APA
Australia's energy infrastructure partner

Submission on AER Draft Decision

Form of Regulation Review:
South West Queensland Pipeline

8 November 2024

Contents

1. Executive Summary

On the 8 October 2024, the Australian Energy Regulator (AER) released its *South West Queensland Pipeline Form of Regulation Review – Draft Decision* (Draft Decision) proposing that the SWQP remain subject to non-scheme regulation.

APA welcomes the AER's draft decision to maintain the current form of regulation for the SWQP. This decision creates confidence to make the necessary investment in the east coast gas grid to support energy security for consumers and the transition to a reliable, affordable and lower emissions energy system.

APA acknowledges this is the first Form of Regulation Review and therefore the first practical application of the amendments to the National Gas Law (NGL) that came into effect in March 2023[1]. Consequently, it is important that this review provide clear guidance for how future reviews are to be conducted. Therefore, while strongly agreeing with the AER's conclusion, APA does have comments on some of the analysis and findings in the Draft Decision. These have been articulated in this submission.

In assessing which form of regulation is appropriate, the AER has appropriately had regard to:

— the form of regulation factors set out in section 16 the NGL;
— how effective each form of regulation will be in promoting access to pipeline services on the SWQP;
— the costs that are likely to be incurred by an efficient service provider, efficient users and prospective users, including the likely costs to end-users; and
— the National Gas Objective (NGO) which includes the long-term interests of natural gas consumers.

The AER have made a number of conclusions that APA agrees with, including that:

— the extent of any benefits of scheme regulation are unclear;
— recent improvements to the regulatory regime have not had time to be utilised and may improve the performance of non-scheme regulation;
— the indirect costs of scheme regulation, associated with delayed investment, are likely to be significant; and
— the benefits of moving to a heavier style of regulation will not outweigh the costs.

While agreeing with the AER's ultimate conclusion, APA does have concerns with some of the findings made by the AER in respect of the costs and benefits of moving to a heavier form of regulation. APA does not believe the costs and benefits are as finely balanced as the Draft Decision suggest.

In assessing the potential benefits of regulation, the Draft Decision suggests that if heavy regulation were introduced, there could be a significant reduction in the prices paid by customers. APA notes in this respect that:

— While the AER acknowledges that the outcomes on the Regulated Asset Base (RAB) are highly uncertain, the conclusion that regulation could reduce prices is predicated on referencing a narrow set of methodologies for setting the RAB. In establishing an initial RAB value, the AER would need to consider a range of factors, including historic construction and acquisition costs, current economic value, and the basis on which tariffs have been set in the past. APA is of the view that there are more appropriate methodologies available that would deliver a significantly higher RAB and would preserve the existing value of the asset;
— The Draft Decision does not appear to take into account all the evidence provided by APA, including expert economic evidence that relevant to the reasonableness of the current level of returns. As articulated in APA's earlier submission, and further detailed in this submission, the returns obtained by APA on the SWQP are no higher than what may be expected in a workably competitive market – and over the last decade, have been below competitive market benchmarks;

[1] See, s 112 of the NGL.

— The Draft Decision appears to be starting from the premise that the only reasonable level of return is a regulated rate, and anything more than this is an 'over recovery'. APA is concerned that this does not give appropriate weight to the risk inherent in developing infrastructure of this nature; and
— Price reductions suggested in the Draft Decision are in comparison with published prices rather than the actual prices paid by customers. This will overstate any reduction that would be available.

Additionally, in assessing the potential costs of regulation, APA believes the Draft Decision underestimates the impact a move to heavy regulation will have on the investment environment in respect of gas transmission pipelines. The AER concludes that the impact on investment of moving to heavy regulation is a transitory timing issue (i.e. an impact that principally arises during the initial access arrangement process). This conclusion fails to consider the enduring longer term investment impact that would arise from shifting to a heavier form of regulation at this time. In this regard, APA refers to the evidence provided in its first submission and reiterated here:

— In the current market environment, there is considerable uncertainty around gas demand forecasts and therefore the potential returns of any investment. These risks can only be supported in a non-scheme regime where a pipeline owner can negotiate a return on investment that adequately reflects these risks and can share the risk with customers through long-term contracts;
— the role of foundation contracts in underpinning the development of pipeline infrastructure, and the impact of imposing tariff regulation part-way through a foundation contract term, is not fully recognised in the Draft Decision. If neither party is willing to accept the risk of regulation undermining tariff certainty or crystalising 'first mover' risk, then it may be that long-term contractual arrangements will no longer be available to support major investments; and
— moreover, the Draft Decision could be viewed as suggesting the introduction of heavy regulation could unilaterally remove $800m of value from a privately owned $2.4bn asset, twelve years after it was acquired in a competitive sale process and while that private owner is still investing significant sums in the asset. This would clearly have a very significant impact on investment confidence.

These are not merely transitory risks to investment that apply during the period in which the initial access arrangement is being developed. These are enduring risks to investment in critical pipeline infrastructure.

APA believes the current form of regulation best supports the long term interests of customers and the achievement of the NGO by enabling the investment required to help decarbonise the Australian energy system. As such, APA supports the AER's Draft Decision to maintain the current form of regulation for the SWQP.

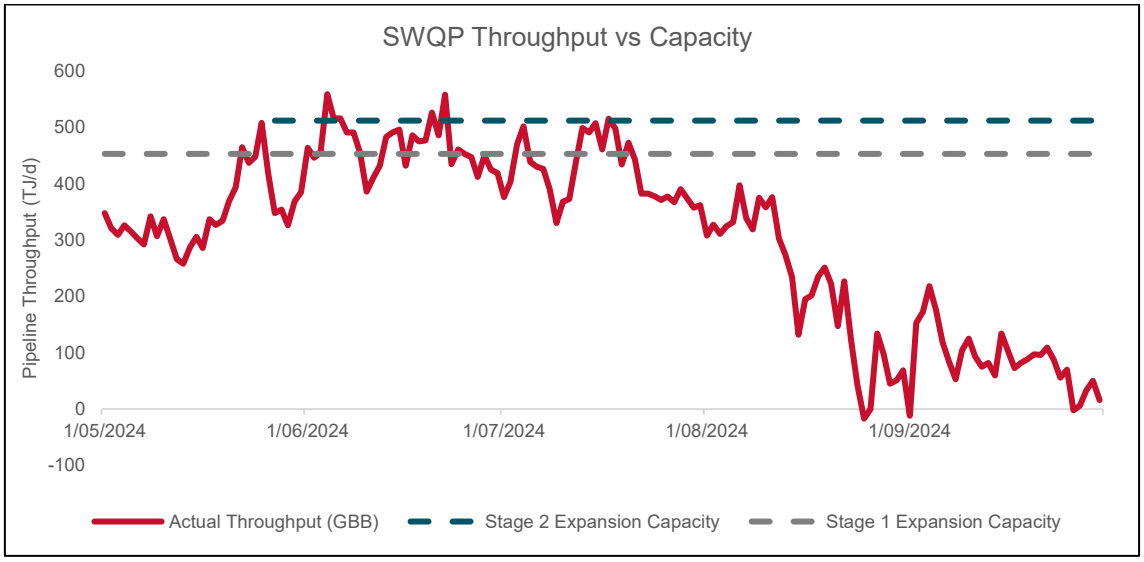
2. SWQP and Gas Supply

The Draft Decision provided a summary of the operation of the SWQP and assumptions regarding future gas supply and demand.

