ACCC RECOMMENDS NEW COVERAGE TEST FOCUSED ON MARKET POWER

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Legal Briefings – By **Chris Jose, Philip Aitken, Sasha Ponniah, Tessa Spence**

Gas producers and pipeline operators have had to operate in an industry undergoing substantial change in recent years. In relation to gas transportation, the Australian Competition and Consumer Commission (**ACCC**) found that most transportation pipeline operators have responded in a dynamic way to these industry changes.

Despite that finding, the ACCC recommends far-reaching changes in the regulation of gas pipelines.

The ACCC suggests that this new approach to regulating gas pipelines is needed to overcome what it perceives as a failure of the current regulatory regime in the National Gas Law (**NGL**) and National Gas Rules (**NGR**) to prevent the use of market power in the supply of transportation services. The ACCC found that the current regulatory regime (including the threat of regulation) has not prevented monopoly pricing for gas transportation services.

These are controversial recommendations that, if implemented, would represent a substantial departure from the trend towards lighter regulation of gas pipelines in recent years. That trend culminated in the current regime, which was introduced in 2008 by the NGL and NGR. Both the NGL and the NGR were the product of the ongoing energy market reform program of the Ministerial Council of Energy (**MCE**) and emerged after the extensive 2002 Parer Review,[1] the Productivity Commission's 2004 review of the Gas Access Regime[2] and the 2006 report of the MCE's Expert Panel on energy access pricing.[3]

The ACCC also considered the way in which pipeline capacity is traded and suggested ways to increase transparency of pipeline capacity and usage.

FINDINGS

Pricing of transmission pipeline services

The ACCC has considered the extent of competition in the supply of gas transportation services as well as the extent to which pipeline operators had responded to current market changes and undertaken necessary investments.

Overall, the ACCC found that pipeline operators have responded in a dynamic way to market changes, for instance:

- by offering more innovative services including bi-directional services, peaking transportation services, interruptible services and premium storage services as well as shorter-term gas transportation agreements and multiple services across inter-connected pipelines, including storage, compression, redirection and transportation services, and
- by undertaking necessary investments in a timely manner – the report identifies substantial investments that 'are paving the way for more flexible and dynamic services to meet the changing needs' of some market participants.

The ACCC focused, however, on what it identified as limited competition from other pipelines and concluded that there are a large number of pipelines which do not compete with other pipelines. A number of other possible influences (including alternative energy sources, the risk of stranding, countervailing power of shippers, and regulation, or the threat of regulation) were not, in the ACCC's view, effective constraints on pipelines.

The ACCC concluded that the majority of existing transmission pipelines 'have market power and their ability and incentive to exercise that power is not being effectively constrained'.

Based upon this finding, the ACCC considered whether there was any evidence of use of this market power. It found no evidence of such conduct in respect of anticompetitive bundling or tying, restricted access or denial of access or anticompetitive price discrimination and considered that reductions in service quality were rare. However, the ACCC found that there was evidence of monopoly pricing on a large number of pipelines.

The ACCC found that monopoly pricing on pipelines is giving rise to higher delivered gas prices and is having an adverse effect on the economic efficiency of the east coast gas market as well as downstream markets (due to lower gas usage) and upstream markets (due to reduced demand).

Regulation not providing an effective constraint

The regulatory regime for gas pipelines is found in the in the NGL and the NGR. Two specific aspects of that regime are of particular relevance in the face of the ACCC's analysis of the regulatory regime.

First is the National Gas Objective (**NGO**) in the NGL which is to:

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

The second is that the regulatory regime only applies to a 'covered' pipeline – 'coverage' is determined where the coverage criteria are satisfied. Two key criteria are that access or increased access to the services provided by means of the pipeline would promote a material increase in competition in a dependent market and that it would be uneconomic to duplicate the pipeline to provide the services.

Under the NGO and the coverage criteria, and in the face of market dynamics, the trend of reform in the National Gas Regime has been toward light regulation.

With that background, the ACCC unsurprisingly found that less than 20% of transmission pipelines are currently subject to regulation under the National Gas Regime.

