Major Energy Users Inc.

2-3 Parkhaven Court, Healesville, Victoria, 3777

ABN 71 278 859 567

6 February 2017

CoAG Energy Council Secretariat
GPO Box 9838
Canberra ACT 2601

By email: energycouncil@environment.gov.au

Dear Secretariat

National Gas Law Amendment
Pipeline Access Arbitration
Draft Amendment

The Major Energy Users (MEU) welcomes the opportunity to provide its views to the CoAG Energy Council Secretariat on the draft amendment to the National Gas law to include a commercial arbitration framework for natural gas pipeline access disputes where pipelines are not regulated – this proposed change is a result of the review of the current test for the regulation of gas pipelines recently undertaken by Dr Vertigan.

The MEU has been actively involved with this issue 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 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 represent some of the largest firms in Australia employing many thousands of workers across a multiple sites and experience international competition.

The MEU proposal for addressing this inequity was to make the coverage test reflect that, where a pipeline provided a monopoly service, it should become a covered pipeline. To a large extent, this is what the ACCC review identified; that the coverage test should be one which assessed the monopoly characteristics of the pipeline rather than an upstream/downstream market test that is designed for where service providers are vertically integrated). Dr Vertigan's approach is to force pipeline owners to be exposed to binding commercial arbitration.

The MEU has a view that monopoly services should be regulated as the monopoly service providers have demonstrated that they not only have power to set prices above the cost of providing the service and other access requirements, but are prepared to use this power to maximize their revenues. It is pointed out that electricity transport is fully regulated in both transmission and distribution services. While gas distribution is generally regulated (like electricity distribution), it is difficult to understand why gas transmission should be considered to be different to electricity transmission – so different that it is considered economic regulation of the gas transmission service is not required[1].

The MEU members report that their experiences with gas transmission service providers are not different to that of electricity transmission owners, in that both use their market power to get the best outcome for themselves. The only difference MEU members report is that as electricity transmission service providers are regulated they tend to be more circumspect in their dealings with end users.

As a core element, the MEU considers that the CoAG Energy Council needs to explain why gas transmission is so different that regulation (as seen for electricity transport) is not needed. In explaining this, the Council should reflect that economically efficient long-distance gas transportation is increasingly a vital segment of Australia's ongoing energy supply security, affordability and sustainability.

The Council should also acknowledge that pipeline coverage is no deterrence to investment. Firstly, the National Gas Law ensures that regulated pipeline owners can recover their efficient costs of efficient new investment and the AER's regulatory decisions reflect this. Secondly, gas pipeline investors will continue to enjoy the 15-year "honeymoon" period for new gas transmission pipeline investments, a privilege not afforded electricity transmission investors.

Is the threat of arbitration sufficient?

In light of Dr Vertigan's proposed approach and the draft amendment, the MEU questions the extent to which monopoly pipeline services providers will be influenced by the threat or outcomes of referral of disputes to commercial arbitration. The assumption at the core of the proposal is that, along with more disclosure, this will balance the asymmetry of knowledge and power inherent between a single end user and the provider of the monopoly service.

The Vertigan proposal specifically includes for greater disclosure and transparency of pipeline service pricing and contract terms and conditions as a way of addressing the information and knowledge asymmetry. However, the MEU is also aware that even the AER (which regulates monopoly energy transport services as its core business) has difficulty in addressing this asymmetry, even with its wide information

[1] The MEU points out that even in the United States of America, gas transmission pipelines are regulated

gathering powers, experience and resources. That both the ACCC and the AER have, at times, experienced difficulty in extracting meaningful commercial information is further demonstration of the difficulty facing applicants in a commercial arbitration process, especially when the service providers have complex ownership structures.

The MEU considers that while the proposed greater disclosure and transparency might redress this asymmetry to some extent, there will still remain a considerable disparity between the resources and knowledge held by the monopoly service provider and an end user, leaving the end user at a significant disadvantage in any arbitration process.

The MEU questions how an end user will be able to provide sufficient countervailing pressure in the arbitration process to offset its lack of detailed knowledge and poorer ability to access critical information in order to provide a competent argument to an arbitrator[2].

Importantly, the arbitrator does not have the information gathering powers available to the AER and will be heavily reliant on information provided by the monopoly service provider.

The MEU points out that an arbitrator's role is not to access information independently (as does the AER in its role to regulate monopoly providers) but only to hear the arguments and assess whether the monopoly service provider has provided accurate information. As the arbitrator has little information of its own, it will rely on the end user to provide the countervailing argument based on its limited knowledge to dispute the arguments provided by the service provider. This then provides the service provider with a clear advantage in the arbitration process.

This asymmetry (even with the additional disclosure of information contemplated) implies that there will be a barrier to accessing commercial arbitration and that it might not appear to be sufficient of a threat to ensure equitable outcomes.

Based on feedback from Kimberly-Clark Australia (KCA) from its application for coverage of a pipeline, it would appear that the threat of coverage was not sufficient to provide an equitable outcome for it and this supports the view that the threat of commercial arbitration might have a similar impact (or lack thereof!)