Since the commencement of this Form of Regulation Review, APA commissioned Stage 2 of its East Coast Grid Expansion which was highly utilised during winter 2024. Due to the long lead times for procuring equipment and construction, and in order to meet APA's expectation for demand in an increasingly dynamic market, the expansions were largely uncontracted and undertaken due to APA taking on the risk.

Ultimately, this investment has proven to be necessary as structural declines in gas supply in Southern states coupled with temporal shocks, such as wind droughts and supply interruptions from the Blacktip field in the Northern Territory, have required SWQP to operate near to or above the pipeline nameplate capacity for large portions of the peak May to September winter period (see Figure 1 below).

Figure 1: SWQP Utilisation winter 2024 vs recent capacity increases.



Source: Gas Bulletin Board

As the gas market is expected to become tighter over coming years, and supply sources become more uncertain, investments in capacity will become increasingly exposed to demand risk and necessitate investment in advance of customer contracting.

3. Form of regulation factors

As noted by the AER, the form of regulation factors can inform an assessment of the degree of market power that a service provider may have in providing pipeline services, and the potential constraints on its ability to exercise that market power.

In the Draft Decision, the AER considered that APA likely has market power in the provision of services on the SWQP though there are some constraints on that market power. The AER's draft view is that:

- APA currently faces few constraints in exercising market power when dealing with the majority of users;
- however, exercises of market power by APA are constrained by the largest shippers – the countervailing power held by these shippers is attributable to the volume they account for rather than their status as foundation shippers;
- constraints on APA's market power are likely to strengthen over time as more substitute services are developed.

While the AER has recognised some constraints on APA's ability to exercise market power, the Draft Decision significantly understates the strength of these constraints. An appropriate assessment of the form of regulation factors suggests that there are stronger constraints than suggested by the AER. In particular:

- consideration of barriers to entry and constraints on market power is unnecessarily limited to pipeline infrastructure and services – a proper assessment must take into account barriers to entry in the transportation of gas more broadly;
- the extent to which 'network effects' contribute to APA's market power in the supply of services on the SWQP has been overstated;
- contrary to the AER's findings, the conditions which afforded countervailing power to foundation shippers remain and continue to constrain APA; and
- the availability and impact of substitutes to pipeline services on the SWQP has been understated – while no one alternative identified is a full substitute for transport on the SWQP, the available substitutes taken together act as a material constraint on APA.

Each of these issues is addressed below.

3.1. Relevance of barriers to entry for non-pipeline natural gas services

In the Draft Decision, the AER considered that barriers to entry in the market in which the SWQP competes are high on the basis of factors primarily concerned with building a duplicate pipeline – in particular, the AER identified significant sunk costs, economies of scale, regulatory approvals and access to land.

This approach leads to an incomplete assessment of the constraints on APA's ability to exercise market power. APA is constrained by the existence of various options available to shippers to meet their ultimate needs. The available options will differ between shippers, but in no case will the construction of a duplicate pipeline be the only alternative to acquiring SWQP services from APA.

In order to properly assess APA's ability to exercise market power, it is necessary to take a broader view of barriers to entry and competitive constraints. This broader view is consistent with the NGO, which refers broadly to 'natural gas services' and requires the AER to take a long term view.

Recent market developments mean that the most immediate competitive threats do not arise from the building of a duplicate pipeline. More immediate and direct competitive threats include:

— shippers being able to access contracted but unutilised capacity instead of acquiring services from APA – either by acquiring services from existing foundation shippers and/or accessing capacity through the Day Ahead Auction (DAA) or capacity trading; and
— the establishment of LNG import terminals. The development of these terminals at Port Kembla and Outer Harbour indicates that these barriers are able to be managed by sophisticated and well-resourced industry participants – Venice Energy, the developer of the Outer Harbour LNG Terminal was recently acquired by Singapore-based AG&P LNG who indicated the terminal will be online by Q1 2027.[2]

A narrow assessment of barriers to entry in the provision of pipeline services fails to account for these more immediate and significant competitive threats.

3.2. Network externalities are limited to pipelines directly connected to the SWQP

In the Draft Decision, the AER considered that APA's supply of "*several other covered gas services, particularly other transmission pipeline services, contributes to its market power*".[3] In forming this view, the AER relied on:

— the breadth of APA's network and APA's description of this network, including 21 transmission pipelines, 2 distribution pipelines, one storage facility and one processing facility, though the East Coast Grid was of particular relevance;
— feedback from shippers that multi-asset agreements are simpler and more efficient than multiple contracts for individual services and often offered greater flexibility around imbalance allowances and efficient nominations;
— the lower price of multi-asset transport relative to standing tariffs for individual services.

The Draft Decision overstates the extent to which these factors contribute to APA's market power.

While APA's network includes several other pipelines, the breadth of this network does not contribute to or enhance market power. Many of these pipelines are utilised by a single or very few large shippers, without which the asset would be stranded - of the nine transmission pipelines in the East Coast Grid, five are utilised by six or fewer shippers and three by three or fewer shippers.[4] Moreover the ability to offer services on one pipeline does not mean that market power can be exercised on others. Shippers can obtain services on each pipeline independently (potentially in combination with competing services), or they can choose multi-asset service offerings.

APA does offer some shippers greater service flexibility through its multi-asset service offerings. However, this is driven by the customer's service requirements. Where APA offers this flexibility, doing so can deliver benefits for both parties but also comes with some commercial risk to APA due to the complexity of balancing contractual rights of shippers, actual nominations and pipeline capacity across multiple pipelines.

