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27 April 2012

Mr John Pierce
Chairman
Australian Energy Market Commission
PO Box A2449
SYDNEY SOUTH NSW 1235

Dear Mr. Pierce,

AER submission in response to the AEMC Draft Rule Determination

The Australian Energy Regulator (AER) welcomes the opportunity to comment on the AEMC's Draft Rule Determination concerning the reference service and rebateable service definitions (the Draft Determination).

The Draft Determination was made in response to the reference service and rebateable service definitions rule change proposal submitted by the AER.

In summary, the AER's rule change proposal sought to change the definition of 'reference service' so as to allow the AER the discretion as to whether or not a pipeline service sought by a significant part of the market should be included in an access arrangement as a reference service. If not a reference service, there would be no need to set a reference tariff. The AER also sought to change the definition of 'rebateable service' by removing the requirement that a rebateable service must be in a substantially different market to any reference service. This would allow the AER in some circumstances to more readily characterise services as rebateable services and as a result rebate non-reference service revenue from reference service revenue.

The AEMC's Draft Determination did not support the AER's rule change proposal. Instead the AEMC adopted a 'more preferable rule'. The AEMC describes its preferable rule as incorporating 'changes to the reference service definition in terms similar to that proposed in the AER's rule change proposal.'¹ However, the AEMC's Draft Determination did not adopt the AER's proposed rule change in respect of the rebateable service definition.

The AER considers the AEMC's preferred rule change provides the AER with the necessary discretion to classify a pipeline service sought by a significant part of the market as a reference service. However, the AER considers that unless the AEMC also adopts the AER's proposed change to the rebateable service definition, the AER

¹ AEMC Draft Determination page 5

is not likely to be able to rebate revenue derived from a non-reference service against a reference tariff(s). This outcome is not consistent with the National Gas Objective (NGO) and in particular the long term interests of consumers of natural gas with respect to price.

The Draft Determination outlined three main reasons why the change to the rebateable service definition was not adopted in the preferred rule:

- APA GasNet is currently rebating users for the volume effect of Authorised Maximum Daily Quantity Credit Certificates (AMDQ CC) (addressed in section 1.2 of this submission)
- ‘Most favoured nation’ clauses in existing contracts may be triggered, negatively affecting the pipeline operator and future investment (addressed in section 1.3 of this submission)
- The fixed principle may not be protected in the Dampier to Bunbury Natural Gas Pipeline, negatively affecting the pipeline operator and future investment (addressed in section 1.4 of this submission)

In the AER’s view, these three reasons are not supported on legal or policy grounds. Consequently, the AER maintains its view that its proposed rule changes, taken together, will contribute to the NGO. The combined changes as proposed by the AER would improve the efficiency of uptake and utilisation of pipeline services, whilst at the same time enabling the AER to rebate (in some circumstances) an appropriate portion of revenue from non-reference services, in the long term interest of consumers.

This submission begins by noting the broader issues associated with this rule change before commenting directly on the three reasons why the AEMC’s Draft Determination did not adopt the AER’s proposal regarding rebateable services.

1.1 The broader need for the proposed rule change

As outlined above, the AER’s rule change proposal sought changes to the reference service and rebateable service definitions in the National Gas Rules (NGR).

The NGR requires that all pipeline services that are likely to be sought by a significant part of the market must be included in an access arrangement as reference services. The regulation of reference services in part requires the AER to set a reference tariff for each reference service.

The AER considers there are some circumstances where it is inappropriate to include a reference service/tariff in a service provider’s access arrangement—even if a pipeline service is likely to be sought by a significant part of the market. In its rule change proposal, the AER set out two main reasons for this view:

- the setting of a reference tariff may be inappropriate on the basis of technical/commercial arrangements. For example, where commercial/technical arrangements preclude an efficient tariff being set and/or would allow an over recovery of efficient pipeline costs

- demand/revenue uncertainty limits the ability to set an efficient reference tariff for a pipeline service. For example, setting a reference tariff for backhaul services could distort the efficient usage of primary and other pipeline service/s²

The proposed rule change to the reference service definition would result in pipeline operators being required to only include at least one reference service in an access arrangement. The AER would also be afforded the discretion to decide whether other pipeline services should be reference services. The AEMC has accepted the AER's proposal in this respect. The AER notes that the AEMC has specified in its preferred rule that the AER in exercising this discretion must take into account the revenue and pricing principles in the National Gas Law (NGL). However, it should be noted that the AER is already required to take into account the revenue and pricing principles in accordance with clause 28(2)(a)(i) of the NGL. It is therefore unnecessary to include subsection (2) as drafted.

As outlined above, the AER also proposed to change the definition of rebateable service. The NGR requires that for a pipeline service to be considered a rebateable service, the service must be in a substantially different market to any reference service.

The AER considers there are a number of pipeline services that may be capable of being regulated as rebateable services alongside a reference service. The AER considers this would benefit the NGO. However, these services could be considered to be in a similar market to the reference service.

