pipeline services plays a key role in ensuring that the system meets the National Gas Objective (NGO) by serving the long-term interests of consumers. PIAC recommends that the AEMC consider the future of pipeline regulation in the context of how it applies to consumers - particularly gas distribution networks that supply to households - not just direct pipeline users.

PIAC has limited our comments to elements of the following issues:

- Regulating distribution pipelines;
- Framework for pipeline regulation;
- Reference services;
- Access arrangements; and
- Capital expenditure

Regulating distribution pipelines

Since 2013, there has been a move towards removing full regulation from distribution pipelines. Two Brisbane distributors and one in Wagga Wagga have had their full coverage revoked; the Brisbane networks moving to light regulation and Wagga Wagga having all regulation removed. In their Issues Paper submission, Jemena Gas Networks in NSW flagged their intention to follow suit.

PIAC contends that this is an inappropriate way to regulate distribution networks that serve small consumers of gas like households and small business.

In the Draft Report, the AEMC concluded that the negotiate-arbitrate model of regulation remains appropriate for regulating distribution pipelines on the basis that small consumers are not required to negotiate with pipeline service providers to access efficient prices for pipeline services; because they are likely to contract for the reference service through their retailer, “the regime becomes a de facto price cap regime, with the reference tariffs acting as the price caps”.

PIAC notes, however, this relies on reference services having been defined for the pipeline, which only occurs through an access arrangement for a full regulation pipeline. Under light

1 AEMC, Review into the scope of economic regulation applied to covered pipelines, Draft Report, February 2018.
3 Jemena Gas Networks, Review into the scope of economic regulation applied to covered pipelines, August 2017, 4.
4 AEMC, Review into the scope of economic regulation applied to covered pipelines, Draft Report, 34-35.
5 NGR, Rule 48.
regulation or Part 23, reference services are not defined, and it is not possible for reference tariffs to act as a "de facto price cap".

This leaves consumers connected to these pipelines without regulatory protection against the market power of monopoly service providers. While customers of large gas transmission pipelines may be able to effectively negotiate, or enter arbitration, with pipeline services providers, this is not the case for small, distribution-connected consumers including households.

The information and power asymmetry between a pipeline service provider and a small consumer is such that it would never be reasonable for a consumer or group of consumers to negotiate with pipeline owners. Arbitration would be even more prohibitive.

Even noting the AEMC’s proposed reforms to streamline the process and allow multiple parties to enter joint dispute resolution hearings, arbitration is an expensive, complex, time consuming process that small consumers are unlikely to have the capacity to engage with.

Instead, consumers rely on their retailer to negotiate and arbitrate on their behalf. Unfortunately, retailers have shown little interest in advocating for consumers. As noted by Major Energy Users (MEU):

…the cost of transport is effectively a ‘pass through’ cost for retailers, the retailers, acting as shippers for their customer, have little incentive to seek lower costs for transport. But it is the retailer that contracts with the pipeline for transport but the consumer that pays. This break in accountability provides a clear barrier to a consumer seeking lower transport prices.  

This is exacerbated by the lack of competition in the retail gas market. The ACCC found that the market was underdeveloped, with “retail market shares still dominated by Origin, AGL and EnergyAustralia.” Because the bulk of gas supplied to small consumers is from a small number of retailers, these businesses can continue passing through inefficient costs without the threat of consumers switching in number. Therefore, retailers have very little incentive to effectively negotiate or arbitrate on behalf of small consumers.

