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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
Response to Implementation Options paper

The Major Energy Users (MEU) welcomes the opportunity to provide its views to the Gas Market Reform Group (GMRG) on its options paper for gas pipeline Information Disclosure and Arbitration Framework.

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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. Throughout the MEU's responses to the various enquiries, it has provided firsthand accounts from its members in regard to 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 a 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 negotiating powers between a gas pipeline monopoly and gas shippers, be they direct end users or retailers acting on behalf 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 monopoly pipelines.

This response to the options paper does not imply agreement with this decision – the MEU still considers that where a pipeline exhibits monopoly characteristics[1], then that pipeline should be regulated. As advised in our letter of 6 February 2017 to the CoAG Energy Council, even the Australian Energy Regulator, with its resources and powers of information gathering, still has challenges in ensuring there is an equitable outcome for shippers when there is no alternative available to the transport of gas from the source of gas to an end user. The MEU therefore 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 Options paper

Economic efficiency must underlie the arbitration process

At the forum with the GMRG executive, it was mentioned that the GMRG activities (including the commercial arbitration process) do have to reflect economic efficiency which is at the heart of the National Gas Objective (NGO). This point was highlighted as it was stated that this aspect was not made explicit in the options paper but was inherent in the GMRG activities.

In contrast to this view, the MEU notes the GMRG observation (page (v) of the Options Paper):

> "In contrast to the regulatory framework that applies to scheme pipelines, which is underpinned by economic efficiency principles, the new information disclosure and arbitration framework is intended to be more commercially focused with its overarching objective to provide for 'reasonable and transparent' access to nonscheme pipelines.
>
> **While the objective is not economic efficiency**, the expected improvements to the timeliness and effectiveness of commercial negotiations and the behaviour of pipeline operators, can be expected to result in:
>
> - more efficient investment in, and efficient operation and use of, natural gas services than would be the case if the status quo was maintained; and
> - the prices charged for pipeline services better reflecting the cost of service provision and the prices that would prevail in a workably competitive market.
>
> The ultimate beneficiaries of these improvements will be consumers of natural gas. The introduction of the new framework into the NGL and NGR can therefore be

[1] 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 regulation in Australia is considered to be inappropriate.

> expected to promote the *National Gas Objective* and contribute to the Council's *Australian Gas Market Vision*." (emphasis added)

This GMRG statement in the Options Paper effectively posits the view that by **not imposing a need for outcomes of the arbitration process to reflect economic efficiency** this will result in achieving the NGO which is all about a need for achieving economic efficiency. The MEU notes that as the process proposed for commercial arbitration is to apply to unregulated pipelines that provide a monopoly service, so the assumption that commercial arbitration will result in outcomes replicating a workably competitive market in the absence of a requirement that the outcome of the arbitration is to be economically efficient, is extremely farfetched.

The MEU also notes that the Options Paper states (page 124):

> "The GMRG agrees with these views [that the arbitrator should not be required to take into account the NGO or that economic efficiency should be the central focus or the extent to which the arbitrator considers appropriate as these] ...would introduce a considerable degree of uncertainty into the arbitration and adversely affect the timeliness of the arbitrator's decision."

The MEU does not agree that the NGO should not be taken into account by the arbitrator. The National Gas Law (NGL) states that (section 23):

> "The objective of this Law is to promote efficient investment in, and efficient operation and use of, natural gas services for the long term interests of consumers of natural gas with respect to price, quality, safety, reliability and security of supply of natural gas."

This means that any activity which is covered by the NGL must reflect the requirements of the Objective. To allow a party to make decisions regarding issues covered by the NGL which do not take into account the Objective, contravenes the Law.

The MEU also notes that the decision by governments (eg as explained in the second reading speeches on the introduction of the national energy Objectives) is that consumers will benefit through imposing an economic efficiency requirement on gas and electricity networks. The MEU points out that the decision to impose commercial arbitration on unregulated pipelines that provide a monopoly service arises from the view express by the ACCC and subsequently endorsed by the CoAG Energy Council that some control is required over these pipeline, short of exposing them to full regulation.