The proposed rule change to the rebateable service definition would allow pipeline services in the same market as a reference service to be treated as rebateable services. The AER provided examples of services that may be able to be regulated as rebateable services alongside a reference service should the proposed change to the rebateable service definition be adopted. These pipeline services include APA GasNet's AMDQ CC service referred to in APA GasNet's 2013–17 revised access arrangement.³

The reference to APA GasNet's revised access arrangement in the rule change proposal, in particular the treatment of AMDQ CC, was provided to outline the need for the rule change and not as the sole basis of the proposal. However, the AER noted in its rule change proposal that it did not pursue the option of amending Part 19 of the NGR which focuses on AMDQ CC given the need to address broader issues in the NGR, other than AMDQ CC.

The AER considers the Draft Determination has focused mainly on APA GasNet's revised access arrangement, rather than the broader need for the rule change—particularly when addressing the rebateable service definition rule change.

For example, the AEMC states in its Draft Determination:

² Page 4 – AER proposal

³ APA GasNet, proposed revised Access Arrangement for 2013-17 for the Victorian Transmission System (VTS); <http://www.aer.gov.au/content/index.phtml?itemId=753586>

The AER has presented the amendments to the two definitions as a package to address its specific concern about the revenue APA GasNet generates from providing AMDQ cc on the Victorian DTS.⁴

Further, in respect of the definition of rebateable services, the AEMC's conclusion states:

The central reason for the proposed rule change is the AER's view that APA GasNet is inappropriately over-recovering on its efficient pipeline costs because the revenue earned from AMDQ cc is in addition to the revenue earned from reference tariffs.⁵

The proposed rule changes are designed to work alongside each other. The change to the definition of a reference service would enable the AER to decide how to deal with services that are likely to be sought by a significant part of the market but for which estimating an efficient tariff would be difficult. The change to the definition of a rebateable service would enable the AER in some circumstances to rebate an appropriate portion of revenue from non-reference services against reference services.

The AER's rule change proposal contemplates that these non-reference services may include, but are not be limited to, AMDQ CC, backhaul, interruptible and park and loan services. In other words, the AER's rule change proposal addresses issues beyond APA GasNet's revised access arrangement and the treatment of AMDQ CC.

The AER observes that the number of pipeline services offered by pipeline operators is growing, and this is likely to continue.

For example, a number of the stakeholder submissions regarding the Roma to Brisbane Pipeline (RBP) 2012–17 access arrangement have identified and raised issues arising from new pipeline services.

Relevantly, Australian Power and Gas submitted:

In revenue achievable, APG is also seeking for the AER to consider that APA offers additional services on the RBP, such as intra-day nominations. Given the risk created by the implementation of the Short Term Trading Market in Queensland, this revenue should be considered as a service that APA is providing and included when determining the service fees.

Further, BP submitted:

In determining that the proposed access arrangement should only include one reference service, being the "Firm Service" (AA. s2.2), APTPPL have assumed that there are no other pipeline services that a significant portion of RBP Users (the "market") would require.

BP asserts that the introduction of the STTM has fundamentally changed the nature of pipeline services required by RBP users, and that contrary to the APTPPL view, a Firm Service no longer represents the complete suite of references services that should be included in the AA.

And TRUenergy submitted:

⁴ AEMC Draft Determination page 10

⁵ AEMC Draft Determination page 18

Why have the APA Group proposed only one reference tariff? Likely developments in the Brisbane market, including implementation of the Short Term Trading Market, may well make 'As Available' and 'Backhaul' services attractive.

The AER supports the AEMC's preferred rule change as it provides the AER with the necessary discretion to achieve a more efficient outcome. The AER, however, considers that the definitions of reference and rebateable services work in tandem and that the outcome most consistent with the NGO requires that the definition of a rebateable service also be amended in the manner proposed by the AER.

The reference service and rebateable service definitions work alongside each other to contribute to the NGO. Without the proposed change to the rebateable service definition, the AER will be unable to rebate an appropriate portion of revenue from non-reference services against reference services. This would not be in the long term interest of consumers. This issue is discussed further in section 1.2.

1.2 Rebating of AMDQ CC revenue

In its rule change proposal, the AER outlined its concerns relating to the over recovery of the efficient costs of the Declared Transmission System (DTS) by APA GasNet in the current and forthcoming 2013–17 access arrangement period. The AER stated that unless AMDQ CC can be treated as a rebateable service, APA GasNet will retain all the additional revenue from the sale of such rights—anticipated to be over and above the revenue requirements to recover the efficient costs of the DTS from its reference service.

The AEMC made two main points in response to this issue:

- Firstly, the AEMC outlined the two possible types of over recovery associated with AMDQ CC, being 'the price effect'⁶ and 'the volume effect'⁷, and stated that the AER only identified over recovery due to the volume effect in its rule change proposal.
- Secondly, the AEMC noted that APA GasNet has been rebating to users part of the revenue earned from the sale of AMDQ CC through its price control model over the current access arrangement period, in effect accounting for the volume effect.

