

# **Examination of the current test for the regulation of gas pipelines**

## ***Consultation Paper***

Dr Michael Vertigan AC

4 October 2016

## Background

On 19 August 2016, the Council of Australian Governments (COAG) Energy Council (the Council) released a comprehensive Gas Market Reform Package responding to the findings and recommendations of the Australian Energy Market Commission's (AEMC) *Eastern Australian Wholesale Gas Market and Pipelines Framework Review: Stage 2 Final Report* and the Australian Competition and Consumer Commission's (ACCC) *Inquiry into the East Coast Gas Market*. Comprising of 15 reform measures in four priority areas (gas supply, market operation, gas transportation and market transparency), the reform package is designed to drive the achievement of the Council's Australian Gas Market Vision:

*“The Council’s vision is for the establishment of a liquid wholesale gas market that provides market signals for investment and supply, where responses to those signals are facilitated by a supportive investment and regulatory environment, where trade is focused at a point that best serves the needs of participants, where an efficient reference price is established, and producers, consumers and trading markets are connected to infrastructure that enables participants the opportunity to readily trade between locations and arbitrage trading opportunities”.*

The ACCC found that there are few constraints on the behaviour of existing gas pipeline operators and evidence of the exercise of market power. Accordingly, the Council are concerned that the existing regulatory regime under the National Gas Law (NGL) does not appear to be working and a new regulatory test is required to see the prices charged by pipeline operators move closer towards the efficient cost of supply.

A key component of the reform package is examining, in consultation with stakeholders, whether a new test for determining if a gas transportation pipeline should be subject to economic regulation is needed. Dr Michael Vertigan AC has been appointed to undertake this examination and will report back to Energy Ministers at the December Council meeting.

Dr Vertigan will also consult with the Senior Committee of Officials through the Gas Market Project Implementation Team, comprised of Council officials, from time to time to keep them apprised.

This consultation paper has been prepared to assist individuals and organisations to prepare submissions as a part of the consultation process.

## Purpose of consultation

Market inquiries undertaken by the ACCC, including the *Inquiry into the East Coast Gas Market*, gather confidential information using their legislative powers. The ACCC consulted with pipeline operators, including at private hearings, on findings of monopoly pricing. The ACCC did not formally consult on their recommendations. The Inquiry Report contemplated that further

consultation would be required as to how a new test for pipeline regulation should be applied and implemented.

This consultation paper seeks stakeholder feedback responding to the ACCC's *Inquiry into the East Coast Gas Market* findings, the significance of the problems identified, the effectiveness of the existing regulatory test, the appropriateness of the ACCC's proposed market power test (see page 10) and, if a change in regulatory arrangements is warranted, alternative means of achieving this. Stakeholders are strongly encouraged to provide evidence to support their claims rather than merely anecdotal material.

Dr Vertigan will lead this consultation process, assess stakeholder feedback against the ACCC's findings and report back to the COAG Energy Council at its December meeting. Relevant stakeholders, including gas market participants, industry associations and consumer bodies, will be invited to participate in a series of roundtable discussions to be held in late October. Dr Vertigan will also be discussing issues with selected stakeholders on a bi-lateral basis.

## Stakeholder submissions

Stakeholders are encouraged to make submissions in response to this Consultation Paper by 5pm (AEST) **Tuesday 18 October 2016**.

Electronic submissions are preferred and can be sent via e-mail addressed to the COAG Energy Council Secretariat at [energycouncil@environment.gov.au](mailto:energycouncil@environment.gov.au)

Stakeholders who wish to provide hard copies by post may do so by addressing their submissions to:

Examination of the Coverage Test  
COAG Energy Council Secretariat  
GPO Box 787  
Canberra ACT 2601

To help generate full and frank debate, public submissions are strongly preferred. All stakeholder submissions will be published on the Energy Council website at [www.coagenergycouncil.gov.au](http://www.coagenergycouncil.gov.au) unless stakeholders have clearly indicated that a submission should remain confidential, either in whole or in part.

The Australian Government reserves the right to refuse to publish submissions, or parts of submissions, which contain offensive language, potentially defamatory material or copyright infringing material. A request may be made under the *Freedom of Information Act 1982* (Cth) for a submission marked confidential to be made available. Such requests will be determined in accordance with provisions under that Act.

