18 October 2016

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

Submitted by email: energycouncil@environment.gov.au

Dear Dr Vertigan

Origin Energy Limited (Origin) welcomes the opportunity to comment on the COAG Energy Council's review of the Coverage Test for gas pipelines. Our views on the issues discussed in the Consultation Paper are set out below.

Purpose of the coverage test

Given relatively high fixed costs (due to the capital intensive nature of the industry), gas pipelines (for the most part) are required to capture the benefits of operating on a large scale to remain viable. Generally, industries such as these exhibit greater levels of market concentration, where the existence of multiple suppliers is unlikely to be feasible or economically efficient in the long term.

With the innate structure of the pipeline industry in mind, the purpose of the coverage test should be to provide a safety net aimed at minimising any potential adverse impacts on market efficiency, brought on by the elevated levels of concentration. In particular, the threat of regulation should serve to ensure that prices do not deviate from a competitive level for extended periods of time.

Competitive markets provide for more efficient outcomes compared to those under a regulated framework. Under regulation a central body would be charged with the difficult task of replicating competitive prices. Where prices are not set at an appropriate level it could serve as a disincentive for future investment. Therefore, the credible threat of regulation is likely to drive more efficient outcomes than regulation itself.

Effectiveness of the current test

A number of factors should be taken into consideration in determining the effectiveness of the current coverage regime, including:

<u>Previous coverage decisions:</u> In recent years coverage has been revoked on a number of pipelines. While this could be viewed as the test being deficient in some way, (e.g. that it prescribes too high a hurdle for the coverage criteria to be met), this may not necessarily be the case. In its recent review of the east coast gas market and pipeline frameworks, the Australian Energy Market Commission (AEMC) examined a number of recent coverage related decisions over the past 15 years. The AEMC noted that:

"The *fact that coverage has been revoked on so many pipelines reflects a more general trend under Part IIIA of the CCA for declaration (equivalent to coverage) to be used in a sparing manner"*[1].

The AEMC also found that each decision was made by the relevant Minister based on the specific circumstances regarding the pipeline.

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[1] AEMC 2015: East Coast Gas Market and Pipeline Frameworks Review, Appendix D, pg194.

Pricing outcomes: The effectiveness of the coverage test could be called into question if the prices of pipeline services are above those likely to be observed in a workably competitive market for an extended period of time. Origin notes the concerns raised by the ACCC in its east coast gas inquiry and expects the issue of whether pipeline companies have been able to consistently engage in monopoly pricing will again be re-examined here. It may also be useful to distinguish between prices observed in long term gas transportation agreements (GTA) for firm capacity, and shorter term as-available or interruptible services. The ACCC notes in its report that:

"There is no well-accepted regulatory principle for the pricing of as available or interruptible services in Australia, but the principle that has been adopted in the EU and the US is that the price of as available or interruptible services should not exceed the price of firm capacity.[2]

In contemplating an appropriate regulatory principle for Australia, it is important to understand if there are any potential impacts on incentives for long term foundation investment where some as-available services are sold at a discount to firm capacity.

Potential areas for reform

Origin has not formed a firm view on the effectiveness of the current coverage test, but nevertheless considers that in examining the test objectively, there are areas for improvement. The current test, consisting of four criteria, largely follows the declaration criteria set out in Part IIIA of the CCA. Criterion (a) which is the subject of most scrutiny, states:

Access (or increased access) to the services provided by means of the pipeline would promote a material increase in competition in at least one other market.

The AEMC in its gas market review highlighted that the application of criterion (a) has been described by the National Competition Council (NCC) and the Australian Competition Tribunal as involving a two stage process whereby the would seek to[3]:

- *Identify an economically separable dependent upstream or downstream markets; and*
- *Assess whether access is likely to promote competition in the dependent markets*.

The NCC goes on to clarify that:

If it is established that a service provider has no incentive and/or ability to exercise market power in the dependent markets, then access is unlikely to promote a material increase in competition[4]*.*

It is not clear why the sole focus of criterion (a) is on the impact of a pipeline's actions on a related upstream or downstream market. It is equally important that competitive outcomes in the market for pipeline services are also considered. The current wording of criterion (a) was perhaps more fitting when there were greater levels of vertical integration in the pipeline industry, but this is no longer the case. It may be possible to enhance the effectiveness of criterion (a) and the coverage test overall by explicitly considering market power in the pipeline market.

The AEMC in a previous review of the wholesale electricity market established the concept of substantial market power. Under this approach market power is problematic if it is exercised to such an extent or with sufficient frequency that it causes long term average prices to be above the efficient level for a sustained period of time[5].

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[2] ACCC 2016: East Coast Gas Inquiry Final Report, pg 109
[3] AEMC 2015: East Coast Gas Market and Pipeline Frameworks Review, Appendix D, pg189-90
[4] *Ibid*
[5] AEMC 2013: Final Determination on Generator Market Power

Origin Energy Limited ABN 30 000 051 696 • Level 45, Australia Square, 264-278 George Street, Sydney NSW 2000
GPO Box 5376, Sydney NSW 2001 • Telephone (02) 8345 5000 • Facsimile (02) 9252 9244 • www.originenergy.com.au

In the case of greenfields pipelines Origin supports retaining the 15 year no-coverage option.

If you wish to discuss any of these issues further please contact me at steve.reid@originenergy.com.au or on 02 9503 5111.

Steve Reid
Manager Wholesale Regulatory Policy

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