It is clear that the concept of arbitration still significantly lacks an ability to address the information asymmetry and therefore is likely to deliver a less equitable outcome than might be expected. As the service provider will be aware of the continuing information asymmetry, the threat of arbitration will be quite limited and unlikely to lead to equitable outcomes; essentially, the threat of arbitration will not offset the concerns identified by the ACCC in its review.

---

[2] The MEU points out that while the arbitration process might require a service provider to divulge identified information, this first requires the end user applicant to know that such information is necessary and is available. The adage "you don't know what you don't know" is quite apposite in this regard

Cost is a barrier too!

The MEU notes that the resources devoted by the AER to carrying out its role as a regulator of energy monopoly services are extensive. To carry out the identification and setting of reasonable access conditions through the arbitration process will be similarly resource intensive and result in significant costs for any end user seeking an arbitrated outcome. This means that for small end users (including residential consumers), the costs to get an equitable outcome will exceed any benefit they might individually gain for reduced pipeline tariffs. Essentially, this limits the use of arbitration to those end users that are significant users of gas and therefore seek considerable savings from an equitable outcome[3].

In an arbitration process, the service provider will be seeking to minimise any reduction to its overall revenue, fully aware that if the arbitrator awards a lower tariff for the end user initiating arbitration, it will be possible that other end users of the same service will also get the same price reduction as the initial end user applicant. As a result, the benefit gained by the initiating end user through the arbitration will be less than the reduction in revenue seen by the service provider[4].

This means that the service provider will be incentivized to challenge the end user applicant‘s arguments to the maximum extent, challenging the arbitrator with extensive information and legal argument to support its case. This will require the end user applicant to have to match this intensive investment by the service provider and at the same time, address the information asymmetry that still exists. This will result in an applicant incurring further costs (over and above the direct costs of the arbitration) for the process in order to provide the additional resources to access and use the information it needs to challenge the arguments of the service provider.

The MEU understands that KCA incurred considerable costs in just seeking coverage of one small pipeline and these costs did not involve any arguments before an arbitrator on what and why it considered were equitable costs for access to that pipeline. In a similar vein, consumer advocates providing input to the AER processes incur significant costs in an environment which is much less demanding than commercial arbitration. This firsthand experience of seeking an equitable outcome

[3]The MEU notes that, while it might be expected that retailers (as significant shippers for multiple end users) would act in the interests of the small end users they provide for, this does not seem to be the case. In the coverage application by Kimberly-Clark Australia (KCA), the MEU noted that retailers did not get significantly involved in the process even though their customers were exposed to the excessive prices asserted by KCA that were being charged by the pipeline owner. Similarly, in AER regulatory processes, retailers are usually not involved in the AER reviews. This implies that retailers tend not to get involved on issues where they all can just “pass through” the same costs faced by their competitors.

[4] For example, if there are 10 users of a pipeline, and each has similar capacity requirements, the service provider is defending 100% of any price reduction whereas the end user initiating the arbitration will only benefit from 10% of any reduction in revenue the service provider might incur. This issue of “free rider” provides the service provider a significant incentive which the initiating end user does not have.

shows that the process facing an end user in taking a case to the arbitrator is potentially very expensive, supporting the view that the costs in entering into commercial arbitration will be a significant barrier to the proposed arbitral process.

While the costs to the service provider of an arbitral process will not be insignificant, they will be significantly lower than those of the end user applicant. This is because the end user applicant has to develop specific knowledge and identify key information to be able to develop and present the arguments to the arbitrator that there is inequity and what the value of that inequity is – essentially an end user will have to provide sufficient information and evidence to disprove the assertions the service provider will deliver to the arbitrator.

Further, the proposed Law change indicates that the cost of the arbitrator will be shared equally between the end user and the service provider, unless the arbitrator considers differently. This adds to the costs an end user will incur in the process. As clearly demonstrated in instances where the AER's decisions have been challenged by electricity and gas network owners, end users will be loath to take on such open ended financial risks, however compelling their case may be[5].

So, in addition to the information asymmetry, the exposure to costs to provide arguments will provide a significant barrier to end users using the arbitration process.

The "free rider" issue

As highlighted above, the implication of the increased disclosure of information to be provided to the market to assist in the arbitral process is that the outcomes of the first end user's arbitration process might be made available to subsequent end users also seeking equitable outcomes. Such an outcome introduces the issue of equity for the first end user as subsequent end users will benefit from "free riding" on the actions and expenditure incurred by the initial end user applicant. This is not equitable.

So not only will the initiating end user incur costs that result from the service provider acting to prevent an outcome that would flow onto other end users, but this will incentivize the initiating end user to accept a less than equitable outcome as the service provider will act to limit its risk exposure to much lower revenues from a flow on. Such an outcome is inefficient as not only does the initial end user applicant have a less equitable outcome but for smaller consumers, they will remain exposed to unnecessarily higher tariffs but without the incentive to seek arbitration as the costs could exceed their lower benefit from arbitration.