The AEMC stated:

Accordingly, under the current access arrangement APA GasNet is rebating users for the over-recovery of revenue from AMDQ cc due to the volume effect. This is occurring even though the ACCC decided not to classify AMDQ cc as a rebateable service in its 2008 final decision on the access arrangement. In fact, it appears that nominating AMDQ cc as a rebateable service is not required to achieve this outcome – the rebating is occurring

⁶ 'The price effect which occurs when the price paid for AMDQ cc is above the reference tariff, and is the difference between these two prices' – page 19 AEMC Draft Determination

⁷ 'The volume effect which occurs when APA GasNet is able to earn additional revenue for providing reference services on unused AMDQ cc contracted capacity. This is revenue that APA GasNet would otherwise not have earned if the holder of the AMDQ cc had fully used its contracted capacity.' – page 19 AEMC Draft Determination

through the application of APA GasNet's approved annual tariff variation process and the operation of its price control model.⁸

The AEMC concluded that it is not satisfied the problem identified by the AER exists because APA GasNet is rebating users for the volume effect of AMDQ CC under the current access arrangement. The AEMC further notes that the AER may propose an amendment to APA GasNet's proposed reference tariff variation mechanism at the next access arrangement review to address this issue.

Following the AEMC's Draft Determination, the AER sought legal advice (attached as Appendix 1) concerning a number of aspects of the AEMC's Draft Determination, including the rebating of revenue against reference tariffs.

Relevantly, the AER asked Counsel:

- a) Does the 'Actual Revenue', as specified in Schedule 4 of the APA GasNet 2008–12 Access Arrangement, permit or mandate that contracted volumes of the AMDQ CC service be taken into account in an annual reference tariff variation when the AMDQ CC service is not a reference service or a rebateable service under the access arrangement?
- b) If allowed under Schedule 4, is the inclusion of contracted volumes of the AMDQ CC service otherwise consistent with the current access arrangement for 2008–12?

The answer to (a) and (b) was No.

Counsel advised:

In my opinion, the inclusion of AMDQ CC volumes as 'injection volumes' is not consistent with the access arrangement, and neither is 'rebating' the AMDQ CC revenue through the price control mechanism.

Division 8 of the NGR (which deals with Tariffs) is also noteworthy. It contemplates that revenue and costs of pipeline services will be allocated between 'reference services' and 'rebateable services.' It is clear that the AMDQ CC service is not a reference service under the 2008-2012 Access Arrangement. Neither is it a rebateable service under the 2008-2012 Access Arrangement and nor could it be under the draft rule determination.

...the AEMC emphasises... that APA GasNet is rebating the additional revenue to users through the annual tariff variation proposals. This leads the AEMC to conclude "On the information available to it, the Commission is not satisfied that the problem identified by the AER exists (that is, that APA GasNet is inappropriately retaining revenue that is in excess of the target regulated revenue)." That conclusion, which turns upon the fact (as found by the AEMC) that APA GasNet is rebating the additional revenue, does not answer the legal question whether the revenue from AMDQ is required or permitted upon the proper construction of the Access Arrangement to be included in the first place.

...In my opinion, the fact that (the rebating) has occurred under the current access arrangement does not address the legal question concerning the proper construction of the current access arrangement.

⁸ Page 21 AEMC Draft Determination

...in my opinion, if contracted volumes of the AMDQ CC service are allowed under Schedule 4, that is inconsistent with the current access arrangement for 2008-12.

This advice supports the AER's position that revenue derived from AMDQ CC cannot be rebated against a reference tariff as it is not a regulated service under APA GasNet's current access arrangement. The AER notes that APA GasNet have proposed the same reference service in its revised access arrangement for 2013-17 which was recently lodged with the AER.

Further, the AER notes that if AMDQ CC *was* a rebateable service, only then could its revenue be rebated against the reference tariff. However, the AER maintains AMDQ CC cannot be classified as a rebateable service under the current definition in the NGR which requires it to be in a substantially different market to the reference service.

1.3 Impact on existing contracts

The AEMC received submissions from service providers⁹ concerned that the proposed change to the definition of a rebateable service could lead to the possible triggering of the 'most favoured nation' clause in bilateral contracts.¹⁰

The Draft Determination explains 'a most favoured nation clause provides that if the tariff for the pipeline service on offer to other users is less than that agreed to in the contract, then the lower tariff will also apply to the contract.'¹¹

Some submissions suggested more services would likely fall within the definition of a rebateable service if reference and rebateable services could be in the same market. It was argued that this would make it more likely that a rebate resulting in a reduction to the reference tariff would occur and this could trigger the most favoured nation clause in any existing bilateral contracts for the pipeline.¹²

The AEMC noted that there exists a limited risk that a most favoured nation clause could be triggered under the current definition of rebateable service. The AEMC considered that as this risk has existed for some time, which it is factored in by the contracting parties. Nonetheless, the AEMC concluded that by allowing rebateable and reference services to exist in the same market it could potentially expose service providers to increased investment risk.

Following the AEMC's Draft Determination, the AER sought legal advice concerning the impact on existing contracts.

Relevantly, the AER asked Counsel:

- (c) In relation to most favoured national clauses (MFN clauses) in existing contracts which the AER understands, set the price as the lower of the price agreed in a contract signed outside the access arrangement (i.e. in contracts entered into before regulation) and a regulated price (i.e. a

⁹ APIA, APA and DBNGP (WA) Transmission Pty Ltd

¹⁰ Page 27 AEMC Draft Determination

¹¹ Page 27 AEMC Draft Determination

¹² Page 27 AEMC Draft Determination

reference tariff):

(i) would the National Gas Law (NGL) (specifically, ss 28(2) and 24(6)) and the National Gas Rules (NGR) require the AER to have regard to the impact of triggering MFN clauses in existing contracts when deciding whether to permit the rebating of revenue under rule 93 of the NGR?