3.3. Foundation customers have retained countervailing power

The AER considers that the conditions which led to foundation shippers having countervailing market power 'no longer exist'. The AER considers that, instead, the current level of countervailing power is

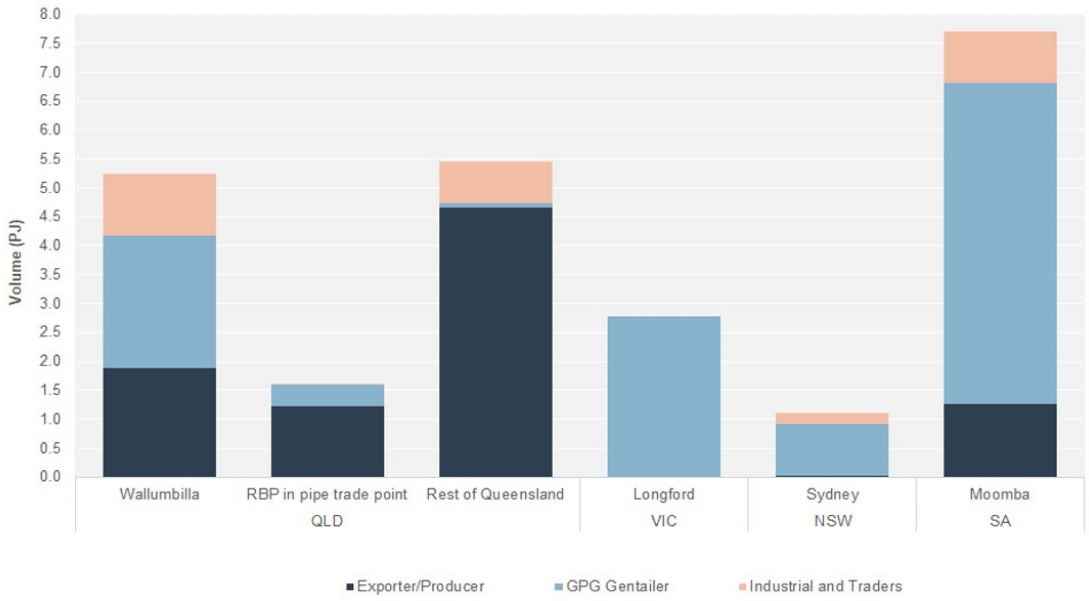
[2] AG&P LNG, *AGP LNG Agrees to Acquire Venice Energy, a 2 MTPA LNG Import Terminal Developer at Outer Harbor in Port Adelaide, Australia* (24 October 2024) (link).
[3] Draft Decision, p 34.
[4] AEMO, GBB Shippers List (15 March 2023) (link). The Reedy Creek to Wallumbilla Pipeline is utilised only by Australia Pacific LNG Marketing Pty Ltd, South East South Australia pipeline utilised only by Origin and Group Energy and the Berwyndale Wallumbilla Pipeline utilised by Shell (Walloons coal Seam Gas Company Pty Ltd and Shell Energy Australia Pty Ltd) and AGL.

attributable to shippers' current ability to threaten bypass of the SWQP and APA's reliance on those shippers.

In APA's view, the key conditions contributing to the countervailing power of foundation shippers at the time foundation contracts were struck largely remain in place:

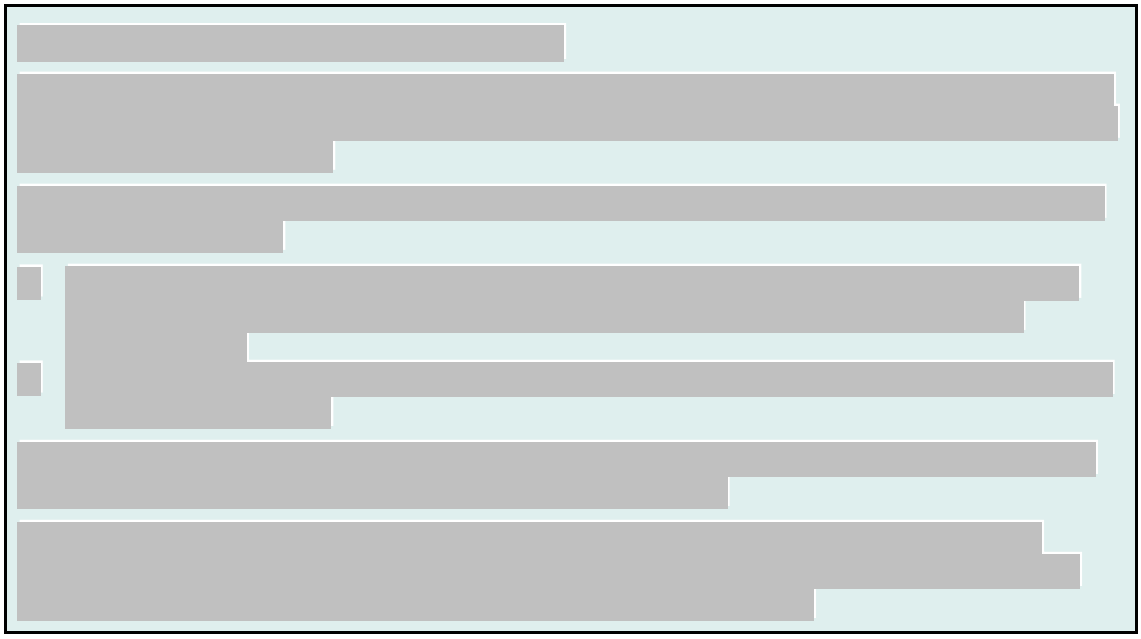
— Then and now, foundation shippers account for the large majority of contracted and actual capacity on the SWQP – [redacted] APA continues to rely heavily on these customers, as it (and Epic) did at the time the foundation contracts were struck;
— Swaps remain a viable alternative to north-south transport and therefore a strong constraint on the SWQP. Large shippers had entered into swap arrangements prior to and following the striking of foundation contracts (Origin and Santos 2004, Origin and Santos 2010). Today, swaps continue to be used as an alternative to pipeline transport. Gentailers and exporter/producers account for over 80% of swaps on the east coast.[5] Further, data from AEMO shows shippers of all kinds continue to utilise swaps with over 23PJ of swaps being executed in the first 10 months of 2023 (see Figure 2:);
— In its Draft Decision the AER highlighted that shippers had given feedback indicating that finding a counterparty and executing a swap can be a difficult and timely process. APA would highlight that AEMO is changing the Gas Supply Hub Exchange Agreement[6] to implement an exchange traded locational swap which will address these concerns.

Figure 2: Participant location swaps grouped by main areas[7]



— There continue to be competing solutions to meet shippers' gas transportation needs. At the time the major foundation contracts were struck, these included alternative pipeline routes. Today, options for shippers seeking additional capacity to meet southern demand include alternative pipelines (e.g. the Hunter Gas Pipeline) and potentially LNG import terminals.
— Further, the AER's conclusion disregards that some conditions contributing to countervailing power are preserved by the foundation contracts themselves – noting some contracts on the SWQP contain terms that are highly favourable, [redacted]

[5] AER, *Special report: Wholesale gas short term transactions reporting* (December 2023) (link), p 20.
[6] Version 17 of the *Gas Supply Hub Exchange Agreement* to be effective from March 6th 2025.
[7] Ibid, Figure 8.



