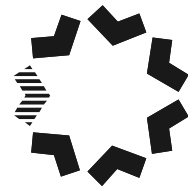


NATIONAL
COMPETITION
COUNCIL



Light Regulation of Envestra's Queensland Gas Distribution Network

Application for a light regulation
determination in respect of the
Queensland Gas Distribution
Network



**Draft decision and
Statement of Reasons -
Public version**

29 September 2014

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Abbreviations and defined terms

ABS	Australian Bureau of Statistics
AEMC	Australian Energy Markets Commission (www.aemc.gov.au)
AER	Australian Energy Regulator (www.aer.gov.au)
APA	APA Group
BREE	Bureau of Resources and Energy Economics
Council / NCC	National Competition Council (www.ncc.gov.au)
Envestra	Envestra Ltd (The Applicant)
ERAA	Energy Retailers Association of Australia
FRC	Full retail contestability—regulatory reform allowing customers to choose [gas] suppliers
Gas Code	The National Third Party Access Code for Natural Gas Pipeline Systems set out in Schedule 2 to the <i>Gas Pipelines Access (South Australia) Act 1997</i>
NGL	National Gas Law – the Schedule to the <i>National Gas (South Australia) Act 2008</i>
NGO	National Gas Objective – as set out in s 23 of the NGL
NGR	National Gas Rules – Rules made under s 294 of the NGL including amendments by the AEMC
Origin	Origin Energy
QGDN	(Envestra’s covered) Queensland Gas Distribution Network

1 Draft Decision

- 1.1 This draft decision is issued in accordance with the National Gas Law (**NGL**) and National Gas Rules (**NGR**) as part of the Council's process for determining an application by Envestra Ltd (**Envestra**) for light regulation of the company's covered Queensland Gas Distribution Network (**QGDN**).¹
- 1.2 **Based on the information available at the time this draft decision was prepared, the Council proposes to make a determination that the services provided by the QGDN be light regulation services.**
- 1.3 The Council's proposed reasons for decision are set out in the following sections of this report.
- 1.4 The Council now seeks further submissions from interested parties in response to this draft decision and reasons. Submissions should be provided to the Council by **5.00 pm on Monday 20 October 2014.**
- 1.5 Once the time for submissions ends the Council has 20 business days to make a final decision on this application. The Council's final decision can be expected on or before 17 November 2014.

National Competition Council
29 September 2014

¹ Envestra also owns gas distribution pipelines serving the Wide Bay-Burnett area and some network extensions in the Brisbane and Northern Regions. These are not covered pipelines and are unaffected by this application. In this report references to the QGDN are to the covered parts of the network with which this application are concerned.

2 Background

The Application

- 2.1 On 15 August 2014 Envestra applied for light regulation of the QGDN pursuant to s 112 of the NGL.
- 2.2 Envestra submitted its written application in accordance with the NGR and containing the information required by Rule 34. Envestra's application is available on the Council's website (www.ncc.gov.au).
- 2.3 The application contains some information which Envestra considers to be commercially confidential. The Council accepts that this information is commercially sensitive and should be protected under s 90 of the NGL.

The QGDN

- 2.4 The QGDN distributes gas in the Brisbane Region (Brisbane CBD, Ipswich and suburbs north of the Brisbane River) and Northern Region (Rockhampton and Gladstone).
- 2.5 The covered part of the QGDN comprises 2500km of distribution pipelines (2200km in the Brisbane Region and 300km in the Northern Region). The QGDN was deemed to be a covered pipeline from the commencement of the Gas Code in 1997. Coverage was continued with the implementation of the NGL. To date the QGDN has been subject to full regulation.
- 2.6 The application contains maps illustrating the scope of the QGDN. These are reproduced in Appendix A of this report.
- 2.7 Unlike the earlier light regulation applications considered by the Council (see footnote 17), the QGDN involves distribution pipelines rather than transmission pipelines. In relation to light regulation the NGL and NGR do not distinguish between transmission and distribution pipelines. The same criteria apply to light regulation of either type of pipeline.
- 2.8 The QGDN and Envestra's other gas distribution networks are operated and managed by the APA Group (**APA**) under an Operating and Management Agreement. This agreement covers: pipeline operation and maintenance; planning, design and construction of pipeline extensions; budgeting and provision of financial information; meter reading and billing gas retailers. Envestra notes that "[i]mportantly, APA does not have any controlling influence over the ... the pricing and contracting decisions of this pipeline" (Application, paragraph 67).²

² Until August 2014, APA had a substantial (33%) shareholding in Envestra. This shareholding ceased with the acquisition of Envestra by the CK Consortium (part of the Hong Kong based

- 2.9 According to Envestra, in 2013-14, the QGDN distributed 15PJ of gas to just over 90,000 users. The breakdown between different user segments is set out in Table 1.

Table 1: QGDN Customer breakdown 2013-14

Segment	Customers (Number, % of total)	Volume Delivered (PJ, % of total)	Revenue (\$M, % of total)
Residential	86,941 (94.7)	0.7 (4.6)	30.0 (40.5)
Commercial (<10TJ)	4,777 (5.2)	1.4 (9.2)	25.5 (34.4)
Industrial – Regulated (>10TJ)	48 (0.1)	2.7 (17.8)	13.9 (18.9)
Industrial – Negotiated (>10TJ) ^a	11 (-)	0.6 (3.9)	3.8 (5.1)
Industrial - Unregulated (>10TJ)	4 (-)	9.8 (64.5)	1.0 (1.3)
Total	91,781	15.2	74.1

^a These customers have negotiated terms and conditions different to that provided under the standard regulatory terms. These customers are also referred to as "Term Sheet" customers.

Source: Application, page 18.

- 2.10 Envestra advises that although the residential segment accounts for the largest number of customers, unusually (for its gas distribution businesses) the non-domestic segments provide the majority of revenue. Envestra notes that this is primarily a consequence of very low penetration and low average gas usage by residential customers in Queensland.³
- 2.11 As can be observed from the information contained in the application, annual average residential gas consumption in Queensland (8 GJ pa) is significantly lower than in South Australia (20 GJ pa) or Victoria (50 GJ pa)⁴ and has been falling since 2011-12.⁵
- 2.12 Table 2 shows overall consumption of natural gas by the residential sector in each of the relevant jurisdictions in 2012-13 as reported by the Bureau of Resources and Energy Economics (BREE) and calculated annual consumption per residential dwelling. Although calculated in a different manner and for a slightly different period, these statistics support Envestra's observations in its application about the relative importance of gas supply to residential consumers in various jurisdictions and that

Cheung Kong Group).

