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# Will revocation of the NGP derogation contribute to the NGO?

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A report for Jemena

13 December 2018

*Confidential information has been removed at some points in this document pursuant to s319(3) of the National Gas Law*

## Report authors

Ann Whitfield

Daniel Young

Greg Houston – peer review

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## Contact Us

### Sydney

Level 40  
161 Castlereagh Street  
Sydney NSW 2000

Phone: +61 2 8880 4800

### Singapore

8 Marina View  
#15-10 Asia Square Tower 1  
Singapore 018960

Phone: +65 6817 5010

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# 1. Introduction and key findings

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The Australian Energy Market Commission (AEMC) has received a rule change proposal from the Institute for Energy Economics and Financial Analysis (IEEFA) and Environmental Justice Australia (EJA) that seeks to revoke the 15 year derogation afforded to the Northern Gas Pipeline (NGP) from the operation of Chapter 6A of the National Gas Law (NGL).<sup>1</sup>

Chapter 6A of the NGL governs access disputes in relation to non-scheme pipelines, such as the NGP, including negotiation of access, referral to arbitration and related matters. The effect of the derogation is to exempt the NGP from the access regime for non-scheme pipelines set out at Part 23 of the National Gas Rules (NGR).

The NGP was developed by Jemena after it emerged as the successful bidder in a competitive tender process held by the Northern Territory government. Maximum tariffs and other terms and conditions of access to the NGP are set out in access principles that were agreed between Jemena and the Northern Territory government and included as part of Jemena's final proposal. Under the current arrangements, the derogation will end after the expiry of the access principles.

The proponents of the rule change proposal claim that revocation of the derogation would prevent Jemena, the owner of the NGP, from engaging in monopoly pricing, in addition to other claims.<sup>2</sup> On 15 November 2018, the AEMC commenced a public consultation on the proposal by releasing a consultation paper.<sup>3</sup>

We have been asked by Jemena to assess whether the proposal to revoke the derogation for the NGP would contribute to the National Gas Objective (NGO), in the context of responding to the AEMC's consultation paper.

## 1.1 Findings of this report

The key findings we draw in this report are:

- the appropriate framework under which the rule change proposal should be assessed is a two step process under which:
  - > it is first important to establish how the current arrangements, in which the derogation from Part 23 is in place and the NGP access principles apply, operate and contribute to the NGO; and
  - > whether the proposed rule, in which both Part 23 and the NGP access principles would apply, would contribute to the NGO.
- the current arrangements, under which the NGP access principles will apply over the period in which the derogation is in place, will contribute to the NGO:
  - > the access principles provide an obligation on Jemena to negotiate in good faith and to supply firm forward haulage and as-available haulage services in line with transparent and orderly procedures;
  - > the access principles set maximum tariffs for firm forward haul and firm nitrogen removal services, which are based on the outcomes of the competitive tender for the NGP and escalate at CPI each year;
  - > the prices established under the competitive tender held for the development of the NGP should be presumed to be reflective of efficient costs and, under the rolled-in-tariff provisions in the access

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<sup>1</sup> IEEFA and EJA, *Request to change National Gas Rules*, 18 July 2018.

<sup>2</sup> IEEFA and EJA, *Request to change National Gas Rules*, 18 July 2018, pp 8-9.

<sup>3</sup> AEMC, *Northern Gas Pipeline – derogation from Part 23*, Consultation paper, 15 November 2018.

principles, prices will change in line with efficient costs where expansions are made, which ensures that pipeline users share in any economies of scale;

- > the access principles also require Jemena to connect the NGP to lateral pipelines at charges reflecting reasonable costs, where it is technically feasible to do so; and
- > the access principles contain a dispute resolution mechanism culminating in binding arbitration by an independent party in accordance with external guidelines if the parties are unable to agree.

Consistent with the above, we expect these arrangements to promote efficient investment in and efficient use of gas pipeline services.

- revocation of the derogation will not contribute to the NGO because:
  - > it appears likely that, in the near term, the outcomes provided for under Part 23 will be similar or identical to those arising from the competitive tender process conducted for the NGP, consistent with commentary made by the ACCC;
  - > we expect that tariffs under the Part 23 access regime will also be cost reflective in the longer term, but the level of certainty provided to access seekers of tariffs under the Part 23 arrangements is much less than is provided under the NGP access principles, since tariffs are determined by economic principles rather than through a formula;
  - > the information that would be disclosed under the derogation is a sufficient basis for shippers to negotiate access to the NGP and the additional information that would be disclosed under the Part 23 access regime could not be expected to materially strengthen shippers' ability to negotiate access;
  - > there may be negative consequences for Australia's ability to attract further investment in new gas pipelines because revocation would affect the ability to use similar mechanisms to encourage such investment, and threatens Jemena's ability to recover the reasonable costs of its NGP investment; and
  - > it would give rise to overlapping regulatory obligations on the NGP as both Part 23 and the NGP access principles would apply, that would increase the complexity of the arrangements without the prospect of material benefits to offset the associated costs of this complexity.

## 1.2 Structure of this report

The remainder of this report is set out as follows:

- section 2 sets out relevant context to the rule change proposal, including a description of the NGP tender process, the circumstances of Jemena's investment in the NGP and a summary of the subsequent changes to the regulation of gas pipelines since the tender process;
- section 3 explains our assessment framework for determining whether the rule change proposal contributes to the NGO and, where applicable, why it differs from that proposed by the AEMC;
- section 4 sets out the current arrangements for providing gas transportation services on the NGP, including the requirements of the NGP access principles and the underpinning project development agreement (PDA), and discusses how these arrangements contribute to the NGO; and
- section 5 assesses whether revocation of the derogation, bringing Part 23 of the NGR into effect on the NGP in addition to the NGP access principles (and PDA), would further contribute to the NGO.

## 2. Background to the rule change proposal

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This section sets out factual material that is relevant to understanding the context for the development of the NGP and the derogation subsequently provided to it under the NGR.

The NGP is a 622 kilometre gas transmission pipeline connecting Tennant Creek in the Northern Territory with Mt Isa in Queensland. It is a 12 inch pipeline with haulage capacity of 90 TJ/day eastward.

The pipeline was conceived of by the Northern Territory government as a link between the northern and eastern gas markets, contributing to the development of a national gas grid, a more competitive gas market, and helping to improve security of supply.<sup>4</sup> It was made possible due to surplus gas that was available to the government-owned Power and Water Corporation (PWC) under its 25 year contract with ENI for gas from the Blacktip field.<sup>5</sup> However, the objectives set out by the government were wider this, since it considered the development of new gas supplies as important to long term employment and economic growth in the Territory.<sup>6</sup>

The remainder of this section:

- confirms that the tender process for the NGP conducted by the Northern Territory government was competitive;
- discusses the nature of the risks confronting Jemena in developing the NGP; and
- explains how the derogation for the NGP came about, and establishes that it formed part of the package of changes made to the regulation of gas pipelines alongside the introduction of Part 23.

### 2.1 The NGP was developed following a competitive tender process

The NGP was developed following a competitive tender process conducted by the Northern Territory government (for what was at that stage known as the North East Gas Interconnector (NEGI)). The tender process commenced in October 2014 with an industry briefing and concluded on 17 November 2015, when Jemena was selected from bids from four short listed tenderers as the winning tenderer.<sup>7</sup>

Jemena's base case proposal was for a pipeline with a diameter of 12 inches. However, it retained the option to develop a larger pipeline if additional demand was realised in time to be reflected in the design of the NGP.<sup>8</sup> This option was also reflected in the project development agreement (PDA) entered into between Jemena and the Northern Territory government.<sup>9</sup>

Table 2.1 below sets out key dates and events in the tender process.

<sup>4</sup> Northern Territory government, *North East Gas Interconnector fact sheet 1*, undated.

<sup>5</sup> See for example: AEMC, *Review of the application of capacity trading reforms in the Northern Territory*, Final report, 16 March 2018, pp 9-10.

<sup>6</sup> Northern Territory government, *North East Gas Interconnector: Request for final proposals*, 1 April 2015, p 5.

<sup>7</sup> Northern Territory government, *North East Gas Interconnector fact sheet 1*, undated.

