SUBMISSION

Gas Pipeline Information Disclosure and Arbitration Framework | July 2017

EUAA
Energy Users Association of Australia

Gas Market Reform Group
c/o Australian energy Market Commission
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Via email: Gas Market Reform Group (GMRG) at enquiries@gmrg.coagenergycouncil.gov.au
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INTRODUCTION

The Energy Users Association of Australia (EUAA) is very pleased to make this submission. We are the peak body representing Australian energy users. Our membership covers a broad cross section of the Australian economy including significant retail, manufacturing and materials processing industries.

Our members are highly exposed to movements in both gas and electricity prices and have been under increasing stress due to escalating energy costs. These increased costs are either absorbed by the business, making it more difficult to maintain existing levels of employment or passed through to consumers in the form of increases in the prices paid for many everyday items.

The EUAA has been very supportive of the moves by the Gas Market Reform Group (GMRG) to reduce the market power of unregulated gas pipelines through a combination of improved transparent information disclosure and a binding commercially orientated arbitration mechanism if commercial agreement cannot be reached.

Unlike many other current energy market reforms, if properly implemented, the Framework's benefits will be almost immediately apparent to users from the time of the first negotiated agreement under the new framework.

The current arrangements for the negotiation of pipeline access agreements operate as a barrier to achieving the National Gas Objective in two ways:

1. It inflates the costs of delivered gas and reduces competition in markets where there is a dominant supplier eg the ACCC in its East Coast Gas Inquiry highlighted how it creates a barrier for new gas sources to compete against the incumbent (and more local) Gippsland Basin JV in the southern States market
2. It seeks to address the problem of "capacity hoarding" where existing gas sellers are able to create barriers to entry to new suppliers who cannot get pipeline access eg this reform is very important to opening up the development of a more integrated spot market in the east coast whether they be LNG projects seeking to trade surplus capacity or new players bringing reserves to market

The key measure of success of the new framework will be the number of contracts successfully negotiated without recourse to arbitration and the absence of the monopoly profits identified in the ACCC East Coast Gas Inquiry. This will only come about with the potential user having all the required information that underpins a contract's pricing and non-price terms and conditions to be as closely as possible reflective of a workably competitive outcome.

This will send a clear message to the pipeline service provider that they cannot game the process and rely on going to arbitration to achieve their desired outcome.

While potential users will have more information at their disposal during the negotiation process they are still likely to face some negotiation asymmetry. A user might undertake this negotiation once every few years and rely in internal resources that are not expert in the finer points of access agreements. The pipeline service provider may well have a dedicated team whose substantial role is negotiating such agreements. Information disclosure and the threat of arbitration does provide some assistance to the prospective end users but negotiation asymmetry can still loom large.

We think there is one key issue that needs to be addressed to ensure the Framework achieves its objective.

Key Issue - Asset Valuation – Rule 569 (2)(a)

By far the major issue that will determine whether this reform is a success is the method used to measure asset valuation, so the EUAA welcomes the GMRG's invitation to comment further on this matter.

We agree with the thrust of the proposed alternative wording for rule 569(2)(a) on page 23 of the Explanatory Note to reflect the AER approach, particularly the concept that the current asset valuation must "…take into account past recoveries of capital".

However, the discussion in Box 2 on page 24 of the Explanatory Note can be confusing given the range of asset valuation methods to be considered for pre-November 1997 constructed pipelines – each of which can give widely varying results depending on how you measure the asset value according to "capital recovered", "depreciation" or "price paid for the asset". This uncertainty could create fertile ground for pipeline service providers to argue for a continuation of the existing approach that has led to the monopoly profits identified by the ACCC and the earlier Vertigan review – and ensure the failure of the proposed Framework.

