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Via online submission

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Dear Tom

GPR0003: Pipeline Regulation and Capacity Trading Discussion Paper

Jemena welcomes the Australian Energy Market Commission's (**AEMC** or **Commission**) continued engagement as it progresses its East Coast Wholesale Gas Market and Pipeline Frameworks Review (**the Review**), and thanks the AEMC for the opportunity to provide feedback on the Pipeline Regulation and Capacity Trading Discussion Paper (**the Paper**).

Key messages

- As a pipeline operator, we face strong incentives to respond to changes in market dynamics, doing what we can to help ensure gas remains a competitive fuel of choice for customers.
- Jemena has made efficient and timely investments to meet the market's needs for additional capacity on our existing assets, and we continue to pursue opportunities to develop new transportation routes to further grow the gas market.
- A clear case for regulatory action has not yet been established—the nature and extent of any issues in gas markets is still unclear and their causes (including any instances of market power being exercised) have not been fully examined.
- Once any problems are clearly understood and a case for action is established, a comprehensive evaluation of the costs and benefits of any proposed policy measures must be considered, ensuring that the long-term interests of gas customers are the principal piece of guidance for any reforms.
- Given the potentially significant costs and risks of interfering with private investment decisions and existing property rights, and the lack of a clear case establishing a need for such regulatory changes, it is not appropriate to continue to consider whether changes to the gas access regime are necessary.

As the owner of significant gas transmission and distribution infrastructure that transports gas across New South Wales, Queensland and Victoria, Jemena understands the importance of the efficient operation of transportation markets in contributing to the efficient operation of the eastern gas market. Similarly, the efficiency of other segments of the gas market can also affect the long-term value of our assets, which deliver what is increasingly a fuel of choice to customers.

Accordingly, we have a strong interest in the Review and in seeing efficient usage and investment decisions being made by participants throughout all segments of the eastern gas market.

A clear case for action and understanding of the causes of any problems needs to be developed

The foreword to the Paper outlines the importance placed by the AEMC on the efficient use of pipeline capacity in the context of the Council of Australian Governments' (**COAG**) Energy Council's Gas Market Vision:

> *"If there are obstacles to participants being able to access transportation capacity, this will inhibit their ability to trade gas. Consequently, efficiency in the use of pipeline capacity will be of fundamental importance in allowing the Vision to be achieved."*

However, due to the central nature of gas transportation arrangements in contributing to the efficiency of the broader gas market, care must be taken when considering regulatory interventions so as not to result in inefficient outcomes. The Productivity Commission held this view in its recent research paper:

> *"Gas market stakeholders have proposed changes to the way capacity is allocated under the contract carriage model. For example, there have been proposals to extend the open access principles that apply under the market carriage model to elsewhere in the eastern Australian gas market.*
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> *Adopting open access principles could put at risk the investments in gas transmission pipelines that would be needed to efficiently respond to further development in the eastern Australian gas market. Some previous gas market reviews have highlighted concerns that the market carriage model may not create sufficient incentives for investment. … [I]f investments are delayed, supply is constrained and gas prices increase in areas directly affected by transmission constraints. Delays to pipeline investments can also increase the volatility of wholesale gas prices.*
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> *There would also be significant risks from adopting mandatory pipeline capacity trading provisions that apply in other countries. Some gas market participants have highlighted that mandatory pipeline capacity trading provisions would compromise or impinge on the property rights of contract holders. … If mandatory pipeline capacity provisions involve the over-riding of private property rights, there could be substantial costs, including by diminishing incentives for future investment."*[1]

[1] Productivity Commission, Examining Barriers to Efficient Gas Markets, March 2015, pp. 119-120.