3.4. The range of available substitutes for pipeline services together impose a strong constraint on APA

The AER has acknowledged that there are a range of alternative services that can be used to supply gas to locations served by the SWQP, either alone or in combination with other pipeline services – these include locational swaps, the DAA, secondary capacity trading and potentially also LNG import terminals in future.

However, the AER did not consider that any of these provided a 'full substitute' such that shippers could switch or credibly threaten to switch away from use of the SWQP – in these circumstances, the AER did not consider there were sufficient substitutes to constrain APA's market power on the SWQP.

APA acknowledges that, in some cases, there will be no single alternative that acts as a full substitute to services on the SWQP. However there does not need to be a single complete substitute for pipeline services in order for there to be a constraint on APA's market power. The AER should take into account the broad range of substitutes, the range of customers to which these are available and the frequency with which these are taken up – all of which indicate that even partial substitutes act as a real constraint on APA's market power. Multiple substitutes can be used together by a customer to effectively avoid or reduce reliance on the SWQP.

For example, Figure 3 represents APA analysis of aggregated and matched allocation data for two SWQP customers for the period 1 January 2023 to 31 October 2024 which demonstrates the competition that substitutes for SWQP capacity pose. The combined gas demand of these customers is relatively constant. The figure shows that not only do substitutes generally compete with SWQP capacity, at times, they wholly replace SWQP services and vary significantly over time based on market dynamics and specific shipper requirements.

Figure 3: Substitution for SWQP capacity by APA non- foundation customers

More broadly, there is evidence of significant use by shippers of these substitute services:

- The shippers on which APA is most reliant, are the most significant users of locational swaps on the east coast. Three shippers (Origin, AGL and Santos) reserved 94% of westernhaul capacity and 99% of easternhaul capacity in 2023 – Exporter/Producers and GPG Gentailers such as these accounted for 87.8% (21PJ) of locational swaps on the east coast in the 10 months to 31 October 2023, with 50% (~12PJ) being between Exporter/Producers at locations related to production or export of gas.[8] In addition to being readily available to these shippers, swaps are often competitively priced – the AER has previously indicated that same day locational swaps between north and south regions were frequently priced at $0/GJ.[9]
- The AER acknowledged that shippers can and do turn to the DAA at least as a partial substitute for firm transport but noted that auction capacity could not be a full substitute on the basis that bids were constrained 20% of the time between March 2019 and August 2024 and that these constraints were trending upward. However, in APA's view this same data indicates that auction capacity is an effective substitute for shippers without contracted capacity 80% of the time. Further, though bids on the DAA are constrained by the amount of contracted but unnominated capacity, they are not indicative of constraints on pipeline capacity overall – shippers may still access capacity through substitutes to pipeline services including direct trades with shippers entitled to higher priority services than auction services or otherwise bypassing pipeline transport by way of swaps.

The constraint posed by the range of existing substitutes available to shippers is compounded by the growing threat of entry by LNG import terminals. APA agrees with the AER's view that LNG import terminals are likely to be an effective substitute for pipeline services and a constraint on APA's market power if developed. We note recent developments regarding the Outer Harbour LNG terminal – as noted above, the terminal is expected to come online in Q1 2027. APA understands based on publicly available information that Origin is in talks to be the sole user of the terminal for a decade – though Origin has not publicly confirmed this, this is consistent with submissions made by Origin to the AER.[10]

[8] Ibid.
[9] Ibid, p 21.
[10] Reuters, *AG&P LNG to acquire Australia's Venice Energy, to develop South Australian Import Terminal* (24 October 2024) (link).

4. Prices and returns on the SWQP

In its Draft Decision, the AER calculated that under scheme regulation, the regulated reference prices would likely be lower than the prices that shippers currently pay to use the SWQP.

The AER suggests that its analysis of prices and returns therefore infers that APA is earning more than it would in a workably competitive market. In saying that, the AER concedes that there is considerable uncertainty in its analysis of prices and returns.

APA agrees that there is much uncertainty when estimating the potential price for access on the SWQP as it will predominantly depend upon the asset valuation methodology used.

Moreover, comparing these estimated regulated returns with the historic returns on the SWQP and suggesting that this is a result of market power is flawed.

APA has shown that the SWQP prices were set under long-term contracts in a competitive process. As such, any assessment of whether current prices are 'reasonable' should be relative to the outcomes of workable competition and not to what could have happened under price regulation. In that context, the analysis of CEG and Incenta[11] demonstrate that APA's returns were no higher than necessary to compensate for the risks associated with the investment in the SWQP.

4.1. AER analysis of indicative price outcomes under scheme regulation

In its Draft Decision, the AER has analysed potential regulated prices on the SWQP but acknowledged that there is a great deal of uncertainty regarding its analysis.

APA agrees that it is highly uncertain what price outcomes would be for customers under scheme regulation. Price outcomes for customers under scheme regulation would depend on a range of factors, including the scope and definition of reference services, methods for calculating the initial capital base and other inputs into the reference tariff calculation, customer demand and service requirements, and the extent to which customers acquire the reference service(s). At this stage of the process, it is not possible to predict the impact on prices paid by customers with any degree of certainty.

APA notes that the AER's calculations reflect a comparison of the notional reference price with the "SWQP's standing prices for long-term firm transport". This will not provide an accurate indication of the potential impact of scheme regulation since many customers do not pay the standing tariff. Depending on a customer's specific service requirements and other factors (e.g. volume and term commitments) they may be paying a price that is lower than the standing prices.

Moreover, there are many variables that will impact the calculation of reference tariffs and the extent to which reference services are taken up by customers. In particular:

— the analysis greatly depends on the methodology used to establish the initial RAB. The Draft Decision only highlights the outcomes of a few methodologies and even in these instances, the results vary greatly. The application of each methodology referred to by the AER is itself underpinned by numerous assumptions that would need to be rigorously tested (e.g. assumptions regarding historic rates of depreciation). We note that when using a depreciated book value, the AER has used an asset value that is almost $800m lower than publicly reported asset valuation;
— in conjunction with the RAB, the regulated prices are based on the current rate of return which in the future can (and have over the last 20 years) vary markedly. Such variations would have a significant impact on the estimated regulated prices but no corresponding impact on the current non-scheme prices as they are linked with long-term contracts.

[11] See Attachment 1: Incenta, *Are the returns to the SWQP consistent with the returns expected in a competitive market?* Report for Gilbert + Tobin, November 2024, and CEG, *Consultation on form of regulation for the SWQP* (March 2024), Appendix J of APA's *Submission to the SWQP/ QNI Link Form of Regulation review*

Indeed, one of the major reasons why the benefits of scheme regulation are uncertain is because there is a range of possible approaches to determining the RAB. In determining an appropriate methodology for the SWQP, there would be a variety of factors to consider, including historic construction and acquisition costs, current economic value, the interests of APA and existing users (including foundation customers) and the basis on which tariffs have been set in the past.[12]

For example, in previous regulatory decisions (including decisions under the Gas Code), historic tariff levels have been an important consideration. In some cases, the asset valuation has even been calculated to maintain an existing price level.