Under a "workably competitive" objective, a pipeline owner should only be able to get recovery <u>of</u> its capital (with an appropriate risk adjusted commercial return <u>on</u> that capital), **<u>once.</u>** The current asset value of the pipeline has little to do with tax or accounting depreciation, and the words in the Explanatory note can be confusing. The asset value today of say a 60-year life pipeline asset that was built 20 years ago and is still owned by the original builder:

- **<u>Is</u>** its original capital base plus capital spent since commissioning, less the component of the tariff users paid over the last 20 years that related to capital recovery
- **<u>Is not</u>** its original capital plus capital spent since commissioning, less the accounting depreciation - which given the asset life may only be one third of the original value – ie what one might interpret (a) in the first dot point in Box 2 to be, and

Giving an arbitrator the options in Box 2 are an invitation to confusion and will almost guarantee the proposed framework will not result in a more efficient process to enable more negotiated agreements. Without a specific guideline – to be part of the AER developed binding guidelines – then there will be continual arguments about asset values. Agreements will not be reached. A prospective user will not be incentivised to go to arbitration because it will mean pot luck on what asset valuation approach the arbitrator decides to use and prospective users will face the full resources of the pipeline service provider. Any concept of addressing the information and negotiation asymmetry will disappear. We will be in a similar situation to what happened with Limited Merits Review of AER's network decisions – which led to its recent abolition.

For this reason, there needs to be a very specific asset valuation guideline – based on the actual past recovery of capital - that will be followed in the publication of tariffs and in the arbitration process. Only then will the threat of arbitration be effective. We would propose an approach that is consistent with the approach the AER uses for regulated networks:

> The lesser of:
>
> (a) the original cost of constructing the pipeline – redundant capital – asset disposals + sustaining/expansion capital + CPI – past recovery of capital, and
> (b) the most recent purchase price – redundant capital – asset disposals + sustaining/expansion capital + CPI – past recovery of capital

This approach should be part of the AER guidelines to be published by December 2017. If the potential user cannot be satisfied that the proposed pipeline tariffs are consistent with that guideline then it can seek arbitration. Then the calculation should be done by the AER and provided to the arbitrator. This means that the threat of arbitration is real and is the major way of addressing the current negotiation asymmetry and the Framework achieving its objectives.
Three criticisms of this approach may be advanced, but we do not regard them as relevant or significant.

(i) It will remove the incentive for further pipeline investment

For this to be true the pipeline owners are effectively saying "I need to get recovery of my original capital investment multiple times or else I will not invest" or alternatively "I need to earn monopoly profits or else I will not invest".

This is not consistent with a "workably competitive" outcome, let alone the National Gas Objective.

We find it difficult to believe that the three LNG pipelines would not have been built under the asset valuation methodology we are proposing here. We expect that most if not all the capital costs of these pipelines will be recovered through tariffs during the 15 year no coverage period. The EUAA believes that a "workably competitive" approach would mean that the assert valuation in year 16 would reflect only the remaining capital not recovered during the first 15 years.

(ii) Sovereign/regulatory risk

The use of the:

> "…price paid for any asset recently purchased by the Service Provider and the circumstances of that purchase"

where that reflects an expectation that the new owner will continue to be able to recover capital more than once, will significantly decrease the chances of the Framework achieving its objectives. Such purchasers are taking regulatory risk and the risk of a move to a regulatory framework that better reflects the National Gas Objective is part of that risk.

(iii) It will be difficult to calculate the asset value in the EUAA proposed approach

We do not think this will be the case. Pipeline companies will have the relevant tariff history and be able to undertake the required calculations. If there are problems then the AER should be able to independently verify the calculations and the EUAA is happy to accept the AER's decision on this matter.

Other Issues

(i) What is a "commercial rate of return" in rule 569(2)(a)?

Given our proposed approach on asset valuation, the allowable rate of return on this asset value is another area where the framework will benefit from more explicit guidance. Consistent with the approach above we suggest a simple approach – application of the forthcoming AER binding rate of return guideline on real WACC. We are not convinced by the likely argument against this approach – this framework deals with non-regulated pipelines and the AER guidelines deals with regulated pipelines – because both deal with monopoly assets that have the potential to extract monopoly rents. Application of a consistent RoR guideline is consistent with a "workably competitive" outcome.

(ii) How the resulting "price" is consistent with a "workably competitive" outcome

There is a requirement that:

> "The price determined by the arbitrator must nonetheless fall within the boundaries of the price offers made by the parties to the dispute."

From the prospective buyer's viewpoint, this price is not simply the $/GJ, it includes all the other non-price terms that influence the effective price eg a price of $1/GJ at 80% take or pay is a lower effective price than $1/GJ at 95% take or pay. The Explanatory note simply says (p.25)

> "In relation to disputes regarding non-price terms and conditions, the arbitrator would be required to assess the reasonableness of the pipeline's offer having regard, as far as practicable, to what would likely prevail in a workably competitive market."