Given these issues highlighted by the Productivity Commission, our submission to the Review's Public Forum Paper[2] emphasised the importance of developing appropriate policy responses to clearly identified problems, consistent with COAG's Principles of Best Practice Regulation.[3] We also expressed the need for the Review to be ultimately guided by the National Gas Objective (**NGO**), requiring, amongst other factors, a comprehensive analysis of the costs and benefits of any proposed regulatory changes. In its Stage 1 Final Report, the AEMC stated that it intends to consider any proposed changes to the regulatory framework by having regard to both the NGO and COAG's Principles of Best Practice Regulation.[4]

The Paper raises and outlines possible regulatory approaches to address a number of potential "obstacles" to the development of a liquid gas market. Despite suggesting that such problems may exist (and citing a limited number of stakeholders' concerns or claims[5]), the Paper offers no clear conclusions in relation to such issues and does not present evidence in support of its suggestions. Although we recognise the approaches outlined in the Paper are still under early appraisal, a policy development approach that is consistent with COAG's Principles of Best Practice Regulation (including clear definition of any problems) must be followed.

As noted in the Paper, the Australian Competition and Consumer Commission (**ACCC**) is currently undertaking a comprehensive review into the eastern gas market, supported by their ability to obtain and consider confidential information.[6] We consider that the findings of the ACCC's East Coast Gas Inquiry will therefore be critical to providing evidence of the existence, nature and materiality of any problems in the gas transmission capacity market or indeed the broader gas market. We note that in September 2015, Rod Sims stated that the ACCC was "not quite at the halfway mark in our 12-month Inquiry, and we are still some way off drawing conclusions."[7] Until the ACCC has completed its Inquiry and its findings are made public, it would be inappropriate to conclude that a clear case for action to address a problem has been established.

The AEMC's review must be based on a sound framework and evidence

We also reiterate the importance of the NGO remaining the primary objective for the Review, as set out in the Review's Assessment Framework. As the AEMC undertakes work to consider the form of a desirable future gas market state and policy measures needed to facilitate its achievement,[8] it is critical to ensure that any potential regulatory interventions are assessed principally against the NGO, rather than principally against the extent to which they may help achieve the COAG Energy Council's Vision. Consistent with the NGO, we consider that it may be more appropriate to use the COAG Energy Council's Vision as a long-term aspiration

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2 Jemena Limited, Submission to East Coast Wholesale Gas Market and Pipeline Frameworks Review, 26 March 2015, pp. 6-7.

3 Council of Australian Governments, Best Practice Regulation, A Guide for Ministerial Councils and National Standard Setting Bodies, October 2007.

4 Australian Energy Market Commission, East Coast Wholesale Gas Market and Pipeline Frameworks Review: Stage 1 Final Report, 23 July 2015, p. 86.

5 As noted below, claims by market participants do not necessarily indicate a market failure.

6 "The confidential nature of gas supply negotiations and the terms available in the gas market also meant that it was difficult to determine policy recommendations for government out of these [previous] inquiries." – Rod Sims speech to Eastern Australia's Energy Markets Outlook 2015 conference, 17 September 2015.

7 Ibid.

8 Notwithstanding our earlier comments about the need to ensure that clearly-defined issues are evident and that regulation is shown to be necessary to address those issues.

rather than a near-term policy objective—the National Competition Council's Gas Guide notes that "the need for a 'long term' perspective is included [in the NGO] as a caution against focussing on short term benefits to consumers which may undermine longer term investment and welfare gains."[9]

Particularly in the context of some of the potential approaches outlined in the Paper, it may not be possible to achieve a liquid wholesale gas market at no cost, and therefore a robust assessment against the NGO will necessitate a rigorous evaluation of both the costs and benefits to ensure that they are consistent with gas consumers' long-term interests. This comprehensive analysis of the market-wide costs and benefits will not be possible without a clear understanding of potential barriers, sources of market power or other market failures in the eastern gas market, particularly in the wholesale and upstream markets, also currently being considered by the ACCC. We therefore do not consider it appropriate for the AEMC to progress work on refining and assessing its proposed approaches until clear evidence of any issues in these markets has been presented by the ACCC's Inquiry.

