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Gas Market Reform Group
c/o Australian Energy Market Commission
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By email: gas@environment.gov.au

Dear GMRG

Gas Pipeline Information Disclosure and Arbitration Framework
Proposed Initial National Gas Rules

The Major Energy Users (MEU) welcomes the opportunity to provide its views to the Gas Market Reform Group (GMRG) on its proposed initial gas rules to implement information and arbitration for non-scheme gas.

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As the GMRG is aware, the MEU has been actively involved with the issue of gas pipeline monopoly rent taking for a number of years, culminating with in-depth discussions and formal responses to the ACCC (as part of its review of the east coast gas markets), the AEMC (as part of its review of the east coast gas markets) and Dr Vertigan's review of the of the test for pipeline coverage. As part of the MEU's responses to the various enquiries, it has provided firsthand accounts from its members describing the total lack of ability for end users to obtain equitable conditions for access to those gas transmission pipelines which are not covered under the Gas Law. This is despite the fact that some of these end users are some of the largest firms in Australia employing many thousands of workers across multiple sites and who experience international competition. It is clear that access to monopoly pipelines is not an issue of whether the shipper is a large firm but one of control of a monopoly asset. Therefore, the MEU is pleased that some action is being undertaken to redress the disparity of "negotiating powers[1]" that exists between a gas pipeline monopoly and gas shippers, be they direct end users or retailers acting on behalf of a number of end users.

The MEU is aware that the CoAG Energy Council has decided that commercial arbitration is its preferred route to addressing the inequities in the current gas pipeline access arrangements for unregulated monopoly pipelines, despite the ACCC's views that pipelines exhibiting monopoly characteristics should be "covered" and subject to full regulation.

This response to the proposed initial national gas rules does not necessarily imply agreement with the decision to implement commercial arbitration – the MEU still

[1] The MEU observes that using the term negotiating when dealing with a monopoly is an oxymoron

considers that where a pipeline exhibits monopoly characteristics[2], then that pipeline should be regulated. Overall, the MEU considers that the proposed commercial arbitration process is a poor second best outcome for shippers and, ultimately, gas consumers.

It is with this caveat in mind, the MEU makes the following observations and responses to the proposed initial rules.

General observations

Generally the MEU considers that the GMRG has prepared a set of Rules that should provide a reasonable ability for many shippers (but not those transporting small amounts of gas) to gain access to non-scheme pipelines on reasonable terms and the following comments reflect the aspects of concerns identified by the MEU with the proposed rules.

The MEU points out that retailers ship gas on behalf of smaller users of gas and there is apparently an expectation that these retailer/shippers[3] will act on behalf of these smaller gas users to remove monopoly rent taking by pipeline owners. The MEU points out that retailers "pass through" the costs of transport of gas and where there is no competitive advantage for the retailer to challenge monopoly rent taking by pipeline owners, retailers will continue to just "pass through" the transport costs. This means that effectively small end users of gas are unlikely to benefit from the changes proposed.

The MEU is still concerned that pipeline owners will use the process proposed to attempt subverting the rules to minimise the impact of this new approach to redress the imbalance between access seekers and a monopoly entity.

Specifically, the MEU considers that pipeline owners will still attempt to prevent access seekers from getting resolution to their concerns primarily based on the cost of the arbitration process. The MEU sees that this can occur through

- Making the arbitration process so expensive that it deters end users from seeking to limit monopoly rent taking. The MEU sees that pipeline owners can make the whole process so complex that the access seeker is deterred from following through. For example, the setting of the asset base will result in significant investigation, modeling and research and the arbitrator is likely to require assistance from experts, imposing considerable costs to gain satisfactory resolution.
- Using time to the disadvantage of consumers. The MEU notes that despite the rules requiring fixed times for the arbitrator to deliver its decision, the power lies with the pipeline owner as to what information is provided and when, the extent to which the pipeline owner invokes the involvement of "experts" in the various