The MEU notes the observation that timeliness is a factor in the GMRG decision to specifically exclude the NGO and economic efficient outcomes from the arbitration process. The MEU points out that end users would prefer the right outcome, even if that takes longer to achieve. A faster but incorrect outcome does not address the

concerns raised by the ACCC or the AEMC in their reviews of the east coast gas markets.

Additionally, the MEU notes the concern that the GMRG expresses regarding the introduction of uncertainty into the arbitration if the NGO and economic efficiency was made central to the process. The MEU considers that the process increases certainty by having economic efficiency as a core aspect to the arbitration process and the GMRG does not explain why it is of the view that excluding an explicit requirement for economic efficiency in the outcomes provides any benefit other than to the owners of monopoly pipelines.

The MEU considers that the new commercial arbitration process proposed must be predicated on delivering economically efficient outcome for shippers and which are in the long term interests of consumers and this essential consideration has guided the MEU in its analysis of the options for developing commercial arbitration in lieu of full regulation.

Will the threat of commercial arbitration incentivize better negotiation?

While the GMRG posits that establishing commercial arbitration, the MEU considers that an in-depth analysis must be undertaken as to why the threat of arbitration will encourage both the owner and shipper to negotiate in good faith. The experiences of MEU members so far do not support this contention. In its simplest form, the threat on pipeline owners is that commercial arbitration will deliver lower prices for access and transport plus the costs it will incur as a result of arbitration. The pipeline owner may also be concerned about the flow on to other shippers of any arbitrated decision.

It is currently proposed that the costs of arbitration are to be shared, or allocated at the discretion of the arbitrator and the arbitrated decision be kept confidential.

The proposed change is that, on request of a shipper, an owner will make an offer of access at a certain price and the shipper can either accept the offer or not. If the shipper does not accept the offer, it can initiate arbitration. The owner will be bound by the arbitrated outcome and it is the threat that a lower price might be arbitrated that is assumed to drive the owner to negotiate and so avoid the costs of arbitration. The pipeline owner knows that similar costs to those it will incur as a result of arbitration will also be incurred by the shipper so where is the driver on the owner to negotiate, other than to offer an outcome that might be less efficient and, at best for the shipper, is set at a level of an efficient price plus the costs a shipper might incur if the costs of arbitration are to be shared equally. In practice, the pipeline owner will either not negotiate (relying on its ability to game the process) or to offer an efficient price plus a multiple of the costs that the shipper might incur, reflecting that the shipper will have to justify any benefit from seeking arbitration against the risk of losing. Effectively, the pipeline owner is not incentivized to offer an efficient price during any negotiating phase.

In contrast, where a pipeline is regulated, the costs for setting efficient reference prices lies with the AER with shippers not being exposed to any significant costs (other than involvement in the regulatory process) and the benefit of the regulation means that all shippers share in the benefit of the regulatory process. It is also noted that the cost to the owner under the regulatory process is probably greater than the costs under the arbitration process as regulation can be quite intrusive.

This assessment means that the arbitration process moves costs from the pipeline owner and significantly increases them for shippers.

The MEU therefore considers that the threat of arbitration must impose considerably more cost to the pipeline owner than just the costs of the arbitration to ensure the owner negotiates in good faith. It is noted above that a shipper will only seek arbitration if it considers that the costs it will incur through arbitration will be more than offset by the rewards it might achieve. In contrast, under the proposed process, the pipeline owner might accept lower prices for the service it offers to the shipper it is negotiating with but it faces the same risk of lower prices if it proceeds to arbitration. This means that the risks to the two parties in moving to arbitration are not equal because there is a commercial driver on the pipeline owner not to negotiate in good faith.

To overcome this dichotomy, the pipeline owner needs to face more risk than the shipper if there is to be balance in the process. The MEU considers that as a result of this, the arbitration process has to impose significant risk and costs for compliance, if the arbitration process is to be considered a real threat.

The MEU sees that one way of ensuring the pipeline owner does negotiate in good faith with a shipper is if a negotiated outcome remains confidential between the owner and shipper, but if the issue proceeds to arbitration, then the arbitrated price of the access is made public so that all shippers on the pipeline can access the same benefits. This approach imposes significantly greater risk on the pipeline owner due to the flow on effect of an arbitrated decision and provides it with an incentive to negotiate in good faith.