(ii) if so, would this be comparable to the requirement under s 2.24(b) of the former Gas Code under which the regulator was to take into account “firm and binding contractual obligations of the service provider or other persons using the Covered Pipeline”?

The answer to (c)(i) and (c)(ii) was Yes.

Counsel advised:

Section 24(6) of the NGL provides that “Regard should be had to the economic costs and risks of the potential for under and over investment by a service provider in a pipeline with which the service provided provides pipeline services”. This is one of the revenue and pricing principles.

Section 28(2) requires the AER to take the revenue and pricing principles into account when exercising a discretion in approving or making those parts of an access arrangement relating to a reference tariff, or when making an access determination relating to a rate or charge for a pipeline service. Further, the AER may take into account the revenue and pricing principles “when performing or exercising any other AER economic regulatory function or power, if the AER considers it appropriate to do so”.

As noted in question (c)(ii), s 2.24(b) of the former Gas Code specifically required the regulator to take into account firm and binding contractual obligations of the Service Provider or other persons using the Covered Pipeline.

...In my opinion, the risk of triggering MFN clauses in existing contracts is a matter that the AER is required to take into account when approving or making those parts of an access arrangement relating to a reference tariff, because it affects “the economic costs and risks of the potential for under and over investment”... This is because having regard to the MFN clauses invariably will result in adjustments that are in favour of the users and are adverse to the interests of the service providers. This is because the MFN clauses are triggered only when the regulated price is lower. That outcome must be taken into account, in my opinion, in weighing “the economic costs and risks of the potential for under and over investment”.

It is in that respect that I consider that s 2.24(b) of the former Gas Code is ‘comparable’. That is, in both the former Gas Code and the NGL, it was and is necessary to consider how existing contracts would be affected by the determination...

The AER supports the legal advice.

The AEMC concluded that ‘any benefit of a change to the rebateable service definition may be outweighed by potential risks to investment on the majority of fully regulated pipelines.’

The AER disagrees with this view. Rather, the AER contends that any increase in risk following the change to the rebateable service definition will be taken into account by the AER in its consideration and it affording appropriate weight to this risk when exercising its discretion taking into account the NGL and the revenue and pricing principles.

Accordingly, the AER notes that it is obligated to consider such risks in accordance with the NGL, regardless of the definition of rebateable service.

1.4 Impact on the Dampier to Bunbury Pipeline Access Arrangement

The DBNGP submitted to the AEMC that if the proposed change to the definition of a rebateable service is made, then it will take precedence over the fixed principle in the DBNGP access arrangement.¹³ Further, the DBNGP also raised the concern that the proposed change to the rebateable service definition would have adverse effects on investment as it would claw back revenue earned under existing contracts.¹⁴

The AEMC in its Draft Determination noted that the DBNGP access arrangement has a fixed principle which will be in effect until 2031. Further, the AEMC noted that rule (94)(b) of the NGR which provides that ‘if a rule is inconsistent with a fixed principle, then the rule takes precedence over the fixed principle.’¹⁵

In this context, the AEMC contemplates the effect of transitional rule 6 of the NGR, which states:

Rule 99(4)(b) does not apply to the fixed principle referred to in clause 7.13(a)(ii) of the Revised Access Arrangement for the Dampier to Bunbury Natural Gas Pipeline dated 21 November 2006.”¹⁶

The AEMC stated that the current access arrangement is not the same as the one referred to in transitional rule 6. Further, in the current access arrangement, the fixed principle is instead referred to in clause 13(a)(ii) instead of clause 7.12(a)(ii) as referred to in transitional rule 6.

As a result, the AEMC considered:

...as the wording is not entirely clear it is possible that transitional rule 6 of the NGR could be interpreted to not apply to the fixed principle described in the current access arrangement. If this interpretation was accepted it would mean that if the proposed rule were made, it would take precedence over the fixed principle. As a consequence, it would be possible for a rebateable service included in any future DBNGP access arrangement to:

- rebate off the reference tariff and trigger any most favoured nation clauses in existing contracts; and
- draw on revenue earned under existing contracts to create a rebate off the reference tariff¹⁷

¹³ Page 29 AEMC Draft Determination

¹⁴ Page 29 AEMC Draft Determination

¹⁵ Page 30 AEMC Draft Determination

¹⁶ Page 30 AEMC Draft Determination

The AEMC concluded that the proposed change to the definition of rebateable services may lead to an increased risk to investment which would outweigh any potential benefits. This increased investment risk would not be conducive to efficient investment and would not be in the long term interests of consumers.

Following the AEMC's Draft Determination, the AER has sought legal advice on the impact of the AER proposed rule change on the DBNGP access arrangement.

Relevantly, the AER asked Counsel:

- (d) In relation to the fixed principle in clause 13(a)(ii) of the Dampier to Bunbury Natural Gas Pipeline Revised Access Arrangement of 22 December 2011:
 - (i) does transitional rule 6 of Schedule 1 of the NGR have any application?
 - (ii) what would be the impact of rule 99(3) of the NGR on the Dampier to Bunbury Revised Access Arrangement should the definition of rebateable service be amended in the manner proposed by the AER?