For further information about the examination or making a submission, please contact the Secretariat via email at [energycouncil@environment.gov.au](mailto:energycouncil@environment.gov.au).

# Context

## Current gas access regime

The National Gas Law (NGL) and National Gas Rules (NGR) set out the regulatory framework for access to gas pipelines. The NGL is enacted as a law of South Australia. Each of the other jurisdictions in which the NGL applies has enacted legislation applying the NGL in its jurisdiction.

The overarching objective of the NGL is the attainment of the National Gas Objective (NGO), which 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.”*

The NGL only results in the application of access regulation to pipelines that are ‘covered’.

Two forms of regulation are available for a covered pipeline – full regulation or light regulation. Full regulation requires the service provider to periodically submit an access arrangement to the Australian Energy Regulator (AER) for approval. The access arrangement sets out the terms and conditions under which third parties can access a pipeline. It must specify at least one reference service likely to be sought by a significant part of the market, and a reference tariff for that service.

Light regulation provides a light handed approach, removing price regulation and the requirement for an ex ante access arrangement. Light regulation means that the pipeline owner determines its own tariffs but must publish relevant access prices and other terms and conditions on its website and an access seeker may seek arbitration from the AER should negotiations for access fail. This reflects the negotiate/arbitrate approach to access in Part IIIA of the *Competition and Consumer Act 2010* (Cth) (CCA).

A party may seek a change in the coverage status of a pipeline by applying to the National Competition Council (NCC) in accordance with the NGR.

Decisions on coverage are made by the relevant Minister on the recommendation of the NCC, with four prescribed “coverage criteria” needing to be met for a pipeline to be covered (i.e. subject to economic regulation).

Section 15 of the NGL sets out the pipeline coverage criteria:

- (a) that access (or increased access) to pipeline services provided by means of the pipeline would promote a material increase in competition in at least one market (whether or not in Australia), other than the market for the pipeline services provided by means of the pipeline;

- (b) that it would be uneconomic for anyone to develop another pipeline to provide the pipeline services provided by means of the pipeline;
- (c) that access (or increased access) to the pipeline services provided by means of the pipeline can be provided without undue risk to human health or safety; and
- (d) that access (or increased access) to the pipeline services provided by means of the pipeline would not be contrary to the public interest.

In deciding whether or not the pipeline coverage criteria are satisfied the relevant Minister must have regard to the NGO.

Access to 'uncovered' pipelines is a matter for commercial negotiation and arrangements.

A service provider who is proposing, or has commenced (but not yet commissioned), a greenfields pipeline project may apply to the NCC to be granted a 15 year no-coverage determination exempting the pipeline from being a covered pipeline. No-coverage determinations are intended to provide regulatory certainty for investors in new pipeline projects and to encourage efficient investment in new pipeline infrastructure.

Decisions on no-coverage determinations are made by the relevant Minister on the recommendation of the NCC. To be eligible for a no-coverage determination it must be proven that one or more of the four coverage criteria will not be met for the 15 year period for which the determination would apply.

### **ACCC East Coast Gas Inquiry**

On 13 April 2015, the then Commonwealth Minister for Small Business and the then Minister for Industry and Science, directed the ACCC to hold an inquiry into the competitiveness of wholesale gas prices and the structure of the upstream, processing, transportation, storage and marketing segments of the gas industry under Part VIIA of the CCA.

The Inquiry was initiated in response to conflicting claims about the availability of gas to east coast consumers and concerns about the efficiency and effectiveness of the market. It is the first inquiry to fully investigate these issues, overcoming a previous lack of information about confidential contracts, prices and negotiations.

The ACCC used its powers under the CCA to obtain information, documents and evidence and produce an evidence-based report outlining its findings and recommendations to improve the gas market.

The Inquiry Report was released on 22 April 2016 and concluded that the current gas access regime is not constraining the behaviour of existing pipelines and should be strengthened. Further information on the relevant ACCC findings and recommendation is outlined in the next section.

The Inquiry Report is available at: <https://www.accc.gov.au/regulated-infrastructure/energy/east-coast-gas-inquiry-2015>.