Scope of the new arbitration process

The MEU is concerned that there is a view that the new arbitration process will be limited to apply to only major pipelines (eg MSP, EGP, SEAGas, MAPS, etc) and that minor pipelines (including laterals off major pipelines) will be exempt from the new approach. The MEU considers that all gas pipelines that provide a monopoly service should be subject to the new approach, regardless of size and capacity[2].

[2] In its report on the east coast gas market review, the ACCC did not differentiate between pipelines but focused on the monopoly characteristics. This implicitly supports a view that all pipelines, regardless of size should be subject to commercial arbitration.

The MEU considers that exempting pipelines from the arbitration process will condemn those end users requiring these to deliver gas to their premises to paying monopoly rents and this is inefficient and would permit monopoly rent taking. Specifically, the MEU considers that laterals to major pipelines must be included as well as minor pipelines.

As the AER is to be used as a "filter" to ensure that vexatious claims are not allowed to run to arbitration, the MEU considers that the rules should allow the AER to decide whether a pipeline should be exposed to the arbitration process or not. This would allow shippers to seek arbitration for any unregulated pipeline providing it can convince the AER that the shipper is potentially suffering inefficient pricing and/or monopoly rent taking

Concerns about information disclosure and the arbitration process

The MEU points out that the bulk of the revenue required by a pipeline owner revolves around the asset base and the return on capital, and these two aspects plus the amounts of capacity required by all shippers basically drive the prices offered for the service.

From its many involvements in regulatory processes for energy assets, the MEU highlights that it is the work in assessing:

- the capital base and the associated depreciation
- the extent of discretion allowed in the energy rules in setting the return on capital and
- the forecasts of capacity that is to be used

that leads to the bulk of dispute between the regulator, the asset owner and consumers.

In particular, for gas pipelines, the setting of the asset base has long been a major source of contention, especially as the Gas Access Code, and the subsequent National Gas Rules, provided options for a number of different methodologies to be used to set the initial asset value[3]. The MEU sees that this element alone will create considerable cause for debate[4] in any arbitration.

The MEU notes that there have already been built a number of unregulated pipelines where foundation contracts, typically of 15 years duration, were used to underwrite the building of the pipeline, and these were to be exempt from any regulatory involvement until the foundation contracts expired. When these foundations contracts expired, a major issue arose in the assessment of the

[3] These range from depreciated actual cost (DAC), depreciated optimised cost (DORC), optimised deprival value (ODV) and actual asset sale values
[4] The MEU can advise that this issue has already been experienced by some of its members in their "negotiations" with pipeline owners.

depreciated value of the pipeline and how much of the depreciation was recovered within the period of the foundation contracts. This then creates considerable opportunity for the asset owner to argue about the extent of the depreciation that has been included in the foundation contracts and any other contracts that were added during the life of the foundation contracts. Unless the information is provided which identifies what depreciation was included in the foundation (and other) contracts and the amounts of depreciation actually recovered, the MEU sees that this issue alone will impose considerable challenges for shippers and the arbitrator.

The MEU also points to the extensive debates regarding the rate of return for regulated monopoly assets; in fact the current review of the limit merits review process highlights that issues relating to WACC have dominated the LMR processes to date. The MEU is very concerned that the arbitrator will be exposed to just as much debate on the issue as has applied for the past decade to AER decisions.

While records of capacity actually used in the past should not be subject to contention, the MEU is aware that the amounts of capacity to be sold in the future (recognizing that it is future capacity that will be used to set future prices and whether capacity will be available) that also has been a major issue for the AER and other regulators in setting future regulated reference prices. Again the MEU can see that debates over future capacity sales will be a major cause of contention.

In relation to all three of these issues, the MEU considers that significant time and cost will be avoided if there are clear requirements for the arbitrator to be strongly guided by the AER processes. While the MEU accepts that some variation by the arbitrator to the AER approaches might lead to a more equitable outcome (eg balancing the cost of the arbitration over the benefits that might come) for all concerned, if there is a deviation from the AER guidelines, the arbitrator should be required to explain in detail why it has decided to move away from them.