³ These features of the Queensland gas market are due in significant part to the limited requirements for space heating in the Queensland climate.

⁴ See Application, figure 3.

⁵ See Application, figure 4.

consumption in Queensland is markedly lower than in the other jurisdictions considered.

Table 2: Gas consumption by residential sector 2012-13

Jurisdiction	Total gas consumption by residential sector (PJ) ^(a)	Average annual gas consumption per residential dwelling (GJ) ^(b)
Victoria	103.8	44.7
NSW	25.7	9.0
SA	11.8	16.1
Queensland	3.0	1.6

Source: (a) BREE 2014, Table 1F. (b) Calculated, residential dwelling numbers ABS data, December 2012

- 2.13 The proportion of households connected to gas supply in Queensland (15 per cent) is also significantly less than in South Australia (75 per cent) or Victoria (90 per cent).⁶ This proportion is also below the proportion of households connected to gas in Sydney which the Australian Bureau of Statistics (**ABS**) estimated to be 48 per cent in 2011.⁷
- 2.14 Envestra advises that consumption of gas by commercial users served by the QGDN has fallen significantly over recent years⁸ and that the larger industrial user segment has been under similar pressure. In particular, Envestra notes the recent announcement of the closure of BP's Bulwer Island Refinery will reduce throughput on the QGDN by 66 per cent. According to the figures provided in the application much of the QGDN is operating at 50 per cent of capacity or less.⁹
- 2.15 Full retail contestability (**FRC**) in gas supply was introduced in Queensland in 2007. Retail prices were deregulated at the same time. This has seen two entrants (AGL and to a lesser extent Alinta Energy) competing with Origin Energy for gas customers.¹⁰ Origin, AGL and Alinta all supply gas to the Brisbane area. At present only Origin supplies gas to the Northern region served by the QGDN. Origin and AGL supply gas to all segments of the market (residential, commercial and industrial). Alinta only supplies a limited number of large industrial gas users and is a relatively insignificant market participant.
- 2.16 Envestra attributes the limited entry that has occurred since FRC and price deregulation to: the small size of the Queensland gas market; the fixed costs associated with gas supply and transportation; and the development of LNG export

⁶ See Application, figure 2.

⁷ See AEMC 2014, footnote 173.

⁸ See Application, figure 5.

⁹ See Application, table 3.

¹⁰ In its submission on the application, Origin advised that there are six registered gas retailers in Queensland (Origin 2014, footnote 5).

facilities in Queensland—which Envestra says has made it more difficult to secure competitively priced long-term gas supply contracts (see Application, paragraph 98).

- 2.17 Envestra’s comments and observations are in line with the conclusions of the Australian Energy Markets Commission (**AEMC**) in relation to the state of competition in gas sales in South East Queensland. In its recent Retail Competition Review the AEMC concluded:

Rivalry appears lower in the retail gas market [in South East Queensland] than the electricity market, with just two gas retailers competing. Switching rates are lower than for electricity, with fewer gas options to choose from. Additional retailers have not entered the gas market primarily due to the small size of the market, with low penetration of gas pipelines to households and small businesses and a low level of average gas demand. Competition is not expected to increase over the next few years for this reason, coupled with issues securing competitively priced gas in the wholesale market. (AEMC 2014, page v)

Council process

- 2.18 In determining this matter the Council followed the standard consultative procedure set out in Rule 8 of the NGR.
- 2.19 Notice of the application was published on the Council’s website and in *The Australian* newspaper on 21 August 2014. A 15 business day period for submissions was provided, with a closing date of 11 September 2014.
- 2.20 The Council received three submissions on the application. These were from the Energy Retailers Association of Australia (**ERAA**) Origin Energy (**Origin**)¹¹ and Simply Energy.
- 2.21 In preparing this draft determination the Council has taken into account the application, the submissions on the application and its own research and analysis. The Council has also consulted with the Australian Energy Regulator (**AER**) as provided for by Rule 35(1)(b). The AER had no particular comments on the merits of Envestra’s application.
- 2.22 Interested parties (including the Applicant) now have an opportunity to make further submissions on this draft decision. Any submissions received will be taken into account by the Council in making its final decision.

¹¹ Origin’s submission contains a small amount of information that the Council has accepted on a confidential basis.

3 General submissions on the Application

- 3.1 Some of the concerns raised in the submissions the Council received in response to the application touch on specific matters which the Council must consider in the context of an application for a light regulation determination, albeit in some cases tangentially. These issues (many of the issues raised by the ERAA and in particular Origin) are addressed as appropriate in section 4 of this report.
- 3.2 In some cases (and particularly in the case of Simply Energy's submission) the concerns are expressed in general terms rather than being linked to the effectiveness or costs of the different forms of regulation, the form of regulation factors or other directly relevant matters effecting a light regulation determination. It is clearer and more convenient to consider these matters here in a separate section, rather than intermingle this consideration in other parts of this report.
- 3.3 In its submission on the application, Simply Energy raises a number of concerns and states that "it does not believe it has any countervailing power against Envestra and cannot support Envestra's application for light regulation".¹² Simply Energy invites the Council to "consider the flow on effects on competition in the retail electricity market from a decision to deregulate the gas network". The company contends that:
- Some customers are dual fuel customers and prefer to contract with only one retailer for both fuels. It is unlikely that smaller retailers such as Simply Energy will be able to negotiate deals with Envestra that match the first tiers [AGL and Origin Energy], potentially restricting our ability to compete for dual fuel customers.
- 3.4 Simply Energy also considers there is scope for it and other "second tier" energy retailers to expand their presence in Queensland including in relation of gas retailing once the retail electricity market is deregulated and the ability to sell gas as well as electricity will be of assistance.
- 3.5 The ERAA draws attention to the prospect of changes in Queensland energy markets with the move to electricity market monitoring¹³ and adoption of the National Consumer Energy Customer Framework from mid-2015.¹⁴
- 3.6 In a similar vein, Origin suggests "a move to light regulation of the QGDN is not appropriate at this time given ... significant energy market change in Queensland next year" (Origin 2014, page 4).

¹² Simply Energy 2014.

¹³ As noted in paragraph 2.15 FRC for gas sales and the removal of controls of retail gas prices occurred in Queensland in 2007.