[2] The MEU considers that there is no gas pipeline in Australia that does not in reality provide a monopoly service. The MEU also notes that even in the United States where there is direct pipeline on pipeline competition, regulation is still applied. The MEU therefore questions why pipeline regulation in Australia is considered to be inappropriate.
[3] The MEU uses the term retailer/shippers to identify where a shipper provides a service to a number of end users not related to the pipeline owner or to a retailer

stages of the arbitration process and the imposition and amplification of complexity. The MEU points out the extent to which the AER has been impacted by the asset owners in full regulation processes and considers that the arbitration process has less ability to control the asset owners than the AER has.
- The pipeline asset owner making secret deals with the access seeker to prevent the flow on of the information needed by smaller access seekers to overcome the cost barriers inherent in the arbitration process.

The MEU has observed the extent to which energy transport providers have gone to in the past to maximize revenue, even when subject to full regulation. As commercial arbitration is less intrusive than full regulation and imposes more costs on access seekers, the MEU is not at all sanguine that the proposed approach will deliver the best outcome for consumers, especially smaller users of gas. Equally, the MEU also recognises that the commercial arbitration approach is better than what exists now.

The MEU makes the following comments on specific aspects of the proposed draft rules:

Exemptions

The MEU notes that a pipeline will be exempt from arbitration if the pipeline does:

> "not provide third party access (ie the service provider and shipper are related)".

While the MEU recognises that in most cases, this basis for exemption is not unreasonable, it points out that where the pipeline is owned by a shipper which is also a provider of gas to a number of end users (eg as a retailer/shipper for a number of consumers), then this exemption would create the opportunity for the owner/shipper to impose monopoly rents on downstream users.

The MEU suggests that the wording be changed so that an exemption from arbitration would not apply if there is an end user of the gas that is unrelated to the shipper. This would allow the unrelated end user to ensure that the service provided by the shipper does not include monopoly rents.

The MEU also notes that the draft rules include for exemption from publishing information if the capacity of the pipeline is less than 10 TJ/day. In this regard, the MEU considers that there needs to be clarity provided in the rules for:

- Assessing the capacity of the pipeline, reflecting that a pipeline is rated on its volumetric capacity rather than its capacity to transport energy. The MEU agrees with the GMRG that there should be a standard conversion from volumetric capacity to energy capacity included in the rules
- Stating why the arbitrary 10 TJ/d has been set, below which information need not be published.
- Providing clarity on how the 10 TJ/d benchmark is to be interpreted for distribution networks. Specifically, the MEU considers that the 10 TJ/d

benchmark should relate to the capacity of the entire distribution network, ie the rated capacity at the entry to the network.

Limitation of access to arbitration

The MEU restates a view that it has consistently made, in that the proposed approach still provides a barrier to smaller gas users to access the process due to the costs involved in the process compared to the likely reward a small user might gain from obtaining a benefit from the process. This provides the service provider with the continued ability to retain monopoly rents.

The MEU is very concerned that this issue has not been addressed as there has been an active decision to prevent smaller users from being made aware that lower tariffs might be available through confidentiality requirements of an arbitrator's decision. The MEU also notes that although a weighted average price is to be published, the timing of the release of the weighted average price imposes a considerable delay on other access seekers being aware that lower transport prices might be available

Assessment of the value of the assets used in provision of the service

As noted in its response to the Options paper on arbitration, the MEU strongly supports greater direction being given to the arbitrator in valuing the asset base to be used for setting prices. While noting the GMRG has proposed wording where greater direction is proposed ie

(i) "if the non-scheme pipeline was commissioned before 1 July 2008, in the manner provided for in rule 77(1)(a);
(ii) if the non-scheme pipeline was commissioned after 1 July 2008, in the manner provided for in rule 77(1)(b); or
(iii) if the non-scheme pipeline has previously been subject to an *access arrangement*, in the manner provided for in rule 77(3)."

the MEU points out that even this increased direction will present considerable challenges to the arbitrator for pipelines commissioned before 1 July 2008. The MEU also notes that there will be challenges in assessing the amount of capital recovery for all pipelines, including those commissioned after 1 July 2008.