<sup>8</sup> Jemena, *North East Gas Interconnector Final Proposal*: [REDACTED]

<sup>9</sup> North East Gas Interconnector Project Development Agreement, clause [REDACTED]

Table 2.1: Timeline of the North East Gas Interconnector tender process

Date	Step
10 October 2014	COAG issues a communiqué supporting efforts by the NT government to establish a competitive process for the private sector to make proposals to operate and construct a pipeline linking the Northern and Eastern gas markets.
13 October 2014	NT government grants major project status to the development of the NEGI.
31 October 2014	More than 70 organisations attend an industry briefing in Alice Springs to explain the project and outline the competitive process.
13 November 2014	Call for expressions of interest released to industry.
15 December 2014	Closing date for expressions of interest – 14 received.
19 December 2014	NT government announces 11 proponents shortlisted to proceed to the request for initial proposals.
2 March 2015	Closing date for initial proposals – nine received.
1 April 2015	NT government announces four proponents invited to proceed to the request for final proposals.
30 September 2015	Closing date for final proposals – four received.
17 November 2015	NT government selects Jemena to construct and operate the NEGI.

Source: Northern Territory government, North East Gas Interconnector fact sheet 1, undated.

As table 2.1 indicates, Jemena faced strong competition to become the successful tenderer for the project, with 14 expressions of interest, nine initial proposals and four final proposals considered during the tender process. During the penultimate tender stage, the nine initial proposals were evaluated by an expert panel consisting of two private sector members and two senior public servants. The bidders in the final stage were Jemena, APA, DUET and China National Petroleum Corporation.<sup>10</sup>

After the closing date for the final proposal submission, the Northern Territory government reserved its rights to negotiate with more than one bidder before the successful proponent was announced.<sup>11</sup> We understand from Jemena that, following submission of a revised final bid, negotiations were held in Sydney, with both Jemena and one other party. We further understand that the parties were located on separate floors of the Sydney offices of the government's legal advisors, and these negotiations continued through to the final 24 hours prior to the announcement of the tender outcome. This process underlines the pressure faced by bidders to propose compelling terms to the government with a view to best addressing its evaluation criteria in contention for the right to develop the NGP.

The evaluation criteria employed by the Northern Territory government included:<sup>12</sup>

- tariff and tariff structure;
- timeliness and certainty of pipeline completion;
- government support required;
- local industry participation; and
- potential to deliver broader economic benefits.

By way of example, announcing the result of the tender, the Northern Territory Chief Minister cited the lower tariffs and lower other charges proposed by Jemena as being compelling aspects of its tender.<sup>13</sup>

<sup>10</sup> Utility Magazine, *Where is NEGI now?*, 11 August 2016.

<sup>11</sup> Northern Territory government, *North East Gas Interconnector: Request for final proposals volume 2*, undated, p 4.

<sup>12</sup> Northern Territory government, *North East Gas Interconnector Factsheet 1: Private sector and government in partnership*, undated. Our review of the tender documentation has confirmed these criteria.

<sup>13</sup> Northern Territory government media release, *NT announces Jemena to build gas pipeline to east coast*, 17 November 2015.

Mr Giles said the proposal from Jemena was compelling as it offered cheaper tariffs, cheaper gas processing costs and the option to increase the capacity of the pipeline prior to the laying of the first pipe if market conditions support increased capacity.

During the tender process, the Northern Territory government sought proposals to develop the NGP as a covered pipeline, or asked respondents to propose alternative arrangements.<sup>14</sup> We understand that Jemena did not and was not willing to submit a proposal on this basis. Jemena instead proposed to develop the NGP on the basis of access principles in lieu of coverage, which we understand were initially proposed by the Northern Territory government.

Most prominently, these principles provide for:

- fixed maximum tariffs for firm forward haul and firm nitrogen removal services which escalate at CPI each year, and cannot be unilaterally changed by Jemena;
- a process for updating published maximum tariffs in the event that the NGP is expanded up to 300 TJ/day, under a formula that does not permit these tariffs to rise, but provides for them to fall if the expansion reduces the average cost of the pipeline; and
- a dispute resolution mechanism culminating in binding arbitration by an independent arbitrator if the parties are unable to agree.

We discuss the nature of the NGP access principles in more detail at section 4.1 below.

## 2.2 Investing in the NGP is a risky endeavour for Jemena

In investing in the NGP, Jemena assumed and maintains significant risk because:

- unlike most newly developed pipelines, a relatively low proportion of the pipeline's capacity is contracted under long term arrangements and demand for the remaining capacity is subject to considerable uncertainty; and
- the NGP is part of a gas supply chain that is in competition with other gas supply chains to deliver gas to east coast customers.

As highlighted by the ACCC in its east coast gas inquiry, it is usually the case that investments in new gas pipeline capacity are underwritten by long-term foundational arrangements with shippers, providing a significant degree of revenue certainty for pipeline investors. The ACCC noted that:<sup>15</sup>

This desire can largely be attributed to the constraints imposed by financiers, who understandably want greater surety of demand given the high upfront costs associated with these investments and the fact that they have few alternative uses if demand does not eventuate.

...

These financial constraints also explain why new pipelines only tend to be built to meet the foundation shippers' demand and why existing pipelines tend to be expanded in stages to meet incremental increases in demand.

In contrast to these arrangements, the NGP was developed with only a modest proportion of its capacity contracted under firm long term arrangements.<sup>16</sup> We understand from Jemena that the tariffs proposed in its tender for the NGP (and reflected in the access principles) were based on assumptions that the NGP would become fully contracted. A failure to achieve full contracting of NGP capacity therefore puts at risk cost recovery for Jemena.

<sup>14</sup> Northern Territory government, *North East Gas Interconnector: Request for final proposals*, [REDACTED]

<sup>15</sup> ACCC, *Inquiry into the east coast gas market*, April 2016, pp 93-96.

<sup>16</sup> Katherine Times, *Incitec Pivot gas deal relies on Mount Isa Northern Gas Pipeline*, 26 June 2018.

Upon winning the tender, Jemena entered into an agreement with PWC for firm forward haulage of 31 TJ/day (plus as available services) to Incitec Pivot Limited's (IPL) Phosphate Hill facility at Mt Isa. The agreement has a term of 10 years from the service start date plus options for further extension.<sup>17</sup>

Jemena has subsequently entered into further agreements with:

- IPL for firm forward haulage of 32 TJ/day to Mt Isa for onward haulage to its Brisbane plant at Gibson Island. The initial term of this agreement runs to 31 December 2019 with option to extend further;<sup>18</sup> and
- Santos for firm forward haulage of 8.3 TJ/day. This agreement ends on 31 December 2021.<sup>19</sup>

In each case, as per the access principles, the shipper also has a contract with Jemena for nitrogen removal services. We understand that both agreements also include further as-available services.

As a result of these agreements, around 80 percent of the NGP's capacity is currently contracted under firm arrangements, but only for the immediate future over the 2019 calendar year. The NGP is lightly contracted for a newly constructed pipeline, with only the initial PWC contract certain to extend beyond 31 December 2021. These arrangements mean that the NGP is exposed to a much greater degree of risk than most newly constructed pipelines. Box 2.1 highlights the material nature of these demand risks for the NGP stemming from changes in policies towards hydraulic fracking since the initial tender.

#### Box 2.1: Risks in relation to future demand on the NGP

The risks associated with the development of the NGP can be clearly understood by reference to the prospect for increased demand on the NGP. At the time of its final proposal submission to the Northern Territory government, Jemena was engaging with explorers who were seeking to develop unconventional gas sources from the Beetaloo basin in Northern Territory.<sup>20</sup>

The base case proposal was for a pipeline with a diameter of 12 inches. The availability of large volumes of additional gas could also provide the economics for Jemena subsequently to develop a much longer pipeline with capacity of up to 700 TJ/day connecting the Beetaloo basin to Wallumbilla.<sup>21</sup> The NGP can be understood in this context as an initial investment that could enable a series of subsequent investments to bring substantial volumes of gas from the Northern Territory to east coast markets.

However, the availability of additional gas is closely linked to prospects for hydraulic fracking in the Northern Territory. On 14 September 2016, the Northern Territory government announced a moratorium on hydraulic fracturing pending the results of an independent scientific inquiry.

The final inquiry report was released on 27 March 2018. It concluded that the risks associated with hydraulic fracturing could be reduced to an acceptable level. Subsequently, the Northern Territory issued a response on 17 April 2018, accepting all recommendations and lifting the moratorium.<sup>22</sup>

Further, the NGP forms part of a supply chain that sells gas produced in Northern Territory to customers on the east coast, in Mt Isa and elsewhere. This activity is subject to competition from other gas supply chains, since the markets for the gas that the NGP services are already served by sources of gas from the east coast using the existing interconnected network of pipelines.

<sup>17</sup> Jemena media release, *Jemena announces new gas transportation contract*, 25 June 2018.

<sup>18</sup> Jemena media release, *Jemena announces new gas transportation contract*, 25 June 2018.