¹⁴ ERAA 2014, page2.

Council's consideration

- 3.7 To the extent Simply Energy raises concerns about a possible future reduction in competition in gas markets, it is important to note that light regulation of the QGDN does not equate to “deregulation” of the gas network. This is not an application for revocation of coverage of the QGDN.
- 3.8 Given Envestra’s assessment of the position of gas in the Queensland market and the constraints imposed by light regulation, the Council finds it difficult to see why or how Envestra would discriminate against Simply Energy or any other party which might encourage additional gas sales. Perhaps more importantly, the Council does not see how a shift to light regulation would materially change Envestra’s ability to do so.
- 3.9 In relation to concerns about electricity markets, it is not clear to what extent any effects on competition in an electricity market can appropriately be considered in the context of an application for light regulation of a gas pipeline. It might be open to consider such an issue under s 122(2)(c) in appropriate situations. However, the Council does not consider this to be such a situation.
- 3.10 In this case the Council does not consider the likely impact of light regulation of the QGDN on any electricity market to be such that it is appropriate to decline Envestra’s application. Given the position of gas as an energy source in Queensland it is difficult to accept that some limitation on availability of dual fuel offers could have a significant effect even if such a situation were to eventuate.
- 3.11 Furthermore any effects from light regulation of the QGDN would presumably arise in relation to the South East Queensland electricity market and the Council notes that in its Retail Competition Review the AEMC concluded that this market is already effectively competitive.¹⁵

¹⁵ AEMC 2014, page v.

4 Deciding on light regulation

4.1 Section 122 of the NGL sets out the principles governing the making of light regulation determinations. The section provides:

(1) In deciding whether to make a light regulation determination ... the NCC must consider—

(a) the likely effectiveness of the forms of regulation provided for under this Law and the Rules to regulate the provision of the pipeline services (the subject of the application) to promote access to pipeline services; and

(b) the effect of the forms of regulation provided for under this Law and the Rules on—

(i) the likely costs that may be incurred by an efficient service provider; and

(ii) the likely costs that may be incurred by efficient users and efficient prospective users; and

(iii) the likely costs of end users.

(2) In doing so, the NCC—

(a) must have regard to the national gas objective; and

(b) must have regard to the form of regulation factors; and

(c) may have regard to any other matters it considers relevant.

4.2 In essence, the determination of whether or not to apply light regulation to the QGDN turns on a comparison of the effectiveness and costs of the two forms of regulation provided for in the NGL—light regulation and full regulation.

4.3 The key difference between the two forms of regulation relates to the requirement to submit an Access Arrangement for approval by the AER. An Access Arrangement provides for up-front price regulation in that it must specify a reference tariff which requires approval by the AER. There is no requirement for service providers of light regulation pipelines to submit an Access Arrangement, although they may voluntarily submit a limited access arrangement to the AER for approval.¹⁶

4.4 Light regulation does not free a service provider to increase tariffs or change terms and conditions at will. The negotiate/arbitrate process that operates under light regulation substitutes ex post regulation for ex ante regulation. It does not remove regulatory oversight of access prices and other terms and conditions.

¹⁶ The requirements for a limited access arrangement are set out in Rule 45 of the NGR.

- 4.5 Access disputes in relation to light regulation pipelines are dealt with through an arbitration process, whereby the AER can determine access prices and other terms if negotiations between the parties prove unsuccessful and an access dispute is notified. This process is similar to the negotiate/arbitrate process for services declared under Part IIIA of the *Competition and Consumer Act (Cth)* (CCA).
- 4.6 Although the Council has so far made light regulation determinations for three pipelines¹⁷, to date, no access disputes concerning a light regulation pipeline have been notified to the AER.
- 4.7 Irrespective of the form of regulation, service providers must disclose a range of information concerning covered pipelines, although the scope of the information disclosure required in relation to light regulation pipelines is less than under full regulation. Many of the other obligations on covered pipelines under the NGL apply to both full and light regulation pipelines.
- 4.8 A table comparing the main elements of full and light regulation is contained in Appendix B of this report.

Effectiveness of regulation alternatives

- 4.9 The critical issues in an application for light regulation are: whether light regulation is likely to be as effective as full regulation in constraining the use of market power and promoting access to pipeline services; and the relative costs of the two approaches. If light regulation is similarly effective as full regulation but involves lower costs, light regulation is the more appropriate form of regulation.

Applicant's contentions

- 4.10 Envestra submits that "light regulation would be as effective as full regulation in terms of promoting access to the QGDN and would result in price and non-price terms and conditions, service quality and access to services being at least as effective under light regulation as would be the case under full regulation" (Application, paragraph 172).
- 4.11 In support of this conclusion Envestra contends that it is not in a position to exercise market power in relation to the services provided by the QGDN because:
- Natural gas is a fuel of choice—there are readily available substitutes for all natural gas applications, particularly from electricity and LPG.

¹⁷ A light regulation determination was made in relation to the covered part of the Moomba to Sydney Pipeline on 18 November 2008, for the Central West Pipeline on 19 January 2010 and for the Kalgoorlie to Kambalda Pipeline on 29 June 2010.

- The cost of switching from natural gas to electricity or LPG is low (given the small number of installed natural gas appliances in most Queensland homes—the mild Queensland climate and consequent lack of heating demand meaning that energy choice is largely determined by cooling requirements).
- Natural gas has no clear competitive advantage over electricity or LPG in the Queensland energy market.

4.12 Additional reasoning in this regard is included in Envestra’s consideration of the form of regulation factors (see Table 3).

4.13 Envestra also notes that negotiation of access to the QGDN even under light regulation would still take place against the background of safeguards provided under the NGL and NGR.

Other views

4.14 As noted in paragraph 3.3, Simply Energy states that it does not believe that it has any countervailing power against Envestra.

4.15 In its submission the ERAA contends that:

New entrants under light regulation will be required to negotiate access arrangements under commercially negotiated terms and conditions with Envestra. The ERAA’s view is that new entrants have little countervailing power against Envestra’s monopoly power to negotiate terms and conditions. (ERAA 2014, page 2).

4.16 The ERAA is also concerned that the terms and conditions for access to the QGDN will deteriorate over time as Envestra seeks to extract greater commercial outcomes from customers. Further the ERAA notes that such changes will likely be iterative meaning retailers will be reluctant to pursue disputes through the arbitration process given the expense involved.