This seems insufficient guidance to the arbitrator. Prospective users need to have confidence that the "price" arbitration takes into account all terms and conditions that impact on the "effective" price and do not allow the service provider to exercise its monopoly power in the non-price elements. A "workable competitive" price quickly becomes "monopoly" price if these non-price terms eg take or pay level, MDQ flexibility, are at very high levels or within narrow bands.

(iii) The information that is available and the potential for variability of arbitrator decisions – rule 581(1)

Even with the adoption of our proposed approach to alternative drafting of rule 569(2)(a), there is still seems to be scope for different arbitrators to come to different decisions on access conditions for the same pipeline.

Under rule 581(1) the details of any final determination including price and other terms and conditions will be confidential. What is not clear is whether this will also prevent a future arbitrator on the same pipeline from having access to this confidential information. We would suggest this access be given to subsequent arbitrators of the same pipeline.

Attached is the template setting out the EUAA's views on many of the other proposed rules.

Andrew Richards
Chief Executive officer
Energy Users Association of Australia

Attachment – EUAA Comments on Draft Rules

Draft Rules	Issue	Feedback
DIVISION 1	**PRELIMINARY**	
546	Objective	Agree with the Objective as expressed and support consideration of amending the NGL to limit it being amended through a rule change process.
547	Application	No comment
548	Structure of this Part	No comment
549	Definitions	No comment
550	Interpretation	No comment
551	Access information standard	Agree
DIVISION 2	**INFORMATION**	
552	Obligation to publish information	The timeframe for publication – particularly the 5 months from the commencement date and financial information by October or December 2018 depending on the service provider's financial year - seem to be overly generous to the service providers. The pipelines have known for at least since May 2017 that they will be required to provide this information, much of which should be already available internally. We suggest two months at the most. In our comments below on the transitional arrangements, we highlight the difficulties for potential users obtaining information (and having confidence in any information provided) after the start of the scheme on 1 August and before the AER's information guidelines are finalised in December. This may limit the start of negotiations until early 2018.
553	Service and access information	No comment
554	Standing terms	No comment
555	Financial information	It is unclear what this means (Framework – Explanatory note for stakeholder consultation) p.9: "The financial information reported by service providers is not intended to bind the arbitrator if there is an access dispute."
556	Financial reporting guidelines	The EUAA supports the proposal to have reporting in accordance with rules 551 and 552 to be classified as civil penalty provisions.
557	Weighted average prices	Agree
DIVISION 3	**ACCESS REQUESTS AND NEGOTIATIONS**	
558	User access guide	Agree – but unclear when this is to be provided by the pipeline – should be at the commencement date
559	Access requests	Agree
560	Access Offer	How do you prevent an access offer that meets the requirements of this rule but also includes other terms and conditions that increase the effective price above what should be the case in a workably competitive market? It seems under rule 563 and the application of Division 4, that these non-price terms can be a reason for the prospective user to refer the matter to arbitration?
561	Negotiations	Agree
562	Access negotiation information	It is not clear what information the service provider can "reasonably" request from the prospective user. In particular there should be no obligation on the prospective user to provide any commercial information. This is not a process to enable a service provider to assess a prospective user's ability to pay. It is a process for the prospective user to gain access to all the information required to enable them to decide if the cost based tariff is indeed reflective of a "workably competitive" market, and if so, to decide if they wish to pay that tariff.