<sup>19</sup> Jemena media release, *Jemena signs new gas transportation agreement with Santos*, 21 September 2018; and Australian Financial Review, *Santos signs contract to use Jemena's new NT gas pipeline link*, 21 September 2018.

<sup>20</sup> Jemena, *North East Gas Interconnector Final Proposal*: [REDACTED]

<sup>21</sup> Jemena media release, *Jemena welcomes call for greater investment in pipeline infrastructure*, 28 February 2018.

<sup>22</sup> Northern Territory government websites, <https://frackinginquiry.nt.gov.au/> and <https://hydraulicfracturing.nt.gov.au/>, accessed 4 December 2018.

Figure 2.1 below is a simplified diagram of Australia's gas pipeline network released with the NEGI tender. It indicates that gas from the Northern Territory competes with gas from east coast sources, such as the Cooper, Surat/Bowen, Gippsland, Bass and Otway basins.

Figure 2.1: Proposed route of the NEGI connecting the north and east gas markets



Source: Northern Territory government. The NGP follows the route above between Tennant Creek and Mt Isa.

### 2.3 The derogation was developed as part of the 2017 package of changes to the regulation of gas pipelines

The NGP tender process concluded in November 2015. Changes to the NGR to institute an access regime for non-scheme pipelines were subsequently introduced in August 2017 – after Jemena had committed to building the NGP but before it was completed.

The derogation for the NGP was developed by the Gas Market Reform Group (GMRG) (in consultation with the Northern Territory government) alongside the changes to the NGR. The derogation provides that the access regime will not apply to the NGP for a period of 15 years from its commissioning – consistent with the term over which the NGP access principles would apply. The derogation effectively ensures a continuation of the regulatory terms and conditions under which Jemena successfully tendered for the development of the

NGP. The derogation only applies for capacity on the NGP of up to 300 TJ/day (which is the capacity covered by the NGP access principles). For any expansion beyond this capacity, in the absence of a further derogation, Part 23 would apply.<sup>23</sup>

Pipelines which are regulated under Parts 8 to 12 of the NGR are referred to as 'covered' pipelines. New pipelines are able to seek a 'no coverage' determination which eliminates the prospect of coverage for a term of 15 years. However, few pipelines are covered and, at the time of the NGP tender process, this was the only route through which pipelines could be regulated.

It was in this context that the Northern Territory government sought interest from prospective investors (including Jemena) to develop the NGP as a covered pipeline. Jemena did not submit a proposal to develop the NGP on this basis. Jemena's proposal was instead made on the basis of the NGP access principles. These access principles are annexed to the PDA entered into between Jemena and the Northern Territory government. A non-confidential version of these principles is publicly available on Jemena's website.

The circumstances underpinning this agreement were subsequently affected when, after the completion of the NGP tender process, a number of events occurred of significance to the regulation of gas pipelines.

On 22 April 2016, the ACCC published its east coast gas inquiry report. The report cited evidence of monopoly pricing by gas pipelines, noting concerns that:<sup>24</sup>

- pipelines were earning high returns on incremental investments, which may allow pipelines to add new capacity at low cost;
- prices on established pipelines, which had previously recovered all or much of initial construction costs, were not reducing charges to reflect this recovery; and
- prices charged for as available, interruptible and backhaul charges, in a few cases, considerably exceeded competitive benchmarks relative to firm haulage.

The ACCC concluded that the coverage test for gas pipelines was misdirected, being focused on the harm caused by denial of access, rather than monopoly pricing. It recommended changes to the coverage test for gas pipelines to provide for coverage if the pipeline has substantial and sustained market power.<sup>25</sup>

On 19 August 2016, the Council of Australian Governments (COAG) Energy Council released its Gas Market Reform Package, creating the GMRG and appointed its Chair, Dr Michael Vertigan, to undertake a review of the coverage test.<sup>26</sup>

On 14 December 2016, Dr Vertigan released his review report. The key finding of this report is that there was not an appetite for increased regulation of gas pipelines and that most gas shippers were seeking a means of reducing the imbalance of bargaining power during negotiations with pipelines.<sup>27</sup> Consistent with this finding, the report recommended that the GMRG be tasked with the development of a scheme for binding arbitration and information disclosure instead of changes to the coverage test.<sup>28</sup> This recommendation was endorsed by the COAG Energy Council.<sup>29</sup>

On 1 August 2017, after a consultation process, new rules developed by the GMRG were made by the South Australian Minister implementing the scheme for binding arbitration and information disclosure as Part 23 of

<sup>23</sup> The rule change proponents' claims to the contrary are incorrect.

<sup>24</sup> ACCC, *Inquiry into the east coast gas market*, April 2016, pp 103-111. Although the AEMC's consultation paper cited that the ACCC found a large number of gas pipeline service providers to be engaging in monopoly pricing (and this reflects the wording of the inquiry report's executive summary) the material concerns raised by the ACCC were much more specific and less wide ranging than is suggested by this characterisation.

<sup>25</sup> ACCC, *Inquiry into the east coast gas market*, April 2016, pp 134, 138-139.

<sup>26</sup> COAG Energy Council, *Gas Market Reform Package: Bulletin Two*, 19 August 2016.

<sup>27</sup> Vertigan, M., *Examination of the current test for the regulation of gas pipelines*, 14 December 2016, pp 77-78.

<sup>28</sup> Vertigan, M., *Examination of the current test for the regulation of gas pipelines*, 14 December 2016, pp 90-94.

<sup>29</sup> COAG Energy Council communiqué, 14 December 2016, pp 1-2.

the NGR.<sup>30</sup> The commencement of Part 23 of the NGR represented a material change to the regulation of gas pipelines. It subjected many uncovered pipelines to a significant degree of regulatory oversight – explained in further detail at section 5.1 below.

The derogation for the NGP was developed by the GMRG, in consultation with the Northern Territory government, as part of these rules.

The inclusion of the derogation was a concerted decision by the GMRG and the COAG Energy Council governments, which recognised the need to accommodate the competitive tender outcome for the NGP under the Part 23 arrangements. During the GMRG's consultation process, Jemena made submissions advocating an exemption for the NGP on the basis both that the NGP was a 'greenfield' pipeline that should expect to receive a holiday from regulation and that, for the first 15 years of operation, it would be subject to the binding contractual obligation to apply the access principles.<sup>31</sup>

The GMRG's explanatory statement describes the rationale for the derogation, and acknowledges that the access principles developed for the NGP address many of the same issues as Part 23:<sup>32</sup>

The derogation provided for under Part 2 exempts the Northern Gas Pipeline (NGP) from the operation of Part 6A of the NGL for a period of 15 years from when the pipeline is commissioned. The NGP is being developed by Jemena Northern Gas Pipeline Pty Ltd (Jemena) following a competitive tender process conducted by the Northern Territory Government in 2015 and is due to be completed in late 2018. The Project Development Agreement signed by Jemena and the NT Government sets out the access principles that were agreed to as a result of the competitive process and are intended to address many of the same issues the framework is designed to address.

### 2.3.1 Alternative approaches are not close substitutes for derogation

In its consultation paper, the AEMC notes two processes whereby the regulatory status of a pipeline can be determined prior to commissioning, namely:<sup>33</sup>

- an application to the regulator to approve the tender process for the pipeline as competitive, under which the pipeline would become covered and subject to full regulation for a period of 15 years with its initial capital base established by reference to the outcomes of the tender process; and
- an application for a greenfield no-coverage determination, under which the pipeline could remain uncovered for a period of 15 years.

These approaches are not, and were never, close substitutes for the derogation.

The competitive tender process route cited by the AEMC (and which would need to have been driven by the Northern Territory government) would have only resulted in the NGP becoming a covered pipeline subject to full regulation. We explain above that Jemena declined to submit a proposal to develop the NGP on this basis.

Similarly, while Jemena could have sought (and could still seek) a greenfields no-coverage determination, it would only offer an exemption from the access regime applying to covered pipelines. Without the derogation, the NGP would still be subject to the access regime set out in Part 23 of the NGR for non-scheme pipelines.<sup>34</sup>

<sup>30</sup> GMRG website, <http://gmr.coenergyCouncil.gov.au/publications/gas-pipeline-information-disclosure-and-arbitration-framework-initial-national-gas>, accessed 27 November 2018.

<sup>31</sup> Jemena, Submission: gas pipeline information disclosure and arbitration framework, 13 April 2017, pp 4-5.

<sup>32</sup> Gas Market Reform Group, *Gas pipeline information disclosure and arbitration framework: Initial National Gas Rules explanatory note*, 2 August 2017, p 47.

<sup>33</sup> AEMC, *Northern Gas Pipeline – derogation from Part 23*, Consultation paper, pp 2-3.