Pipeline operators face a strong incentive to respond to changing market dynamics

The Paper questions the ability and likelihood for market-driven responses to emerge in the face of changing dynamics. As part of its analysis, the Commission has correctly identified that the owner of a natural monopoly facility does not face an incentive to undertake monopoly pricing where it is not a participant in related markets, as is the case with the eastern gas market. Indeed, this natural monopolist faces a strong incentive to ensure its prices are as efficient as possible to maximise the achievement of efficient outcomes in related markets. As the owner of long-lived, capital-intensive assets that transport what is increasingly a fuel of choice, it is strongly in our interest for efficient outcomes to be achieved in all segments of the gas market. This is consistent with the incentives faced by natural monopolies in other infrastructure markets (where vertical integration is absent), for example, airports. Despite possessing market power in some cases, airports face a strong incentive to encourage airlines to utilise their capacity, increase the number of passengers served and also to encourage new airlines to use the airport. This has helped deliver the efficient the investment outcomes the Productivity Commission has identified in that sector.[10]

Similarly, Jemena continues to respond to incentives to grow the use of gas. We have proactively worked to encourage and facilitate capacity trading through our capacity trading platform (which is soon to be expanded to the Eastern Gas Pipeline). We will continue to look for opportunities to enhance this and other services in the future if there is sufficient interest from the market. It is strongly in our interest to provide our shippers (or prospective shippers) with flexibility where feasible—in a dynamic market where participants' transportation needs are changing, their likelihood of using our services (and therefore the likelihood of us being able to recover our sunk investment costs) is increased.

As noted in the Paper, we also offer 'as-available' services where a shipper (or a third party with which they may have traded their transportation rights) is not using its full firm capacity on any day (noting that there is currently no firm capacity available on either of our pipelines). However, long-term services sold on a take-or-pay basis

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9 National Competition Council, Gas Guide, October 2013, p. 27.

10 Productivity Commission, Economic Regulation of Airport Services, Inquiry Report, 14 December 2011.

are generally priced at a discount relative to day-ahead as-available services (which we charge for on an 'as-delivered' basis), which reflects the significantly lower asset stranding risk we face as a pipeline owner when our shippers commit to long-term contracts. Shippers' ability to commit to these long-term arrangements has enabled efficient investment in capacity and a lower cost of funding these capital-intensive assets. This allows us to minimise our charges and their contribution to the end price of gas (consistent with our incentive to minimise the level of risk we face) by influencing efficient outcomes in all segments of the gas market.

As noted by a range of market participants during the Review to date, the contract carriage model has provided strong signals for efficient and timely investment in new capacity to meet the market's needs. Additionally, a significant amount of this efficient private investment over the past decade has occurred in instances where price regulation is not in place. There has recently been very strong interest from the gas transmission sector (including from Jemena) in the construction of a new gas pipeline linking the Northern Territory and the eastern gas market. Jemena has recently committed to market-driven expansions of both the Eastern Gas Pipeline and the Queensland Gas Pipeline, in addition to the construction of a new link between the Eastern Gas Pipeline and the Moomba to Sydney Pipeline that will increase the flexibility and utility of Eastern Gas Pipeline services for shippers during off-peak times when demand in New South Wales is low. As explained further in the next section, given the potential costs (including the costs of inefficiencies resulting from distorted investment signals) involved with an alternative market carriage model or price regulation, we consider it is unlikely that these positive investment outcomes would be able to have been achieved to the same extent under price regulation.

Jemena has also been an active participant in the development and is broadly supportive of the low-cost information provision measures proposed in the Commission's Enhanced Information for Gas Transmission Pipeline Capacity Trading draft rule. We consider that some of the specific measures under Approach A in the Paper, such as the standardisation of contractual terms and conditions related to capacity trading, may represent similarly low-cost initiatives that could be implemented by industry without the need for regulatory intervention.

Despite the Paper identifying the views on the incentives of pipeline operators from the Hilmer Review,[11] no evidence is presented to suggest that pipeline operators in the eastern gas market are acting in a manner inconsistent with these incentives, or that the market is unlikely to respond to potential issues in a timely manner in the absence of regulatory intervention.