In proposing light regulation, pipeline service providers suggest that the inability of consumers to access negotiation and arbitration is of no consequence because gas is a ‘fuel of choice’ for small consumers that faces competitive pressure from electricity that will act to prevent monopoly pricing. While the relative economics of gas and electricity has changed to the extent there remains uncertainty about the long-term viability of gas for household use in Australia, the assumption that consumers can switch between fuels to high pipeline charges verges on the absurd. PIAC addressed this in our submission to the Issues Paper:

For some consumers, the [up-front] cost of changing household appliances from gas to electricity may be too high, while for renters it not a decision they can make for themselves. In

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6 AEMC, Review into the scope of economic regulation applied to covered pipelines, Draft Report, 158-160.
7 MEU, Review into the scope of economic regulation applied to covered pipelines, Submission by Major Energy Users Inc, August 2017, 12.
8 ACCC, Inquiry into the east coast gas market, Final Report, April 2016, 151.
such situations, electricity is unable to provide any competitive pressure and consumers are forced to remain gas users no matter what price pipeline service providers charge.\textsuperscript{9}

PIAC’s concerns about light-regulated distribution networks have been borne out by consumer experience under current arrangements.

Envestra and Allgas have avoided natural reductions in prices faced by fully regulated gas networks by linking their pipeline charges to CPI. While CPI-linked pricing was intended as a safeguard for consumers, against higher prices, it has sustained Brisbane gas distribution charges an inefficiently high level, reflecting post-GFC rates of return, during a period of declining charges for consumers in covered distribution networks.

More concerning, PIAC understands that where some retailers have negotiated lower access charges from light-regulated pipelines in Brisbane this has not been passed through to consumers.

End-use household consumers of light-regulated distribution pipelines are not protected from inefficiently high pipeline charges by the regulatory framework, competition from electricity or retailer negotiation. This outcome is clearly not in the long-term interests of consumers and recommends that all distribution pipelines be fully regulated.

\textit{Recommendation 1}

\textbf{PIAC recommends the application of full regulation to all distribution pipelines.}

\section*{Framework for pipeline regulation}

\textbf{The need for full regulation}

The purpose of regulation applied to gas pipelines in Australia is to address the exertion of market power through monopoly pricing by pipeline service providers, a market failure that the ACCC has found to be pervasive in the gas transport sector.\textsuperscript{10}

The natural market power of monopoly pipelines is exacerbated by the inability of consumers to engage effectively in negotiation and arbitration without the support of full regulation. Under full regulation, pipeline service providers are required to have a full access arrangement approved by the AER, including a set of reference services and corresponding reference tariffs.\textsuperscript{11} This provides strong guidance on access prices and helps protect consumers from inefficient prices.

Without this regulatory involvement, consumers are unable to effectively negotiate or enter arbitration with pipelines. In addition to the issues identified in relation to small consumers and distribution pipelines above, Issues Paper submissions by MEU and the Energy Users

\textsuperscript{9} PIAC, \textit{Submission to the AEMC Review into the scope of economic regulation applied to covered pipelines Issues Paper}, August 2017, 13.
\textsuperscript{10} ACCC, \textit{Inquiry into the east coast gas market}, Final Report, 121.
\textsuperscript{11} NGR, 48.
Association of Australia note that even large consumers dealing have difficulty in negotiating and seeking arbitration because of the asymmetries of power and information.\(^\text{12}\)

**The risk of under-regulation**

Despite the need for full regulation, the current framework does not ensure that it is always applied where necessary.

In previous submissions, PIAC argued that the current framework does not serve the long-term interests of consumers because the criteria for coverage determinations in Section 15 of the NGL results in too many pipelines being uncovered.\(^\text{13}\) This is because Section 15 states that coverage should be applied where:

- that access (or increased access) to pipeline services provided by means of the pipeline would promote a material increase in competition in at least one market (whether or not in Australia), other than the market for the pipeline services provided by means of the pipeline;
- that it would be uneconomic for anyone to develop another pipeline to provide the pipeline services provided by means of the pipeline;
- that access (or increased access) to the pipeline services provided by means of the pipeline can be provided without undue risk to human health or safety; and
- that access (or increased access) to the pipeline services provided by means of the pipeline would not be contrary to the public interest.