The MEU draws attention to the recent discussions being held by the current LMR review where there is a distinct bias by officials of the CoAG Energy Council to have the AER rate of return guideline made binding to avoid many of the disputes that have arisen in previous years. In this regard, the LMR review has identified that different panels of the Competition Tribunal have recently delivered different (almost diametrically opposed) outcomes on rate of return issues in recent years, highlighting the complexities inherent in settling on a rate of return. This means that different arbitrators could deliver different outcomes on the same issue creating significant inconsistency and a lack of faith in the process.

The MEU questions how an arbitrator can reach an efficient outcome with the limited resources available to it when the national regulator and the Competition Tribunal require many months and deep analysis to reach decisions which can withstand the rigours of an appeal process.

Overall, the MEU considers that greater direction will lead to efficient outcomes and which should provide greater consistency in decision making, even if there are

different arbitrators. The MEU can imagine the outcry if there are two different arbitrators appointed for different shippers on the same pipeline and the different arbitrators deliver different outcomes for the same service!

Information Disclosure options

It is clear that availability of information lies at the heart of the commercial arbitration process and that there is a significant asymmetry because the pipeline owner holds all the information necessary to perform the commercial arbitration proposed. Experience of MEU members highlights that pipeline owners will minimise the amount of information they provide and by doing so make it more difficult for the applicant for access the information essential for it to be able to argue its case. In practice, it will be the applicant shipper that has to prove to the arbitrator the merits of its case in order for the arbitrator to move away from the view put by the pipeline owner. Effectively, the onus of proof will lie with the applicant.

Even the AER finds that getting sufficient information to carry out its task is challenging, so to expect the pipeline owner to provide all of the necessary information to sustain a case for change will be more difficult than under regulation as the AER has extensive information gathering powers to support its activities. With this in mind, the MEU considers that the right to more information is essential.

As a starting point for the extent of information disclosure, the MEU considers that there is little difference between the information required by the AER in developing its reference prices for a regulated pipeline to the information required by a shipper for a non-regulated pipeline. To allow a pipeline owner to provide less information under the commercial arbitration process than it is required to provide for the full regulatory model, reduces the ability of an applicant to provide sufficient argument to the arbitrator to sustain its claim

The first issue the MEU sees regarding the different levels of information disclosure is the extent of the “base level information” to be provided that is alluded to in the options paper. The MEU can accept that in an early stage, the amount of information required by a prospective shipper might be quite modest but as the shipper further develops its decision to formally seek access and prices, it will require additional information to ensure that it is not paying monopoly rents. What is most important is when the shipper decides to challenge a proposal from the pipeline owner and a decision is made to seek commercial arbitration. Once arbitration is enacted, then the amount of information required will further increase.

The various stages and information required might reflect the following pattern:

> Level 1 where the shipper needs to identify if the pipeline meets its requirements in terms of operating pressures and capacity to meet its needs. If these requirements are met, then the shipper might ask for prices to gain

access. In particular, information about available capacity (including imminent future capacity requirements) should be provided[5].

Level 2 is where the offered prices are analysed. To assess whether the offered prices are reasonable might require detailed information as to actual connection requirements and hardware to be provided, sufficient for the applicant to get independent pricing for the capital costs for the connection. At the same time, detailed information would be required to enable the shipper to develop its assessment of the ongoing costs for capacity. Such information would require sufficient information to develop a building block approach for the costs the pipeline owner incurs and to develop a reference price based on the actual capacities already contracted.

Level 3 is where the arbitration is initiated because there is a dispute between the shipper and the pipeline owner. At this stage, the MEU considers that all of the information that the AER would need to complete its tasks should be provided so that an equitable and efficient outcome is achieved.

Addressing the need for information disclosure in this way, it provides a staged approach where a single solution for information disclosure requirements might not be appropriate. This might be implemented by the pipelines being required to provide certain information publicly (eg on their website) but then required to provide more information on request by a shipper depending on the stage of the process reached and that the additional information might need to be subject to some form of confidentiality.

The MEU notes that the GMRG has identified that they consider option 2 for information disclosure is at the level needed by shippers to ensure they have efficient prices and can confidently enter into arbitration. The MEU does not agree.

