

# Form of Regulation Review: South West Queensland Pipeline

Explanatory note

December 2024

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### **Amendment record**

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# 1 Introduction

The Australian Energy Regulator (AER) has made a final decision not to make a scheme pipeline determination for the South West Queensland Pipeline (SWQP) owned and operated by APA Group (APA). This means the SWQP will remain subject to non-scheme regulation.

In making this final decision, we have applied the regulatory determination test set out in section 112 of the National Gas Law (NGL).

This explanatory note outlines the key issues raised by stakeholders in response to the draft decision and sets out our response to these issues. It is intended to provide clarity around our assessment, and where relevant, how these issues were addressed in the final decision. We note that this explanatory note only addresses issues, raised in submissions, which may not have been sufficiently addressed in the draft decision, or which had not been previously raised by stakeholders.

## 1.1 Consultation process

On 9 October 2024, we published the draft decision on the SWQP form of regulation review and invited stakeholders to provide feedback by 8 November 2024.

We received seven submissions on the draft decision from:

- APA Group
- Australian Pipelines and Gas Association
- Business Council of Australia
- Darebin Climate Action Now
- Energy Networks Australia
- Energy Users Association of Australia
- Origin Energy.

We have published these submissions on our website, and we have had regard to each of these submissions in developing the final decision. Further to these submissions, we held meetings with a number of stakeholders. While the specific details of these meetings are confidential, we have considered the views expressed by these stakeholders in making our final decision.

## 2 AER response to submissions to the draft decision

With the exception of Darebin Climate Action Now, all the stakeholders that made submissions to the draft decision supported the draft decision not to make a scheme pipeline determination for the SWQP at this time. We have considered all submissions and respond to the key issues raised in the various submissions below.

While most stakeholders supported the draft decision, several raised issues with various aspects of our draft decision, including our:

- a) application of various form of regulation factors
- b) approach to assessing the effect of regulating the SWQP as a scheme or non-scheme pipeline on promotion of access
- c) consideration of the potential investment risks associated with scheme regulation
- d) consideration of the emissions element of the National Gas Objective (NGO).

A number of stakeholders raised concerns about form of regulation reviews, and the impact the threat of regulation could have on investment, and the AER's power to initiate such reviews of pipelines.

We set out below our response to the more substantive issues raised by stakeholders.

### 2.1 Application of form of regulation factors

APA Group (APA) made submissions in relation to barriers to entry and substitutes (location gas swaps and LNG import terminals).

#### **Barriers to entry**

APA submits that the AER's assessment of barriers to entry is incomplete as it primarily focuses on factors such as sunk costs, economies of scale, regulatory approvals and access to land, as are relevant to the building of an alternative pipeline. APA submits that in order to properly assess APA's ability to exercise market power, it is necessary to take a broader view of barriers to entry, including competitive threats such as shippers being able to access contracted but unutilised capacity instead of acquiring services from APA, and the establishment of LNG import terminals.

#### *AER response*

The assessment that APA is responding to relates to our assessment of the form of regulation factor at section 16(a) of the NGL, which requires us to consider 'the presence and extent of any barriers to entry in a market for pipeline services'. This particular form of regulation factor requires us to focus on the barriers to entry 'in a market for pipeline services', which is what we have done.

Separately, we have considered shippers access to contracted but unutilised capacity and the potential establishment of LNG import terminals, under the form of regulation factor at section 16(e) of the NGL, which focuses on substitutes for a pipeline service.

## Substitutes

### Locational gas swaps

With respect to locational gas swaps, APA submitted that AEMO is changing the Gas Supply Hub Exchange Agreement to implement an exchange-traded locational swap in March 2025.<sup>1</sup> APA contends that this will resolve concerns in using swaps in relation to finding a counterparty and easily executing swaps in a timely manner.<sup>2</sup>

#### *AER response*

While AEMO's decision to implement an exchange-traded locational swap in March 2025 may help reduce some of the barriers to entering into short-term swaps,<sup>3</sup> there are only a small number of parties in the east coast that can facilitate such swaps over the medium to longer term.<sup>4</sup> This will continue to pose a constraint on the extent to which swaps can be used to bypass the SWQP over the medium to longer term.