This framework, particularly subsection (a), is insufficient, as it is only used to determine if access will produce an increase in competition in a market downstream of the pipeline rather than address market power. In practice, this requirement has proved very difficult to fulfil and many pipelines with market power are left uncovered.

The Draft Report argued that reform of the coverage criteria is no longer necessary because the introduction of the Part 23 access regime for non-scheme pipelines means that pipelines now face a form of regulation.\(^\text{14}\) PIAC acknowledges this, and supports the notion that all pipelines should have a form of access regulation applied as a safety net for when coverage is not achieved.

However, it does not address the risk of under-regulation, where a pipeline may have Part 23 applied instead of a more appropriate full regulation determination. By maintaining the current criteria, pipelines will continue be ineligible for full regulation by not meeting criterion (a). In fact, the AEMC notes that the introduction of the Part 23 regime may make this problem worse by making the criteria harder to meet and, as a result, even fewer pipelines will be eligible for full regulation.\(^\text{15}\)

\(^{12}\) MEU, Review into the scope of economic regulation applied to covered pipelines, Submission by Major Energy Users Inc, 12; EUAA, EUAA Submission to AEMC Review into the scope of economic regulation applied to covered pipelines, August 2017, 5.

\(^{13}\) PIAC, Submission to the AEMC Review into the scope of economic regulation applied to covered pipelines Issues Paper, 8; PIAC, Testing the bounds of regulation, October 2016, 10.

\(^{14}\) AEMC, Review into the scope of economic regulation applied to covered pipelines, Draft Report, 39.

\(^{15}\) Ibid, 40.
While having the Part 23 access regime as a safety net is considerably better than the previous arrangements, it is still insufficient where the extent of a pipeline’s market power requires full regulation.

**Addressing the risk of under-regulation**

There are two clear options for addressing the risk of under-regulation due to the coverage test, neither of which AEMC has proposed to adopt in the Draft Paper.

The AEMC could promote the recommendation of the ACCC, PIAC and other stakeholders to amend the coverage criteria to explicitly address market power. By making this change, the AEMC would align the criteria with the fundamental market failure that economic regulation of pipelines should aim to address and ensure that full regulation could be applied to all pipelines with market power.

Alternately, PIAC considers that the potential reforms outlined on pages 43-45 of the Draft Report may be an appropriate means of addressing this risk. This option reduces the risk of under-regulation by applying the coverage criteria only to pipelines that do not provide third-party access. All other pipelines would bypass the Section 15 criteria and instead go to the ‘forms of regulation’ criteria associated with the current light regulation test. This option allows the National Competition Council (NCC) to decide the appropriate form of regulation independently of the Section 15 criteria.

The AEMC appears to have two reasons for not adopting either of these reforms:

- That Part 23 of the NGR has only been in operation for a short period of time; and
- The length of the process associated with changes of that scale to the NGL.

In PIAC’s view, neither of these are valid arguments for the status quo. The AEMC’s guiding principle in this review is the long-term interests of consumers inherent in the NGO. Given that the under-regulation of pipelines is clearly leading to outcomes that fail this objective, the AEMC should act to address that concern, regardless how long Part 23 has operated and the length of reform process.

**Recommendation 2**

PIAC recommends that the AEMC proposes either:

- Amending the coverage criteria to reflect the monopoly pricing market failure pipeline regulation should address; or
- Adopting the framework option outlined on pages 44-45 of the Draft Report.

**NCC process**

PIAC considers that the AEMC should recommend improvements to the NCC’s process of applying the coverage criteria and light regulation test.

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16 ACCC, Inquiry into the east coast gas market, Final Report, 11; PIAC, Submission to the AEMC Review into the scope of economic regulation applied to covered pipelines Issues Paper, 8; EUAA, EUAA Submission to AEMC Review into the scope of economic regulation applied to covered pipelines, 3; MEU, Examination of the current coverage test for the regulation of gas pipelines, October 2016.