When an issue gets to commercial arbitration, option 3 ("Disclosure of a base level of information that shippers require when considering whether to seek access to a pipeline, financial reports and detailed cost, demand and financial information that shippers can use to assess the reasonableness of the price offered ("Option 2 and detailed cost information")) is an essential requirement for a shipper to be able to provide an adequate argument before an arbitrator on price and other issues. The absence of such detailed information provides an avenue for pipeline owners to use the asymmetry of information to the disadvantage of the shipper.

The MEU members have at various times attempted to replicate pricing provided by pipeline owners. They advise that this can be a particularly challenging process and

[5] One MEU member reports that in "negotiations" with a pipeline owner, the owner considered it was entitled to a premium on the transport tariff if the delivery pressure was increased, as delivery at a higher pressure would supposedly limit the sale of future capacity, even though there was already excess capacity and there was no such new capacity likely to be sold.

it is only when some work has been completed does it become apparent that more information is required[6].

With this in mind, the MEU notes that, while some detail is provided in the Options paper regarding the extent of information that might be provided, the MEU observes there is probably insufficient detail included to ensure whether the descriptions (eg "base level information") will fully cover the scope of information needed by a shipper to ensure that a pipeline owner is providing efficient pricing for the service. The MEU is aware that the AER requires significant detailed information when it carries out its regulatory processes and the MEU considers that this same level of information should be available to a shipper so that it can carry out a detailed assessment. The MEU also considers that there needs to be some ability to access additional information if the shipper finds that what is provided by the pipeline owner is insufficient for its needs. The MEU considers that rather than attempting to specify in detail the information that must be provided, the rules of the arbitration process should allow for the arbitrator to require the owner to provide more information requested by the shipper.

Additionally, as noted elsewhere in this response, other shippers on the pipeline might not be able to enter into arbitration due to the cost barrier. To enable them to enjoy the benefits of efficient pricing, they should be made aware of the prices that are available to others on the same pipeline. This implies that Option 5 would be essential to ensure that the information asymmetry is better balanced for all shippers and anything less than this will continue to allow information asymmetry to favour the pipeline owner.

While it is assumed that the actual information to be disclosed will relate to the specific pipeline where access is sought, the Options paper does not make this clear or even this information might be aggregated. The MEU considers that the information must be pipeline specific. This then raises the question as to how corporate overheads are to be allocated when an asset owner has more than one pipeline in its fleet and whether some of these other pipelines are regulated. This requires clear direction as to how costs that are general in form are to be allocated to each specific pipeline. The MEU notes that this has already been identified as an issue that the AER and other regulators have grappled with for many years. There is still no clear outcome or resolution so the MEU considers the GMRG must address this issue so that the arbitrator can ensure equity in this regard.

The MEU also observes that until the actual template for the details for provision of information is developed, it is uncertain as to whether the options really do meet the needs of shippers. The MEU expects that the details of the template for information disclosure will be made available for review in the near future to assess whether it does include all of the information required.

[6] The MEU notes that the same issues apply to the AER, where the AER has defined the amount of information it requires yet when it examines the information in detail, it identifies a need for more information which has to be provided.

Other aspects that impact information disclosure

The MEU is also concerned that there will be a barrier to many shippers for commercial arbitration due to the costs involved both in terms of the internal costs to provide the arguments before the arbitrator and the costs of the arbitration itself. This barrier will apply to most shipper/customers and only those shippers with very large gas demands will find it commercially practical to initiate a commercial arbitration process. To limit access to an equitable outcome for all shipper/customers because of cost, is not efficient and nor is it in the long term interests of consumers. The MEU is concerned that even though the Options Paper recognises this (eg. see pages 73 and 74), the Options Paper still does not propose a solution, implicitly accepting the draft Amendment Bill conditions for cost allocation.

To overcome this barrier, it is suggested that prices that other shippers pay for transport on a pipeline should be made available on request. A failure to provide such pricing information will lead to most shippers never being able to ensure they are paying only the efficient price for the service. This implies that option 5 of the information disclosure options becomes necessary because, for smaller gas users, prices available to other shippers become the only avenue to ensure that they too are paying efficient prices for their transport. Disclosure of the price(s) delivered by arbitration is intended to be confidential but unless these prices are provided this will be a barrier to small shippers gaining the benefit of the outcome. While confidentiality provides protection from “free-riding” on the input provided by a large shipper, it provides a barrier to small shippers benefitting from economic efficiency.