Case Study: Determination of an initial capital base for Telstra fixed-line assets

As part of a transition from a TSLRIC+ methodology[13] to a building block model for pricing of Telstra's declared fixed-line services, the ACCC needed to establish an initial valuation for the fixed-line assets. In this context, the ACCC considered various methodologies, including DORC, DAC, and indexed historic cost. The ACCC ultimately adopted a valuation that was between the estimated DAC and a DORC put forward by Telstra, calculated so as to maintain the existing price level for the key access service (the unconditioned local loop service, or ULLS). This implied an uplift of around $1 billion over the ACCC's estimated DAC value.

The ACCC explained this aspect of its decision in its 'Discussion Paper' as follows:[14]

> *"The ACCC considers that, in determining an initial RAB value for the CAN and Core assets, it is important to protect the legitimate business interests of both access seekers and Telstra. This consideration has led the ACCC to conclude that a clear justification is required for any significant change in existing prices. Based on this view, the ACCC has decided to maintain the $16 ULLS price in Band 2 included in the IADs. In addition, for the reasons set out in chapter 11, the ACCC decided that a single ULLS price of $16 should apply in Bands 1 to 3.*
>
> *To determine a RAB value consistent with an averaged ULLS Band 1 to 3 price of $16, the ACCC calculated the net present value of the cash flows expected from the ULLS Band 1 to 3 price and the prices for the other fixed line services estimated by the FLSM as being consistent with the $16 ULLS Band 1 to 3 price. The relativities between these prices and the ULLS Band 1 to 3 price are determined within the FLSM based on the relative costs of providing those services (see chapters 10 and 11).*
>
> *The net present value calculation implies an initial opening RAB value of $17.75 billion as at 1 July 2009, when the increment above the RAB estimate of $16.31 billion (based on a DAC value with indexed land asset values) is allocated to the 'ducts and pipes' asset class. Since this value falls within the suitable range of potential RAB values (set by DAC and DORC), the ACCC has determined that this value represented an appropriate value for Telstra's CAN and Core assets used to provide the fixed line services."*

The same approach was maintained by the ACCC in its Final Decision, but with an adjustment to the DAC uplift so as to maintain the $16 'tie-point': [15]

> *"After revising the initial tax asset value, the ACCC made a consequential revision to the initial RAB value. An initial RAB value of $17.75 billion (as proposed in the April 2011 Discussion Paper) would no longer provide the degree of price stability considered desirable by the ACCC in the transition to the BBM pricing approach. The ACCC has therefore*

[12] Gas Code, s 8.10.
[13] TSLRIC+ stands for total service long-run incremental cost, plus a contribution to common costs. The TSLRIC+ methodology was applied by the ACCC to determine prices for declared access services in the telecommunications sector until 2011. Since 2011, the ACCC has applied a building block methodology to determine prices for declared telecommunications services.
[14] ACCC, Public inquiry to make final access determinations for the declared fixed line services: Discussion paper, April 2011, pp 47-48.
[15] ACCC, Inquiry to make final access determinations for the declared fixed line services: Final Report, July 2011, p 44.

> *reduced the 'ducts and pipes' increment from $1.44 billion to $911 million, as at 1 July 2009. The lower increment maintains a $16.00 'tie-point' ULLS price between the old and new pricing approaches (TSLRIC+ and BBM)."*

4.1.1. Hub compression

In the context of assessing the value of the RAB of the SWQP, APA also considers that there is further uncertainty created when assessing the *scope* of the SWQP. In particular, the AER has commented that its assessment of the SWQP includes compression at Wallumbilla and at Moomba – that is, at either end of the pipeline:[16]

> *For the purposes of this Review and based on the information provided by APA in response to a notice issued under section 42 of the NGL (the s 42 Notice) and the Discussion Paper, we have treated the compressors that APA owns and operates at Moomba and Wallumbilla as part of the SWQP.*

APA notes that the compression facilities at Wallumbilla and Moomba are *hub compressors* – that is, they are not dedicated to any one pipeline. This can most easily be seen from a review of the Wallumbilla hub schematic diagram posted on the APA website.[17] It is clear that there are many pipelines that draw high pressure gas from the high pressure header and other pipelines that *inject* into the Wallumbilla hub low pressure header.

The Wallumbilla and Moomba hub compression services are required to be reported separately under Part 18A of the National Gas Rules. While APA acknowledges that a high inlet pressure is required to access pipeline transport on the SWQP, it is important to note that any required compression services are sold independently from (although sometimes bundled with) the pipeline transportation services.

In this respect, APA submits that a more indicative assessment of the RAB of the SWQP would exclude the asset value of the hub compressors.

4.2. Comparing current tariffs and returns to those that would apply under scheme regulation

Even if it was possible to reliably estimate a notional reference price that might apply under scheme regulation, comparing current tariffs to this notional reference price does not, in itself, indicate whether market power is being exercised.

A price reflecting the outcome of workable competition may be above or below the reference price that would apply if scheme regulation were to be imposed today, for several reasons including:

- Under workable competition, tariffs are not automatically reset every five years. Instead, parties often enter into longer term contracts, with risks shared between the parties over the term of the contract. In the case of the SWQP, the vast majority of contracted capacity is priced under contracts with a term of at least ten years. The price under these contracts reflects competitive conditions and the expectations of the parties at the time of contracting. The fact that pricing under these contracts may differ from a notional reference price calculated today does not mean that this pricing no longer reflects a competitive market outcome, as the AER suggests – rather, it may simply reflect market circumstances diverging from the parties forecasts and expectations at the time of contracting.
- Parties operating in a competitive environment will face a different risk profile to regulated businesses, and as such will require a different level of return. The AER has acknowledged that

[16] AER draft decision s4.1 p17.
[17] https://www.apa.com.au/globalassets/our-services/gas-transmission/east-coast-grid/south-west-queensland-pipeline/wallumbilla-hub-schematic.pdf

non-scheme pipelines may face greater risks than scheme pipelines and this could justify a higher rate of return. Empirical analysis by Incenta confirms that this is indeed the case.[18]

Taking these factors into account, Incenta has provided an alternative analysis of SWQP returns over the past decade (in effect, recreating Table 6.1 of the Draft Decision). Incenta shows that SWQP returns were in fact below what may be expected in a workably competitive market over the past decade.