17 AEMC, Review into the scope of economic regulation applied to covered pipelines, Draft Report, 3.

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6 • Public Interest Advocacy Centre • Review into the scope of economic regulation applied to covered pipelines
As noted in our Issues Paper submission, the NCC currently makes determinations with very little oversight or involvement from consumers and other stakeholders. In relation to its removal of full regulation from Brisbane distribution pipelines, PIAC noted that:

…there was a lack of transparency in the decisions. In both cases, the NCC only received submissions from very small numbers of retailers…anecdotal evidence from the consumer advocate community in Brisbane suggests that they were unaware of the changes until well after the decisions were made. This suggests that the service providers and the NCC did not actively seek consumer input into the decision despite its importance to consumers. PIAC considers this to be poor stakeholder engagement practice that goes against the engagement principles promoted by other energy decision-making institutions such as the AER and AEMC.18 19

To prevent this occurring again, the AEMC should recommend reforms to the NCC’s processes to align them with the good consumer engagement practices promoted by the energy market institutions. PIAC observes that the AEMC has in this review raised a number of questions, and considered issues, on matters that sit outside of its own responsibilities for the national energy regulatory framework; accordingly it should be prepared to make recommendations to reform NCC processes.

Recommendation 3
PIAC recommends that the AEMC propose reforms to the NCC’s engagement practices to ensure that it does not again change the form of regulation applied to pipelines without proper stakeholder engagement.

The treatment of pipeline expansions and extensions
PIAC supports the AEMC’s draft recommendations regarding the treatment of pipeline expansions and extensions. While expansions are highly likely to require the same regulatory treatment as the existing pipeline, PIAC supports AER discretion for extensions as a means of preventing pipeline service providers from recovering a regulated price from consumers for speculative extensions.

This is a particular concern in distribution networks, where PIAC is concerned that existing consumers may cross-subsidise pipeline service providers speculatively extending the network to reach new customers.

Recommendation 4
PIAC recommends that the AEMC adopt its draft recommendations about the treatment of pipeline expansions and extensions in the final report.

19 PIAC, Submission to the AEMC Review into the scope of economic regulation applied to covered pipelines Issues Paper, 11.
Reference service

Updating the test for determining a reference service

In its east coast gas inquiry, the ACCC found that the current test for determining a reference service does not prevent the exertion of market power through monopoly pricing for services that are not demanded by a significant part of the market.20 This is because it only requires pipeline services that are demanded by a significant part of the market to be included as reference services. As the ACCC notes, services that are not demanded by large parts of the market may also not be contestable. Therefore, the customers that do seek these services find them unregulated and uncontested, leaving them vulnerable to monopoly pricing. PIAC concurs with this finding.

In the Draft Report, the AEMC addresses this concern by amending the test to take the following factors into account:

- Historical and forecast market demand for the service;
- The extent to which the service is substitutable with other pipeline services;
- The feasibility of allocating costs to the service; and
- The usefulness of the service in supporting access negotiations.21

In particular, the substitutability criterion seeks to address the market power issue by implying that non-substitutable services should be included in access arrangements as reference services. In PIAC’s view, this proposal is a considerable improvement over the single ‘significant demand’ criterion.

Recommendation 5

PIAC recommends that the AEMC adopt its draft recommendations about the test for determining a reference service in the final report.

Defining reference services

PIAC supports the AEMC’s draft recommendations regarding reference service definition.

PIAC concurs with the AEMC that the current framework does not make it clear how the very broad requirement to define pipeline services can be effectively translated into specific reference services that are useful in access negotiations.22 For this reason, PIAC supports the AEMC in clarifying the definition requirements in the NGL and NGR.

PIAC also supports the introduction of a reference service setting period prior the access arrangement process. PIAC considers the framework and approach (F&A) process to be an useful equivalent feature of electricity network regulation that allows the AER and service providers to negotiate the definition of services to be regulated before the bulk of the regulatory process commences, as well as the form of price control to apply for the regulatory period.