4.17 Origin questions the effectiveness of light regulation of the QGDN. Origin contends that Envestra’s application overstates the degree to which its market power is mitigated by substitution opportunities. Origin also sees benefits associated with full regulation which are not available under light regulation and which are not offset by cost savings.

4.18 In its submission Origin offers a high level analysis of customer switching in the QGDN. In relation to residential customers Origin suggest that, including the fixed gas supply charge, the annual saving from switching to electricity for supply of hot water is small [confidential information redacted]. For customers using gas for cooking, the saving is smaller still [confidential information redacted].

- 4.19 Origin also points to projected increases in residential customer numbers in the AER's decision on Envestra's 2011-16 Access Arrangement for the QGDN, suggesting this indicates that Envestra "anticipated new customer connections in excess of existing customer disconnections" (Origin 2014, page 3).¹⁸
- 4.20 For large industrial customers Origin contends the argument for switching energy sources is even less persuasive. Origin notes that large industrial customers account for 86 per cent of delivered gas.¹⁹ Based on its customers on the QGDN, Origin considers that the majority of large customers are manufacturers which use gas for more than heating. For these customers gas is a feedstock. Such customers are likely to hold long term gas contracts which will prevent them switching to other fuels.
- 4.21 Origin also discounts the ability for customers to connect to an alternative gas pipeline service. Even for new customers Origin suggests there will be other more pertinent factors in determining plant location and few will have a choice of distribution network.
- 4.22 Origin places particular value on the processes for arriving at an access arrangement under full regulation. Origin note:
- Full regulation centres on the preparation and submission of an Access Arrangement proposal with the AER on a periodic basis. The AER's assessment of the proposal is a multi-stage process with distinct steps that allow interested parties to provide feedback on the proposal. This open, transparent and consultative process ensures all interested parties, not just retailers who eventually undertake negotiations on access, of the robustness of the terms and conditions outlined in the Final Access Arrangement.
- 4.23 Origin is not confident that in the absence of full regulation it will have a fair and reasonable bargaining position on access to the QGDN, particularly over the longer term. Origin suggests that past regulatory information will become less relevant overtime and comparisons with other distribution networks cannot "explain the underlying fundamentals that drive changes in the QGDN".
- 4.24 Origin is also concerned the opportunities full regulation provides for input from interested stakeholders who do not have a direct relationship with Envestra (including consumer advocacy and representative groups) will be lost under light regulation.
- 4.25 Origin conclude that:

¹⁸ Actual growth in residential customer numbers has been approximately 25 per cent less than projected. The Council does not consider growth in residential customer numbers is inconsistent with gas facing significant constraint from other energy sources.

¹⁹ The Council notes, however, that this 86 per cent includes 4 connections which accounted for 64.5% of total delivered gas in 2013-14 which are not regulated and use supply assets (some of which are provided by the user) that are excluded from Envestra's regulatory asset base. A further 3.5 per cent of gas is delivered to industrial users on negotiated tariffs.

There is a real potential that a weakening bargaining position over time will result in price increases and more onerous terms and conditions of access.
(Origin 2014, page 6)

Council's consideration

- 4.26 In the Council's view, the QGDN enjoys, and will continue to enjoy, market power in distribution of gas in the relevant parts of Queensland. It is highly unlikely that any party would seek to develop an alternative means of distributing gas to the area served by the QGDN. The Council considers that significant barriers to entry for the provision of pipeline services are likely to remain for the foreseeable future. As Envestra itself notes the nature of its large sunk investment means that there are economies of scale associated with the QGDN that would not be available to any new entrant.
- 4.27 There is some potential fringe competition between the QGDN and the neighbouring Allgas distribution network in Brisbane and from the ability for some large gas users to connect to transmission pipelines.
- 4.28 The most significant constraint on market power associated with the QGDN is the ability for end users to substitute other forms of energy—electricity and LPG. The Council acknowledges the precarious competitive position of gas in the areas served by the QGDN (see paragraphs 2.9 - 2.17). These factors offset some of the market power which the QGDN would otherwise enjoy. Importantly the level of constraint imposed by these factors is unlikely to be reduced by the application of light regulation to the QGDN.
- 4.29 Council notes under light regulation Envestra is still required to disclose a range of information regarding the QGDN, as well as details regarding negotiations with access seekers. Though these requirements are generally less than under full regulation, Envestra must still publish its terms and conditions of access, including the prices on offer, and capacity information on its website. The Council considers this information will assist prospective users in determining the reasonableness of prices offered and if necessary to trigger an access dispute. While some of this information may become less relevant over time, dramatic changes in relation to the operation of the QGDN seem unlikely.
- 4.30 The Council accepts that an aggrieved party may face significant costs if an access dispute requires arbitration and that it is less likely smaller incremental changes to terms and conditions of access will give rise to arbitration proceedings. However, the Council considers the position of gas in the Queensland energy market is such that Envestra is unlikely to push matters to that point given the likelihood that it would lose customers for its distribution services and face further reductions in throughput. The Council also notes that Envestra has indicated a desire to standardise its non-price terms and conditions for pipeline services across both its regulated and non-

regulated networks. Departures from such standard terms and conditions would be readily observable.

- 4.31 In the event an access dispute is notified to the AER, the Council considers that the AER is in no less a position to determine an appropriate outcome than it would be if the pipeline were subject to full regulation. The NGL also provides some scope for consumer advocacy groups and other interested parties who do not have a direct relationship with Envestra to participate in arbitration of access disputes. The Council notes, however, that unlike some other parts of the NGL, the provisions dealing with arbitration of access disputes have not been updated to reflect an enhanced role for consumer advocates and representatives in regulatory processes.
- 4.32 In the Council's view it is the risk of losing business as users switch to other energy forms that is the most significant constraint on Envestra's actions in relation to the QGDN. The Council does not see how that constraint is diminished by a move to light regulation.
- 4.33 For the above reasons, the Council is of the view that light regulation is likely to be similarly effective as full regulation in protecting users and other parties that are dependent on access to the QGDN.

