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To whom it may concern,

The Energy Users Association of Australia (EUAA) is very pleased make this submission to the Gas Pipeline Information Disclosure and Arbitration Framework review.

The EUAA is 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.

**Introduction and summary**

The EUAA strongly agreed with the findings in the December 2016 report to COAG energy ministers *"Examination of the current test for the regulation of gas pipelines" (Examination)* around the large imbalance of bargaining power faced by shippers when seeking access to pipeline services. We also agreed with recommendations made to reduce this imbalance around:

1. Increased disclosure and transparency on pipeline services to be made available to the shipper to reduce the large information asymmetry, and
2. A framework for binding arbitration for all open access pipelines in the event parties are unable to reach a commercial agreement

We believe these recommendations will help achieve the objective of more timely and effective commercial negotiations between shippers and the operators of non-scheme pipelines

This submission sets out our comments on the Implementation Options Paper ("Options Paper").

At the outset, we believe that the recommendations in the Options Paper are a necessary, but not sufficient, condition to address the "…significant imbalance of bargaining power between pipeline operators and shippers in their negotiations." (p.10). As we have seen in the case of electricity network regulation, the provision of hundreds of pages of information from networks does not automatically lead to a more even playing field for consumers seeking to engage in debate on the revenue cap process or a Limited Merits Review appeal to the Australian Competition Tribunal. Even the AER struggles to fully review the volume of information provided.

Generally, the EUAA supports the direction the Options Paper is heading in – with our preference to go further regarding information disclosure and arbitration principals that address information asymmetry between the pipeline operator and the shipper in resources and bargaining power.

While increased information disclosure combined with the shipper having the option of binding arbitration as proposed in the Options Paper is a significant improvement on the current situation, we do not believe it will address the significant imbalance in resources and bargaining power, between pipeline operators and end use gas customers. The Options Paper agrees: (p.73):

> "It is recognised that even with the additional information contemplated by this paper, there will still be a disparity between the resources and knowledge held by the pipeline operator and the shipper. It is important the arbitration framework does not leave the shipper at a significant disadvantage during the arbitration process and costs are limited to the extent possible."

The EUAA believes that the following principals should drive the minimisation of this resource and bargaining asymmetry and increase the chances of reaching a negotiated outcome without having to go to arbitration:

- The more information provided up front to the shipper, prior to and during the negotiation process, the better.
- An arbitration process that has checks and balances to prevent the pipeline operator gaming the system which suggests less rather than more discretion of the arbitrator.

For many end use gas customers, the prospect of getting into binding arbitration is not something they would welcome. They simply do not have the resources to match the pipeline operator. So, if they are reluctantly forced to go into arbitration, they need to have confidence it will be conducted on a reasonably level playing field.

As the Options Paper comments (p.14):

> "In general, the new information disclosure and arbitration framework should…
>
> Not impose an excessive burden on parties, in terms of time and/or cost."

For these reasons this submission supports:

*Information disclosure – two tiers*

Tier 1 – Option 3 to be published on the pipeline operator's website – with guidelines developed by the AER. Our preference for option 3 over Option 2 is based on our view that the pricing principles require the arbitrator to apply a cost of service methodology.

Tier 2 – Option 5 to be provided only when a shipper seeks to negotiate with the pipeline operator. The additional information required over Option 3 would be provided only to the potential shipper and only under a confidentiality agreement.

*Arbitration mechanism*

Option 3 – Conventional arbitration with enhanced procedural protection and partial transparency

*Arbitration principles*

Option 3b - Pricing principles based on the actual cost of service provision (including a commercial rate of return) supplemented by other principles (including principles on how the prices of derivative and ancillary services should be determined) with further guidance in pricing principles on how the assessment of the reasonableness of the offer is to be carried out.

Ideally the pricing principal would be based not on the "actual cost of service" but the "efficient level of costs". A cost based pricing methodology rewards inefficiency in a pipeline's capital and operating costs with shippers having to pay for this inefficiency or so-called "gold plating". We would encourage the GMRG to explore ways that an efficiency element might be introduced to the arbitration process to assess a cost based tariff.