Another important limitation on the use of swaps to bypass the SWQP is that to address the projected supply shortfalls in the south, gas needs to physically flow south on the SWQP. This necessarily places a cap on how much gas can be swapped.

We have included a note on the upcoming changes to the Gas Supply Hub in our final decision under section 5.6.1.

### LNG import terminals

In relation to LNG import terminals, APA submits that this is an emerging competitive threat which poses a further constraint on its market power, in addition to existing SWQP substitutes.<sup>5</sup> APA highlights new developments with Venice Energy's Outer Harbour LNG terminal in October 2024, which has a commissioning timeframe by the first quarter of 2027.<sup>6</sup> APA also notes its understanding that Origin will be the sole user of the terminal for a decade.<sup>7</sup>

#### *AER response*

We note the new developments raised by APA in its submission about the Outer Harbour LNG terminal. Venice Energy confirmed in February 2024 that its negotiations with Origin about the 10-year terminal user agreement had been impacted by uncertainties and

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<sup>1</sup> APA, [Submission on AER draft decision: form of regulation review, South West Queensland Pipeline](#), 8 November 2024 (APA submission to draft decision), p 8. See also, AEMO, [GSH Exchange Agreement v17.0 Draft](#), 4 November 2024, accessed 15 November 2024.

<sup>2</sup> APA submission to draft decision, p 8.

<sup>3</sup> APA submission to draft decision, p 8. See also AEMO, [Gas Supply Hub Exchange Agreement v 17.0 Draft](#), 4 November 2024, accessed 18 November 2024.

<sup>4</sup> For example, in order for a swap to occur between Wallumbilla and the southern states over the medium to longer term, there must be a party that has access to gas at Wallumbilla that it requires in the south and another party with gas in the south that requires an equivalent volume of gas at Wallumbilla. There are only a limited number of parties in the east coast that are in this position to do this over the medium to longer-term.

<sup>5</sup> APA submission to draft decision, p 10.

<sup>6</sup> APA submission to draft decision, p 10.

<sup>7</sup> APA submission to draft decision, p 10.

proposed government changes to domestic gas supply and it was negotiating with Origin on potential solutions.<sup>8</sup> Since then, neither party has publicly confirmed whether the agreement for the Outer Harbour terminal has proceeded. However, we note that some recent media articles appear to indicate that Origin has decided not to proceed with this agreement.<sup>9</sup>

To make this clear in the final decision, we have noted the new developments on this issue under section 4.4.3. The new developments do not change our views about LNG import terminals. It is unclear whether they will pose a constraint on APA's market power in the future as there is still uncertainty as to whether any of the proposed LNG terminals will become operational and able to secure commercial underwriting for their projects.

## 2.2 Approach to assessing the effect that regulating the SWQP as a scheme or non-scheme pipeline would have on the promotion of access

APA submitted that an assessment of whether its current prices are 'reasonable' should be based on a comparison of what would occur in a workably competitive market and not what would occur under scheme regulation.<sup>10</sup> In this context, APA submitted that reports prepared by Incenta and CEG demonstrate that the SWQP returns were no higher than necessary to compensate APA for the risks associated with the investment in the SWQP.<sup>11</sup>

### 2.2.1 AER response

We have considered the analysis submitted by APA (including from its consultants, CEG and Incenta).

However, section 112 of the NGL does not require the AER to compare what is occurring under non-scheme regulation with what would occur in a workably competitive market. Rather, it requires us to consider the effect of regulating the SWQP as a scheme or non-scheme pipeline on:

- the promotion of access to pipeline services, and
- the costs likely to be incurred by an efficient service provider, efficient users and prospective users and likely costs to end users.

This is why, in considering the effect that scheme regulation may have on promoting access to the SWQP's pipeline services, we considered, amongst other things, the reference prices that may apply under scheme regulation.

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<sup>8</sup> Venice Energy, [Chairman's Update](#), 15 February 2024, accessed 14 November 2024.

<sup>9</sup> C Packham, [Origin baulks at LNG import terminal in SA, as east coast supply pressure increases](#), *The Australian*, 14 February 2024, accessed 14 November 2024. See also, AFR, [Choke in gas supply makes imports, once unthinkable, almost inevitable](#), 19 August 2024, AFR website, accessed 14 November 2024.

<sup>10</sup> APA submission to draft decision, p 11.

<sup>11</sup> APA submission to draft decision, p 11.