## Issues for Comment

This paper provides some specific questions to guide stakeholder submissions. The questions are not intended to be exhaustive and stakeholders are encouraged to address any issues they regard as directly relevant to the examination. The questions have been framed to elicit responses from stakeholders and in no way should be interpreted as indicating any particular direction that the examination may take. Stakeholders should not feel obligated to respond to every question posed. Stakeholders are strongly encouraged to familiarise themselves with the ACCC Inquiry Report and provide specific information which will assist the assessment of competing claims.

### **What is the problem and why does it need addressing?**

The ACCC investigated the concerns raised by a number of market participants about the market power exercised by some transmission pipelines. Distinguishing between new and existing pipelines, the ACCC found that competition to build a new pipeline can be effective in limiting market power. The ACCC identified the Northern Gas Pipeline and QSN Link as examples to suggest that competition to build a pipeline can impose an effective constraint on the access behaviour of new pipelines. The ACCC did not recommend removing the existing 15 year no-coverage option for greenfields pipelines.

In contrast, in relation to a number of existing pipelines examined by the ACCC in response to concerns raised by market participants, the ACCC found:

1. The majority of existing transmission pipelines on the east coast have market power.
2. There are few constraints on the behaviour of existing pipelines and a large number of the pipelines on the east coast are using their market power to engage in monopoly pricing.
3. Some pipeline operators are charging excessive prices for as-available and interruptible transportation services on key routes between Queensland and southern states and for hub services at Wallumbilla.

While there is no contravention of the CCA, the ACCC found that a number of major pipelines are engaging in monopoly pricing, that is, prices that significantly exceed the long-run average cost of supply for a sustained period. More specifically the ACCC found that:

- the high rates of return that pipeline operators expect to earn on incremental investments are consistent with monopoly pricing;
- the prices charged by pipeline operators that have already recovered the cost of construction are higher than would be the case under full regulation; and

- the prices charged by some pipeline operators for as-available, interruptible and backhaul services are excessive on key routes between Queensland and southern states and for hub services at Wallumbilla.

The ACCC outlined that the totality of the evidence gathered through the Inquiry combined with the lack of competitive constraints faced by most pipelines is highly indicative of the exercise of market power.

Evidence gathered by the ACCC indicated that monopoly pricing by transmission pipelines is giving rise to higher delivered gas prices for users and in some cases lower ex-plant prices for producers. The ACCC observed that this could have adverse effects on the economic efficiency of the east coast gas market and upstream and downstream markets, with some of the more significant economic inefficiencies likely to flow from this behaviour including:

- lower than efficient levels of gas production and investment in gas exploration and reserves development;
- lower than efficient levels of gas use and investment in downstream facilities that use gas; and
- inefficient pipeline utilisation, distortions in gas flows across the market, and gas failing to flow to where it is valued most highly.

#### **Questions for stakeholders**

1. Do you agree with the ACCC's finding that the majority of existing transmission pipelines on the east coast have market power and are using this power to engage in monopoly pricing? Why/Why not? Please provide evidence to support your argument.
2. Is the ACCC's characterisation of why monopoly pricing is a problem accurate? Why/why not?
3. Are there any additional effects of monopoly pricing on gas market participants that the ACCC did not identify?

#### **Is the existing regulatory test working?**

The ACCC found that the current gas access regime under the NGL is not imposing an effective constraint on the behaviour of a number of unregulated pipelines. The ACCC concluded that the current coverage criteria are not designed to address the monopoly pricing observed in the Inquiry that results in economic inefficiencies with little or no effect on the level of competition in dependent markets. While monopoly pricing does not contravene the CCA, monopoly pricing does have an effect on the operation and efficiency of the market.

The current coverage criteria largely mirror the declaration criteria in Part IIIA of the CCA. An application for a pipeline to become covered must satisfy all four of the coverage criteria stipulated in section 15 of the NGL. Criterion (a), that access would promote a material increase in competition in upstream or downstream markets, has proved most difficult to satisfy in pipeline coverage and revocation decisions. The ACCC indicated this is because pipeline operators are generally not vertically integrated and have an incentive to encourage access to maximise profits and reduce the risk of asset stranding. While pipeline operators may not have an incentive to adversely affect competition in another market, the ACCC found they do have an incentive to engage in monopoly pricing and many are acting on that incentive.