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20 ACCC, Inquiry into the east coast gas market, 134-135.
21 AEMC, Review into the scope of economic regulation applied to covered pipelines, Draft Report, 11.
22 Ibid, 64-65.
By introducing an upfront process for defining reference service, the AEMC will extend a similar process to gas pipeline regulation.

**Recommendation 6**

PIAC recommends that the AEMC include its recommendations regarding the clarification of requirements for defining pipeline/reference services and the introduction of an upfront process for setting reference services in the final report.

**Increasing consistency in reference service definition**

PIAC contends that the AEMC recommend stronger changes to reference service definition. As noted in our Issues Paper submission, the current framework allows different pipelines to define very similar services in different ways. This will remain the case under the AEMC’s draft recommendations.

In PIAC’s view, this is undesirable, and inconsistent with the NGO, because it has the potential to create confusion among pipeline users, making it more difficult for them to negotiate pipeline access at efficient prices.

To address this concern, the AEMC should recommend the AER define common reference services and require their use in access arrangements. Given that the regulators already have discretion over the approval of reference services, PIAC understands that this is within the powers of the regulators. In practice, they could produce a reference service definition guideline or approach paper to be applied during the reference service definition process.

This would not prevent service providers from defining new, innovative services, but would allow the AER to use standardised definitions of reference services when approving an access arrangement.

**Recommendation 7**

PIAC recommends that the AEMC proposes for the AER to define a common reference services to be used when including these services in access arrangements in the final report.

**Access arrangements**

**Reference tariff setting: consistent financial models**

PIAC supports the AEMC’s draft recommendation to require the use of a single, regulator-determined set of financial models when setting reference tariffs within an access arrangement.

Currently, the financial models used to set total revenue requirements and reference tariffs vary between pipeline service providers. PIAC supports the points, made by other stakeholders at the AEMC’s stakeholder workshop for this review, that this inconsistency does not promote the long-term interests of consumers as it is difficult to engage in the access arrangement process and for pipeline customers to negotiate with different pipelines.

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23 PIAC, Submission to the AEMC Review into the scope of economic regulation applied to covered pipelines Issues Paper, 20.
By requiring the use of consistent models, the AEMC will reduce complexity, facilitate more effective negotiation by pipeline users and therefore better contribute to the long-term interests of consumers.

**Recommendation 8**

PIAC recommends that the AEMC include its draft recommendations regarding reference tariff setting in the final report.

**Regulatory discretion**

PIAC supports the removal of the ‘no discretion’ and ‘limited discretion’ provisions from the NGR.

PIAC concurs with the AEMC that “as a matter of principle, the regulator should not be prevented making a decision on an access arrangement proposal that best promotes the NGO, having regard to all the relevant factors, criteria and principles in the NGL and NGR.”

Given that the AER and ERA feel that they have been constrained from making decisions that best promote the NGO due their lack of discretion on some components of access arrangement, PIAC contends that they should be given full discretion to make these regulatory decisions.

**Recommendation 9**

PIAC recommends that the AEMC include its draft recommendations regarding regulatory discretion in the final report.

**Capital expenditure**

**Speculative capital expenditure**

PIAC supports incentivising pipeline service providers to use the speculative capital expenditure account with appropriate return on the risk associated with that expenditure, but remains concerned about the operation of this mechanism.

In PIAC’s Issues Paper submission, we noted that it is unlikely to ever be in the long-term interest of consumers for existing pipeline users and consumers to carry the risk for speculative investments on the part of pipeline service providers. PIAC maintains this view.

PIAC is particularly concerned about this risk as it relates to distribution networks supply of residential consumers. For example, when a distribution pipeline service provider builds a network to supply a residential development, they may wish to invest in extra capacity to ensure they can serve future gas demand in that area. Given the changing economics of residential gas demand, this investment would be inherently speculative.