## 2.3 Investment risks

APA submitted that a scheme pipeline determination for the SWQP would affect incentives to invest and inhibit long-term future investment, stating the following:

- Scheme regulation would introduce the risk of regulatory truncation (capping any potential upside returns while leaving the provider to bear the downside risk) for returns from current investments, setting a precedent that all future investments would need to consider.<sup>12</sup> Further, APA stated that the AER did not fully appreciate APA’s concern that the review’s focus on whether regulated prices would be lower than current prices is in effect truncating the return on future investments.
- Scheme regulation would impose price regulation part-way through the term of a foundation contract, which could, depending on the Most Favoured Nation protections, undermine the foundation contracts.<sup>13</sup>

Elaborating further on the latter of these points, APA submitted that scheme regulation could result in lower prices for non-foundation users, which it noted could undermine tariff certainty and create a “first mover risk” (where foundation customers have a long-dated contract at a higher price than its competitors are paying) for foundation shippers.<sup>14</sup> APA also submitted these risks would mean investors could not rely on long-term contracts for future investment.

ENA made similar comments to APA about avoiding disruption to the operation of long-term contracts underpinning the development and expansion of the SWQP. It submitted that regulatory intervention would undercut these commercial arrangements, introducing new risks for the pipeline operator and shippers.

### 2.3.1 AER Response

#### Risk of regulatory truncation

As explained in section 7.2.3 of the final decision, we do not consider that the risk of regulatory truncation is likely to create disincentives for future investment. In this regard, it is worth noting that the NGO is not promoted by *any* investment in the pipeline (e.g. if a service provider overinvested in a pipeline as a result of high returns earned from an exercise of market power), it is promoted only where investment is efficient. Where there is the potential that market power is being exercised, removing the ability to do so should promote efficient investment.<sup>15</sup>

As to the specific issues APA has raised about regulatory truncation, it is worth noting the following. Firstly, there are a number of ways to address the potential for regulatory

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<sup>12</sup> APA submission to draft decision, p 20. Regulatory truncation is also discussed further under section 7.2.3 of the final decision.

<sup>13</sup> APA submission to draft decision, p 17. A most favoured nation clause essentially provides that if the service provider contracts with another user on terms and conditions more favourable than in the relevant contract, the user who is a party to that contract must be offered the same terms and conditions of access.

<sup>14</sup> APA submission to draft decision, p 17.

<sup>15</sup> As discussed in section 7.2.2 of the final decision, efficient investment in the the context of natural monopoly infrastructure is investment which meets genuine current and future service needs, and is priced so that it best balances “productive efficiency” (providing services at lowest cost), “allocative efficiency” (encouraging the best use of existing capacity), and “dynamic efficiency” (preserving incentives to undertake new investment). See AEMC, [‘How the national energy objectives shape our decisions’](#), August 2024, p 4.



truncation under the scheme regulation framework when setting a reference price.<sup>16</sup> Second, under scheme regulation, parties can contract on price and non-price terms that differ from those approved by the AER, meaning that a scheme pipeline is still able to earn a return commensurate with the risks faced. Finally, there is little evidence that scheme regulation has inhibited investment on scheme pipelines.<sup>17</sup>

We also observe that to the extent a change in the form of regulation gives rise to a risk of regulatory truncation, that this is not a new risk. Rather, it has been possible for a pipeline to be subject to a form of regulation change since the introduction of the original Gas Code in 1997. It does not appear that the threat of form of regulation change has resulted in systemic issues in pipeline investment over this time (i.e. due to concerns about the potential truncation of returns).

When considering the effects of the threat of regulation, it is also important to note that a service provider of a pipeline under scheme regulation is allowed to recover, and earn a reasonable rate of return on, all prudent and efficient costs in accordance with Part 9 of the NGR and the National Gas Objective.

It is also important to recognise that scheme regulation would not appropriate or truncate the returns in any contracts that are in effect if a non-scheme pipeline becomes a scheme pipeline. This is because the terms and conditions in pre-existing contracts are protected under the NGL.<sup>18</sup> This means that the returns expected under these contracts would be locked in, protecting the integrity of the investment process for pipelines underwritten through bilateral contracts. For clarity, this is also discussed in section 7.2.3 of the final decision.