The arbitrator would have less rather than more discretion to limit the ability of the pipeline operator to game the arbitration process. The arbitrator would have the use of AER developed guidelines in key areas and the shipper would have the ability to bring in the AER for independent advice. There would be procedural safeguards e.g. set timetable for a decision that is not appealable, no legal representation permitted, limits on the volume of submissions parties can submit and on the introduction of new arguments not raised during the negotiation process.

We have no desire to see a repeat of the extensive arguments between electricity networks and the AER and no desire to see the arbitration become some variation of the Limited Merits Review process.

A final point to note is that even if the proposed changes do achieve their objectives, it may well have only limited beneficial impact on the competitiveness of delivered gas prices over the next two years.

Commercial and industrial gas users currently seeking a new or replacement gas contract face a combination of lack of gas availability and, where it is being offered, extraordinarily high prices that are well above LNG netback. When gas is being offered at $15-20/GJ excluding transport, even a significant reduction in transport charges (probably very unlikely) will make significantly less difference to the viability of gas users than if the offered gas price were an LNG netback of say $6-8/GJ.

Many medium to large gas users are unable to survive for long paying $15-20/GJ + transmission/distribution. It remains to be seen that the prospect of demand destruction from high gas commodity prices is a more effective constraint on pipeline operators' behavior than the changes we are discussing in this Options Paper.

## 1. Information disclosure

A number of EUAA members have had first-hand experience of information asymmetry in negotiations with operators of non-scheme pipelines. The data in Table 3.1 of the Options Paper clearly shows the lack of information currently provided. While this will change slightly with the current AEMC reforms and rule changes, we agree with the Options Paper that much more needs to be done to achieve the desired level of transparency.

The more information provided to the shipper the more the information asymmetry is broken down and the more the bargaining asymmetry is broken down. Information provides increased discipline on the pipeline operator and should facilitate a much clearer and hopefully quicker negotiation process. This in turn means there is a higher chance of a negotiated agreement without having to go to the costs of a binding arbitration. As the report notes (p. 4):

> "The extent to which the arbitration mechanism will need to be triggered will, in part, depend on the efficacy of the information disclosure requirements. That is, if shippers have access to the information they require to assess the reasonableness of offers and the parties negotiate in good faith, then resort to arbitration should rarely be required."

In terms of the other categories of information:

*Costs and other financial information*

We support the conclusions reached by both the *Examination* and the ACCC East Coast Gas Report that the lack of information on pipeline costs can hide the existence of monopoly profits and hence there should be disclosure of cost information. If the pipeline operators are confident they are offering cost reflective tariffs and not earning monopoly profits, then they have nothing to be concerned about in publishing the cost data to prove their position.

In a competitive market buyers get cost discovery and confidence that prices are around their efficient level through the competitive negotiation process. This is not possible with monopoly pipelines.

Even where the pipeline has the appearance of having competition (and we are not aware of any pipeline that could be described as being in this situation), the ACCC found that competition from other pipelines and services may not be as effective in constraining the behaviour of pipeline operators as might be expected.[1]

It is impossible to determine whether the pipeline operator is earning monopoly profits if only general company-wide financial data is published. The appropriate test is whether monopoly profits are being earned by each pipeline, not by the operator "overall". In the absence of regulatory oversight, the shipper needs to have the information to do a bottom-up analysis of the pipeline operator's costs to understand if the offer is at an efficient cost level and if there is an indication of monopoly profits are being earned.

The lack of this information during the commercial negotiations is simply going to decrease the chances of a successful negotiation and increase the incidence of proceeding to binding arbitration.

We agree that our preferred information disclosure will require the pipeline operator to maintain detailed separate accounts for each pipeline – just as it does now with scheme pipelines. There will need to be clear guidelines on how joint and common costs e.g. overheads, are allocated to each

[1] ACCC, Inquiry into the east coast gas market, April 2016, p. 98.

pipeline so there is not cross-subsidisation between pipelines which may distort the level of profitability for individual assets.