Costs of form of regulation alternatives

Applicant's contentions

- 4.34 Based on its experience in relation to preparation of several Access Arrangements, including past Access Arrangements for the QGDN, Envestra estimates the cost to it from preparing a further Access Arrangement for the QGDN to be \$3 million.
- 4.35 Half of this amount is made up from internal staff costs. The other half is made up of the costs of various consultants and legal advisors. The amount includes \$410,000 for conduct of a merits review of the AER's initial decision.
- 4.36 Envestra contends that this estimate is conservative as it does not allow for "the AER's new requirement that service providers undertake a robust consumer consultation process" prior to submitting an Access Arrangement for approval (Application, paragraph 185). Envestra suggests that this could add \$250,000 to its costs in preparing an Access Arrangement.
- 4.37 Envestra notes the AEMC has found that the direct costs to a regulator of a revenue or pricing assessment process ranges from \$0.5 million to \$3.0 million.²⁰ Envestra suggests the mid-point of this range (\$1.75 million) is a reasonable estimate of the costs to the AER in considering a new Access Arrangement for the QGDN. In addition

²⁰ AEMC 2009, page 10.

Envestra suggests other parties which may be involved in the process for considering a new Access Arrangement are likely to incur costs of \$100,000.

- 4.38 Drawing on the above, Envestra estimates the cost of full regulation to be \$5.2 million over a five year regulatory period.
- 4.39 In contrast, Envestra estimates the costs of light regulation to be in the range of \$0.4 to \$0.8 million depending on the number of access disputes requiring arbitration that might arise or a limited access arrangement to be lodged.
- 4.40 The difference in cost between the two forms of regulation is therefore some \$4.6 million.
- 4.41 In its application Envestra states that it will pass back the avoided cost of full regulation to users (Application, paragraph 212).²¹

Other views

- 4.42 The ERAA suggests that the Council undertake “complete benchmarking to ensure the accuracy of Envestra’s expenses under both forms of regulation and therefore the quantum of savings identified in the Envestra Application” (ERAA 2014, page2).
- 4.43 The ERAA also calls for Envestra to be required to develop a robust plan to ensure the full financial benefit of a move to light regulation is received by customers as a prerequisite for light regulation of the QGDN.
- 4.44 Origin considers that it is preferable to consider costs savings from light regulation for each class of customer rather than on overall per customer basis. Origin calculates that for an average residential customer the potential savings from a shift to light regulation is \$2.42 over a five year regulatory period.

Council’s consideration

- 4.45 The Council does not consider the outcome of this application is particularly sensitive to the level of costs associated with full and light regulation and the difference between these. In the Council’s view the estimates supplied by Envestra are broadly reasonable and there is no need for the additional precision which might result from more extensive analysis.
- 4.46 As noted in footnote 21, the Council has some concerns as to the enforceability of Envestra’s commitment to pass on the cost savings from a shift to light regulation. While a “robust plan” for doing so, as sought by the ERAA, might assist in that regard,

²¹ The Council notes that this commitment might be difficult to enforce. However, were Envestra not to reduce (or moderate increases that would otherwise occur in relation to) gas distribution charges this might trigger access disputes.

the Council does not consider that it has the power to impose such requirement. The Council also notes that the principle governing light regulation determinations relating to the costs of the full and light regulation requires the Council to consider whether a shift to light regulation will reduce costs to various parties. It does not, however, require costs savings for one party to be shared or passed on to customers or end users.

- 4.47 In the Council's view, a shift to light regulation has potential to result in significant cost savings for Envestra. Some savings for other parties such as the AER, retailers and end users are also likely, although these may be small. This remains the situation even if the costs of developing and gaining approval for an access arrangement were to reduce over time as all parties become more efficient in meeting the relevant regulatory requirements. In this regard the Council notes that it considers the development of a robust consultation process between providers of pipeline services and users of those services (including end-users) to be a positive development which may reduce regulatory disputation rather than an additional regulatory impost. The Council also notes that the AEMC commentary on the costs of regulation cited by Envestra is now somewhat aged (footnote 20). The Council expects the costs of full regulation will reduce as all parties gain experience and continue efforts to make regulatory processes more efficient. Nevertheless the costs of full regulation of the QGDN will remain significant.
- 4.48 Whether the potential cost savings from a shift to light regulation will eventuate is critically dependant on the number and nature of any access disputes. A small number of arbitrations may be less costly than full regulation. However, if the outcome of light regulation is a series of access disputes and arbitrations, then the potential for cost savings will be quickly eaten up and the regulatory determination of tariffs and terms under full regulation is likely to be more cost effective.
- 4.49 The Council considers that the likelihood of a significant number of access disputes in relation to the QGDN under light regulation is likely to be low. The Council notes that the opposition to this application from Origin, Simply Energy and the ERAA may indicate some greater prospect for disputation in relation to the QGDN than other pipelines which have been light regulated.
- 4.50 Nevertheless, the Council accepts that the costs of light regulation of the QGDN are likely to be significantly less than those associated with full regulation.

National gas objective

- 4.51 In making a light regulation determination the Council must have regard to the National Gas Objective (**NGO**) contained in s 23 of the NGL. That section provides:

The objective of this Law [the NGL] is to promote efficient investment in, and efficient operation and use of, natural gas for the long term interests of

consumers of natural gas with respect to price, quality, safety, reliability and security of supply of natural gas.

- 4.52 Drawing on its conclusions regarding the effectiveness of light regulation and the likely costs of each form of regulation, Envestra submits that “light regulation will be a more efficient form of regulation for the QGDN relative to full regulation” (Application, paragraph 215) and that “[i]n keeping with the NGO, these efficiency benefits can be expected to benefit the long term interests of end-users with respect to price, quality, safety, reliability and security of supply of natural gas” and “light regulation will therefore better promote the NGO relative to the continued application of full regulation” (Application, paragraph 216).
- 4.53 In the Council’s view, where light regulation is similarly effective to full regulation but involves a lower cost, it is the most suitable form of regulation and a light regulation determination is consistent with the national gas objective. As noted in paragraph 4.50, the Council agrees that the shift to light regulation would provide cost savings. Further, the Council does not consider that the shift to light regulation would disadvantage pipeline users or end users, particularly with the recourse to binding arbitration providing a restraint on the exercise of market power.

Form of regulation factors

- 4.54 Section 16 of the NGL sets out the form of regulation factors the Council must have regard to in deciding whether to apply light regulation to the QGDN. The Council’s *Gas Guide* contains a summary of the Council’s views on how each form of regulation factor might, in principle, affect its determination of a light regulation application (see paragraph 4.58 and following, and Table 5).
- 4.55 Table 3 provides a summary of Envestra’s submissions in relation to the form of regulation factors.