Draft Rules	Issue	Feedback
DIVISION 4	**ARBITRATION OF ACCESS DISPUTES**	
563	Application of Division 4	Agree
564	Access Dispute Notice	Agree – though more information should be given on what fees would be paid when submitting the access dispute notice so this is not a barrier to submission.
565	Reference to arbitration	Agree
566	Conduct of the parties	Agree
567	Statements to be provided to the arbitrator on appointment	We have concerns about the ability of new information to be presented to the arbitrator that was not relied on during the negotiations.
568	Arbitrator to give effect to negotiation principles	The EUAA's concern is with subrule (1) allowing the provision of additional information that was not provided during the negotiation process. The fundamental objective of the negotiation process is that the transparent provision of detailed information by the pipeline service provider is crucial to addressing the acknowledged information and negotiation asymmetry between service provider and potential user. We are concerned that this will lead to the potential users being at a disadvantage in the arbitration process – particularly given the limited time period provided for the potential user to respond to this new information.
569	Pricing and other principles	The EUAA agrees with the intention of the proposed alternative drafting of rule 569(2)(a). However, we strongly believe that it should be further refined to ensure that there is no ambiguity in the asset valuation methodology set out in the AER guidelines to be published by December 2017. To be consistent with the AER approach and the workable competitive objective, we propose the valuation be based on: The lesser of: (a) the original cost of constructing the pipeline – redundant capital + sustaining/expansion capital + CPI – past recovery of capital, and (b) the most recent purchase price – redundant capital + sustaining/expansion capital + CPI – past recovery of capital More detail should be provided about how "non-price" disputes are to be resolved – non-price terms can have a large impact on the "effective" price paid by the prospective user and it is important to ensure that these terms are not used to return monopoly rents to the service provider
570	Matters that may be dealt with in the determination	Generally agree. The Explanatory note says: "…unless the service provider agrees otherwise, a determination must not provide for a user to acquire an interest in a non-scheme pipeline by funding an expansion of the capacity of the pipeline." A common way for the prospective user of getting the full benefit of paying for an expansion is to take equity in the expansion. This can avoid a dispute about the asset value to apply at the end of the foundation contract term – when the user is negotiating a new contract and wants to get the pricing benefit in the new contract of the depreciation it has paid under the foundation contract. This provision should not be used to allow the service provider to inflate the asset value at the end of the foundation contract.
571	Interim access determinations	Agree
572	Final access determinations	Agree
573	Effect of final access determination	Agree – however what is the process if the prospective user thinks that the service provider is not correctly implementing the terms of the final access determination?
574	Arbitration procedures	Agree

Draft Rules	Issue	Feedback
575	Experts appointed by the arbitrator	Agree
576	Confidentiality	Agree
577	Conflict of interest	Agree
578	Termination of arbitration	Agree
579	Correction of errors	Agree
580	Costs	Agree in principle. However, the issue of costs should never be a barrier to a prospective users seeking arbitration. Arbitrators need to be aware of the potential for service providers to seek to impose additional costs eg appointment of independent experts, that may put the prospective users in an unfair position regarding ability to meet their share of the arbitration costs.
581	Information to be published about access determinations	Agree with the information to be published when a final access determination is made. Disagree with the low level of information to be provided in the event of no final access determination being made.: • agree with not publishing the identities of the parties or the arbitrator involved • support publishing other information required under rule 581 (2) particularly the asset value, valuation method adopted, the assets to which the valuation applied and the determination of the asset value should be published. Suggest that the subsequent arbitrators on the same pipeline have access to the confidential parts of previous final determinations to assist in their deliberations.
DIVISION 5	**SCHEME ADMINISTRATOR**	
582	Role of the scheme administrator	Agree
583	Pool of arbitrators	Agree
584	Non-scheme pipeline arbitration guide	Agree
DIVISION 6	**EXEMPTIONS**	
585	Exemption categories	Agree
586	Exemption conditions	Agree
587	Revocation	Agree

Draft Rules	Issue	Feedback
588	Making and form of application	Agree
589	Decision on application	Agree
590	Decision to vary or revoke an exemption	Agree
Proposed Transitional Rules		
Item 51, schedule 1	Initial financial reporting	See comment on Item 53
Item 52, schedule 1	Initial weighted average prices	See comment on Item 53
Item 53, schedule 1	Access requests before the commencement date	This comment is a combined response to Items 51, 52 and 53. With the bringing forward of the commencement date to 1 August 2017, negotiations could commence some months before the provision of service, access, standing terms and weighted average price information due by 1 February 2018 and financial information by October 2018. While potential users can request service providers provide this information, including for example the asset valuation methodology, ahead of the deadline dates, it might be difficult to interpret this data in the absence of the agreed AER data guidelines. This suggests negotiations could be slow to begin with and perhaps increase the chance of the matter being referred to an arbitrator – which, depending on timing - may face similar information constraints. The alternative may be that negotiations do not begin until early 2018.