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24 Ibid, 95.
25 Ibid.
26 PIAC, Submission to the AEMC Review into the scope of economic regulation applied to covered pipelines Issues Paper, 17.
27 Alternative Technology Association, Are We Still Cooking with Gas?, November 2014.
If this expenditure was made as conforming capital expenditure, consumers would hold the demand risk by paying for it as part of the capital base from the date of investment. While the AER would need to approve this investment as prudent, there is currently an incentive for pipeline service providers to place as much speculative investment into conforming capital expenditure as possible. Instead, this investment should be made through the speculative capital expenditure account to ensure consumers do not pay for the extra capacity until, and unless, it is needed.

According to pipeline service providers, they have never used this mechanism because they are unsure whether rule 84(2) of the NGR will provide them with a rate of return on that investment commensurate with the increased risk they have taken. Given that it is in the interests of consumers for pipeline service providers assume that risk, PIAC contends that it is a worthwhile trade-off for consumers to pay a risk-reflective rate of return on a speculative investment if the capacity is ever demanded.

The Draft Report notes the merits of applying a risk-reflective rate of return to speculative investments but it is unclear how the AER would go about doing this. Further consideration would need to be given to how this would work in practice.

In this case, the AER would need to perform two new tasks, which may be without obvious precedent: identify and evaluate the speculative portion of the investment, and determine an appropriate rate of return. Under the proposed amendment to rule 84(2), the AER would have no guidance as to how to perform either of these tasks. PIAC contends that the AEMC should give further consideration to how they would practically perform this role.

**Recommendation 10**

PIAC recommends that the AEMC consider further how the AER will be able to identify the proportion of an investment that is speculative and apply a special rate of return to that investment.

Further, the Draft Report does not consider how amended rule 84(2) would interact with the COAG Energy Council’s work to set a binding rate of return guideline. The Energy Council is consulting on a legislative package that would move much of the description of how to set the rate of return from the NEL/NGL into the AER’s rate of return guidelines.\(^{28}\) PIAC contends that the final report should explore how this change would impact with the ability of the AER to make rate of return determinations for individual speculative investment projects.

**Recommendation 11**

PIAC recommends that the AEMC consider how the binding rate of return legislation would impact the ability of the AER to make rate of return determinations for individual speculative investment projects.

If the AEMC is unable to address the concerns about the implementation of a risk-reflective rate of return for speculative investments, then PIAC contends that it should not allow them to be applied. Given recent experience, there is no consumer desire for another avenue for network businesses to use inflated rates of return to charge them ineffectively high prices.

Recommendation 12
PIAC recommends that if AEMC cannot address practical concerns about risk-reflective rates of return for speculative investments, they should amend rule 84(3) to ensure that higher rates of return are not allowed.

New capital expenditure criterion
PIAC supports the AEMC’s recommendation to amend rule 79 of the NGR to clarify that all new capital expenditure by a pipeline service provider must be considered prudent as well as meeting any criterion in rule 79(2), particularly the safety criteria.29

In PIAC’s recent experience, there has been a tendency for regulated energy businesses to seek approval for new capital expenditure on the basis that “safety is non-negotiable”, with less regard given to the prudency of the investment. PIAC supports the amendment to rule 79 on the basis that it will limit this occurring in relation to new capital expenditure on pipelines.

Recommendation 13
PIAC recommends that the AEMC include its draft recommendation regarding the new capital expenditure criterion in the final report.

Further engagement
PIAC would welcome the opportunity to discuss these issues in more depth. For any queries please contact:

- Policy Team Leader, Energy and water, Craig Memery at cmemery@piac.asn.au or on (02) 8898 6522; or
- Policy Officer, Energy and water, Tim Harrison at tharrison@piac.asn.au or on (02) 8898 6518.

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29 AEMC, Review into the scope of economic regulation applied to covered pipelines, Draft Report, 106.