Significant changes to the gas access regime should be considered with caution

Despite the lack of a clear definition, materiality or cause of any actual problems in the eastern gas market, the Paper raises a number of questions and presents analysis on whether the gas access regime is 'fit-for-purpose'. Jemena is concerned by the Commission's views on the need to make changes to a fundamental part of the regulatory framework that could result in very significant costs to gas consumers and the broader economy, particularly given that a clear case for *any* type of regulatory intervention has not been established.

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[11] That for an owner of an essential facility who doesn't participate in upstream or downstream markets, "maximising competition in vertically related markets maximises its own profits." – National Competition Policy Review, Final Report, 25 August 1993, p. 240.

A number of high-level questions in relation to the broader purpose and intent of competition policy are raised by the Paper's analysis on the "targeting" of coverage criterion (a) of the gas access regime (the question of whether the criterion should focus on market power or impacts on competition in related markets). The analysis also raises questions about the appropriateness of treating one form of infrastructure (gas transmission[12]) as a 'special case' in relation to access regulation. The Productivity Commission's 2004 Review of the Gas Access Regime recommended that the gas access regime's coverage criteria should provide the same threshold for coverage as those under the national access regime,[13] a view supported in the Ministerial Council on Energy's response in 2006.[14] Furthermore, despite explicitly considering the appropriateness of the coverage criteria of the national access regime (which remain consistent with those of the gas access regime), the recently-completed year-long, comprehensive review of Australia's competition policy (the 'Harper Review') did not raise these issues. The Harper Review did, however, emphasise the importance of recognising that market power in itself is not necessarily contrary to the long-term interests of consumers—it is the misuse of market power to the detriment of competition that could constitute an issue.

Parallels can be drawn with Australia's airport industry, which was the subject of a Productivity Commission Inquiry Report in 2011. The Productivity Commission considered outcomes under a light-handed monitoring regime that replaced price regulation in the airport industry, noting that despite some airports possessing significant market power, "aeronautical charges do not point to the inappropriate exercise of market power"[15] to the detriment of the community. It also noted, "airport operators appear to consult with airlines and other users about the nature and timing of investments,"[16] resulting in positive investment outcomes, and that "commercial tensions [between some airports and airlines] are to be expected and airlines' dissatisfaction is not indicative of systemic failure."[17]

Furthermore, the benefits of moving towards increasingly bespoke, infrastructure-specific arrangements for economic regulation are unclear. The broader technological, customer and policy trends influencing the energy market point towards the emergence of new service providers, increased integration of energy and other services and increasing degrees of competition. These drivers of significant change may indicate that the harmonisation of economic regulatory frameworks may be a more appropriate direction over the long term than one which leads to arrangements becoming increasingly specific. Additionally, the Paper states that as the gas access regime was established separately to the national access regime, divergences between the two may have been contemplated.[18] That the two regimes were established separately (which may instead be explained by the intention under the Australian Energy Market Agreement that each state's energy access regimes be

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12 As noted in the Paper, potentially as distinct from gas distribution (a departure from current treatment), or even gas transmission infrastructure in the eastern gas market as distinct from other parts of Australia.

13 Productivity Commission, Review of the Gas Access Regime, 11 June 2004, p. 224.

14 Ministerial Council on Energy, Review of the National Gas Pipelines Access Regime, Decision, May 2006, p. 10.

15 Productivity Commission, Economic Regulation of Airport Services, Inquiry Report, 14 December 2011, p. XX.

16 Ibid, p. XLVII.

17 Ibid, p. XXXI.

18 Australian Energy Market Commission, East Coast Wholesale Gas Market and Pipeline Frameworks Review, Pipeline Regulation and Capacity Trading Discussion Paper, 18 September 2015, p. 48.

certified) and yet there was no divergence in the coverage criteria, in fact suggests that consistency between the national and gas access regimes was considered to be entirely appropriate.