<sup>34</sup> We discuss the costs and benefits of this arrangement in section 5 below.

## 3. The appropriate assessment framework

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The AEMC may only make a rule if it is satisfied that the rule will or is likely to contribute to the achievement of the NGO.<sup>35</sup> The NGO is:<sup>36</sup>

...to promote efficient investment in, and efficient operation and use of, natural gas services for the long term interests of consumers of natural gas with respect to price, safety, reliability and security of supply of natural gas.

In this report, we assess the proposed rule change by examining:

- the current arrangements, in which the derogation from Part 23 is in place and the NGP access principles apply, and how they contribute to the NGO; and
- whether the proposed rule, in which both Part 23 and the NGP access principles would apply, would contribute to the NGO.

In this section, we explain why our assessment framework is a two step process and why the assessment should include the circumstances of the NGP, but should not be limited to this.

### 3.1 Our assessment framework is a two step process

In our view, it is necessary first to understand the current arrangements and how these contribute to the NGO before it is possible to assess whether (and if so, how) the proposed rule change would contribute to the NGO.

The AEMC's proposed assessment framework focuses on a comparison of the expected outcomes under the current arrangements as compared with expected outcomes under the proposed rule change.<sup>37</sup> This focus is further revealed in the first two questions asked in the consultation paper, which focus on the extent to which these outcomes are similar.<sup>38</sup>

Expected outcomes under the current arrangements and under the rule change proposal are undoubtedly of importance to an assessment of the proposal. If there are no significant differences in these outcomes, then the rule change proposal cannot contribute to the NGO. However, even if there are significant differences in these outcomes, this does not establish that one of the scenarios better contributes to the NGO than the other. That is, establishing differences in expected outcomes is *necessary*, but not *sufficient*, to establish that the rule change proposal contributes to the NGO. The further step that is required is to show that those changes in outcomes contribute to the NGO.

By way of example, the AEMC states that, in undertaking its assessment of the rule change proposal, it proposes to take into account *'the likely outcomes for market power, information asymmetry, regulatory complexity and any special circumstances that may be impacting the NGP.'*<sup>39</sup> We note that these outcomes are an intermediate step for assessing the NGO. Ultimately, the assessment of the rule change proposal requires consideration of whether differences in expected outcomes due to the revocation of the derogation contribute to the NGO.

In our view, this requires forming an understanding of the current arrangements and how they contribute to the NGO. This provides a framework for understanding how changes that would arise under the rule change

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<sup>35</sup> NGL, s 291(1).

<sup>36</sup> NGL, s 23.

<sup>37</sup> AEMC, *Northern Gas Pipeline – derogation from Part 23*, Consultation paper, 15 November 2018, p 10.

<sup>38</sup> AEMC, *Northern Gas Pipeline – derogation from Part 23*, Consultation paper, 15 November 2018, p 12.

<sup>39</sup> AEMC, *Northern Gas Pipeline – derogation from Part 23*, Consultation paper, 15 November 2018, p 10.

proposal might be expected to give rise to different outcomes and whether these outcomes would serve to contribute (or otherwise) to the NGO.

### 3.2 The assessment framework should consider outcomes more broadly

In our opinion, the assessment of the rule change proposal should not be limited only to how expected outcomes for the NGP would contribute to the NGO but should consider more generally expected outcomes for efficient investment in, and efficient operation and use of, natural gas services. The AEMC's consultation paper does not explicitly state that it will consider these broader issues.

The derogation for the NGP is consistent with an established practice of providing incentives to new pipelines (via allowing a fixed period over which the pipeline is not subject to any regulation) in order to promote efficient investment in natural gas services – a practice that has previously been held to contribute to the NGO.<sup>40</sup> It is important that the assessment framework considers the potential implications for efficient investment of the proposed rule change on:

- the ability to provide similar derogations in the future for greenfields pipelines; and
- more generally, the credibility of regulation, given that only a year has elapsed since the derogation providing a 15 year period of relief from regulation was provided and the NGP has not yet commenced operations.

These considerations are important beyond the direct effect that the revocation of the derogation would have on the operation and use of the NGP, because they potentially give rise to differences in expected outcomes for investment, both for expansions and extensions of the NGP as well as the development of other new pipelines.

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<sup>40</sup> This is discussed further in section 5.3.

## 4. Requirements of the NGP access principles

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In this section we outline key features of the NGP access principles and discuss how these principles serve to contribute to the NGO.

We find that the access principles:

- set out an access regime that provides for a transparent and orderly system under which Jemena will address applications for access and provide information that is relevant for this purpose;
- impose maximum tariffs which are cost-reflective, given the context of the competitive tender for construction and operation of the NGP, and which will change in line with costs over the term of the principles (which matches that of the derogation); and
- provide for independent binding arbitration in the event that disputes arise in relation to compliance with the access principles.

### 4.1 Jemena's obligations under the NGP access principles

The NGP access principles are included as an annexure to the PDA agreed between Jemena and the Northern Territory government. Although the PDA is confidential, a non-confidential version of the access principles is available on Jemena's website.<sup>41</sup>

We understand that the NGP access principles were proposed by the Northern Territory government in lieu of coverage as an obligation for the successful tenderer. We further understand that these access principles were issued following independent discussions, at the instigation of the Northern Territory government, with each bidder. The access principles apply for 15 years from the commissioning of the pipeline, or the term of the PDA, whichever is longer. However, the access principles will not apply if the NGP becomes a covered pipeline, over the period that the pipeline remains covered.<sup>42</sup>

The NGP access principles impose material obligations on Jemena, summarised in Table 4.1 below. The access principles apply to any shipper using the NGP, including PWC, at the option of the shipper, and can be enforced by the Northern Territory government.<sup>43</sup> The access principles cannot be unilaterally changed by Jemena and can only be changed by agreement with the Northern Territory government.<sup>44</sup>

The remainder of this section describes the key requirements in greater detail.

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<sup>41</sup> Jemena's website, <https://jemena.com.au/getattachment/industry/pipelines/Northern-Gas-Pipeline/Services/NGP-Access-Principles.pdf.aspx>, accessed 28 November 2018.

<sup>42</sup> NGP access principles, clause 37.

<sup>43</sup> NGP access principles, clauses 38-39.

<sup>44</sup> The rule change proponents incorrectly assert that the access principles are subject to change by Jemena at any time, based on the definition contained in the public version of the access principles. However the access principles are an annexure to the PDA, and under the terms of the PDA expressly cannot be changed by Jemena without the agreement of the Northern Territory government.

Table 4.1: Summary of requirements of the NGP access principles

Issue	Requirement of the NGP access principles
Applications for access	Sets out a procedure under which applications for access must be processed and imposes requirements on Jemena to negotiate in good faith. If it cannot provide the services sought, Jemena must advise what services it can provide. Describes the procedures for forming and maintaining an access queue if demand exceeds capacity.
Connection of laterals	Requires Jemena to connect lateral pipelines to the NGP with charges at reasonable costs, if it is feasible to do so.
Maximum tariffs	Establishes maximum tariffs for firm forward haulage and firm nitrogen removal with escalation for CPI Jemena is not able to charge above these tariffs.
Rolled in tariffs	Expansions or extensions of the pipeline with incremental costs that are lower than existing charges will bring down those charges. Expansions or extensions of the pipeline with incremental costs that are higher than existing charges will face an additional charge that reflects those costs.
Provision of information	Jemena must publish and make available to access seekers the access principles and its standard terms and conditions. Jemena must notify the Northern Territory government of changes to tariffs and reasons for the changes and must publish this information.
Dispute resolution	Mandates a dispute resolution procedure, the final step of which is referral to binding independent arbitration
Scope of access principles	The access principles apply to the NGP and expansions or extensions of the NGP within a defined scope – up to 300 TJ per day capacity.
Sanctions for non-compliance	The Northern Territory government may issue an access default notice which could lead to coverage of the NGP if Jemena does not then comply.

Source: NGP access principles, North East Gas Interconnector Project Development Agreement, clause [REDACTED]

The access principles set out a procedure under which Jemena must process applications for access. The application process sets a timeline under which Jemena must advise access seekers of its ability to meet their requirements and negotiate in good faith to enter an access agreement that satisfies those requirements. Where Jemena cannot meet the requirements, it must advise the access seeker of what capacity it could provide and when it could provide it.<sup>45</sup> Further, the access principles also set out a process under which a queue for firm capacity will be established and maintained if demand for firm service exceeds the capacity of the pipeline.<sup>46</sup>

Jemena is also required to provide for connection of lateral pipelines to the NGP if it is operationally and technically feasible to provide for this – and at rates equal only to the reasonable costs of providing this connection.<sup>47</sup>

The access principles set out maximum pipeline tariffs for firm forward haulage and firm nitrogen removal, subject to escalation for CPI. Firm tariffs to shippers cannot exceed these published rates, and Jemena is not unilaterally able to change these tariffs.<sup>48,49</sup> These tariffs were a key outcome of the competitive tender process, as set out in section 2, and it should be presumed that they reflect the efficient costs of providing the pipeline services.