The MEU highlights that the AER (and the ACCC before it) have experienced considerable difficulty in applying the section 8.10 of Gas Access Code rules in reaching an appropriate asset base as proposed by Rule 77(1)(a). Further, the MEU points out that even 77(1)(b) needs to be clarified as this presents the potential for double counting of inflation in the "asset value times rate of return" calculation.

The MEU points out there are a number of major issues that need to be more clearly explained

1. Referring to Box 2, there is considerable difference between first dot point (a) and first dot point (b). This aspect has created considerable debate over the years (and is still being debated) as to whether "depreciated actual cost (DAC)" should be used in preference to depreciated optimized replacement cost (DORC)". The different approaches to asset valuation are also impacted by the rate of return on the assets that is used.
2. As the commercial arbitration approach only makes reference to the rate of return having to be "a commercial rate of return" there needs to be some more definition as the usage of DORC asset valuation described under 77(1)(b) requires the return on assets to be a "real" rate of return whereas a DAC valuation described under 77(1)(a) requires a nominal rate of return to be applied. The MEU points out that the AER is currently having difficulty in developing a "real" rate of return due to the challenges in the setting of forward looking inflation rates essential in developing a "real" rate of return
3. The MEU notes that the amounts of capital recovery that have been made in the past (whether using post or ante 1 July 2008 cut of) vary considerably dependent on what the life of the asset was expected to be when the pipeline was first built, what its life might be under various changed circumstances and whether it was built with a 15 year exemption from coverage. These changes will impact what capital might have been recovered in the past and this will introduce significant debate; so the issue needs to be better clarified. For example, the tariffs on a pipeline built with an expected 15 year life will have a much greater capital recovery included than the same pipeline built with an expected life of 60 years, where the tariffs would reflect a lower rate of capital recovery.
4. The price paid for a pipeline asset for sale will be based on the expectation of the tariff used and volumes of gas transported into the future. A tariff reflecting monopoly rents will therefore attract a higher sale price and potentially an increased asset valuation. This then would imply that dot point 1 item (j) might provide an inflated assessment of the asset value for the pipeline. The MEU considers that pipeline sales data has the potential to include considerable monopoly rent taking and should not be used for asset valuation for the arbitration process[4].

The MEU has been involved in a number of asset valuation processes with regulators and points out that asset valuation is a very challenging exercise, even where the rules are apparently clear and unambiguous.

While supporting there being more direction provided to the arbitrator, the MEU considers that the proposed initial rules are insufficient for avoiding considerable debate about asset valuation. The MEU notes that the arbitrator may seek help via an expert, but the MEU highlights that the lack of direction still leaves considerable doubt regarding the issue.

[4] The MEU points out that consistently energy transport asset sales exceed the regulatory asset base by factors ranging from a 30% premium to a 70% premium, implying asset sales are a poor basis to base an asset value for tariff setting

Further, as the MEU noted in its previous response on arbitration, the methodology included in the framework could result in the bizarre situation where one arbitrator delivers a different outcome for the same pipeline for different shippers/end users.

With this in mind, the MEU considers that, rather than require the arbitrator to develop its own approach to assessing the current value of the asset from the range of different approaches set out in section 8.10 of the Gas code (as outlined in Box 2 first dot point) the MEU considers that much more direction is required to be applied than proposed with the revised approach. Specifically, the MEU considers that the arbitrator should require the AER to develop an appropriate asset value for the pipeline under consideration and to advise whether a nominal or real rate of return should be applied to the asset value so calculated.

Non-price terms of access

The MEU is concerned that non-price terms of access can effectively increase the overall cost to the end user of the service provision. With this in mind, the MEU considers that the arbitrator should be required to ensure that the non-price terms are not made onerous and the cost implications of the terms and conditions are included in the overall cost assessment by the arbitrator. In this regard, the MEU notes that there appears to be an assumption that the standard terms and conditions offered by the pipeline owner might be acceptable. The MEU considers that it should be made clear that acceptable terms and conditions must reflect those more generally seen in the transport of gas.