#### **Questions for stakeholders**

4. What do you believe is the objective of the existing coverage test?
5. To what extent does the current interpretation of the existing coverage test fulfil the objective?
6. Is the existing coverage test an effective constraint on pipeline operators' behaviour? Why/why not?
7. Do you agree with the ACCC that the existing coverage criteria, and in particular criterion (a), establishes a hurdle for regulation that is unlikely to be met by the majority of transmission pipelines on the east coast? Why/why not?
8. Can the current coverage criteria address the market failure identified by the ACCC - monopoly pricing that gives rise to economic inefficiencies with little or no effect on the level of competition in dependent markets? Why/why not?
9. Could the coverage criteria be satisfied in the case of a non-vertically integrated pipeline? Why/why not?

#### **What is the relationship between this examination and other reforms being considered/progressed?**

The COAG Energy Council and the Australian Government are progressing, and/or considering, changes to address issues identified in a number of related policy arenas, including capacity trading reforms, limited merits review and amendments to the CCA. While the substantive issues associated with these areas are beyond the scope of this examination, it is important to understand how changes being considered/progressed may interact with issues being considered in this examination.

### Market reforms

The COAG Energy Council's Gas Market Reform Package includes a range of reforms intended to assist the market transact more efficiently with pipeline operators and facilitate capacity trading between market participants. Specifically, the Council agreed to establish a capacity trading platform(s), day-ahead auction of contracted but un-nominated capacity, standardisation of key primary and secondary capacity contractual terms, and information on capacity trades.

### Review of the Limited Merits Review

On 19 August 2016, the Energy Council tasked the Senior Committee of Officials (SCO) with undertaking a review of the Limited Merits Review (LMR) regime by December 2016. The Review will assess the effectiveness of the merits review regime, including the role of the Tribunal, under the National Electricity Law and NGL. Officials will consider options for reform of the LMR regime that will best advance the interests of consumers.

A consultation paper was released on 6 September 2016 and stakeholders were invited to submit written feedback by COB Monday 3 October 2016. Further, a public consultation session was held on 21 September 2016 in Melbourne.

Of relevance, the LMR regime allows parties affected by coverage recommendations by the NCC, coverage decisions by the relevant Energy Minister, and AER access arrangement decisions to apply for the decisions to be reviewed by the Australian Competition Tribunal where it can be established that there are grounds for this to occur; for example, regulatory errors.

Dr Vertigan is consulting with SCO officials undertaking the Review and is cognisant of the issues under consideration. Both reports will be presented to Ministers in December.

### Amendments to the CCA

On 24 November 2015, the Australian Government released its response to the Competition Policy Review (the Harper Review) and on 16 March 2016, the Government further agreed to implement the Review's recommended changes to section 46 of the CCA concerning the misuse of market power.

On the 5 September 2016, the Government released an Exposure Draft of the Competition and Consumer Amendment (Competition Policy Review) Bill 2016. The Exposure Draft includes amendments to section 46 on the misuse of power, as well as a number of other amendments to the CCA which were supported by the Government, including, but not limited to, amending the National Access Regime declaration criteria.

The Exposure Draft is available at: [https://consult.treasury.gov.au/market-and-competition-policy-division/ed\\_competition\\_law\\_amendments](https://consult.treasury.gov.au/market-and-competition-policy-division/ed_competition_law_amendments).

The Government invited stakeholders to provide written feedback on the Exposure Draft by 5pm (AEST) Friday 30 September 2016.

### *Declaration criteria*

The National Access Regime provides a regulatory framework for third parties to seek access to nationally significant infrastructure services owned and operated by others. The Regime provides a means of promoting competition in markets where the ability to compete effectively is dependent on being able to use a service provided by a piece of nationally significant infrastructure.

The Regime was reviewed by the Productivity Commission in 2013, and then by the Harper Review in 2015. Both review processes examined the application of the declaration criteria, and whether it was effectively promoting the objectives of the Regime by promoting effective competition in dependent markets.

As part of the Government response to the Harper Review, the Government decided to implement all of the recommendations of the Productivity Commission relating to the declaration criteria. The amendments seek to refocus and clarify the intent of the Regime, in particular the declaration criteria that the NCC and designated Minister must be satisfied of in order to recommend that a service be declared, as this determines when arbitration by the ACCC will and will not be available to access seekers or access providers.