The answer to (d)(i) was No.

The answer to (d)(ii) was 'it would protect the fixed principle.'

In respect of question (d)(i), Counsel advised:

...this transitional rule does not refer to clause 13(a)(ii); rather it refers to its predecessor clause, 7.13(a)(ii).

I am not aware of any provision that amends transitional rule 6 to make it apply to clause 13(a)(ii).

...Therefore, in my opinion, transitional rule 6 does not have any application to clause 13(a)(ii) of the current Dampier to Bunbury Natural Gas Pipeline access arrangement.

In respect of question (d)(ii), Counsel advised:

Rule 99(3) provides that a fixed principle approved before the commencement of the Rules, or approved by the AER under the Rules, is binding on the AER and the service provider for the period for which the principle is fixed.

The AER did not propose to amend Rule 99(3).

It seems to me, therefore, that Rule (99)(3) would continue to give binding force to existing fixed principles in existing access arrangements.

...the AEMC discussed precedence over the fixed principle in section 3.1.3 and section 7.2 of its Draft Determination. The analysis does not consider, or even mention, Rule 99(3). In my opinion the effect of that rule is to protect the fixed principles in the existing access arrangements.

The AER supports the legal advice.

¹⁷ Page 31 AEMC Draft Determination

This advice concludes that while transitional rule 6 of the NGR does not apply to the fixed principle referred to in clause 13(a)(ii) of the current DBNGP access arrangement, the fixed principle is protected by rule 99(3) of the NGR.

Contrary to the AEMC's Draft Determination, the AER considers that if the proposed change was made to the rebateable service definition, it would not take precedence over the fixed principle. Rather, as noted above, rule 99(3) of the NGR would act to protect the fixed principle.

1.5 Pricing impacts of the AEMC's 'preferred rule change'

The AER considers that consumers of natural gas will pay more under the AEMC's 'preferred rule change' in comparison to the effect of the AER's proposed rule change.

This is because, under the AEMC's 'preferred rule change', pipeline owners will retain all the revenue derived from pipeline services which are not reference services. This outcome could arise from APA GasNet's sale of AMDQ CC and for other pipeline services such as interruptible and backhaul services sold on pipelines such as the RBP.

The Draft Determination noted a volume effect and a price effect associated with APA GasNet's sale of AMDQ CC.¹⁸ The AEMC concluded that the volume effect represented the majority of AMDQ CC generated revenue. The AER has compared APA GasNet's proposed Port Campbell injection tariff in its proposed 2013-17 access arrangement (\$1.969/GJ)¹⁹ with the terms that APA GasNet tendered the sale of 353 TJ/day of daily capacity for injection at Port Campbell for 2013-17. The tender terms set the price for AMDQ CC at the higher of a \$ per GJ daily charge amount or the AER's approved injection tariff.

On the basis of APA GasNet's proposed injection tariff for 2013, the AER considers the per GJ daily charge will result in APA GasNet earning approximately an additional \$27.5 million (real dollars) from AMDQ CC generated revenue over the 2013-17 access arrangement period.

This is a price effect alone and is based on the difference between the \$/GJ/day amounts set out in APA tender documentation when compared to the 10 day peak proposed Port Campbell injection tariff.²⁰ This is revenue in addition to the approximate \$35 million of revenue over the 2013-17 access arrangement period that it proposes as required to recover efficient costs associated with maintaining Port Campbell injection related pipeline assets through the Port Campbell injection tariff. The extra revenue does not include any volume effect it may obtain. As noted above, the AER cannot return to users any extra revenue due to the volume effect or price effect unless AMDQ CC is defined as a rebateable service.

¹⁸ Page 21 AEMC Draft Determination

¹⁹ See schedule A-2 of APA's proposed access arrangement (2013-2017). It is also noted that injection tariff is defined in the proposed access arrangement to mean the tariff for injections of gas into the VTS rather than a capacity tariff.

²⁰ The AER can provide a copy of this tender documentation on request by the AEMC.

The price impact is not specific to the AMDQ CC example. As noted above, submissions to the RBP Access Arrangement (2012-17) identified a number of additional services on the RBP beyond firm haulage—intra day nominations, interruptible and backhaul services. Further, confirming these submissions, APA advised the AEMO STTM Consultative Forum on 27 March 2012 that it is negotiating with shippers on the RBP for backhaul services.

The AER's proposed rule change is current and future looking. There are a number of pipelines such as RBP where capacity is becoming constrained and there is increased demand for pipeline services beyond traditional forward haulage services. The proposed rule change seeks to place the regulator in a better position to be able to consider what proportion of 'secondary' pipeline service revenue should be retained by pipeline businesses subject to full economic regulation from time to time. It would be appropriate for the regulator to determine what proportion of this revenue should be returned to users, taking into account the pricing principles in the NGL. Unless the rebateable service definition is changed, it is unlikely that a proportion of this revenue will be returned to users.