We have difficulty understanding how the provision of this additional information will impose significant costs on pipeline operators. A well-run business should have most, if not all, of this information already available internally. How else is management going to present their commercial negotiating strategy for internal approval without detailed knowledge of the costs of provision of each service for each pipeline? We see the additional cost of publication as much less significant than is implied in the Options Paper. We would expect that for much of the information it would be a case of simply adjusting existing information into the appropriate form for publication according to the AER guidelines.

*Prices paid by other shippers*

The EUAA supports the publication of prices (and associated terms) paid by other shippers in some aggregated form, recognising the bespoke nature of many pipeline contracts in Australia.

We are not convinced by the arguments discussed in the Options Paper that are advanced by some stakeholders against this approach:

- Yes, past prices charged before this proposed regime comes into place may provide no real insight into the prices being offered to the first shipper after the new regime comes into place, but they could give an indication of the level of monopoly profits earned by the pipeline operator in the past. But the second shipper under the new regime will learn a lot from the prices paid by the first shipper
- In our members' experience, shippers are interested in the price paid by other shippers to assess whether a tariff reflects the efficient level of costs; whether or not the other shipper is a competitor or not is irrelevant
- Unlike the APGA, we do not see homogeneity as necessarily a bad outcome; in fact homogeneity, if it is reflecting a situation where the same efficient cost based price is charged for the same service, as a pretty good indication of a competitive market and hence something that should be welcomed
- Further, we are surprised the APGA seems to thinks its members are incapable of differentiating customers for the particular benefits they may bring to the pipeline operator. Discounts/price discrimination happens for all sorts of reasons in competitive markets – buy an electrical appliance from retailer 1 this week and it could be cheaper than last week because they have a particular sales target to reach this week. Does the APGA think that a process that goes something like:
    - Shipper 2 gets detailed information on the individual pipeline's costs and details on what shipper 1 is paying
    - Shipper 2's bottom-up analysis indicates that the price to shipper 1 is below an efficient costs based price and asks the pipeline operators for the same discount
    - Pipeline operator says Shipper 1 got a special deal because of x and y and as shipper 2 does not bring these advantages, the price to shipper 2 is higher than shipper 1

  That shipper 2 will take the pipeline operator to arbitration seeking the same price as shipper 1? We would be surprised if shipper 2 would be successful.

Our members recognise there may be limitations on the relevance of this price/terms information. However, this is not a reason for not publishing it. It is a reason for publishing it in a way that

ensures the shipper is able to evaluate it in comparison with the conditions it is seeking e.g. if shipper 2 is looking for say MDQ at 105% and shipper 1 paid $x/GJ for MDQ at 110%, this information gives a data point to assist shipper 2 in their negotiation.

To argue that it should not be published simply perpetuates the information asymmetry. With the information available, along with the detailed cost information (by pipeline), the pipeline operator and the shipper can then have a much more informed negotiation about what shipper 2's price should be. This, again, increases the chance of arriving at a negotiated outcome without resorting to binding arbitration and its associated costs.

The fundamental proposition here is that more information, with the appropriate context explained, is much better for an efficient negotiating outcome. Less information simply leads the shipper to think that pipeline operators have something to hide and increases the chances of getting to potentially expensive binding arbitration or the shipper caving in if they cannot afford the arbitration.

We are not convinced that the confidentiality issues are as important as the Options Paper suggests. We think there is a case for this type of information to only be made available to genuine potential shippers under a strict confidentiality agreement i.e. not available, like the base information, on the pipeline operator's website.

Given this:

- If shipper 2 is not a competitor with shipper 1 then we fail to see an issue around confidentiality
- If shipper 2 is a competitor with shipper 1 then if the pipeline terms and conditions to all shippers are designed to reflect a competitive market outcome, then it should not be surprising that shipper 2 gets comparable prices/terms to shipper 1 (unless, of course, as discussed above, shipper 1 offers something that shipper 2 cannot)

We wonder about the confidentiality concerns about shipper 2 knowing the transmission price its competitor, shipper 1, pays when both know that transmission tariffs for every shipper on that pipeline are set on the basis of the actual costs of service provision.