Gas transmission pipeline owners compete with a broad range of other infrastructure types in capital markets for funding. It is potentially damaging to future investment in the sector for the prospect of the heavy-handed, costly and complex regulatory intervention in private investment decisions and existing property rights to be under consideration. The potentially significant costs and risks to both consumers and the broader economy of price regulation have been well documented, including in the two reports prepared to inform the AEMC's Paper.[19]

Price regulation is an imperfect tool that can inflict cost inefficiencies on consumers and the broader economy, by negatively impacting or distorting investment incentives and price signals, stifling innovation and restricting competition. Indeed, the AEMC is currently examining significant issues in the Victorian gas market associated with a sub-optimal reliance on regulatory processes to drive pipeline investment. The Productivity Commission has also previously highlighted how Australian airports have responded to their incentive to grow passenger numbers through efficient investment in new capacity in the absence of price regulation (and have often done so in consultation with airlines). In its 2011 inquiry, it noted there was little evidence of material benefits in moving away from light-handed regulation and back towards price regulation, and indeed there were material risks (of compromising these efficient investment outcomes and the engagement between infrastructure owners and users) in doing so.[20] Just as the Productivity Commission noted that engagement between airports and their customers (airlines) has likely led to more efficient investment outcomes than under price regulation, we consider that driving investment through regulatory process is likely to result in significantly inferior outcomes compared to those realised under our strong history of working closely with customers to build new transmission capacity and grow the gas market.

Price regulation also imposes material direct costs on asset owners (and the regulator), which would ultimately flow through to higher transportation charges. Based on the direct costs Jemena currently incurs in preparing and submitting a price review proposal for its regulated networks each period, these costs would represent between five and ten per cent of the total operating and maintenance expenditure for each of our gas transmission pipelines on an annual basis. Additionally, we incur a range of other direct costs in regulatory information provision and participating in regulatory framework development activities.

Furthermore, changes to the coverage criteria and some of the measures outlined under Approach B raise potentially significant regulatory and sovereign risk issues that could undermine future investment. As previously noted in the Paper, long-term (in some cases up to 20 year) contracts between pipelines and shippers play a fundamental role in the gas transmission market, underwriting sunk investments. Measures that impact shippers' or pipelines' property rights could therefore reduce incentives for future investment or increase the return required by investors as compensation for the level of risk they face, and must therefore be considered very carefully. Material changes to the regulatory framework for transmission pipelines could also increase regulatory risk for pipeline operators, making it more difficult

