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AEMC project number GPR0004

Submission via website

Dear Sir/Madam,

Review into the scope of economic regulation applied to covered pipelines - Issues Paper

AGL welcomes the opportunity to make a submission to the AEMC's *Review into the scope of economic regulation applied to covered pipelines, Issues Paper, 27 June 2017* (Issues Paper).

AGL is one of Australia's leading integrated energy companies with about 3.7 million electricity and gas customers in New South Wales, Victoria, Queensland and South Australia. AGL has gas supply contracts with producers and transportation agreements with pipeline owners to supply approximately 1.4 million gas customers.

AGL notes that the Issues Paper covers transmission and distribution pipelines. In transmission, there are only a few pipelines which are currently subject to full regulation such as the Declared Transmission System in Victoria whilst major pipelines such as the Moomba-Sydney Pipeline (MSP), Eastern Gas Pipeline and Moomba-Adelaide Pipeline are no longer covered under the Natural Gas Law (NGL) and hence not subject to the Natural Gas Rules (NGR). In distribution, most gas networks are subject to full regulation.

In principle, AGL agrees that commercial arrangements are best managed by negotiation between the service providers and users. However, it is important that regulators and rule makers recognise that in practice, these negotiations are often difficult because of the monopoly power retained by the asset owners, regardless of if they are covered or uncovered under the NGL.

AGL notes that the impetus of the AEMCs work in this space arose from the Australian Competition and Consumer Commission (ACCC) inquiry into the competitiveness of east coast gas markets. The ACCC review found, *inter alia*, that there were 'a number of gaps in the regulatory framework that allow covered pipelines subject to full regulation to engage in monopoly pricing' and further that 'information asymmetries add to the issue, limiting the ability of shippers to identify any exercise of market power and to negotiate effectively with pipeline operators.'[1]

The ACCC's conclusions provide an important context for the AEMCs work and the need for, or otherwise, to implement policy solutions to address issues raised.

[1] Source: https://www.accc.gov.au/system/files/ACCC%20submission%20to%20AEMC%20Part%208-12%20pipeline%20review%20-%2016%20August%202017.PDF

AGL's comments on the matters raised in the AEMC Issues Paper are outlined below.

Purpose of the regulatory framework

Given the NGO, the NGR requires access arrangement proposals to be approved by regulators if services are provided such as would be incurred by a prudent service provider acting efficiently, in accordance with accepted good industry practice, to achieve the lowest sustainable cost. This aim is referred to in rules 79(1)(a) and 91(1) in relation to capital expenditure and operating expenditure respectively.

In contrast, the stated objective of the Gas Market Reform Group (GMRG) is to facilitate access to services at reasonable prices and terms which would apply in a workably competitive market. The workably competitive market construct is a key feature of the GMRG framework.

In AGL's view, both aims are compatible with NGO if they can be achieved in practice. In AGL's dealings with transmission and distribution asset owners, there is clear recognition that these service providers have monopoly power. Whilst the asset owners may have some commercial incentives to negotiate on terms and conditions, including price, AGL invariably has regulatory and legal imperatives that require it to obtain these services from the asset owner. The ability to negotiate is therefore limited.

In the case of uncovered or non-scheme pipelines, there is greater scope for asset owners to extract additional revenue. Even with covered pipelines and networks, the prices are determined by the regulator through a detailed process of assessing capital expenditure, operating costs, cost of capital and other relevant factors however, the terms and conditions remain balanced towards the asset owners.

Regulatory framework and incentive based regulation

AGL has observed that the application of incentive-based regulation could lead to regulatory gaming due to information asymmetry. For instance, under this approach, a pipeline may propose capital expenditure for a specific project which is judged to be prudent, only to substitute the project with a lower expenditure but continue to receive revenues which have been determined on the basis of the higher unspent expenditure. There should be consideration whether a clawback mechanism is necessary for these situations to ensure the aims of the NGO are met.

GMRG and light regulation

The GMRG framework for non-scheme pipelines has a focus on the publication of information and a commercially oriented arbitration mechanism. AGL supports this framework.