<sup>45</sup> NGP access principles, clauses 3 to 6.

<sup>46</sup> NGP access principles, clauses 11 to 20.

<sup>47</sup> NGP access principles, clauses 21 to 22.

<sup>48</sup> NGP access principles, annexure 1 and clause 23. However, there may be circumstances in which additional cost reflective charges could be applied to shippers. For example, clause 18.1 of the NGP standard form gas transportation agreement provides Jemena the ability to change tariffs to reflect changes in costs resulting from new obligations under the law.

<sup>49</sup> The rule change proponents claim that changes in tariffs under the access principles only require notification to the Northern Territory government. We consider that this is a selective reading of the pricing framework and that Clause 24 of the access principles must be read in the context of clauses 23 to 26, the formulation for firm tariffs set out in Annexure 1 and the requirements of the PDA.

Firm tariffs will be revised upon expansions or extensions of the pipeline that fall within the scope of the access principles (ie, up to 300 TJ/day) – called a ‘rolled in tariff’. Under this formulation (which was proposed by Jemena as part of its tender proposal), the rolled in tariff can never increase, and can only decrease. The essential economic principles on which this calculation rests are that:<sup>50</sup>

- expansions with incremental costs that are higher than the highest user charge will incur an additional charge above the firm tariff that reflects these higher costs; and
- expansions with incremental costs that are lower than the highest user charge will share these savings with existing users.

A more detailed description of the rolled in tariff regime, using an example introduced in the NGP access principles, is set out in box 4.1 below.

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<sup>50</sup> NGP access principles, annexure 1.

Box 4.1: How the rolled-in tariff calculation in the access principles works

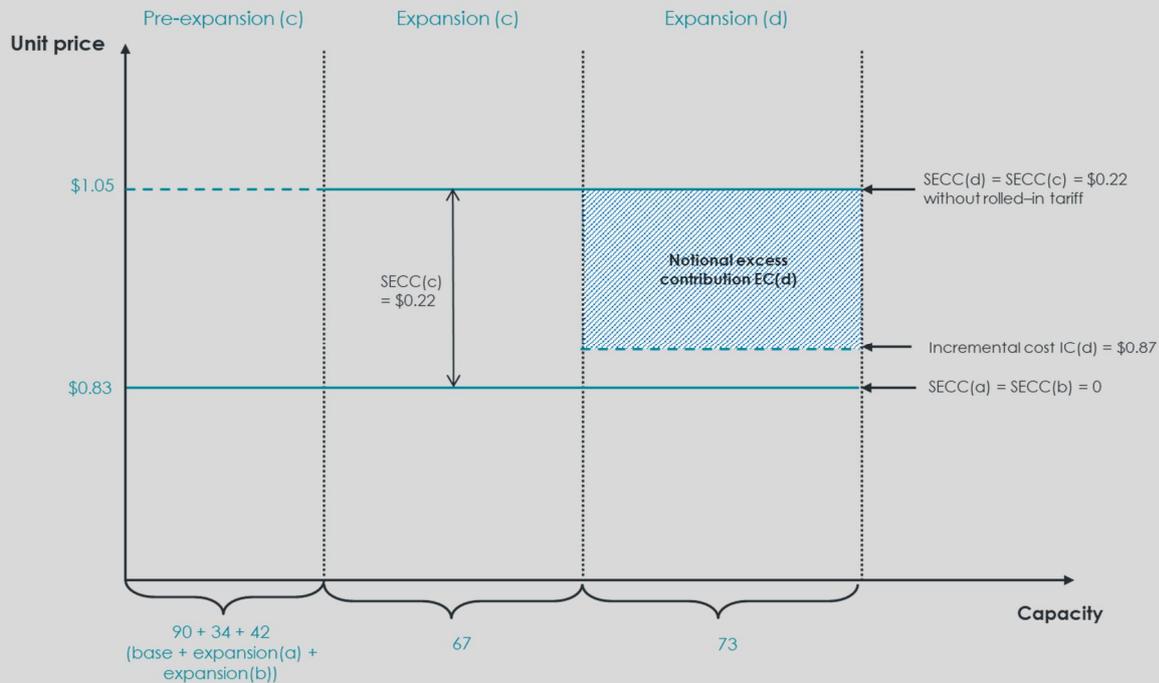
The rolled-in tariff set out in the access principles is formulated so that:

- expansions with incremental costs that are higher than the highest user charge will incur an additional charge above the firm tariff that reflects these higher costs, known as a shipper expansion capacity charge (SECC); and
- expansions with incremental costs that are lower than the highest user charge will share these savings with existing users, establishing a new uniform SECC that will apply to all users who had previously paid more than this and lowering the firm tariff if all SECCs are reduced to zero.

The NGP access principles set out an example showing how these principles apply. In the example, the pipeline has capacity of 90 TJ with a foundation firm tariff of \$1.00 per GJ. Then:

- expansion (a) has capacity of 34 TJ per day and incremental costs of \$0.50 per GJ – this reduces the maximum firm tariff to \$0.86 per GJ;<sup>51</sup>
- expansion (b) has capacity of 42 TJ per day and incremental costs of \$0.75 per GJ – this further reduces the maximum firm tariff to \$0.83 per GJ;<sup>52</sup> and
- expansion (c) has capacity of 67 TJ per day and incremental costs of \$1.05 per GJ – this is higher than any charged faced by a user, so a SECC of \$0.22 above the maximum firm tariff is applied to users of this expansion.

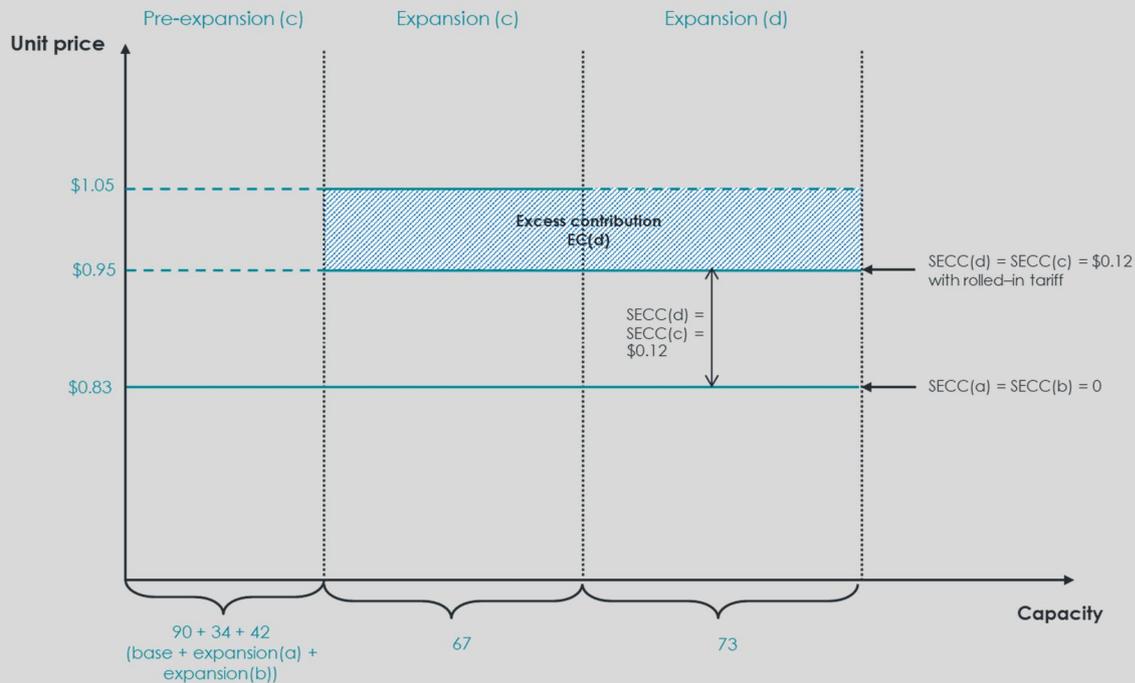
The key features of the rolled-in tariff methodology are revealed with a further expansion (d), which adds 73 TJ per day at an incremental cost of \$0.87 per GJ. This incremental cost is less than the highest charge of \$1.05 per GJ, which means there is a notional ‘excess contribution’ of approximately \$13,140 per day that could be shared amongst users. The situation is set out in the diagram below.