The final point to note is that while increased information disclosure is helpful, the "bargaining" resources available to the pipeline operator, particularly where they are negotiating with an end use customer, are likely to be significantly greater than those of the shipper. As the Options paper notes (p.59):

> "For example, retailers that have a portfolio of gas supply and transportation contracts are likely to have increased bargaining power as a result of their size, understanding of the market and their needs relative to smaller parties. They would also have more resources to devote to the negotiation process."

This is a quite different situation for an end use customer. The more information provided up front, the lesser the bargaining advantage of the pipeline operators and the higher the chance of getting to a negotiated settlement, which we all agree is the best outcome.

Summary – Information Disclosure

The EUAA supports a two-tier information disclosure process:

Tier 1 – Option 3 to be published on the pipeline operator's website – with guidelines developed by the AER. Our preference for option 3 over Option 2 is based on our view that the pricing principles require the arbitrator to apply a cost of service methodology.

Tier 2 – Option 5 to be provided only when a shipper seeks to negotiate with the pipeline operator. The additional information required over Option 3 would be provided only to the potential shipper and only under a confidentiality agreement.

This two-tier approach is seen as the best option to:

- Address the information asymmetry around the price/service bundle offer to the shipper and the bargaining asymmetry given the mismatch in resources between the negotiating parties
- Increase the chances of a there being a negotiated outcome without having to go to binding arbitration.

Proceeding with just Option 3 will impose a cost on shippers to undertake the analysis to try to second guess the data for the particular pipeline they are considering using. So why not have that information available under Option 5 at the start of the negotiations? Why does the shipper have to wait (and pay half the costs of) to eventually get that information as part of the binding arbitration process?

The EUAA does not believe the costs of disclosure are as high as implied in the Options Paper.

Implementation issues

The EUAA agrees with:

- the proposed exemptions in paragraph 3.4.6.1:
    - for particular pipelines from all disclosure requirements, and
    - for limited disclosure for smaller pipelines below a minimum reporting threshold, similar to the practice in Canada
- the proposed compliance role for the AER in paragraph 3.4.6.2
- the publication of the Option 3 information annually within 4 months of the end of the pipeline operator's financial year applying guidelines developed by the AER in paragraph 3.4.6.3
- there being circumstances where it would be reasonable for the shipper to pay the reasonable costs of the pipeline operator's specific studies eg where new/expanded investment in pipeline capacity is required as discussed in paragraph 3.4.6.5

**2. Arbitration**

The EUAA supports the concept of arbitration as a dispute settlement method where negotiations are at an impasse. In particular, we support the concept of a non-judicial approach to dispute resolution for the reasons set out in Paragraph 4.1 of the Options Paper. Our experience with the Limited Merits Review process for electricity networks has shown how judicial processes can work in the opposite direction to the National Electricity Objective.

We recognise arbitration does have limitations but believe that measures can be taken to reduce these through increased information disclosure as discussed above and protocols around the arbitration process discussed below.

*Design proposals to reflect key arbitration characteristics*

The EUAA:

- Agrees in principle with the proposal that the request for arbitration should be made in writing and in accordance with the pipeline operator's negotiation framework. However, we need to have confidence that the pipeline operator has not been able to "game" the negotiating framework to their advantage. Will a shipper be able to appeal to the AER if they consider this framework to be biased?
- Agrees with the need to protect existing contractual rights
- Has questions around the proposed safeguards to avoid distorting investment and innovation e.g.
    - While the shipper might be happy to fund the expansion, what if the shipper believes that the chosen pathway to construct the expansion eg chosen contractor, is not the cheapest? What incentives does the pipeline operator to ensure the lowest cost expansion given the price is a pass through to the shipper?
- Agrees with the role of the AER as proposed in paragraph 4.4.1.4
- Agrees with the role of the AER in publishing a guide to arbitrators and the arbitration mechanism, establish and maintain a list of arbitrators, and the timetable for the appointment of the arbitrator
- Agrees that arbitration should be final and binding on the parties, and the rules for seeking a variation and enforcement – particularly supporting the inability to appeal to the Australian Competition Tribunal for a review of the determination