The AER considers that both elements of its proposed rule change are required to provide a better economic regulatory framework where revenue is earned from multiple pipeline services. Both elements are required to better promote the long term interests of consumers of natural gas with respect to price. The change to definition of a reference service goes some way to achieving an outcome more consistent with the NGO but the overall the effect will be limited if not accompanied by a change in the definition of a rebateable service as proposed by the AER.

1.6 Transitional arrangements

The AER proposes that the AEMC include a transitional provision that deals with the operation of any amended rule and its application to resets already in progress. In particular, the AER seeks clarification from the AEMC as to when the Rule is to take effect (as distinct from when it commences) and specifically whether any amended Rule is it to apply to the current APA GasNet reset.

If you require further information regarding this submission, please contact Blair Burkitt (blair.burkitt@aer.gov.au) (03 9290 1442) or Jeremy Llewellyn (jeremy.llewellyn@aer.gov.au) (03 9290 1428).

Yours sincerely,



Chris Pattas
General Manager
Network Operations and Development

Appendix 1

CHARLES SCERRI *oc*
Barrister

IN THE MATTER OF the AER's Proposed Rule Change and the AEMC's Draft Rule Determination on National Gas Amendment (Reference Service and Rebateable Service Definitions) Rule 2012

MEMORANDUM OF ADVICE

INTRODUCTION

1. In August 2011, the Australian Energy Regulator (AER) submitted a rule change proposal to the Australian Energy Market Commission (AEMC) that sought changes to the definitions of reference service and rebateable service. These proposed changes related to the regulation of Authorised Maximum Daily Quantity Credit Certificates (AMDQ CC).
2. The AER proposed that AMDQ CC should be characterised as a rebateable service. The rebate mechanism was proposed to be included in an access arrangement.
3. In March 2012, the AEMC released a draft rule determination. If finalised, the amendments proposed by the AEMC would not allow the AER to classify AMDQ CC as a rebateable service.
4. The AEMC has requested submissions on its draft rule determination by 26 April 2012 and I have been asked to provide this advice by 16 April 2012.
5. I have been asked to comment upon the draft rule determination in several specific legal respects. The AER may choose to attach my written advice to support its submission to the AEMC.

THE REASONS FOR THE RULE CHANGE

6. The AER's reasons for submitting the proposed rule change include, of course, policy issues as well as legal issues. I comment below only upon the specific legal questions with which I have been instructed to deal.

7. The need for a rule change became apparent to the AER when considering the forthcoming review of APA GasNet's Access Arrangement for 2013-2017. The revenue that APA GasNet raises from entering into AMDQ CC contracts is not regulated under the existing Access Arrangement (2008-2012).

8. I am instructed that the AAER is concerned that since APA GasNet's existing Access Arrangement (2008-2012) does not include AMDQ CC as either a reference service or a rebateable service, any rebate of the revenue back to users by APA GasNet appears to be voluntary. That is, the current Access Arrangement does not appear to prescribe the inclusion of AMDQ CC contracted volumes in determining forecast volumes to derive the annual reference tariff variations.

9. On 31 March 2012 APA GasNet submitted its proposed Access Arrangement for 2013-17. It proposes to deal with AMDQ CC as in its current Access Arrangement for 2008-12.

SUMMARY OF ADVICE

10. The specific legal questions that I have been instructed to address, and my answers to them, are as follows (the reasoning is set out below):
 - (a) Does the 'Actual Revenue', as specified in Schedule 4 of the APA GasNet 2008-12 Access Arrangement, permit or mandate that contracted volumes of the AMDQ CC service be taken

into account in an annual reference tariff variation when the AMDQ CC service is not a reference service or a rebateable service under the access arrangement?

Answer: No. See paras. 11 to 21, below.

- (b) If allowed under Schedule 4, is the inclusion of contracted volumes of the AMDQ CC service otherwise consistent with the current access arrangement for 2008-12?

Answer: No. See paras. 22 to 23, below.

- (c) In relation to most favoured nation clauses (MFN clauses) in existing contracts which the AER understands, set the price as the lower of the price agreed in a contract signed outside the access arrangement (i.e. in contracts entered into before regulation) and a regulated price (i.e. a reference tariff):

(i) would the National Gas Law (NGL) (specifically, ss 28(2) and 24(6)) and the National Gas Rules (NGR) require the AER to have regard to the impact of triggering MFN clauses in existing contracts when deciding whether to permit the rebating of revenue under rule 93 of the NGR?

(ii) if so, would this be comparable to the requirement under s 2.24(b) of the former Gas Code under which the regulator was to take into account "firm and binding contractual obligations of the service provider or other persons using the Covered Pipeline"?

Answer: Yes to both parts. See paras. 24 to 30, below.

- (d) In relation to the fixed principle in clause 13(a)(ii) of the Dampier to Bunbury Natural Gas Pipeline Revised Access Arrangement of 22 December 2011:

(i) does transitional rule 6 of Schedule 1 of the NGR have any application?

(ii) what would be the impact of rule 99(3) of the NGR on the Dampier to Bunbury Revised Access Arrangement should the definition of rebateable service be amended in the manner proposed by the AER?

Answers: (i) No.

(ii) It would protect the fixed principle.

See paras. 31 to 43, below.