For example, a non-price term of access might be for the requirement for an automatic ratcheting of MDQ where the MDQ is set on an unusual operational condition of gas usage which is unlikely to be replicated. Another non-price term might be where the cost and frequency of over-runs is set at an exorbitant level and bears no relationship to the costs incurred by the pipeline owner or the impact on the operation of the pipeline.

The MEU considers that the arbitrator should be required to include in its assessment the impacts of non-price terms on the overall cost to the end user of the service provided and that the terms and conditions set reflect gas pipeline services seen more generally, both in Australia and overseas.

Disclosure of information

The MEU notes that the details (especially price) of an arbitrator's determination will be kept confidential. While the MEU agrees that certain information about the determination should be kept confidential, the MEU questions how smaller users can access similar terms without going through the costly process inherent in arbitration.

As the MEU notes above, cost should not be a barrier to all end users of the same service to having similar prices to those determined by the arbitrator – after all, regulation provides all end users (large and small) with the same benefits without the expense of arbitration.

Without disclosure of price information, small end users will still be exposed to monopoly rent taking. The MEU notes that a weighted average price must be published for each pipeline service offered, but not in the case where there are fewer than three users of the pipeline. The MEU points out that this criterion has the potential to be misused. For example, where there are only one or two retailer/shippers using the pipeline or where one retailer/shipper has contracted all of the pipeline capacity, this would preclude the publication of a weighted average price. This circumstance would preclude potential shippers of seeing what the average price(s) might be.

While the MEU accepts that publishing information which might provide an indication of price(s) paid by an **end user** should be avoided, the MEU agrees there is a need to conceal the price(s) two or less **end users** might be paying. However, the MEU considers that where a shipper is a retailer/shipper (ie a shipper providing a service for multiple end users), there should not be an exemption from publishing a weighted average price

The MEU also notes that the pipeline owner must provide information to a shipper so the shipper can assess the reasonableness (or otherwise) of the proposed conditions for access to the pipeline. The question is raised as to whether a failure to provide sufficient and/or accurate information should be assessed as a civil or conduct obligation. The MEU is concerned that if the penalty is a conduct obligation, this imposes a further cost barrier to accessing adequate information. Already there is a cost barrier for smaller users of gas due to the costs of the arbitration and these costs would further increase if the shipper has to seek a court order to provide the required information.

With this in mind, the MEU considers that a civil penalty enforced by the AER is the appropriate approach.

Allocation of indirect costs to a pipeline

It is recognised that, with the significant concentration of ownership of gas pipelines existing on the east coast gas network, pipeline owners will have within their fleets a mix of regulated, light regulated and unregulated pipelines, as well as other assets providing revenue. This provides the pipeline owners the opportunity to allocate costs in a way that maximizes the benefit to the pipeline owner.

While the direct costs for each element in the asset portfolios of the pipeline owners can be allocated reasonably to each pipeline or network, there are considerable costs that cannot be so readily allocated on an equitable basis. Of these the most obvious is overheads but care also needs to be taken to ensure that umbrella operating agreement costs are also allocated equitably so that each element of the portfolio is appropriately allocated the indirect costs applicable to each.

The MEU considers that the new rules need to stipulate some method to allocate indirect costs equitably and appropriately between each element of the portfolio to ensure that cost shifting is prevented. Further, the MEU considers that there needs to be an independent auditing function applied so that in aggregate across all assets in a pipeline owners portfolio the allocation of indirect costs (including overhead and umbrella contracts) reflects the total of the indirect costs incurred by the owner.

The MEU also notes that the issue of related party contracts has been a focus of regulators over the years. A related party contract allows the ability for overstating the value of a contract for service with the premium recovered by the owner through the profits of the related party. The MEU considers that the new rules need to ensure that the commercial arbitrator has the necessary powers to ensure that costs for service incurred by a related party are reflective of what would occur should the service be provided on a competitive basis.

We appreciate the opportunity to have provided this input to the draft initial rules Should you wish for amplification of any of the comments provided in this response, please contact our Public Officer (David Headberry) on 03 5962 3225 or at davidheadberry@bigpond.com .

Yours faithfully

David Headberry
Public Officer