Table 3: Application of form of regulation factors to the QGDN

Form of regulation factor (s 16)	Applicant’s views
(a) the presence and extent of any barriers to entry in a market for pipeline services	The barriers to entry associated with replicating the QGDN are offset by the fact that consumers do not have a strong preference for natural gas in Queensland (that is, the barriers are offset by consumers choosing electric or LPG appliances)
(b) presence and extent of any network externalities (that is, interdependencies) between a natural gas service provided by a service provider and any other natural gas service provided by the service provider	There is no market power arising from any network externalities arising from the services provided by Envestra across the QGDN, reflecting that the QGDN is characterised by low penetration, low average consumption and high unit costs of supply which has led to strong competition from electricity and LPG

Form of regulation factor (s 16)	Applicant's views
(c) presence and extent of any network externalities (that is, interdependencies) between a natural gas services provided by a service provider and any other service provided by the service provider in any other market	There are no network externalities between the services provided by Envestra on the QGDN and any other related services provided by Envestra, including services that are either directly related to gas distribution or in any other dependent market (particularly retail services)
(d) the extent to which any market power possessed by a service provider is, or is likely to be, mitigated by any countervailing market power possessed by a user or prospective user (countervailing market power)	Users of the QGDN currently have and are exercising countervailing market power, which is reflected in the price outcomes achieved in our unregulated markets, the low penetration rates and average usage on the network. Moreover, negotiations of the type required for access to the QGDN are commonplace for retailers and other large users
(e) the presence and extent of any substitute, and the elasticity of demand, in a market for a pipeline service in which a service provider provides that service	There is competition in the market for pipeline services given large users can connect to either the neighbouring Allgas distribution network or directly to the Roma to Brisbane Pipeline or the Queensland Gas Pipeline depending on their location. Smaller customers however have less scope to change their location to access competing pipeline services but face relatively insignificant costs to change their energy sources or appliances
(f) the presence and extent of any substitute for, and the elasticity of demand in a market for, electricity or gas (as the case may be)	Natural gas is a fuel of choice, meaning there are readily available and competitive energy (electricity and LPG) alternatives for all natural gas applications. The switching costs are relatively low in Queensland reflecting the low average usage of customers
(g) the extent to which there is information available to a prospective user or user, and whether that information is adequate, to enable the prospective user or user to negotiate on an informed basis with a service provider for the provision of a pipeline service to them by the service provider	There is significant information available to facilitate effective access negotiations

4.56 Although in some respects Envestra's application plays down its market power, the Council generally accepts the Applicant's views in relation to the form of regulation factors. The Council considers that the scope for gas users to connect to other means of distributing gas are likely to be more limited than suggested by Envestra's discussion of form of regulation factor (e). Similarly, established industrial gas users are unlikely to be able to readily switch to other pipelines to obtain gas supplies, although the Council accepts new users may be able to choose a location allowing them to select how gas is supplied to them.

4.57 It is the Council's view that consideration of the form of regulation factors and the circumstances of the QGDN support the conclusion that light regulation is likely to be similarly effective as full regulation.

Other matters

4.58 The Council does not consider that there are any further matters arising from this application (including the more generalised concerns raised by Origin, Simply Energy and the ERAA in their submissions—see paragraphs 3.9 to 3.11) that are not encompassed within the other elements of its consideration or require consideration under s 122(2)(c).