*Costs*

An efficient regulatory system minimises transaction costs. In this case, the cost minimisation objective is best achieved by doing everything possible to ensure a negotiated agreement is reached and arbitration is not required. This is best achieved by giving the shipper access to all the information under Option 5, rather than the shipper having to effectively pay half the costs of getting that information through an arbitration process.

The issue of costs is particularly important for end users who do not have the resources of either the pipeline operator or large retail shippers. As the Options Paper notes, smaller end users in particular are likely to be concerned about going into arbitration given the likely costs and this may act as a barrier to them proceeding to arbitration. We agree with the comment (p.74):

> "Adequate safeguards need to be in place to ensure the arbitration process does not provide a platform for pipeline operators to exert their superior negotiating power resulting from the disparity in resources able to be dedicated to an arbitration compared to a small industrial gas user."

The EUAA agrees with the proposed approach – give the arbitrator the ability to apportion costs other than 50/50, to seek to limit costs and the AER to cap the arbitrator's fee.

*Form of arbitration*

On the basis of a high level review of the options presented, it appears that the Paper's preferred Option 3 - Conventional Arbitration with enhanced procedural protections and partial transparency – offers the best outcome for shippers:

- Covers disputes over all aspects of access – not just pricing as with Option 2
- Procedural requirements are designed to minimise costs and hence may assist smaller parties which do not have the same resources as the pipeline operator; requirements also reduce the ability of any party to game the arbitration process
- The risk of the AER's advice compromising the independence of the arbitrator is considered very low; arbitrators are appointed because of their particular expertise in assessing particular points of view – whether they come from the parties involved or the AER
- We are not concerned about risk of reputational damage that a shipper might suffer from the public's knowledge that it is involved in an arbitration process; publication is more likely to result in the shipper getting support from other shippers for being willing to exercise their rights under the National Gas Law

**3. Arbitration Principles**

The EUAA supports:

- Arbitration to assess the reasonableness of the pipeline operator's offer based on the "efficient" level of costs rather than the "actual" costs the pipeline operator incurs (including a rate of return on capital) in providing the service; we would encourage the GMRG to explore ways that an efficiency element might be introduced to the arbitration process to assess a cost based tariff.
- The arbitrator having only limited discretion by having to employ a particular methodology when assessing whether the price offered is reasonable which is part of wider procedural controls to limit the ability of the pipeline operator to game the arbitration process.

We agree with the problems discussed in the Options Paper around the use of the alternative "prices paid for comparable pipeline services by other pipelines" approach. For example, apart from the difficulties in finding representative set of prices from other pipelines, and then undertaking the adjustment to make them comparable to the circumstances of the pipeline in question, we wonder how the issue of confidentiality would be handled. How would a shipper know if the prices were indeed comparative without knowing the original prices from the comparative pipelines? How would the shipper know whether those prices contain an element of monopoly rent?

Alternatively, using prices charged by the pipeline operator for services in other pipelines in its portfolio gives the shipper no confidence that the comparison will enable the pipeline operator to earn monopoly profits on the pipeline, which is the subject of the arbitration.

The argument that this approach provides for a straightforward and hence quick and low cost arbitration ignores the aim of the shipper to have the lowest overall cost of negotiation/arbitration + tariff. End users are not interested in a low cost arbitration methodology that leaves them with a monopoly price under their transport contract.

The EUAA supports the cost of service approach even though it is more complex, because it hopefully, removes the monopoly-pricing element that is the root cause of our concern.