The ACCC considered that this relatively low level of coverage, in comparison to other jurisdictions (such as Europe and the US), is due to the coverage criteria not being directed 'to the right market failure'. In particular, pipelines are not being covered due to difficulties in demonstrating that coverage of the pipeline would lead to a material increase in competition in a dependent market.

In addition to the perceived difficulties in having pipelines covered under the National Gas Regime, the ACCC found what it considers to be a number of 'gaps' in the regulatory framework as it relates to covered pipelines. In particular, it found that:

- ex ante pricing does not apply to all contestable services provided by pipelines and the threat of arbitration was not a sufficient constraint on the pricing of these services,
- the Australian Energy Regulator (**AER**) has the discretion to exclude expansions of regulated pipelines from regulation, and
- information asymmetries can restrict shippers from identifying monopoly pricing, which reduces a shipper's ability to negotiate effectively.

Facilitating trading in pipeline capacity

The ACCC made a number of findings in relation to the trading of pipeline capacity. Most significantly, it found that:

- there was no evidence of economic withholding of capacity on major pipelines;
- there was some evidence of economic withholding on a number of smaller regional pipelines and laterals off major arterial pipelines. Evidence of economic withholding of capacity in regional pipelines was found in circumstances where a single retailer was able to control all, or a dominant proportion, of the capacity on the pipeline, and
- search and transaction costs can be a barrier to secondary trading of capacity. These costs could be alleviated through increased transparency of usage, the adoption of standard terms and conditions and development of trading platforms.

RECOMMENDATIONS AND FURTHER ACTION

Many of the ACCC's key recommendations flow from its finding that a large number of pipeline operators have significant market power and that their ability and incentive to exercise that power is not being effectively constrained.

To address this finding, the ACCC has recommended that the COAG Energy Council (**COAG**) introduce a new market power based test for the regulation of gas pipelines. While the current test for regulation under the NGL is not designed to address monopoly pricing that results in economic inefficiencies with little or no effect on the level of competition in dependent markets, the new test will take these factors into account and therefore widen the regulatory catchment to include pipelines that are currently unregulated.

Further, to address concerns that once fully regulated, pipelines may still be able to exercise market power, the ACCC has recommended that COAG review and amend Parts 8-12 of the NGR (which relate to access arrangements, price regulation, requests for access and disputes concerning access).

The ACCC has also proposed that COAG direct the Australian Energy Market Commission (**AEMC**) to explore how the scope of information disclosure requirements in the NGL should be expanded in order to address the information asymmetries currently disadvantaging shippers.

Introduction of new market power based test for coverage

Most significantly for gas transportation, the ACCC has recommended introducing a new market power based test to regulate gas pipelines. The new test will replace the current coverage criteria test and is designed to address the monopoly pricing that is causing economic inefficiencies in gas transmission.

(a) Reasons for new test

The current test only regulates pipelines if, amongst other factors, regulation is required to promote a 'material increase' in competition in upstream or downstream markets. Since, for the most part, transmission pipelines are not vertically integrated, pipeline operators do not have an incentive to behave in a way that adversely affects competition in dependent markets. However, pipeline operators maintain an incentive to engage in monopoly pricing and, as the Inquiry has found, are acting on that incentive.

(b) New test directed towards market power

Under the proposed new test, the relevant Minister must decide to grant coverage if the Minister is satisfied of the following three conditions:

- **The pipeline has substantial market power** – This will involve an assessment of the degree of market power a pipeline possesses and the extent to which this power is likely to be constrained by competition from alternative pipelines or energy sources, the risk of asset stranding, any countervailing power held by shippers, and any other relevant considerations.
- **Over the medium term, the pipeline will, or is likely to, continue to have substantial market power** – This will involve consideration of whether the pipeline's market power will dissipate in the medium-term, including the likelihood of future investments in, and demands on, pipeline infrastructure.
- **Coverage of the pipeline will, or is likely to, contribute to the achievement of the National Gas Objective** – This will require a qualitative assessment of whether constraining the pipeline's market power will, or is likely to, promote efficient investment, operation and use of gas services for the long-term benefit of consumers with respect to price, quality, safety, reliability and supply security.