On balance, the MEU considers that arbitrated (and perhaps even negotiated prices) must be made available.

While the MEU is aware that a pipeline owner may elect to “negotiate” a special price with a large shipper that is prepared to initiate arbitration in order to avoid a flow on of that “negotiated” price to other shippers[7], this raises the question as to whether such “negotiated” prices should be available to other shippers as a negotiated “special” price would probably be “commercial in confidence”, and so knowledge of it would not be available to other shippers, leaving then with potentially inefficient monopoly pricing. The Options paper does not identify how this circumstance would be managed. The MEU considers not addressing the issue allows the pipeline owner to continue its monopoly pricing practices for small shippers which cannot for financial reasons go to arbitration and this does not result in an efficient outcome or one in the long term interests of consumers.

It is also important to note that it cannot be assumed that retailer/shippers will be active in reducing the cost of transport on behalf of their customers. The MEU has noted that where a retailer can “pass through” the cost of transport (and by doing so

[7] It is assumed that a negotiated price for the service would be kept confidential as it is an agreement between the two parties

not affect their competitive advantage) they will just accept the price for transport set by the pipeline owner. In this regard, it is pointed out that retailer/shippers have not in the past been active in driving pipeline owners to reduce the costs of transport to efficient price levels regardless whether these are non-regulated pipelines or even regulated pipelines. This means that it is entirely up to end users to fight their own battles in getting the best transport prices for the gas they use, even if they operate through a retailer.

A major concern for consumers is whether gas users, as a group, are paying an inflated return to the monopoly transport provider. For example, if there is existing capacity on a pipeline and the revenue from the existing customers provides a reasonable return to the asset owner, what should occur if the spare capacity is sold to a new shipper? Should the additional revenue flow to the asset owner or should all existing shippers share in lower costs. Economic efficiency would seem to dictate that the additional revenue should lead to lower prices for other shippers[8], but it is not clear how under the proposed commercial arbitration model this efficient outcome will be achieved. The MEU considers this aspect needs to be investigated by the GMRG as part of its establishment of the rules applying to “non-scheme” pipelines.

Arbitration mechanisms

The MEU notes the five different options for arbitration proposed by the GMRG and its view that option 3 (Conventional arbitration with additional procedural protections and partial transparency) is the best suited for the purpose. The MEU agrees.

The MEU considers, much for the same reasons provided by the GMRG that options 4 and 5 introduce considerable risk for both the shipper and the asset owner, although the MEU agrees that these options might deliver faster decision making. However, the MEU considers that economic efficiency will not necessarily be delivered by either.

The MEU considers that options 1 and 2 do not offer sufficient certainty for shippers as there are often more than price issues to be assessed in a pipeline access agreement, yet it is these other issues that also impact on the price that should apply in order to provide for an economically efficient outcome.

For the reasons detailed in the Options Paper, the MEU agrees with the GMRG that option 3 is the most appropriate and efficient approach for the arbitration mechanism.

[8] As it does on regulated pipelines

Arbitration principles

The MEU accepts that where a pipeline has been built based on a competitive process and if the initial prices used to develop the pipeline are included in the foundation contracts for transport then these foundation contracts should remain in force. The question then arises about what prices should be paid by additional shippers to that pipeline, especially where economic efficiency could imply that lower prices should be offered to foundation shippers while keeping the pipeline owner whole. To charge new shippers the same as foundation shippers poses the concern that the owner receives an unearned windfall and this is not necessarily economically efficient. While not offering a view at this stage, the MEU considers that this issue needs to be explicitly addressed in the principles.

The MEU agrees with the GMRG (for the reasons stated in the Options paper) that arbitration principles should be based on the actual cost of the service and this is basically the approach used in current regulation of pipeline services.