Importantly, in reviewing the declaration criteria, the Productivity Commission highlighted that where competition is not disrupted but monopoly pricing exists, a different form of intervention may be required, such as through the application of industry specific access regimes, citing the example of electricity networks.

### *Section 46*

Section 46 prohibits a corporation with a substantial degree of power in a market from taking advantage of that power in any market for one of three specific purposes. These purposes focus on damaging an actual or potential competitor. Subsection 46(6A) sets out considerations that may be taken into account in determining whether a corporation has 'taken advantage' of its substantial market power.

On 16 March 2016, the Australian Government endorsed the Harper Review's recommendation to replace the misuse of market power provision in section 46 of the CCA with a new provision. The new provision re-frames section 46 to prohibit a firm with a substantial degree of power in a market from engaging in conduct with the purpose, effect or likely effect of substantially lessening competition in any market.

### Questions for stakeholders

10. What is the relationship between the gas pipeline capacity trading reforms and the gas access regime?
11. What are the implications of any changes to the LMR regime in the context of this examination?
12. Absent this examination and any decision by Energy Ministers, once implemented, the amendments to the declaration criteria will see the coverage criteria differ from the CCA. Should the coverage criteria continue to be consistent with the declaration criteria or is an industry-specific test warranted? Why/why not?
13. What impact, if any, is the amendment to section 46 of the CCA likely to have on pipeline operators who operate in a manner consistent with that identified by the ACCC as engaging in monopoly pricing?

### How could the regulatory test be improved?

The ACCC highlighted that the majority of transmission pipelines in Australia are unregulated, in contrast with other comparable international jurisdictions, such as the United States of America, New Zealand and the European Union, where the majority of transmission pipelines are subject to economic regulation. In these jurisdictions the decision to regulate or to revoke regulation has tended to turn on whether the pipeline has a substantial degree of market power and the ability and incentive to exercise that power rather than whether access will promote a material increase in competition in another market, as it does in Australia.

Reflecting international experience, the ACCC recommended replacing the current coverage test with a market power test to control monopoly pricing on gas pipelines.

The ACCC report recommended that:

*3. The COAG Energy Council should agree to replace the current test for the regulation of gas pipelines (the coverage criteria) in the National Gas Law (NGL) with a new test. This test would be triggered if the relevant Minister, having regard to the National Competition Council's recommendation, is satisfied that:*

- *the pipeline in question has substantial market power;*
- *it is likely that the pipeline will continue to have substantial market power in the medium term; and*

- *coverage will, or is likely to, contribute to the achievement of the National Gas Objective.*

*The COAG Energy Council should also ask the AEMC to carry out further consultation on the specific matters that should be considered when applying this test and how it should be implemented and to advise the COAG Energy Council of the amendments that would need to be made to the NGL and the National Gas Rules (NGR) to give effect to this new test.*

The proposed test was designed by the ACCC to be industry specific under the NGL, targeted at addressing the market failure observed by the Inquiry, that is, monopoly pricing that results in economic inefficiencies and does not promote the NGO. A wider change to the National Access Regime was not proposed.

The ACCC considered that if a market power test was applied to pipelines, the existing 15 year no-coverage option for new greenfields pipelines, which is based on satisfaction of one of the coverage criteria, would also need reviewing. The ACCC noted two options: an automatic 15 year no-coverage determination for a greenfields pipeline; or that the granting of exemption from regulation be subject to a market power test.

The ACCC suggests that implementation of the proposed test would likely see the prices charged by pipeline operators move closer towards the efficient cost of supply resulting in:

- lower delivered gas prices for customers that transport their own gas and other end-users of gas if retailers pass the benefits of lower charges through
- more efficient levels of gas production and investment in exploration
- more efficient levels of gas use and investment in downstream facilities that use gas
- more efficient utilisation of the transmission pipelines, less distortions in the flow of gas across the market and gas flowing to where it is valued most highly.