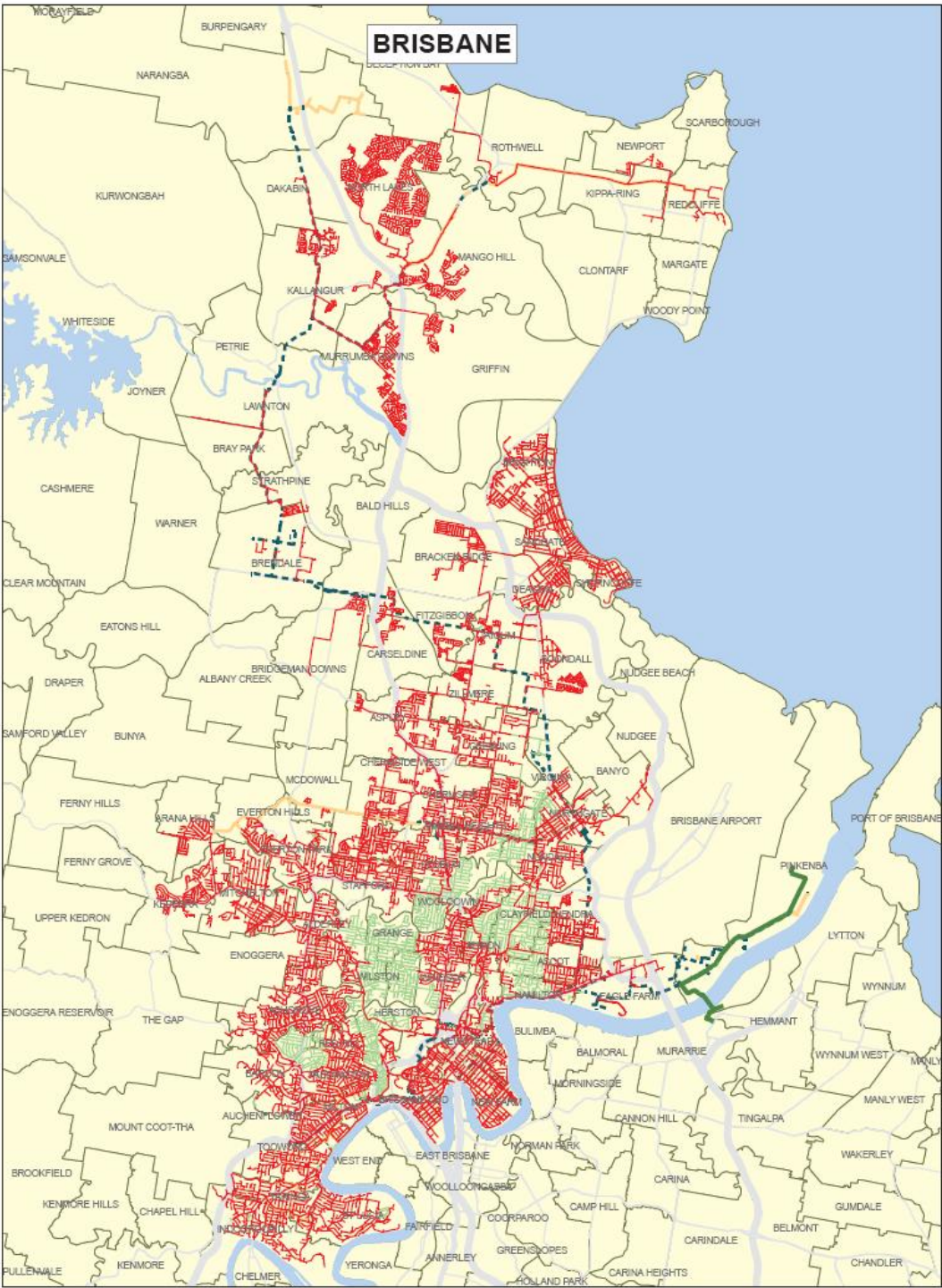
Council's conclusions

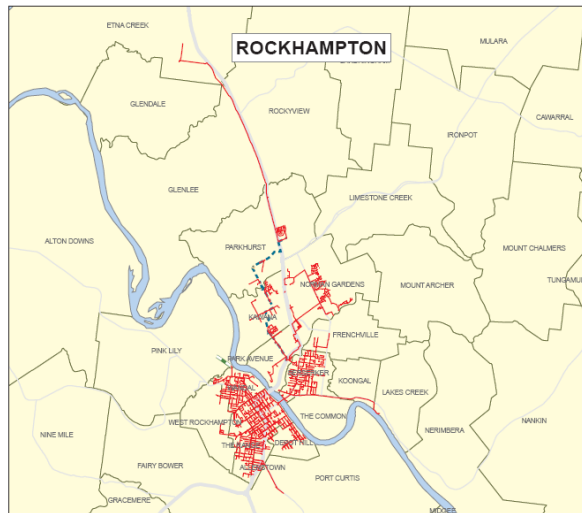
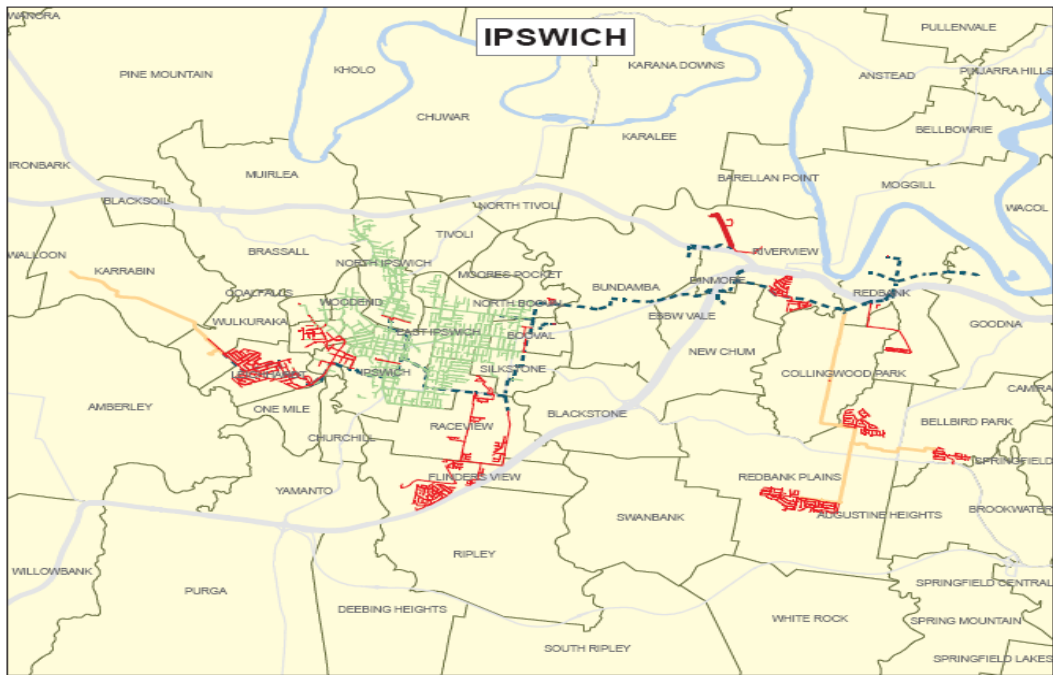
4.59 In summary the Council's conclusions are:

- Light regulation is likely to be similarly as effective as full regulation of the QGDN. Users and other interested parties may notify an access dispute where this is necessary and in such an event the AER is no less able to address relevant issues than it would be in a full regulation context.
- Light regulation is likely to involve significant cost savings—primarily for Envestra, but also for other parties.
- Light regulation of the QGDN is consistent with promotion of the national gas objective.
- Consideration of the form of regulation factors supports these conclusions.

4.60 Subject to further analysis and consideration of submissions it receives on this draft determination, **the Council proposes to make a light regulation determination in respect of the QGDN.**

Appendix A – Maps of the QGDN





Appendix B - Key features of light vs full regulation

Full (access arrangement) regulation	Light regulation (additions or differences from full regulation)
<p>Service provider subject to general duties:</p> <ul style="list-style-type: none"> • Must be a specified legal entity (principally a corporation - s 131). • Must not engage in conduct to prevent or hinder access (s 133). • Obligated to disclose gas supply information in certain circumstances (r 138). 	No difference.
<p>Subject to 'ring-fencing' requirements</p> <ul style="list-style-type: none"> • Must not carry on a related business (s 139). • Must keep marketing staff separate from associate's related businesses (s 140). • Must keep consolidated and separate accounts (s 141). • Must comply with any AER regulatory information instrument about information reporting (s 48). • Must keep sensitive information confidential (r 137). • Any additional requirements ring-fencing imposed by the AER under s 143. 	No difference.
<p>Contracts with associates must not be entered into, varied or given effect to if they substantially lessen competition in a market for natural gas services or breach competitive parity rule unless approved by the AER under the rules (ss 147 and 148 and r 32). Entering into or varying an associate contract must be notified to the AER (r 33).</p>	No difference.
<p>Subject to rules relating to facilitating requests for access and information disclosure:</p> <ul style="list-style-type: none"> • Requirements to publish information and access arrangement (r 107). • Must provide certain information about tariffs (r 108). • Must not bundle services (r 109). • Must respond to request for access in structured manner (r 112). 	<p>Subject to same rules as for full regulation pipelines and additionally:</p> <ul style="list-style-type: none"> • Must report annually to the AER on access negotiations (r 37). • Must publish terms and conditions of access, including prices on offer, on website (r 36).