There is a risk to consumers in this approach in that there is an assumption that the actual costs incurred reflect prudent investment and the costs are efficient and appropriate for the service provided. For example, as the cost of service is based on the capital invested, it has to be demonstrated that the amount of capital used was not the result of poor investment decisions (or even poor design and construction practices) by the developer of the pipeline, i.e. costs that would not be incurred by an efficient and prudent developer. To overcome this significant issue, as a back up to the cost of service approach, direct comparison with other (efficiently developed) pipelines provides confidence that the cost of service model is delivering an efficient outcome and that consumers can be assured that the prices they ultimately pay for the service are efficient. Price comparisons could also be made with pipelines in overseas jurisdictions.

However, actual costs of services need to have clearly defined approaches to develop the prices to demonstrate they are reasonable. The AER has devoted considerable effort to the development of tools that deliver this outcome and it would be preferable that the arbitrator should use these tools in preference to others that might be proposed, not only because they were developed to deliver equitable outcomes, but because they are readily understood by pipeline owners and generally accepted by consumers. Such an approach is demonstrably transparent – an aspect that must not be overlooked. What is just as important is that the outcomes would deliver a consistent approach to arbitrations that might be initiated for the same pipeline by different appellants.

The GMRG has proposed that option 2b (the actual costs (including a commercial rate of return) the pipeline operator incurs in providing the service) is their initial preference for arbitration principles. The MEU considers that this option does not deliver:

- Certainty that the capital invested was efficient and prudent – an issue that is at the core of ensuring economic efficiency is achieved. The MEU considers that assessing the outturn prices from the cost of service approach needs to be tested against prices for similar services on other pipelines, including overseas pipelines
- An arbitration process uses proven tools for developing prices that are transparent, understood and accepted as efficient
- An arbitration process which delivers consistency in approach and outcomes.

With these requirements in mind, the MEU considers that option 3b is more likely to deliver to the expectation of consumers that the process delivers efficient outcomes and option 3b should be augmented to include comparison of prices of comparable pipelines to ensure that the cost of service approach actually delivers efficient outcomes.

The MEU points out that under a cost of service model, the largest element of the cost build up of the revenue, is the asset base times the cost of capital. The MEU notes that the GMRG uses the term “a commercial rate of return” as the cost of capital but does not define what this might be. The MEU notes that a reasonable rate of return varies considerably with the type of service being provided. For example, a highly speculative investment would warrant a high rate of return to be “commercial” as it reflects the very high risks that the investor is exposed to. Conversely, a commercial rate of return for a service that has low risk (such as a monopoly service provider with tied customers) would be considerably lower, reflecting the rate of return used by the AER for regulated pipelines.

The MEU considers that the rules need to be quite specific as to what is considered to be a “commercial rate of return” that an arbitrator should use so that the outturn pricing is efficient and, just as importantly, seen to be efficient. In this regard, the MEU is aware that the AER guideline on the cost of capital is already used by regulated gas pipelines and has been tested in the Competition Tribunal. This provides a clear case for its use in the commercial arbitration process as it is already being used as the primary tool for identifying a commercial rate of return for gas pipeline monopoly assets. This supports a view that option 3b is needed to be used.

The other leg of the major impact on price (i.e. asset base) is discussed in an earlier section of this response. The MEU reiterates that the development of the asset base is not straight forward and clear instructions are needed for the arbitrator to ensure that in the development of the asset base used to develop prices, there are clear rules provided. This again implies that option 3b is preferred.

The MEU is aware that the GMRG has expressed a view that it prefers to allow the arbitrator some discretion, and that option 2 provides more discretion than option 3. The MEU notes that the gas and electricity rules provide the AER with significant discretion and this has led to extensive and expensive appeals. The MEU considers that where possible, discretion should be limited when there are clear and tested tools available to be used rather than for discretion to be more widely used. The

MEU is very concerned that the wider the use of discretion, the greater the potential for lower consistency in outcomes. The MEU does not support increased discretion when there is little value to be gained in the arbitration process but increased risk for consumers.

Conclusions

The MEU considers that of the options provided, it considers that the commercial arbitration process should be based on the following:

1. Information disclosure should be based on option 5 (option 3 with price reporting of arbitration decisions)
2. Arbitration mechanism should be based on option 3
3. Arbitration principles should be based on option 3b

The MEU has used the term “based on” advisedly as the options need also to reflect the comments the MEU has made in the detailed text of this response

We appreciate the opportunity to have provided this input to the Options Paper 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