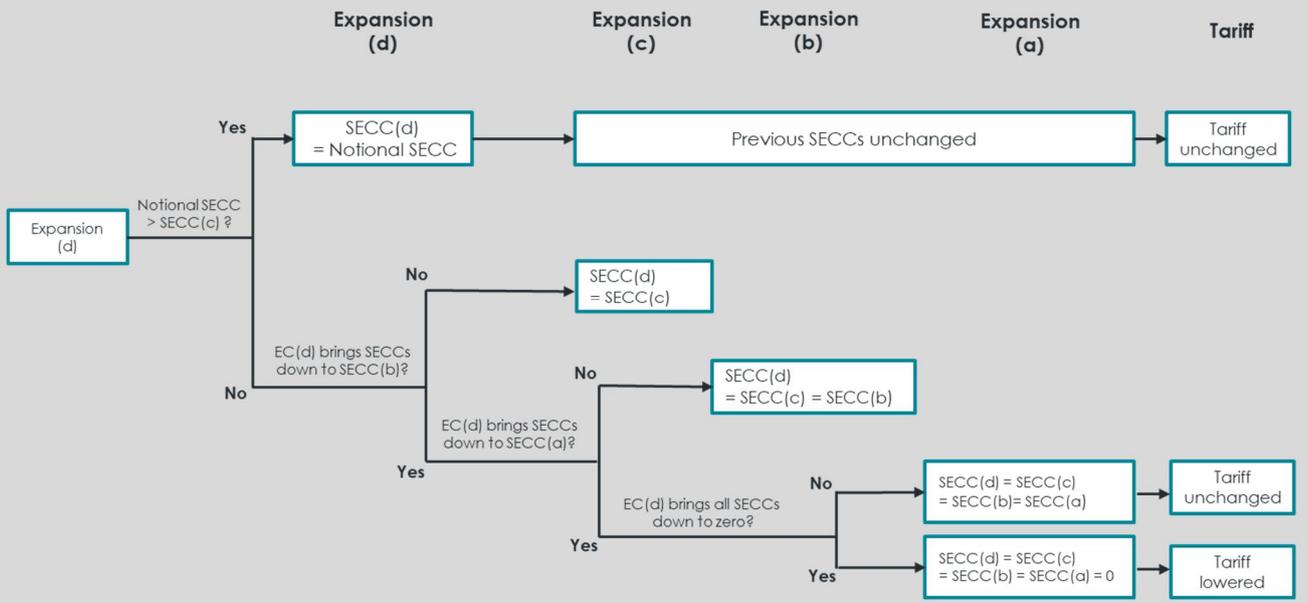
<sup>51</sup>  $(90 \times \$1.00 + 34 \times \$0.50) / (90 + 34) = \$0.86$

<sup>52</sup>  $(124 \times \$0.86 + 42 \times \$0.75) / (124 + 42) = \$0.83$

Under the access principles, users of expansion (c), who currently face a SECC of \$0.22 per GJ, are the first beneficiaries of expansion (d). Sharing the excess contribution amongst the users of expansions (c) and (d) gives rise to a uniform SECC of \$0.12 per GJ – for a total charge of \$0.96 per GJ.<sup>53</sup>



If the excess contribution from expansion (d) were large enough so that it brought charges faced by the users of expansion (c) and (d) below those faced by the users of expansion (b), then the contribution would be shared with the users of expansion (b) under a uniform SECC – and so on. The diagram below sets out the full set of considerations for how the charges faced by each user would be affected by expansion (d).



Under the requirements of the access principles, Jemena must publish on its website and make available the access principles and its standard terms and conditions on which it will provide access to firm services. It must also notify the Northern Territory government of any proposed changes to tariffs and provide

<sup>53</sup> The figures do not add due to rounding.

information as to the date that the change will take effect and the reason for the proposed changes. It is clear in the context of the remainder of the access principles that this relates only to tariff changes that are otherwise permitted by the access principles – which are limited to indexation for CPI or following an expansion or extension of the pipeline. This is consistent with Jemena’s obligations under the PDA. This information must be published on its website at all times and made available when requested.<sup>54</sup>

The access principles set out a dispute resolution procedure which applies in the event that an access seeker and Jemena are unable to reach agreement. The final step of this procedure is referral of the matter to arbitration under the arbitration rules of the Institute of Arbitrators and Mediators.<sup>55</sup> These rules are largely procedural. Since the NGP access principles set out the basis under which tariffs are calculated, arbitration will not be on the basis of price but on other terms and conditions.

The penalty for non-compliance with the terms of the access principles can extend to coverage being imposed on the NGP. [REDACTED]

[REDACTED]

The access principles apply to expansions up to 300 TJ<sup>57</sup> but not to extensions of the pipeline (beyond the development of compressor stations at Phillip Creek and Mt Isa).<sup>58</sup> For expansions and extensions beyond these parameters, the Part 23 access regime would apply – unless a further derogation or other exemption was sought and provided. This follows from the definition of ‘Northern Gas Pipeline’ under the derogation, which states that it includes:<sup>59</sup>

...any extension to, or expansion of the capacity of, that pipeline that is subject to the access principles.

## 4.2 How the NGP access principles contribute to the NGO

We expect that arrangements which ensure that gas pipeline services are made available to access seekers at tariffs that are reflective of cost will contribute to the NGO. The aspects of the NGO that are likely to be directly affected by the NGP access regime are the outcomes for investment in and use of gas pipeline services on the NGP. There are also indirect effects on gas pipeline investment more generally that we discuss in section 5 below.

In general, efficient investment in gas pipeline services is likely to be promoted by regulations or rules that provide service providers the opportunity to recover their efficient costs of provision. Subject to this, efficient use of gas pipeline services will be promoted when:

- prices for gas pipeline services reflect differences in the costs of providing those services; and
- prices for gas pipeline services do not, in expectation, exceed the efficient costs of provision.

We set out at section 2 above that the NGP was developed following a competitive multi-stage tender process in which Jemena’s proposal was successful. Given the competitive nature of this process, it should be presumed that the prices secured by the Northern Territory government reflect the efficient costs of

<sup>54</sup> NGP access principles, clauses 7, 24 and 26.

<sup>55</sup> NGP access principles, annexure 2.

<sup>56</sup> North East Gas Interconnector Project Development Agreement, clause [REDACTED]

<sup>57</sup> We understand from discussions with Jemena that expansion of the pipeline beyond this capacity would likely require substantial investment in further pipeline and could not be achieved using either compression or looping of the existing pipeline.

<sup>58</sup> NGP access principles, clause 28; and Jemena, *Northern Gas Pipeline: draft environmental impact statement*, p 2-5.

<sup>59</sup> NGR, sch 4, s 3.

developing the pipeline. In its east coast gas inquiry, the Australian Competition and Consumer Commission (ACCC) arrived at a similar conclusion, noting in the specific case of the NGP that:<sup>60</sup>

Under the proposal process, bidders were free to compete by offering different combinations of construction timing, capacity, pricing, routes and other terms and conditions. The rate of return adopted in the winning bid suggests that there was a reasonable level of competition between these bidders.

The NGP access principles provide certainty for current and future customers that the tariffs charged by Jemena will reflect costs and change over time following any expansions so as to allow customers the benefit of any reductions in these costs. Further, the enforcement of these provisions is subject to a dispute resolution mechanism that provides access to independent and binding arbitration and, ultimately, coverage.

The proponents of the rule change raise concerns about the ability of Jemena to be able to make expansions of the NGP at low cost, while charging the same tariff as is set out in the NGP access principles for the initial capacity of the pipeline.<sup>61</sup> These concerns are similar to those raised by the ACCC in its east coast gas inquiry in relation of the ability of established gas pipelines to make high rates of return on incremental expansions.<sup>62</sup>

However, these concerns are not justified in relation to the NGP. The design of the access principles is responsive to these concerns by constraining the maximum tariffs that can be charged on the NGP and require Jemena to share economies of scale associated with expansions with pipeline users.<sup>63</sup> The access principles have the effect of ensuring that the rate of return that Jemena earns on any expansions is the same as that reflected in its initial tariffs to construct the NGP. Moreover, the ACCC's inquiry report makes clear that it regards the rate of return earned by Jemena under the NGP tender as a competitive benchmark against which to assess other pipeline owners:<sup>64</sup>

The differences between the returns depicted in this chart, the return on equity estimated by the AER and the return adopted in the winning bid for the NGP are substantial and are consistent with the significant degree of market power that existing pipeline operators can use when negotiating the prices to access incremental projects.