In the east coast, only one transmission pipeline is subject to light regulation – the Moomba to Marsden section of the MSP. In distribution, the two networks in Queensland are under light regulation while all the other distribution networks in the east coast are under full regulation.

If the GMRG framework is in place, AGL expects little impact on the overall gas market in Australia if light regulation is removed. This will simplify the arrangements for coverage, that is, pipeline will be classified as either scheme (full regulation) pipelines or non-scheme pipelines.

Terms and conditions of access arrangements

AGL believes that commercial arrangements are best managed by negotiation between the service provider and users. However, in monopoly situations, the ability to negotiate is limited and, if unregulated, the costs of the services are unlikely to be the ‘lowest sustainable cost’

The monopoly position of the service providers can be seen in the terms and conditions of the access arrangements. Generally, the provisions for force majeure, indemnity and warranty are skewed against users (including retailers).

In relation to transmission pipelines, which are mostly uncovered, the ability to trade capacity between third parties is limited, with the service providers inserting themselves in the transactions. Other instances of rigid terms and conditions include limits on access to delivery points and the ability to amend delivery points. In addition, responses to requests can be slow. These restrictions prohibit the development of gas as a tradeable commodity and, in AGL’s view, not in the interest of the NGO.

With distribution networks, instances where the terms and conditions for access are clearly biased towards the asset owners include retailers being financially responsible for metering errors even though the assets are owned by the networks and networks failing to meet performance standards with no penalty.

These terms and conditions often remove commercial risks from the service providers. It is important that the regulator ensure a more balanced outcome between the interests of the service provider and users in the terms and conditions of the access arrangements. As the services provided are similar, if the terms and conditions are balanced, AGL supports the use of standard terms and conditions across pipelines (transmission and distribution, separately) and jurisdictions. Standardisation will also reduce regulatory costs in the long term.

Reference services

AGL agrees with the concern raised in the Issues Paper that rule 101 in the NGR which defines reference services in relation to market demand rather than the contestability of the service. This potentially creates opportunities for service providers - who have monopoly power - to increase revenue through non-reference services such as park and loan, backhaul and capacity trading. In electricity distribution reviews, there is a framework and approach process to classify if a service is to be regulated or not. AGL suggests that a similar approach should be used to categorise each of the services provided by a covered pipeline. This would mitigate the possibility of services being regulated, when the market is able to provide its own solution to delivering the service.

Discretion

The NGR sets three levels of regulatory discretion – no, limited and full discretion. There is merit in reviewing the purpose of this discretion and considering if, by limiting the matters which the regulator can review, the rules are restricting regulators from responding to changes in the market conditions and preventing the establishment of a standardised approach to economic regulation.

The discretion provided to service providers to treat extension or expansion as part of a covered pipeline or not is another example of the rules tilted in favour of asset owners. The main concern of users is the ability to ship gas from one location to another at a reasonable price. If there is no realistic alternative, this discretion allows the pipelines to choose an option which could result in higher prices.

Arbitration

Part 12 of NGR provides a framework for the resolution of access disputes. However, it is focussed on safety and capacity expansion, and the process is unclear. AGL has not referred any arbitration under the rules. Arbitration can be costly and time consuming, and the outcome uncertain. Instead, AGL has undertaken legal proceedings where service providers have not complied with their obligations under the rules.

It is preferable that the regulator ensure that the requirements of the rules are complied with, the range of services that transmission and distribution pipelines provide are at a reasonable cost, and the terms and conditions are fair to the asset owners and users. These will potentially reduce any need for arbitration in the first place.

Summary

There is some opportunity to improve the NGR by clarifying the role of limited regulation, regulatory discretion and the definition of reference services.

An area of concern to AGL when dealing with monopoly asset owner is the imbalance of the commercial interests and risks of service providers and users. While prices and revenue are determined by the regulator, there has been less focus on the terms and conditions of the access arrangements in which risks are transferred from the service provider to users. In addition, AGL supports greater standardisation of these terms and conditions across pipelines and jurisdictions which will reduce regulatory costs over time.

Should you have any questions in relation to this submission, please contact Meng Goh, Manager Regulatory Strategy, at mgoh@agl.com.au or (02) 9921 2221.

Yours sincerely,

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