Table 1: Incenta comparison of SWQP returns with competitive market benchmark

4.3. Reasonable historic returns on SWQP

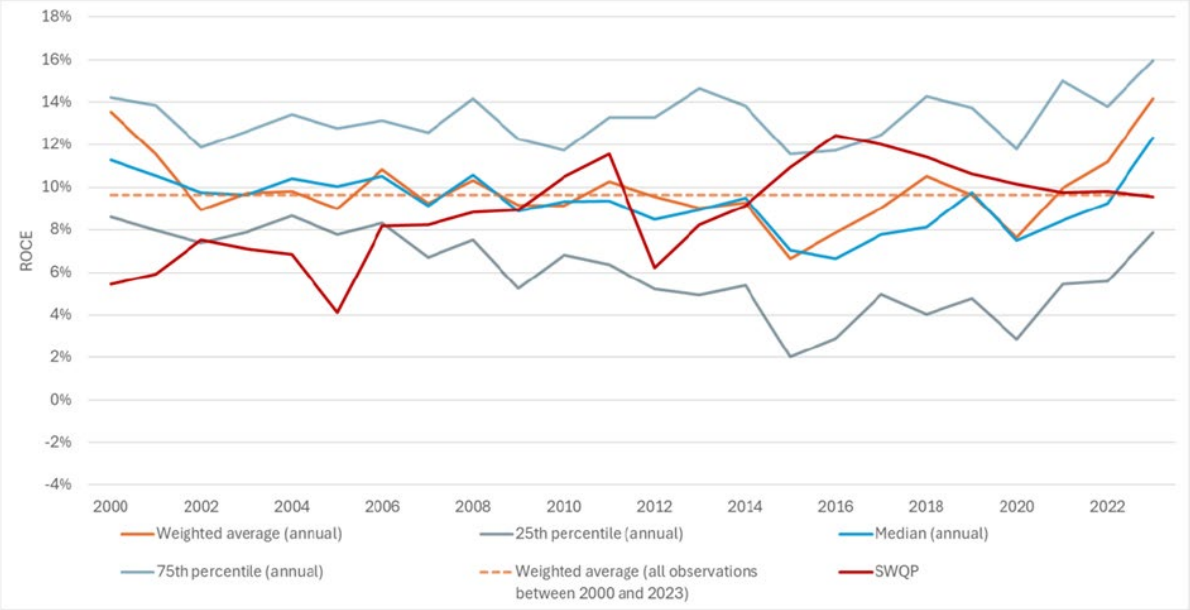
The AER only compared historic returns on the SWQP with estimated regulated returns which is not appropriate as discussed above.

In its submission to the Issues Paper, APA included CEG analysis that compared achieved returns on the SWQP with returns on capital for US pipelines over the same period [19]. This comparison is shown in Figure 4.

This "apples for apples" comparison shows that the SWQP has been earning returns within the range of comparable pipelines.

[18] See Attachment 1: Incenta, *Are the returns to the SWQP consistent with the returns expected in a competitive market?* Report for Gilbert + Tobin, November 2024
[19] CEG, *Consultation on form of regulation for the SWQP*, Report for Gilbert + Tobin, March 2024, p10

Figure 4: Comparison of SWQP return on capital with US pipeline businesses



Source: Bloomberg and APA's Financial Information Disclosure under Part 23 National Gas Rules, CEG analysis

It also highlights that the achieved return on investment fluctuated over the life of the SWQP and in periods of low demand (particularly in the early years of its operations) returns to investors were relatively low. Returns have improved as demand and throughput have increased.

4.4. Foundation contracts

In its Draft Decision, the AER considers that, even if foundation contracts represented competitive outcomes at the time they were struck, they may not represent competitive terms now.[20]. The AER notes that the revenue earned by APA from these foundation contract prices appears to have been "higher than the efficient cost of providing pipeline services for several years".

APA is concerned that the AER appears to consider the relevance of foundation contracts as an issue of countervailing power only, rather than as an issue fundamentally relevant to the appropriate price for pipeline services and level of returns. The AER may not fully appreciate the key role that foundation contracts play in attracting capital to pipeline investment projects, and the key role they will continue to play to attract capital for future pipeline investment. In order to support major investments in pipeline infrastructure, long-term commitments have been made by both pipeline owners and foundation shippers. Under these long-term commitments, there is both risk and potential reward for both parties – including the potential for **actual** returns over the life of the contract to be higher or lower than what was **expected** at the time those commitments were made. In seeking to divorce the foundation contracts, and the circumstances in which they were negotiated, from consideration of the appropriate economic returns for the asset today, the AER risk undermining the fundamental basis on which assets of this size, risk and complexity are built and operated.

4.4.1. Foundation contracts are a risk sharing tool fundamental to ongoing investment confidence

Foundation contracts are a fundamental and necessary condition of any significant infrastructure asset being developed. They are a risk sharing tool, and the ability to give effect to this risk sharing agreement

[20] AER draft decision s6.1.2 p60

over the total life of the contract is necessary if investors are to have the necessary level of confidence to continue to invest in Australian infrastructure. The price struck in a foundation contract, entered into in a competitive environment, is the economically efficient price taking into account the risk allocation achieved by the parties, and does not cease to be an economically efficient price with the passage of time.

Risk borne by pipeline project proponent

The winning pipeline proponent will be the firm whose proposal featured the most attractive tariff and terms of access, which will be a function of:

— lowest construction costs;
— lowest forecast of operating costs;
— lowest assumed cost of capital;
— most ambitious load growth forecasts; and
— highest assumed residual value at the end of the foundation contract term.

The winning pipeline proponent is then carrying the risk that the project will not deliver on its forecast. If construction is more costly, if load does not grow as forecast, or if the cost of capital in global financial markets increase, the pipeline will be at risk of not achieving returns on the equity invested.

In a competitive environment, as with SWQP, the pipeline proponent that takes on the highest level of risk will win the opportunity to construct the project. Given the uncertainties, it is unlikely that actual returns will reflect what was originally expected – actual returns may be higher or lower depending on the realisation of upside or downside risk.

Further, it cannot be assumed that the total investment in the pipeline will be returned by the expiry of the foundation contract/s - there is often a residual value at risk at the expiry of the foundation contracts. The owner of the pipeline will often take a 'recontracting risk', whereby it must assume that a portion of its investment will be recovered through recontracting volume at the end of the foundation contracts.

Risk borne by foundation shipper

Foundation shippers also take on significant risk, including:

— that the volumes they have forecast and contracted for exceed their actual demand, and so they are 'over contracted' and incurring cost they cannot offset through sales; and
— 'first mover risk', whereby their competitors who are also shippers on the asset are able to enter into shorter term, and potentially lower priced contracts, off the back of the risk taken by the foundation shippers.

Importance of MFNs and impact of regulation on MFNs

The price and terms of the contract will ultimately reflect the risk allocation. While the risk associated with these long-term commitments cannot be entirely mitigated, they can be managed to some extent through contractual mechanisms A very common term that is used to manage the 'first mover risk' for foundation shippers is a MFN provision.