Question (a)

11. This question is set out in paragraph 10(a) above.
12. Schedule 4 to APA GasNet's 2008-2012 Access Arrangement relates to the Price Control Formula. Transmission Tariffs may be altered in accordance with, among other things, Schedule 4.
13. Within Schedule 4, the price control formula works relevantly by reference to 'volume adjusted target revenue' (VATR) calculated in accordance with clause 4.4 of that Schedule.
14. The formula for calculating VATR includes:
 - 'TR' - target revenue, excluding NRRV;
 - 'TV' - "the total volume withdrawn from the PTS Excluding NRRV"; and
 - 'NRRV' - "for the purposes of TR, the target revenue and for the purposes of TV, the volume associated with" certain matters.
15. As I understand it, APA GasNet has included AMDQ CC contracted volumes as part of the 'injection volumes' for the South West Pipeline. This is artificial because injection volumes properly relate to physical volumes of gas injected into the system. The revenue generated by injection likewise properly relates to physical volumes. The inclusion of AMDQ CC as 'injection volumes' has the effect of

including the associated revenue from the AMDQ CC service. Then the price control mechanism in Schedule 4 has been applied by APA GasNet, upon annual revisions, to allow for the additional revenue. This is the sense in which the AMEC refers to APA GasNet having 'rebated' the AMDQ CC revenue to users. In my opinion, the inclusion of the revenue from the sale of the AMDQ CC service is not properly included in revenue in Schedule 4.

16. In my opinion, the inclusion of AMDQ CC volumes as 'injection volumes' is not consistent with the access arrangement, and neither is 'rebating' the AMDQ Cc revenue through the price control mechanism.
17. Division 8 of the NGR (which deals with Tariffs) is also noteworthy. It contemplates that revenue and costs of pipeline services will be allocated between 'reference services' and 'rebateable services'. It is clear that the AMDQ CC service is not a reference service under the 2008-2012 Access Arrangement. Neither is it a rebateable service under the 2008-2012 Access Arrangement and nor could it be under the draft rule determination.
18. In its rule change proposal, the AER noted (p.6) that APA GasNet receives two streams of revenue: one from "the volumes of gas flowed" and one from "issuing and administering AMDQ Credit Certificate (AMDQ CC) contracts to gas shippers based on the capacity of the relevant part of the DTS". I agree with this analysis.
19. The AEMC, in its draft rule determination, does not appear to have addressed the legal question that I have been asked, namely, whether the price control formula upon its proper construction requires or permits the amount that is derived from the AMDQ CC service to be included as 'revenue'. Rather, the AEMC emphasises (see especially section 5.5 of the draft rule determination) that APA GasNet is rebating the additional revenue to users through the annual tariff variation proposals. This leads the AEMC to conclude "On the information available to it, the Commission is not satisfied that the problem identified by the AER exists (that is, that APA GasNet is inappropriately retaining revenue that is in excess of the target regulated revenue)". That conclusion, which turns upon the fact (as found by the

AEMC) that APA GasNet is rebating the additional revenue, does not answer the legal question whether the revenue from AMDQ is required or permitted upon the proper construction of the Access Arrangement to be included in the first place.

20. By email dated 2 April 2012 I was instructed that, in fact, with its first annual tariff reset (and in subsequent resets), APA GasNet submitted an updated price control model (with subsequent price control) which included AMDQ CC volumes. As I understand it, this is why the AEMC concluded (at p.21) that "APA GasNet is rebating users for the over-recovery of revenue from AMDQ CC due to the volume effect. The rebating is occurring through the application of APA GasNet's approved annual tariff variation process and operation of its price control model".
21. In my opinion, the fact that this has occurred under the current access arrangement does not address the legal question concerning the proper construction of the current access arrangement.

Question (b)

22. This question is set out in paragraph 10(b) above.
23. I refer to my comments above in relation to the revenue from reference services and rebateable services, and the distinction between contracted volumes in AMDQ contracts and physical volumes injected and extracted from the PTS. It follows from those comments that, in my opinion, if contracted volumes of the AMDQ CC service are allowed under Schedule 4, that is inconsistent with the current access arrangement for 2008-12.

Question (c)

24. This question (which is in two parts) is set out in paragraph 10(c) above.

25. Section 24(6) of the NGL provides that "Regard should be had to the economic costs and risks of the potential for under and over investment by a service provider in a pipeline with which the service provided provides pipeline services". This is one of the revenue and pricing principles.
26. Section 28(2) requires the AER to take the revenue and pricing principles into account when exercising a discretion in approving or making those parts of an access arrangement relating to a reference tariff, or when making an access determination relating to a rate or charge for a pipeline service. Further, the AER may take into account the revenue and pricing principles "when performing or exercising any other AER economic regulatory function or power, if the AER considers it appropriate to do so".
27. As noted in question (c)(ii), s 2.24(b) of the former Gas Code specifically required the regulator to take into account firm and binding contractual obligations of the Service Provider or other persons using the Covered Pipeline.
28. I have been instructed that s.2.24(b) of the former Gas Code has been considered in determinations on a few occasions, albeit briefly. It is necessary to mention only the Amadeus Basin to Darwin decision of 4 December 2002. It was there noted (at para. 2.11) that 'the protection of ... binding agreements is in the broader public interest'..
29. In my opinion, the risk of triggering MFN clauses in existing contracts is a matter that the AER is required to take into account when approving or making those parts of an access arrangement relating to a reference tariff, because it affects "the economic costs and risks of the potential for under and over investment". (In section 3.1.3 of its draft determination, the AEMC refers to this as "increased financial and investment risk as the risk / reward relationship inherent in these contracts may be altered".) This is because having regard to the nature of MFN clauses, the triggering of the MFN clauses invariably will result in adjustments that are in favour of the users and are adverse to the interests of the service providers. This is because the MFN clauses are triggered only when the regulated price is lower. That outcome must be taken into account, in my opinion, in weighing "the economic costs and risks of the potential for under and over investment". Also, as Instructing Solicitors have pointed out, the AER is