We also note that the access principles commit Jemena to connecting lateral pipelines to the NGP at rates reflecting the reasonable costs of providing such connection, which removes a further source of potential concern in relation to pricing of incremental services.

Further, as highlighted above, the access principles also provide for provision of information relevant to obtaining access (including publication of standard terms and conditions), a process for providing access and a dispute resolution mechanism culminating in binding arbitration by an independent arbitrator in accordance with external guidelines if the parties are unable to agree.

<sup>60</sup> ACCC, *Inquiry into the east coast gas market*, April 2016, p 97.

<sup>61</sup> IEEFA and EJA, *Request to change National Gas Rules*, 18 July 2018, pp 7-8.

<sup>62</sup> ACCC, *Inquiry into the east coast gas market*, April 2016, pp 104-106.

<sup>63</sup> Except for expansions of the pipeline beyond 300 TJ – which are not covered by the derogation, and to which Part 23 would apply in the absence of a further derogation.

<sup>64</sup> ACCC, *Inquiry into the east coast gas market*, April 2016, p 105.

## 5. Revocation of the derogation will not contribute to the NGO

In this section, we set out the arrangements that would apply if the derogation for the NGP is revoked. In these circumstances, the Part 23 access regime will apply to the NGP alongside the NGP access principles.

We assess whether the application of the Part 23 access regime over the period that the derogation would otherwise apply for would contribute to the NGO beyond what is achieved already under the current arrangements. Our framework for this assessment, as set out in section 3 above, considers the extent to which:

- the requirements under the Part 23 access regime materially differ from those under the NGP access principles and would be expected to give rise to different outcomes; and
- any differences in outcomes that are expected under the revocation of the derogation will contribute to the NGO.

### 5.1 Jemena's obligations under the Part 23 access regime

The Part 23 rules set out a scheme for binding arbitration and information disclosure that applies to non-scheme pipelines, with the exception of those in the exemption categories set out at rule 585.

The objective of Part 23 of the NGR is set out at rule 546(1):

... to facilitate access to pipeline services on non-scheme pipelines on reasonable terms, which, for the purposes of this Part, is taken to mean at prices and on other terms and conditions that, so far as practical, reflect the outcomes of a workably competitive market.

Rule 569 sets out pricing and other principles that an arbitrator must take into account in making a final access determination under the scheme. In particular, the pricing principles require that:<sup>65</sup>

- the price for access to a gas pipeline service should reflect the cost of providing that service; and
- the value of any assets used in the provision of that service should be determined on the basis of a form of depreciated actual cost (DAC) unless this would be inconsistent with the scheme objective.

In addition to this requirement, Part 23 has extensive requirements regarding the process for access disputes, including the provision of a user access guide, the making of access requests and access offers, obligations during negotiations and the provision of information during the negotiation process.<sup>66</sup>

Finally, Part 23 also requires a substantial degree of information disclosure, including the following:<sup>67</sup>

- service and access information – including information about capacity, details and location of receipt and delivery points, access policies, usage information and projected availability;
- standing terms – being the standard terms and conditions applicable to the pipeline service;
- financial information – being the information required under the AER's financial reporting guideline, including a recovered capital method (RCM) asset value; and
- weighted average price information – being the average price paid by users in each financial year.

<sup>65</sup> NGR, s 569(3)(a) and s 569(4).

<sup>66</sup> NGR, s 558 to 562.

<sup>67</sup> NGR, s. 553 to 556.

## 5.2 Differences between the Part 23 access regime and the access principles

There are a number of important similarities between the outcomes that are likely under the Part 23 access regime and the NGP access principles. For instance, both regimes provide for:

- the application of gas pipeline tariffs that reflect the cost of service;
- the sharing of information that is relevant to the provision of access; and
- the availability of independent and binding arbitration if disputes cannot be resolved.

Both regimes also provide a set of prescriptive rules regarding the obligations of the parties in the context of negotiations for access. In our view, the extent of this alignment is sufficiently close that we consider it unlikely the revocation of the derogation would contribute to the NGO. We discuss each of these matters in more detail below.

### 5.2.1 Gas pipeline tariffs reflect the cost of service

We explain above that, under the NGP access principles, the tariffs that have been determined through the competitive tender process are updated to reflect the cost of expansions or extensions. Similarly, under the Part 23 access regime, the pricing principles require that prices for gas pipelines services must reflect the cost of providing that service, subject to the objective to reflect the outcomes of a workably competitive market.<sup>68</sup>

While both regimes provide for charges that reflect costs, there is a difference in the degree of transparency and predictability that they provide. The NGP access principles set out a replicable approach for determining maximum prices, based on the initial maximum prices determined under the tender process, adjusted for additional costs incurred in relation to expansions and extensions. By comparison, the Part 23 access regime sets out a list of economic principles, the effect of which is subject to interpretation by the arbitrator. Since all other principles are subservient to the objective of Part 23, it is important to consider what outcomes an arbitrator might consider would reflect those of a workably competitive market.

In our opinion, over the near term, the outcomes provided for under the Part 23 access regime are likely to be similar to or identical to those arising from the competitive tender process conducted by the Northern Territory government.

This is because it appears likely that when determining outcomes that are consistent with those of a workably competitive market, the arbitrator is likely to give predominant or sole weight to the outcomes of the tender for the NGP. This reflects a view, consistent with that expressed by the ACCC inquiry report, that prices for foundation contracts procured in competitive circumstances (expressly including those negotiated for the NGP) are not affected by the exercise of market power.<sup>69</sup>

If there is effective competition to develop and build a pipeline ('competition for the market'), then the market power of the ultimate pipeline owner is likely to be limited for a period of time. By negotiating prior to the pipeline being built, foundation shippers will usually be able to use competitive tension between prospective pipeline owners to negotiate long-term contracts that are not affected by the exercise of market power.

The prices arrived at in the competitive tender process are those set out under the NGP access principles.

Over the longer term, where market conditions may change, it is less certain that the outcomes under the Part 23 access regime and the NGP pricing principles would necessarily be identical. The NGP access principles offer certainty that prices will not increase – and may decrease with expansions of the pipeline

<sup>68</sup> NGR, s 569(3)(a).

<sup>69</sup> ACCC, *Inquiry into the east coast gas market*, April 2016, p 96.

(including for shippers with existing contracts). By comparison, the outcome of any arbitration process under the Part 23 access regime is uncertain, depending on the interpretation of key economic principles. Under the Part 23 rules, shippers with existing contracts cannot benefit from economies of scale created by expansions until their contracts expire or their needs for gas pipeline services increase.

However, the fact that differences in outcomes *may* arise does not provide grounds to form an expectation that the Part 23 access regime would give rise to an *expectation* of outcomes that better contribute to the NGO than the NGP access principles.

### 5.2.2 The sharing of information relevant to the provision of access

The information provided under the NGP access principles is considerable, and sufficient to inform access seekers of:

- the availability of capacity on the pipeline;
- the maximum price that can be applied to that capacity and the basis for updates of this price; and
- the terms and conditions that would apply to gas pipeline services.

These appear to provide a sufficient basis for shippers to negotiate access. The additional information disclosure that would be required under Part 23 was proposed in the context of pipelines constructed substantially before the NGP, to address concerns in relation to a lack of (predominantly historical) information that would enable shippers to be able to negotiate a cost reflective charge.

These concerns do not arise in relation to the NGP, as has been described above the terms of the access principles themselves ensure that charges are cost reflective, and change in line with efficient costs.

### 5.2.3 The availability of independent and binding arbitration

Both the NGP access principles and the Part 23 access regime offer independent and binding arbitration in the event that disputes arise.

The rule change proponents raise concerns that the access dispute mechanism under the NGP access principles is not overseen by the AER or informed by the NGR.<sup>70</sup> In our view, those concerns are misplaced – the most important aspects of each dispute mechanism are the terms that are enforced and the independent nature of the arbitrator. How the terms of the NGP access principles contribute to the NGO or otherwise is a matter that can be addressed separately, and which we have addressed at section 4 above.

## 5.3 Changes in incentives to make efficient investments

Beyond the narrow circumstances of outcomes for the NGP, revocation of the derogation for the NGP can be expected to make new risky investments in greenfields pipelines less attractive, since it removes a mechanism for overcoming the effect of regulatory risks in discouraging these investments and undermines the broader credibility of the regulatory framework for new investments. Removal of the derogation also raises the prospect of ‘forum shopping’ in the specific case of the NGP, which introduces a risk in relation to the prospects of the recovery of the reasonable costs of the investment. We expand on each of these three points below.