[5]The MEU notes that the COAG Energy Council recognised this issue in the case of the AER/Tribunal decisions and has amended the National Electricity Law and National Gas Law to better facilitate users effective participation in the appeal process. The MEU questions why the COAG Energy Council does not appear to recognise this issue when it come to the economic regulation of gas transmission pipelines

For example, if a large end user considers that an equitable outcome is a 20% fall in tariff, to avoid the costs of the arbitral process, it might accept a 10% reduction. This outcome would not be made public as it would be a “commercial in confidence” agreement[6] between the two parties. This would allow the monopoly service provider to maintain or even increase the tariffs for other end users as it would be aware that the benefits the other end users might accrue through their own arbitration would not offset the costs those other end users might incur.

Further, even if there is disclosure of the basic access tariff that was negotiated between the pipeline owner and an individual end-user, there are many other charges that could be imposed on different users that sit outside the process and could require a specific arbitration to address them.

In contrast, under regulation, all consumers contribute to the costs of regulated outcomes and all benefit to the same extent.

Expeditious outcomes

The MEU and its associates have been involved in pipeline regulatory activities since the first energy network regulation process in the late 1990s. The MEU has seen the regulatory process grow immeasurably over the past two decades. Whereas in the early years of pricing for energy transport, proposals for new tariffs were relatively simple and comprised a single document, yet even so there was a considerable amount of work required to develop what were considered to be equitable pricing. The amount of work now involved reflects proposals running to many tens of documents (eg the current proposal from APA for the Victorian transmission network comprises 40 different documents). The MEU can see that even under a commercial arbitration process service providers would generate significant numbers of documents so as to demonstrate the reasonableness of their position to an arbitrator. This approach will lead to significant time demands and delay outcomes.

While not explained within the draft amendment, it would appear that the Gas Rules will be varied to provide the basis for an arbitrator to make assessments of the prices for access in the arbitration process. Under the current rules, prices are developed based on a cost build up using the building block approach coupled to an estimate of forecast usage to generate prices. This process has been used in gas pipeline regulation for over 20 years to identify appropriate pricing for tariffs and it would seem that this same approach is likely to be used for the arbitration process.

The MEU notes that it is not only actual data that is used in the development of transport pricing but there are extensive assumptions to provide forecasts for the different elements[7] used in the building block approach to assess the

[6] Such an agreement would not be made public as it reflects a specific agreement between two parties and therefore would be confidential

[7] These include the capital base, the rate of return, the operational expenditure, any new capital required, rates of future depreciation, depreciation already included, forecast inflation, forecast

reasonableness of an assertion of price. Even aspects of the AER's decisions are debated between the AER and the service provider so it would be extremely challenging for an arbitrator to provide a binding decision when there are so many assumptions needed to demonstrate equity in the outcomes.

With this in mind, it is of considerable concern that the arbitration process would tend to emulate the AER regulatory process where decisions can require many months (even years) to reach a decision. Even AER decisions, while binding, can be appealed by the service provider and it is feasible that a service provider could well appeal an arbitrator's decision further extending the period to reach a final decision.

Conclusions

The theory underpinning the Vertigan report is that, with little or no information asymmetry, commercial arbitration would redress the problem identified by the ACCC[8].

However, commercial arbitration does not address the fundamental issues which are detailed above. But an overarching aspect of the proposed commercial arbitration approach is that effectively the onus of proof is on the end user as the end user has to prove to the arbitrator that the service provider is overcharging whereas the service provider only has to show that its prices are reflective of its costs.

The other aspects – that:

- The threat of commercial arbitration is overstated
- The cost of the process is a barrier to an equitable outcome
- There is a free rider issue that needs to be recognised
- Expeditious outcomes might not occur

still have to be addressed yet these critical issues do not appear to have been adequately considered.

The MEU is very concerned that the move to commercial arbitration to address the concerns raised by the ACCC is unlikely to deliver the equitable outcomes contemplated by the ACCC.

Further, the MEU is not convinced that the concerns raised in its response to the Vertigan review (see MEU letter dated 18 October 2016) will be adequately addressed by the proposed actions.

More generally, the proposal fails to recognise and respond to the fact that in an increasingly complex and challenged energy market, gas transmission (both within

---

volumes of transport and the allocation of the total costs incurred by the service provider to provide for the specific transport arrangements sought by the end user

[8] And which was supported by the Vertigan review

and between states) will play an ever more important role in our energy security and costs for the essential services of gas and electricity supplies. The current coverage test fails to respond to these new developments and this is well recognized. The proposed amendments, however, fall well short of addressing the issue of gas transmission pipeline monopoly that exists – on prices, access, services and information.

This means that the proposed amendments ultimately fail the test of servicing the long term interests of consumers and Australian energy policy more generally.

We appreciate the opportunity to have provided this input to the review process of the LMR. 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