### Questions for stakeholders

14. Is a new regulatory test required under the NGL? Why/why not?
15. What percentage of the price of delivered gas do transportation costs (transmission and distribution) represent?
16. What impact would a change to the coverage test have on pipeline investment, including capital-raising, debt servicing and innovation?
17. What impact would a change to the coverage test have on investment, including equity and debt-raising, in upstream and downstream industries/companies?
18. In relation to the market power test proposed by the ACCC:
  - Is it likely to address the problem identified? Why/why not?
  - Is it likely to better facilitate the achievement of the NGO? Why/why not?
  - Would the test increase the number of pipelines regulated? Why/why not?
  - Would the test likely see the prices charged by pipeline operators move towards the efficient cost of supply? Why/why not?
  - Are the outcomes associated with pipeline prices moving towards the efficient cost of supply appropriate? Why/why not?
  - Should the proposed test be implemented, what impact, including costs, benefits and risks, would you expect this to have on market participants?
  - If implemented, should the proposed test also apply to 15 year no-coverage determinations?
  - Are there any unintended consequences of the test?
19. Is there a regulatory test that would be more appropriate than that proposed by the ACCC? If so, please provide details of what form this test could take.

## Glossary of terms and abbreviations

Term	Description
15-year no-coverage determination	As defined in section 2 of the NGL: <i>15-year no-coverage determination means a determination of a relevant Minister under Chapter 5 Part 2.</i>
ACCC	The Australian Competition and Consumer Commission
Access arrangement	An arrangement setting out the terms and conditions of access to pipeline services provided by means of a pipeline
AEMC	The Australian Energy Market Commission
AER	The Australian Energy Regulator
CCA	<i>Competition and Consumer Act 2010 (Cth)</i>
COAG	The Council of Australian Governments
Coverage or covered	The status of a pipeline which is, or is deemed to be, the subject of a coverage determination and accordingly subject to economic regulation under the NGL
Coverage criteria/test	Criteria for the coverage or revocation of coverage of a pipeline outlined in section 15 of the NGL
Full regulation	The form of regulation applicable to covered pipelines without a light regulation determination
Greenfields pipeline project	As defined in section 149 of the NGL: <i>means a project for the construction of—</i> <i>(a) a pipeline that is to be structurally separate from any existing pipeline (whether or not it is to traverse a route different from the route of an existing pipeline); or</i> <i>(b) a major extension to an existing pipeline that is not a covered pipeline; or</i> <i>(c) a major extension to a covered pipeline by means of which light regulation services are provided if that extension is exempted by the AER under section 19</i>
Light regulation	The form of regulation applicable to a covered pipeline when a light regulation determination of the council is in force
NGL	National Gas Law, the Schedule to the <i>National Gas (South Australia) Act 2008</i>
NGO	National Gas Objective as set out in section 23 of the NGL

Term	Description
NGR	National Gas Rules, initially made by the South Australian Minister under section 294 of the NGL and subsequent amendments made by the AEMC under the NGL
Reference service	As defined in section 2 of the NGL: <i>means a pipeline service specified by, or determined or approved by the AER under, the Rules as a reference service</i>
Reference tariff	As defined in section 2 of the NGL: <i>means a tariff or charge for a reference service—</i> <i>(a) specified in an applicable access arrangement approved or made under a full access arrangement decision; or</i> <i>(b) determined by applying the formula or methodology contained in an applicable access arrangement approved or made under a full access arrangement decision</i>
Relevant Minister	As defined in section 2 of the NGL: <i>means if, in a coverage recommendation, no-coverage recommendation, classification decision under the Rules or reclassification decision, the NCC determines the pipeline is—</i> <i>(a) a cross boundary transmission pipeline—the Commonwealth Minister;</i> <i>(b) a transmission pipeline situated wholly within a participating jurisdiction—the designated Minister;</i> <i>Note—</i> <i>The term designated Minister is defined in the Act of this jurisdiction that applies this Law as a law of this jurisdiction.</i> <i>(c) a distribution pipeline situated wholly within a participating jurisdiction—the Minister of the participating jurisdiction;</i> <i>(d) a cross boundary distribution pipeline—the Minister of the participating jurisdiction determined by the NCC in the recommendation as being the participating jurisdiction with which the cross boundary distribution pipeline is most closely connected</i>
Service provider	As defined in section 8 of the NGL: <i>(1) A service provider is a person who—</i> <i>(a) owns, controls or operates; or</i> <i>(b) intends to own, control or operate,</i> <i>a pipeline or scheme pipeline, or any part of a pipeline or scheme pipeline</i>