A MFN clause provides that any future shippers cannot access pipeline capacity at a rate lower than that struck in the foundation contract. This provides a degree of protection for the foundation shipper, and will often be necessary for the foundation shipper to be willing to make the long-term commitment.

4.4.2. Foundation contract terms continue to be competitive for the contract duration

In negotiating foundation contract terms, the parties will agree a price, risk allocation and other terms for the entire duration of the contract. These terms will reflect a competitive market outcome for the entire contract duration. They do not cease to be competitive market terms if market conditions change over the term of the contract – e.g. if costs or demand turn out to be higher or lower than expected.

Of course, parties could choose to include contractual terms to adjust tariffs and other terms of the contract if market conditions change – e.g. there could be a periodic tariff review mechanism, with tariffs

to increase or decrease to reflect changes in costs or demand. However, in most cases parties choose not to include such mechanisms, or only provide for very limited adjustments (e.g for CPI). This generally reflects a desire on the part of both parties for tariff certainty over the term of the contract, and a sharing of risks associated with changes to costs or demand. Typically, the pipeline owner bears the risk of costs being higher of demand being lower than expected but will be rewarded if costs can be reduced or demand is higher than expected (and conversely the shipper is protected from the risk of increased costs and/or lower than expected demand leading to tariff increases).

The obvious implication of this is that tariff and return outcomes under long-term foundation contracts are very unlikely to reflect outcomes that would be observed under tariff regulation. Under regulation, tariffs are reset much more frequently, implying that both pipeline owners and shippers are more exposed to tariff fluctuations, but are also protected from the risk of changes in demand and/or costs.

Crucially, the fact that outcomes under long-term foundation contracts do not reflect what would be observed under regulation does not mean that foundation contract terms are not competitive market terms. It simply reflects a different allocation of risk between pipeline owners and shippers in relation to the setting of tariffs, cost movements and changes in demand.

4.4.3. Risk to future investment if tariff regulation is imposed part-way through foundation contract term

The imposition of tariff regulation part-way through the term of a foundation contract will potentially alter the allocation of risks embedded in those contracts. For example, depending on the terms of a foundation shipper's MFN protection, this could effectively be undermined by tariff regulation allowing competing shippers to access a lower tariff.

If there is an environment in which the risk allocation achieved through foundation contracts, including the MFN can be disrupted by the subsequent introduction of regulation, this will have very significant implications for the ability of parties to negotiate a MFN that covers their risk, and consequently the willingness of shipper to enter into foundation contracts.

— If a MFN does not operate to protect a foundation shipper from the impact of regulation, in that the introduction of a regulated price will not 'offend' an MFN, then the 'first mover' risk will crystalise, and the foundation shipper will be left with a long-dated contract at a price higher than its competitors are paying;
— This will provide a disincentive to all potential future foundation shippers from entering into such arrangements in the future. Any shipper contemplating underwriting a new pipeline will seek to negotiate a MFN that would provide the shipper with any lower, regulated price. This would not be acceptable to the pipeline developer, as it would not provide sufficient long term revenue certainty to underwrite the project.

The potential for tariff regulation to be imposed part-way through a foundation contract term therefore poses a significant risk to future investment in pipeline infrastructure. If neither party is willing to take the risk of regulation either undermining tariff certainty or crystalising a 'first mover' risk, then it may be that long-term contractual arrangements will no longer be available to support major investments.

This is not merely a transitory risk to investment that applies during the period in which the initial access arrangement is being developed. ***This is an enduring risk to investment in critical pipeline infrastructure.***

5. Costs of regulation

In assessing which form of regulation is appropriate, the AER is required to have regard to the costs likely to be incurred under each form of regulation. In its Draft Decision, the AER has considered both the direct costs and the potential indirect costs associated with scheme regulation and how this aligns with its consideration of the NGO.

APA is very supportive of this approach.

In particular, the AER has considered the indirect costs are likely to be a result of delayed, reduced or foregone investment and found that these costs could be substantially more significant under scheme regulation than under the current non-scheme regulatory framework. The AER also noted it was concerned that such costs could have broader implications for the east coast market.

APA agrees with the AER that there exists the potential for serious economic harm if gas infrastructure investment was impacted at this time. Furthermore, without the critical investment required in gas infrastructure in the short to long term, there exists a threat to energy reliability and security that many Australian households and business rely upon every day.

The AER's major concern was focused on the introduction of scheme regulation being slow to implement, not providing any immediate certainty and therefore risking infrastructure investment which is urgently needed.

Although this is a valid consideration, it is not the only impact of introducing scheme regulation on the SWQP and APA believes the Draft Decision underestimates the effect that imposing scheme regulation would have on current and future investment decisions.

5.1. Direct costs of scheme regulation

In its Draft Decision, AER found that direct regulatory, transaction, and administrative costs under scheme regulation are likely to be higher than those under non-scheme regulation but the difference between these costs was not large.

APA agrees with the AER that these increased direct regulatory costs are secondary when compared to the impact that any delayed investment would have on consumers and are therefore not material in its assessment.

5.2. Indirect costs of scheme regulation

The role of gas as a transition fuel supporting the energy market transition means that locations and patterns of demand for gas are likely to change considerably, including potentially increased demand for GPG capacity to support intermittent renewables.

APA is therefore particularly concerned about the ability to attract capital for investing in critical projects over the next decade, such as the Beetaloo basin and expansion of the ECG (including the SWQP), that can accommodate these new requirements.

The AER has identified this issue and concluded that the indirect costs associated with delayed or foregone efficient investment would be greater under scheme regulation than non-scheme regulation.

The Draft Decision has attributed this to the uncertainty created by the scheme regulatory process at a critical time for the east coast gas market and that the uncertainty that would exist until the first access arrangement is approved could delay the necessary investment in the SWQP.

APA agrees with the AER's concerns but believes the costs of scheme regulation would be much more significant than the AER suggests. Scheme regulation would have further impacts on efficient

investment beyond just process uncertainty and that these impacts are not transitory or short term as suggested.

Rather, APA believes that imposing scheme regulation on the SWQP would inhibit long-term investment in gas infrastructure by:

— limiting the ability to invest on the SWQP, given the uncertainties that exist around the location of new gas supplies, the long-term demand outlook and the pace and dynamics of industry change;
— introducing the risk of regulatory truncation through scheme regulation and therefore creating a precedent that all future investments would need to consider; and
— creating a real disincentive for the use of competitively negotiated foundations contracts (including MFN clauses) that are currently used to mitigate the risk of investments. If investors and shippers cannot rely on long-term contracts, then investments that carry both upside and downside risk are unlikely to be supported.