Full (access arrangement) regulation	Light regulation (additions or differences from full regulation)
<p>Requirement to submit and have in force a full access arrangement which sets out terms and conditions of access and reference tariffs for services likely to be sought by a significant part of the market (s 132). Importantly:</p> <ul style="list-style-type: none"> • Non-price conditions subject to AER approval, including capacity trading requirements, changes of receipt and delivery points, extension and expansion requirements and queuing requirements (rr 103 - 106). • Total revenue to be determined by the AER taking into account the revenue and pricing principles (s 24 and 28) and using the building blocks approach to economic regulation (r 76) which is highly dependent upon: <ul style="list-style-type: none"> • rules relating to the establishment and roll forward of a regulatory capital base; • determination of a rate of return on capital; • assessment of regulatory depreciation allowances and schedules; • estimates of corporate income tax (where post-tax model adopted); • maintenance and reporting of incentive arrangements; • determining allowances for operating expenditure; • creating a reference tariff variation mechanism based upon total revenue and appropriate cost allocation; and • complex arrangements relating to surcharges, capital contributions, speculative investment and capital redundancy (see generally Part 9 of the NGR). 	<p>No requirement to submit or have in force a full access arrangement. A limited access arrangement (governing only non-price terms and conditions) may be submitted for approval by the service provider if it chooses to do so (s 116).</p> <p>Note that only conforming capital expenditure is included in a capital base while a pipeline is on full regulation, however if a light regulation pipeline returns to full regulation actual capital expenditure in the intervening period is rolled into the capital base (r 77(3))</p>

Full (access arrangement) regulation	Light regulation (additions or differences from full regulation)
Requirement to submit detailed access arrangement information with an access arrangement and keep this information available (rr 42 - 43). This extends to detailed financial and operational information (r 72). The AER may also impose additional information requirements to allow them to assess an access arrangement as a regulatory information instrument (s 48).	No general requirement to submit or have approved access arrangement information. Minimal access arrangement information on capacity required if service provider chooses to submit a limited access arrangement (r 45(2)).
Requirements relating to compliance (usually annually) with the reference tariff variation mechanism to increase reference tariffs by the control mechanism (including any pass through arrangements) (r 97).	No such requirements imposed.
<p>A user or prospective user is able to notify to the dispute resolution body (the AER everywhere but Western Australia) an access dispute about any aspect of access to pipelines services provided by means of a covered pipeline (s 181) and the access determination may deal with any matter relating to the provision of a pipeline service to a user or prospective user (s 193). The dispute resolution body must take into account the national gas objective and revenue and pricing principles in resolving a dispute (s 28). Existing user rights and usage are protected (s 188) and the applicable access arrangement must be applied (s 189). Geographical extensions of a pipeline cannot be ordered (r 118(1)(b)).</p> <p>Note that pipeline services which are not likely to be sought by a significant part of the market (i.e. non-reference services) may still be subject of an access dispute even though no price is provided by the access arrangement (s 181).</p>	<p>Access dispute provisions apply, any approved limited access arrangement must be applied, but otherwise price and non-price terms and conditions determined by the dispute resolution body.</p> <p>In relation to capacity expansions, for a light regulation pipeline the access seeker needs to fund the expansion entirely (r 118(2)(a)), an extension or expansion requirement in an access arrangement governs the ability for a service provider to be required to fund the expansion of a full regulation pipeline (r 118(2)(b)).</p>
Price discrimination between users recognised in both prudent discount provisions (r 96) and pricing principles for distribution services (r 94). While service providers can offer other discounts, these would not be reflected in reference tariffs (r 96).	Prohibition on engaging in price discrimination unless that discrimination is conducive to efficient service provision (s 136).
Must comply with queuing requirements in an approved access arrangement (s 135).	Where a limited access arrangement is in force, the queuing policy must be complied with under s 135. Where no limited access arrangements are in place, issues about the priority of access could be resolved as part of an access dispute.

Full (access arrangement) regulation	Light regulation (additions or differences from full regulation)
Other than for the queuing requirements, service providers and users are free to agree on alternative terms and conditions of access than set out in the access arrangement (s 322).	No difference.
Pre-existing contractual rights protected (ss 188 and 321).	No difference.
The extent to which an extension or expansion of a pipeline is taken to be part of the covered pipeline, and regulated by the regime, is governed by the extensions and expansion requirements in the access arrangement (s 18).	As for full regulation where a limited access arrangement applies, but otherwise all extensions and expansions are taken to be part of the covered pipeline (s 19).
May apply to be uncovered if no longer satisfied coverage test (s 102).	No difference. Note also that any person can at any time apply to revoke the light regulation determination (s 118).
<p>Must, for interconnected transmission pipelines, disclose information to the Bulletin Board:</p> <ul style="list-style-type: none"> • nameplate rating (r 170). • 3-day capacity outlook (r 171). • linepack/capacity adequacy indicators (r 172). • nominated and forecast delivery nominations (r 173). • actual delivery information (r 174). 	No difference.
<i>Must, unless exempt distribution network, maintain a register of spare capacity on its website (r 111).</i>	<i>No difference.</i>

Source: NCC 2013, see Table 3 commencing on page 68

Appendix C – Materials considered by the Council

C.1 Application

Envestra (2014), *Application for Light Regulation of Envestra's Queensland Gas Distribution Network*, 15 August 2014 (public and confidential versions)

C.2 Submissions

ERAA, *RE: Application for light regulation of Envestra's Queensland Gas Distribution Network*, 11 September 2014

Origin, *Application for light regulation of Envestra's Queensland Gas Distribution Network*, 11 September 2014

Simply Energy, *RE: Application under the National Gas Law for light regulation of Envestra's Queensland Gas Distribution Network*, 11 September 2014

C.3 Other materials

AEMC (2009), *Perspectives on the building block approach - Review into the use of total factor productivity for the determination of prices and revenues*, 30 July 2009, Sydney

_____ (2014), *Retail Competition Review, Final Report*, 22 August 2014, Sydney

BREE (2014), *2014 Australian Energy Update*, July, Canberra

NCC (2013), *Gas Guide - A guide to the functions and powers of the National Competition Council under the National Gas Law*, October 2013, Melbourne