In considering the impact the new test may have on pipeline operators, the ACCC noted that in the short to medium-term, the changes 'may have little to no effect' on some pipelines since pre-existing contractual rights are protected under the NGL and the capacity of some pipelines is largely contracted. However, the ACCC noted that the proposed changes should impose a behavioural constraint when current contracts come to an end or when entering into new contracts.

(c) Further consultation required

The ACCC has recommended that COAG direct the AEMC to consult with market participants on the following issues concerning the application of the new test:

- factors to be considered when assessing whether the new test is satisfied,
- who should bear the onus of establishing whether the new test is met,
- how the new test should be implemented when it comes into operation, and
- how the new test will interact with other parts of the access regime, including the 15-year no-coverage provisions and the full and light regulation framework.

Amendments to regulation of access arrangements

The ACCC recommended that COAG direct the AEMC to review and, where appropriate, amend Parts 8-12 of the NGR, which regulate access arrangements.

This recommendation is aimed at addressing what the ACCC perceives to be gaps in the current regulatory framework that may allow transmission pipelines to exercise market power even once they are subject to full regulation. The ACCC considered that access arrangements should operate to prevent fully regulated pipelines from engaging in monopoly pricing to the detriment of consumers and economic efficiency. The ACCC also recommended that the AEMC consider whether changes can be made to the dispute resolution mechanism in the NGL and NGR in order to make it more accessible to shippers.

Increased disclosure of financial and operational information

The ACCC concluded that shippers currently have limited ability to identify the exercise of market power by pipeline operators, determine whether the prices they are offered by pipeline operators are cost-reflective, and subsequently negotiate effectively with those pipeline operators.

To address this issue, the ACCC has recommended that COAG direct the AEMC to examine how to expand the scope of information disclosure provisions in the NGL. It is believed that the increased accessibility of financial and operational information regarding the costs incurred by pipeline operators in providing services and the relationship between these costs and the prices charged for services will allow more effective negotiations between shippers and pipeline operators.

AEMC to consider options facilitating capacity trading

The ACCC has called for the AEMC to consider other recommendations that are designed to facilitate capacity trading:

- **Monitoring of flexibility of trading** – Consideration of how to monitor changes in the level of trading flexibility available to gas buyers over time, and how the trading risks and other risks of having to purchase gas and transportation services on a day-ahead basis can best be managed.

- **Introduction of centralised capacity trading platform** – Consideration of whether to introduce a centralised capacity trading platform to facilitate secondary capacity trading and day-ahead auctioning of unutilised capacity. Currently, there is no transparency around the utilisation of regional pipelines. The ACCC is concerned with the lack of competition between pipeline operators and shippers for secondary capacity, which it considers is resulting in higher prices for access.

- **Short term auction of hub services** – If the AEMC decides to implement the recommendation for a day-ahead auction for pipeline services, then it should also consider the benefits of a short-term auction process for hub services (compression and redirection services).

Action – ACCC to investigate withholding on regional pipelines

The ACCC found evidence of economic withholding of capacity on some regional pipelines. In response to this, the ACCC will investigate whether the availability of pricing of capacity on regional pipelines constitutes a possible contravention of the prohibition on the misuse of market power (section 46 of the CCA) or the prohibition on exclusive dealing that substantially lessens competition (section 47 of the CCA).

ENDNOTES

1. *Towards a Truly National and Efficient Energy Market*, presented by Warwick Parer as Chair of the Ministerial Council of Energy on 20 December 2002.

2. *Review of the Gas Access Regime, Productivity Commission Inquiry Report*, No. 31, 11 June 2004.

3. *Report of the Expert Panel on Energy Access Pricing*, presented to the MCE on 13 April 2006.

This article is one of a series that Herbert Smith Freehills is publishing on the ACCC's East Coast Gas Enquiry.

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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