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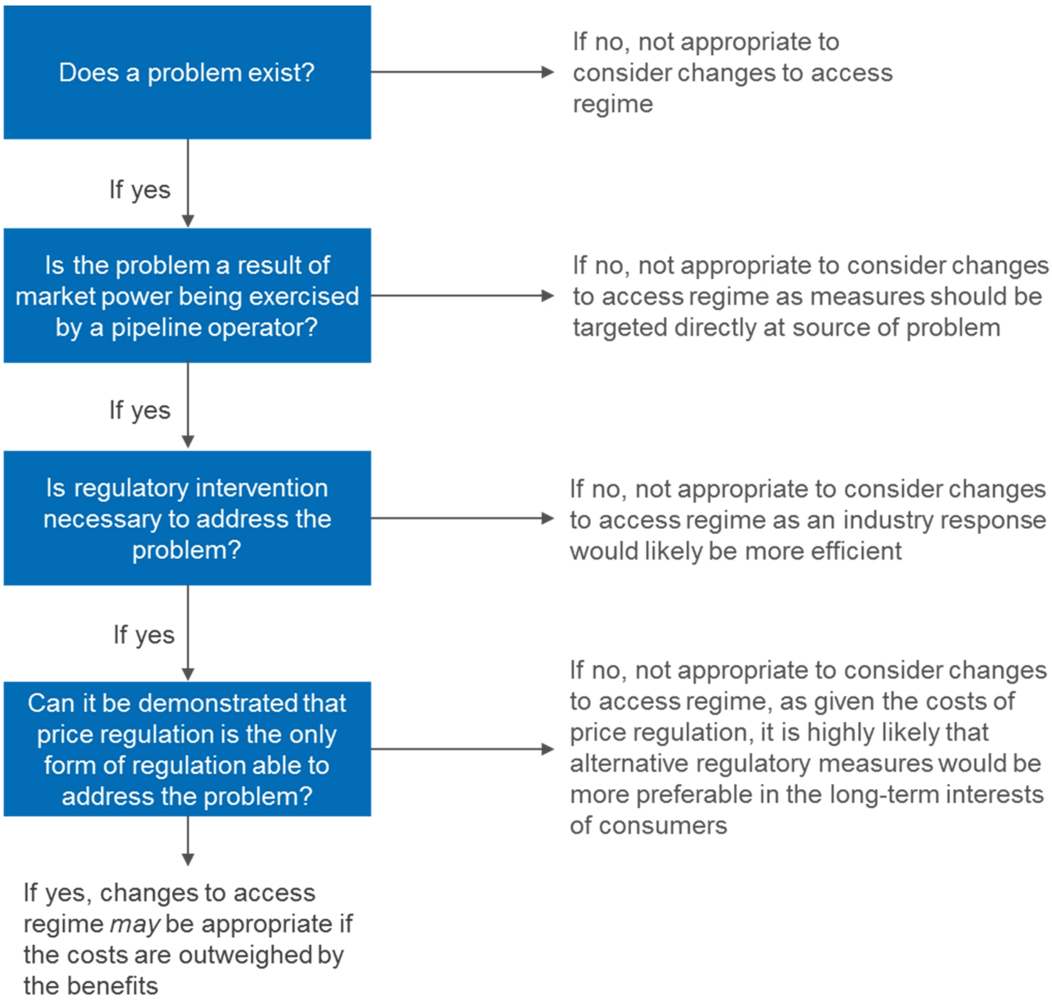
19 Castalia, AEMC Gas Access Regime Advice, 10 August 2015 and Incenta, Assessment of the Coverage Criteria for the Gas Pipeline Access Regime, September 2015.

20 Productivity Commission, Economic Regulation of Airport Services, Inquiry Report, 14 December 2011.

(expensive) to attract capital for future investments. As noted by the Productivity Commission, such constraints on future investment can impede the market's ability to respond to future changes, and may ultimately be contrary to the long-term interests of gas consumers.

Given these costs and the need to ensure outcomes that are in the long-term interests of consumers, the Hilmer Review identified that price regulation should be used only as a 'last resort' option.[21] Therefore, in relation to the question of the appropriateness of progressing work by the AEMC on the coverage criteria even in the absence of market power being exercised in the sector, the points outlined in the figure below should be considered.



The Paper sets out a range of potential measures in terms of the level of regulatory intervention. Should it be determined that regulation is necessary to address a clearly defined problem, we consider a staged approach to implementing measures would be the most likely to avoid the imposition of unnecessary costs on consumers. Such an approach could involve the introduction of information or transparency improvements designed to facilitate trading between parties first (such as those that are currently the subject of the Enhanced Information for Gas Transmission Pipeline Capacity Trading rule change). These measures should be given sufficient time to be fully implemented and for their effectiveness to be assessed before further steps are considered. Given the high costs associated with price regulation, it is likely that

21 National Competition Policy Review, Final Report, 25 August 1993, p. 271.

these more light-handed, less costly approaches may be better aligned with the long-term interests of gas consumers. This approach would also reduce the uncertainty associated with decisions about whether regulation is justified, therefore reducing the risk of costs associated with making a 'false positive' decision to impose regulation where it is not necessary, while still allowing further measures to be taken in the future if warranted. As noted in Castalia's report prepared for the AEMC, "the access regime—either in its present or a possibly modified form—is not the right tool to address potential obstacles to the development of the market."[22]

Jemena would welcome the opportunity to meet with the Commission to discuss this and other matters being considered by the Review further. Should you have any questions about this submission, please contact Benjy Lee, Manager Energy Policy, on (03) 9173 7894 or via email: benjy.lee@jemena.com.au.

Regards

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22 Castalia, AEMC Gas Access Regime Advice, 10 August 2015, p. 1.