In regards to APA submitting that our review focuses on comparing current prices to regulated prices, we note that this is only one aspect when considering the likely effect of scheme regulation in promoting access to pipeline services. As indicated in the final decision, APA's returns appear higher than what would be expected in a workably competitive market, based not only on comparing current prices with those likely under scheme regulation, but considering this in the context that APA likely has market power in supplying services on the SWQP, and that there are few constraints on this market power.<sup>19</sup>

### **Scheme regulation and foundation contracts**

It has been possible for a pipeline to be subject to a form of regulation change since the introduction of the original Gas Code in 1997.<sup>20</sup> There has therefore been a risk for some time that if a pipeline became subject to scheme regulation, that reference tariffs may be set at a lower price than those under pre-existing contracts. We consider that it has been (and still is) possible for the parties to manage this risk contractually, including when the SWQP

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<sup>16</sup> As indicated in section 7.2.3 of the final decision, delaying the recovery of capital and accelerating the recovery of capital are two ways of addressing the potential for regulatory truncation under the scheme regulation framework when setting a reference price.

<sup>17</sup> See AER, *Form of Regulation Review, South West Queensland Pipeline: final decision*, 6 December 2024 (AER final decision), pp 75-76.

<sup>18</sup> See section 163 of the NGL.

<sup>19</sup> See AER final decision, p 57.

<sup>20</sup> Third Party Access Code for Natural Gas Pipeline Systems.

foundation contracts were entered into between 2007 and 2011.<sup>21</sup> For example, by including a Most Favoured Nation clause, an automatic adjustment, or other contractual mechanism that would be triggered in response to a scheme pipeline determination or access arrangement.

It is therefore unclear why the outcomes of how the parties have contracted to manage this risk (or not, as they may choose) is a cost of scheme regulation. As agreement terms cannot be changed under scheme regulation, it is also unclear how scheme regulation would “disrupt” the Most Favoured Nation protection or impact the risk allocation in these agreements. As such, we have not considered this risk to be a cost of scheme regulation.

We also note that the parties agreed to the contract, including the terms and conditions regarding how they would deal with a potential form of regulation change, and how any associated risks would be allocated between them (e.g. the consequences of scheme regulation). As such, it is difficult to reconcile APA’s argument that scheme regulation would undermine the contract, with their characterising the agreement (and its terms) as efficient due to reflecting a competitive market outcome.

[REDACTED]

## 2.4 Consideration of emissions as part of the NGO

Darebin Climate Action Now (DCAN) disagreed with our draft decision and submitted that the SWQP should be a scheme pipeline.<sup>22</sup> In doing so, it submitted that the AER should consider the emissions component of the NGO, which in its view should be central to the consideration of whether the SWQP should be a scheme pipeline.

DCAN also submitted that the AER should pursue opportunities to transfer monopoly profits away from APA in order to support jurisdictions in achieving emission reduction targets.

### 2.4.1 AER response

We have considered emission reduction component of the NGO when applying the regulatory determination test set out in s 112 of the NGL. However, as our assessment is that the achievement of the jurisdictional emissions reduction targets is likely to be similar under both forms of regulation, we do not consider the emissions component of the NGO to

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<sup>21</sup> Hastings Diversified Utilities Fund, [Epic Energy signs foundation contract with AGL, underpinning construction of the QSN Link](#), 13 July 2007, accessed 14 November 2024; Origin, [Origin completes gas transportation agreement with Epic](#), 15 December 2009, accessed 14 November 2024; Hastings Diversified Utilities Fund, [Gas transmission agreement with Santos is now unconditional](#), 21 September 2011, accessed 14 November 2024.

<sup>22</sup> Darebin Climate Action Now, *DCAN submission to the Australian Energy Regulator: South West Queensland Pipeline form of regulation review*, 7 November 2024, pp 1-2.

be a material factor in this decision. This has been discussed further in sections 3.3 and 3.4 of the final decision.

We also note, while scheme regulation could result in the ‘transfer (of) monopoly profits away from APA’, there is no mechanism within the access arrangement or regulatory power held by the AER to determine how these cost savings be specifically used (e.g. to support emissions reductions targets) by any party. The main function of an access arrangement is to set AER approved price and non-price terms and conditions of access to reference services.