In calculating the cost of service, the EUAA agrees with the shortcomings of the 'hypothetical new entrant' standard expressed in the Options Paper. There is simply little or no chance of direct competition for existing pipelines in the Australian market. Attempts to apply it would prolong the arbitration process and add significantly to costs. As the Options Paper notes:

> "(Using the 'actual cost' standard) is consistent with the view expressed by shippers that the prices charged by some pipeline operators are not cost reflective and either build in inappropriate revaluations and/or do not properly account for past recoveries of capital from shippers. While no conclusion has been made as to whether these assertions are correct, it would seem inappropriate for the new arbitration mechanism to not have the scope to address this contention."

Ideally the pricing principal would be based not on the "actual cost of service" but the "efficient level of costs". A cost based pricing methodology rewards inefficiency in a pipeline's capital and operating costs with shippers having to pay for this inefficiency or so-called "gold plating". We would encourage the GMRG to explore ways that an efficiency element might be introduced to the arbitration process to assess a cost based tariff.

A key issue for our members is that the asset value methodology for assessing the 'actual cost' considers both past and future recoveries and excludes inappropriate revaluations. Our position on information disclosure is to support the publication on the pipeline operator's website of asset values that reflect actual capital expenditure and recoveries at the relevant date.

What our members are concerned to see removed is the ability of pipeline operators to recover their historical capital multiple times. The asset value should be locked in with no revaluations allowed and cost recovered only once. For example, in the case of a new pipeline that is project financed over say a 15 year period of the foundation contracts where all debt and at least some equity is repaid at the end of that 15 years, the cost base in year 16 should exclude the debt and the portion of equity repaid by the end of the foundation contracts. It should be reflective of sustaining capex and operating and maintenance costs.

Related to this is our concern around how the arbitrator will assess the 'commercial rate of return' given the pipeline's risk profile. The Options Paper refers (p.133) to the Revenue and Pricing Principles in the NGL as "a useful starting point" and at footnote 208 p.139 it simply notes:

> "The commercial rate of return should be commensurate with the conditions in financial markets and the risks involved in providing the service."

While the arbitrator can draw on other WACC measures e.g. from the work of the AER, ACCC, ERA and IPART, our concern is that there will be extensive submissions from the pipeline operator seeking to re-argue the case. It is the desire to avoid this situation that the current Limited Merits Review is working towards developing a rate of return guideline covering WACC and gamma that is not appealable to the ACT and would apply for a period of time before review.

The EUAA supports less rather than more discretion for the arbitrator, though, given the short time for preparing this submission, we have not been able come to a firm view on where the division should lie between the discretion of the arbitrator and the application of AER guidance. Here are some thoughts:

- AER guidance on how the asset value calculation is undertaken as well as pricing principles and derivative and ancillary services

- AER to set a rate of return guideline covering WACC and Gamma along the lines currently under consideration in the LMR review
- Ability of the shipper to call on the AER's expertise during the arbitration

We would also support the development of more detailed procedural guidelines e.g. set timetable for a decision that is not appealable, no legal representation permitted, limits on the volume of submissions parties can submit and on the introduction of new arguments not raised during the negotiation process. These would be similar to those currently under consideration in the LMR review.

Summary - Arbitration

Our preference is for Option 3b. We support the comments in the Options Paper (p.141):

> "The main advantage of this option is that it will reduce some of the potential sources of dispute that could otherwise arise under Option 2b and provide for a more timely resolution of disputes."

The key advantage over the GMRG's proposed option 2b is that we favor more direct guidance to be provided to the arbitrator on asset values. Our concern is that given the importance of the starting asset value to the eventual pricing level, arguments between the parties over the methodology to determine these values could significantly extend the time and cost of the arbitration process and be a barrier for many smaller gas users to triggering arbitration. We have seen the efforts network go to in these matters with the AER and then ACT appeals for electricity networks and we have no interest in repeating that experience with gas pipelines.

**4. Transitional Issues**

We have not had the opportunity to review the proposed transition arrangements and timetable in any detail. We do support the new rules coming into effect as soon as possible and 1st August 2017 seems a reasons date. We also support the disclosure of cost base information earlier than April 2019. As we noted above we do not believe the costs of information disclosure are large.

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