Undermining incentives for new pipeline investment affects the prospects of new gas supplies being brought to market, and therefore has implications for the long-term outlook for domestic gas prices.

The derogation for the NGP is consistent with an established practice of providing incentives to new pipelines (via a fixed period during which regulation does not apply) in order to promote efficient investment in natural gas services – a practice that has previously been held to contribute to the NGO, as set out in the

<sup>70</sup> IEEFA and EJA, *Request to change National Gas Rules*, 18 July 2018, p 3.

box below. The current situation whereby the NGP enjoys a derogation under the Part 23 access regime is consistent with these arrangements.

### Box 5.1: Basis for the provision for a 15 year no coverage determination for greenfields pipelines

There was a strong principled basis for providing a 'regulatory holiday' for newly constructed pipelines, following reviews by an expert panel lead by Warwick Parer and subsequently the Productivity Commission. The findings of the Productivity Commission were accepted by the COAG Energy Council.

A key recommendation of the Parer review was to offer '15 year economic regulation free periods for new transmission pipelines'. The panel observed that the rationale for regulation may not be as strong for new transmission pipelines as it is for established pipelines since, in the absence of vertical relationships, prospective initial users of a new pipeline have a significant degree of countervailing power. It concluded that, taking costs into account, the short term impact of regulation for these pipelines is likely to be negative and may create uncertainty which could result in some marginal investments not proceeding. The panel recommended that prospective gas transmission pipelines should have the option to choose not to be subject to price regulation for the first 15 years of operation.<sup>71</sup>

The Productivity Commission highlighted that investors in new gas pipelines are subject to potentially significant regulatory risk under the gas access regime. The Commission echoed the Parer review in recommending the allowance for binding 'no-coverage' rulings prior to the construction of new pipelines to deal with coverage risk, ie, uncertainty about whether a pipeline will be covered.<sup>72</sup>

The Ministerial Council on Energy accepted that greater certainty about the coverage status of a proposed pipeline would reduce the regulatory risk for proposed pipelines and therefore encourage further investment. It also accepted that regulation (or its prospect) could complicate negotiation of foundation contracts and potentially create incentives to underbuild or defer a pipeline. It adopted the Commission's recommendation to provide for binding no-coverage rulings in respect of new pipelines.<sup>73</sup>

Part 23 of the NGR introduced a new set of regulatory obligations applying to gas pipelines that were previously unregulated. The AEMC has previously noted that these obligations applying to uncovered pipelines are arguably heavier-handed than those that apply to lightly regulated pipelines, which satisfy all the coverage criteria.<sup>74</sup> This change has meant that the only gas pipelines now not subject to regulation are the NGP and those that meet the exemption criteria for Part 23.<sup>75</sup>

Removal of the derogation would revoke the regulatory holiday that it provides to the NGP from commencement of operations. This would have implications for the ability to provide similar incentives to other greenfields pipelines in the future through targeted relief from regulation – removing the number of levers that can be applied to promote efficient investment and contribute to the NGO.

Removal of the derogation so soon following the competitive tender process run for the NGP, and even before project completion, also raises more fundamental concerns about the credibility and effectiveness of regulation. The ability of well-designed regulatory instruments to send effective incentives to investors to make efficient investments contributes to the NGO. These instruments and the incentives that they provide are likely to be less effective if investors cannot expect consistency in regulatory policy.

Finally, the revocation of the derogation could result, at the discretion of access seekers, in two access regimes applying in parallel to the NGP – being the access principles (which are an obligation on Jemena

<sup>71</sup> Parer, W., Breslin, P., Sims, R. and Agostini, D., *Towards a truly national and efficient energy market*, 20 December 2002, pp 211-214.

<sup>72</sup> Productivity Commission, *Review of the gas access regime*, 11 June 2004, pp 398-405.

<sup>73</sup> Ministerial Council on Energy, *Review of the national gas pipelines access regime: decision*, May 2006, pp 15-16.

<sup>74</sup> AEMC, *Interim report: Review into scope of economic regulation applied to covered pipelines*, 31 October 2017, p 11.

<sup>75</sup> There are 54 pipelines that have currently been granted exemptions to Part 23, as discussed further below.

under the PDA independent of whether the derogation is in place) and the Part 23 framework for the NGP. While these regimes may give rise to similar pricing outcomes in the short term, they are unlikely to have the same profile of prices over time. This opens the prospect that access seekers may be able to engage in 'forum shopping' by being able to select the access regime that gives them the most favourable terms and conditions at any point in time. This in turn reduces the prospect of recovery of the reasonable costs of the NGP investment, since shippers may be able to switch between access regimes at the point where they considered that would lower their costs.

## 5.4 Changes in regulatory complexity

Removal of the NGP derogation will substantially increase the complexity of regulation compared to the status quo, at least as it applies to the NGP.

The NGP access principles are a legally binding agreement entered into between Jemena and the Northern Territory government. We set out above that the imposition of the Part 23 access regime is unlikely to give rise to outcomes that would contribute to the NGO over the term of the derogation. However, were the derogation to be revoked, it would leave the NGP subject to new regulatory arrangements under the Part 23 rules that significantly overlap with the NGP access principles, giving rise to substantial additional complexity about how to resolve potentially conflicting requirements. For example:

- the required procedures for seeking and providing access set out in the NGP access principles are different from those set out under the Part 23 access regime, including different mandated timelines;
- the basis for pricing under the NGP access principles is determined under a formula whereas the Part 23 access regime sets out pricing principles; and
- there would be two separate avenues through which to seek arbitration, one under the NGP access principles and one under the Part 23 access regime.

It follows that to add the Part 23 access regime to the NGP access principles must increase complexity, not reduce it, and this increase in complexity could be expected to give rise to additional compliance costs.

By way of example, we understand in order to comply with the Part 23 access regime for the NGP, Jemena would need to:

- commission a recovered capital method valuation and keep this up to date;
- develop financial reporting for the pipeline including the asset valuation, other costs (which are not currently calculated on an asset specific basis) and weighted average prices, and have these assured for publication; and
- prepare and publish an access guide and the other non-financial information disclosures.

Further, Jemena may need to engage in price arbitrations under the Part 23 access regime in situations in which it has complied with its obligations under the NGP access principles, but these tariffs are challenged by the shipper.

The AEMC raises the prospect that there may be complexity involved in having different regulatory arrangements that apply to the NGP as against those that apply to other pipelines.<sup>76</sup> This source of complexity is outside the AEMC's control, since Jemena is contractually obliged to comply with the NGP access principles.

In any case, it does not appear that this type of complexity is of sufficient concern to have affected the design of gas regulatory regimes under the NGR. For example, there are many pipelines that are exempt

<sup>76</sup> AEMC, *Northern Gas Pipeline – derogation from Part 23*, Consultation paper, 15 November 2018, p 13.

from some or all of the requirements of the Part 23 access regime. Section 585 of the NGR sets out the exemption categories and associated criteria, which are:<sup>77</sup>

- Category 1 – the pipeline is exempt from the access application process and binding arbitration if the pipeline is not a third party access pipeline;
- Category 2 – the pipeline is exempt from the information disclosure requirements if the pipeline is either not a third party access pipeline or is a single user pipeline;
- Category 3 – the pipeline is exempt from the information disclosure requirements, other than pipeline and pipeline service information, if the average daily injection over the last two years is less than 10 TJ per day.

The AER maintains a public register of non-scheme pipeline exemptions on its website.<sup>78</sup> The register indicates that 54 pipelines have been granted exemptions. Of these:

- 32 are exempt from all requirements under the Part 23 rules because they fall into Categories 1 and 2;
- 16 are exempt from all information disclosure requirements because they fall into Category 2 (but not Category 1); and
- 6 are exempt from some information disclosure requirements because they fall into Category 3 (but not Categories 1 or 2).

We therefore conclude that removal of the derogation would increase the complexity of the regulatory arrangements. Our assessment in sections 5.1 and 5.2 has highlighted that this increased complexity would not be offset by other contributions to the NGO, compared with the current arrangements.

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<sup>77</sup> NGR s 585(4).

<sup>78</sup> AER website, <https://www.aer.gov.au/networks-pipelines/non-scheme-pipelines/public-register-of-non-scheme-pipeline-exemptions>, accessed 4 December 2018.



# HOUSTONKEMP

Economists

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## Sydney

Level 40  
161 Castlereagh Street  
Sydney NSW 2000

Phone: +61 2 8880 4800

## Singapore

8 Marina View  
#15-10 Asia Square Tower 1  
Singapore 018960

Phone: +65 6817 5010