required to ensure that an access arrangement is consistent with the national gas objective in section 23 of the NGL, and one purpose of the national gas objective is to promote efficient investment.

30. For the foregoing reasons, I consider that s 2.24(b) of the former Gas Code is 'comparable'. That is, in both the former Gas Code and the NGL, it was and is necessary to consider how existing contracts would be affected by the determination. Under the NGL, the statutory language is much more general than under the Gas Code. But, in my opinion, each required or requires that the risk of triggering MFN clauses be taken into account.

Question (d)

31. This question (which is also in two parts) is set out in paragraph 10(d) above.
32. A particular concern expressed by the AEMC (see section 3.1.3 of its draft determination) was that if the proposed change to the rebateable service definition were implemented, it might impact on the fixed principle in the Dampier to Bunbury Natural Gas Pipeline access arrangement. The AEMC said "if the proposed rule was made then it may be interpreted as taking precedence over the fixed principle in the current DBNGP access arrangement".
33. Transitional rule 6 of Schedule 1 to the NGR provides that Rule 99(4)(b) does not apply to the fixed principle referred to in clause 7.13(a)(ii) of the Revised Access Arrangement for the Dampier to Bunbury Natural Gas Pipeline dated 21 November 2006. Clause 7.13(a)(ii) of the 2006 access arrangement was in identical terms to clause 13(a)(ii) of the current Dampier to Bunbury Natural Gas Pipeline access arrangement to which question (d) relates.
34. Rule 99(4)(b) provides that "if a rule is inconsistent with a fixed principle, the rule operates to the exclusion of the fixed principle". It seems that it is this rule that concerned the AEMC: see para. 32 above. However, as Instructing Solicitors have pointed out, the rule proposed by the AER is a change

to the definition of rebateable service. This rule could not be 'inconsistent' with the fixed principle. The inconsistency could arise only if the rule change were made and then the AER (ignoring Rule 99(3) for present purposes – see below) applied the new definition so that in its application the rule resulted in an outcome that was inconsistent with the fixed principle.

35. The first part of question (d) is whether transitional rule 6 has any application to clause 13(a)(ii) of the current Dampier to Bunbury Natural Gas Pipeline access arrangement. As noted above, this transitional rule does not refer to clause 13(a)(ii); rather it refers to its predecessor clause, 7.13(a)(ii).
36. I am not aware of any provision that amends transitional rule 6 to make it apply to clause 13(a)(ii). For example, I am not aware of any provision that says that a reference in the NGR to a provision in an access arrangement applies to corresponding provisions in access arrangements that replace the first-mentioned access arrangement.
37. Therefore, in my opinion, transitional rule 6 does not have any application to clause 13(a)(ii) of the current Dampier to Bunbury Natural Gas Pipeline access arrangement.
38. In Section 7.2.3 of its draft determination the AEMC says "In the current access arrangement, the fixed principle referred to in transitional rule 6 of the NGR is at clause 13(a)(ii)". No authority or reference is given for that proposition, and with respect, I do not agree that it reflects a proper construction of transitional rule 6. The AEMC goes on to say (Section 7.2.4) that "...as the wording is not entirely clear, it is possible that transitional rule 6 of the NGR could be interpreted to not apply to the fixed principle described in the current access arrangement". For the reasons stated above, I consider that the wording is not unclear and my opinion is that the proper construction of transitional rule 6 is that it does not apply to the fixed principle described in the current Dampier to Bunbury access arrangement.
39. The second part of question (d) concerns the impact of rule 99(3) of the NGR on the current Dampier to Bunbury Revised Access Arrangement, should the definition of rebateable service be amended in the manner proposed by the AER.

40. Rule 99(3) provides that a fixed principle approved before the commencement of the Rules, or approved by the AER under the Rules, is binding on the AER and the service provider for the period for which the principle is fixed.
41. The AER did not propose to amend Rule 99(3).
42. It seems to me, therefore, that Rule 99(3) would continue to give binding force to existing fixed principles in existing access arrangements.
43. As noted above, the AEMC discussed precedence over the fixed principle in section 3.1.3 and section 7.2 of its draft determination. The analysis does not consider, or even mention, Rule 99(3). In my opinion the effect of that rule is to protect the fixed principles in the existing access arrangements.

CONCLUSION

44. I have discussed a draft of this memorandum by telephone conference before I finalised it, but should Instructing Solicitors have any queries they should not hesitate to contact me.

Charles Scerri

CHARLES SCERRI

Chancery Chambers

11 April 2012