5.2.1. Scheme regulation impedes investment with uncertain demand

Under the current form of regulation, APA is prepared to commit to investment in the SWQP (and the ECG more broadly) based on its forecasts of future demand and revenues. However, in the current market environment there is considerable uncertainty around these forecasts and therefore the potential returns of any investment. There are considerable risks and associated downside for such an investment that can only be supported by APA setting a required return on investment that adequately reflects these risks and/ or sharing the risk with customers through long-term contracts.

Scheme regulation would not facilitate such an investment. It cannot deal with the uncertainty and risk associated with the pipeline as it does not provide the scope for the regulator to align the rate of return with the risk on an investment.

In its Draft Decision, the AER suggests that it can accommodate these risks (predominantly uncertain demand and stranding risk) under scheme regulation through:

— delaying the recovery of capital (depreciation);
— long-term contracts which can be used under both scheme and non-scheme regulation; and
— investment impairment also applies under scheme and non-scheme regulation.

It concludes that the form of regulation applying to the SWQP should not impact APA's ability to manage these risks.

The AER focusses on mitigating risk through the regulatory framework that is available to it under the NGL and NGR. However, APA's concern is that the tools available under the NGL and NGR are too limited. For example, the AER is unable to amend the rate of return to reflect the risk associated with a particular investment and this is only possible in the non-scheme framework.

The limitations of the NGL/NGR tariff regulation framework in addressing the types of risks faced on the SWQP are explained in the report prepared by Incenta Economic Consulting which was provided with APA's initial submission to this review.[21] Incenta explains why the tariff regulation framework under the NGL/NGR is ill-equipped to address these risks, for several reasons.

First, delaying depreciation assumes that there is either:

— an increase in future demand to align with the future increase in depreciation which will maintain prices; or,
— given no future increase in demand, that the pipeline can simply increase prices and recover the additional revenue from current shippers.

21 Incenta, *Economic principles for deciding on the appropriate form of regulation for the South West Queensland Pipeline* , Report for Gilbert + Tobin, March 2024

These assumptions would apply for electricity networks but are not practical for gas pipelines. With a gas pipeline, prices will either be constrained by long-term contracts or competitive forces. If the uncertain future demand does not eventuate then it is highly unlikely a pipeline can increase prices to its current shippers. The future risks of demand uncertainty to a pipeline are not mitigated by delaying depreciation.

Secondly, APA agrees that long-term contracts can be used in both scheme and non-scheme regulation, but they are used to mitigate greater levels of risk. The AER's suggestion, that parties contract away from the regulated terms, appears to acknowledge that tariff regulation may not adequately address these risks. However, it fails to acknowledge that regulation itself will dampen incentives for parties to enter into long-term contracts (as discussed above).

Finally, the risk of asset stranding is not adequately accounted for in tariffs set under full regulation. Under a lighter form of regulation, APA can seek to calibrate its required return on investment to reflect the risk associated with asset stranding of a particular investment. This is not possible under scheme regulation and the RORI framework.

As identified by the AER, asset impairment can occur under both scheme and non-scheme regulation, However, it is much less likely in a non-scheme regime because of the broader range of tools available to manage risk. Under scheme regulation, there is little avenue for risk mitigation, as discussed above, and asset impairment is a more likely result of under-utilisation of assets.

The AER has expressed confidence in its Draft Decision of its ability to make decision on investment as it can rely on its previous approaches to assessing access arrangement proposals, including capex, are well established and understood by service providers and stakeholders. It points to its other decisions where there is uncertainty about the future, including recent gas distribution pipeline determinations where there is considerable uncertainty around future demand for gas.

While APA fully agrees with the AER about its experience in assessing prudency and efficiency of capital expenditure, APA expects that in the coming years increasingly difficult and risky decisions will need to be made in relation to pipeline investment, at short notice. Moreover, the heavy regulation framework does not allow the AER flexibility to provide greater consideration for cost recovery and how future uncertainty and stranding risk is accounted for.

5.2.2. Truncation of returns deters investment

Truncation refers to the effect of regulation capping any potential upside returns on a risky investment, while leaving the service provider to bear downside risk. In its earlier submission, APA highlighted that truncation was a concern when reviewing whether scheme regulation would apply.

In its Draft Decision, the AER did not consider that setting a reference price under scheme regulation would lead to a truncation of returns. However, the AER only made this conclusion regarding the distribution of returns under an access arrangement.

The AER has not fully appreciated APA's concern that if the form of regulation review is focussed on whether regulated prices would be lower than current prices then it is in effect, truncating the returns of an investment and will impact future investment decisions.

In the case of the SWQP, APA has demonstrated that it was not a monopoly infrastructure development. The investment was made in a competitive environment and contracts were entered into at terms agreed with by shippers. These contracts must continue to the end of their term to maintain the integrity of the investment process. To do otherwise is to truncate or appropriate returns from an investment and create a precedent that is likely to curtail future investments.

5.2.3. Scheme regulation would impact future investment incentives

There is significant investment required to support the energy market transition and maintain security of supply. Facilitating that investment requires:

— an environment that supports nimble and responsive investment;

— confidence that projects can earn rates of return commensurate with their risk; and
— confidence for foundation shippers.

Regulation of reference tariffs on a pipeline such as the SWQP, even if it is applied in a perfect manner in accordance with the NGL and NGR, will erode incentives for efficient investment,

Much of the investment required to support the market transition and maintain security of supply will carry considerable risk. Given the uncertainty around the pace and shape of the market transition, there is likely to be the potential for both upside returns and downside risk on any investment. The prospect of tariff regulation being imposed after risk has been assumed by investors with a view to capping any upside returns will create a real disincentive for investment at this critical juncture.

It is likely to mean that investors are less willing to support investment which carries both upside and downside risk – and in some cases such investment may only be supported if long-term contracts or other risk mitigants are in place.

At the same time, customers may be less willing to provide support for major investment through long-term contracts. As explained above in section 4.4.3, shippers may be less willing to establish foundation contracts if future tariff regulation means that competitors will be able to avail themselves of a lower regulated price if regulation is imposed.

Such signals would inevitably create uncertainty on the part of both the foundation shipper and the pipeline and will increase the perception of risk in both parties' views. In global financial markets, additional risk translates directly into a higher required return on invested capital. This will ultimately increase the costs of pipeline capacity expansion and increase costs to users and end users.

APA is most concerned that this uncertainty will mean that new pipeline investment and capacity expansion projects are unable to attract capital on competitive terms, and these necessary projects do not proceed. This will undermine the security of supply in southern gas and electricity markets. markets – an outcome that would be contrary to the long-term interests of consumers.

Maintaining the current form of regulation would provide the necessary certainty and preserve incentives for pipeline owners and shippers to make commitments to the type of investment that is needed to ensure security of gas supply. This security of supply is ultimately in the long-term interests of energy consumers and will support Australia's transition to a net zero economy.