## 2.5 Issues with form of regulation reviews

APGA submitted that the threat of increasing regulation of pipeline infrastructure acts as an ongoing disincentive to infrastructure investment.<sup>23</sup> It also submitted that the process for the AER shortlisting pipelines for form of regulation reviews was not transparent and that, as a result, pipeline operators face the threat of a form of regulation review at any time, which it noted was not a cost-free exercise. APGA therefore submitted that the AER should reconsider the process of AER-initiated form of regulation reviews, including developing a transparent framework on the conditions that would prompt a review. It also suggested that the AER discontinue its planned program of reviews until this framework is developed.

BCA submitted that the negative consequences of over-regulation needed to be considered with a preference to allow the market to operate, which is increasingly important in attracting investment to and managing the gas supply in Australia.<sup>24</sup>

### 2.5.1 AER response

We note that the arguments raised by APGA and BCA are not specific to the SWQP review. Rather, they relate to the broader form of regulation review regime in the NGL and our proposed program of reviews.

The AER was made responsible for determining the form of regulation that should apply to gas pipelines as part of reforms, introduced in March 2023, aimed at improving and simplifying the gas pipeline regulatory framework.

We acknowledge APGA’s concern that the threat of regulation may disincentivise investment and BCA’s concern of the consequences of over-regulation. However, we would observe that one of the reasons for the changes to the regulatory framework (including the ability of AER to conduct form of regulation reviews) was to address the concern that the prior regime was potentially resulting ‘in under-regulation and inefficient investment and use of [gas] pipelines’.<sup>25</sup> We therefore consider it important for the AER to have the ability to continue initiating reviews where necessary, so as to ensure the appropriate form of regulation applies to pipelines. This is important in preventing scenarios where service providers are able to exercise market power when determining the terms and conditions of access, which can lead to inefficiencies and higher prices for end-users, including consumers. In addition, we

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<sup>23</sup> Australian Pipelines and Gas Association, *Submission: Draft Decision – South West Queensland Pipeline*, 7 November 2024, pp 1-2.

<sup>24</sup> Business Council of Australia, *Draft Decision on South Queensland Pipeline Review*, 7 November 2024.

<sup>25</sup> Energy and Climate Change Ministerial Council, [Options to improve gas pipeline regulation: Regulation Impact Statement for Decision](#), May 2021, pp vi, 33.

consider the threat of regulation itself is important and can also assist in achieving these aims.

We also note that in our draft decision we had indicated we intend to closely monitor APA's behaviour and the terms and conditions of access to the SWQP through the pipeline information disclosure regime and our monitoring and reporting powers under sections 63A and 63B of the NGL. Given our findings on current terms and conditions, we would like to see greater downward pressure on prices on the pipeline and negotiation on non-price terms and conditions improving, particularly for smaller shippers. We are aware that more capacity on the pipeline will begin to become available from early 2028. We will closely monitor the prices, terms and conditions on which the newly available capacity is sold. If we see prices on the SWQP increase without reasonable justification, this could justify further review of the form of regulation in the future. We have maintained this position in the final decision.

In regard to conducting future form of regulation reviews, as noted in the AER's [Regulatory Determinations and Elections Guide \(the Guide\)](#), we will consider whether to commence an AER-initiated review where it appears the level of regulation of a pipeline may not be appropriate, considering the regulatory test.<sup>26</sup> As explained in the Guide, the AER may consider commencing an AER-initiated review of a non-scheme pipeline where there is evidence to suggest that a service provider may have the ability and incentive to exercise market power, and may be exercising market power, in the supply of pipeline services.<sup>27</sup> We also note that the AER may also conduct a form of regulation review in response to an application from any person.

The AER has previously indicated that it intends to conduct a program of form of regulation reviews over several years. The findings from this current review and stakeholder submissions received, commenting on form of regulation reviews more broadly, will be assessed and used to inform our approach to future reviews.

We agree that being subject to a review and providing the information required under section 42 of the NGL information request is not a costless exercise for a service provider, but consider these costs need to be weighed against the potential benefits to the long-term interests of consumers. We will therefore take these factors into account when considering whether to review a pipeline.

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<sup>26</sup> AER, [Pipeline Regulatory Determinations and Elections Guide](#), June 2024, p 6.

<sup>27</sup> AER, [Pipeline Regulatory Determinations and Elections Guide](#), June 2024, p 6.