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[redacted]

21 February 2014

Andrew Gee MP
Chair, State and Regional Development Committee
Parliament of New South Wales
6 Macquarie Street
SYDNEY NSW 2000

Dear Mr Gee

Downstream gas supply and availability in NSW

Please find the AER's response to the NSW Parliament State and Regional Development Committee's request on 30 January 2014 for information in relation to downstream gas supply and availability in NSW below at Attachment A.

If you have any questions in relation to the AER's response, please contact [redacted]

Yours sincerely

[redacted]

ATTACHMENT A

1) Under full regulation, on what basis does the AER determine the maximum prices and charges that can be levied by distributors for the use of their distribution networks?

State of the Energy Market 2013 (AER, December 2013) outlines the basis on which the AER determines charges for gas distribution pipeline operators:

> "The (AER) assesses the revenues needed to cover efficient costs (including a benchmark return on capital), then derives reference tariffs for the pipeline. (The AER) uses a building block model that accounts for a pipeline's operating and maintenance expenditure, capital expenditure, asset depreciation costs and taxation liabilities, and a return on capital."[1]

What is the process for making these determinations?

The *Access Arrangement Guideline* (AER, March 2009) outlines the AER's process for assessing access arrangements for full regulation pipelines in detail.[2]

Where a pipeline is subject to full regulation, the gas distribution pipeline operator must periodically submit an access arrangement to the AER for approval. An access arrangement sets out the terms and conditions under which third parties can use a pipeline. It must specify at least one reference service likely to be sought by a significant part of the market, and a reference tariff for that service. The AER assesses the revenues a gas distribution pipeline operator requires to cover prudent and efficient costs of operating the pipeline (including a benchmark return on capital), and derives reference tariffs for third party access and use of the pipeline.[3]

2) Does the current scheme regulating network distribution costs result in appropriate end-point gas prices being paid by retail customers?

The *State of the Energy Market 2013* shows that rising capital and operating expenditure, as well as other cost drivers (including higher financing costs and the rising cost of unaccounted for gas) have resulted in an increase in the revenue required for Jemena to cover the efficient costs of operating the NSW gas distribution pipeline (15 per cent compared to the previous access arrangement period).[4]

The AER notes a 5 per cent increase in residential gas bills in NSW over the current access arrangement period. As gas distribution charges typically make up 40 to 60 per cent of a residential gas bill, the aforementioned increase in required revenue will have likely contributed to the increase in charges to retail customers.[5]

However, as discussed in response to 1), the AER's determination process is aimed at ensuring Jemena's gas distribution tariffs are set such that it is able to generate just enough revenue to cover the prudent and efficient costs of operating its pipeline network/s. This ensures that third parties seeking access to the pipeline are charged an appropriate (i.e. efficient) price. So, while pipeline costs and distribution tariffs have been increasing over recent years, the AER's regulatory framework and determination process limits gas pipeline operator revenues to levels required to cover prudent and efficient costs.

[redacted]

3) Can effective competition in the gas market play a role in driving down gas distribution network prices for retail customers?

Given the natural monopoly characteristics of the gas distribution sector, direct competition at this level of the gas supply chain is virtually non-existent. However, as outlined in response to 1) and 2), the AER assesses the revenues a gas distribution pipeline operator requires to cover prudent and efficient costs of operating the pipeline (including a benchmark return on capital), and derives reference tariffs for third party access and use of the pipeline.

The efficiency of the tariffs at the distribution level is reflected in retail charges, but for a mark-up by the gas retailer to cover the cost of billing the end user. Competition among gas retailers acts to limit the size of the mark-up imposed by gas retailers on end users.

4) Are there regulatory changes that could be made to drive down gas network prices?

The *State of the Energy Market 2013* report outlines recent policy/rule changes, or flagged changes, in the AER's assessment approach and supply issues in eastern Australian gas markets.

A recent rule change proposed by the AER and implemented by the Australian Energy Market Commission is likely to result in a more appropriately set return on capital for gas pipelines. Following a rule change proposal by the AER in 2011, the new rule, which was enacted in November 2012, requires a holistic assessment of the overall rate of return that a benchmark entity needs to meet its efficient costs. The AER was previously locked into a parameter-by-parameter assessment of the rate of return, with limited scope to consider the appropriateness of the overall allowance. Additionally, the regulatory assessment can now account for a wider range of information, allowing for decisions that better reflect conditions in capital markets.[6]

Policy makers are also implementing reforms to help alleviate pressures in the eastern gas market, such as:

- A gas trading exchange at Wallumbilla, Queensland, set for launch in March 2014. This aims to alleviate bottlenecks in the tight Queensland gas market by facilitating short term gas trades

- Reforms to pipeline capacity trading to promote trade in the significant amounts of idle capacity that is contracted to gas retailers and industrial consumers. Capacity trading could make more efficient use of existing infrastructure by reallocating idle capacity and allowing the delivery of additional gas to the market.

- Other measures such as strategically planning gas market development, refining spot market design, and streamlining the processes for making rule changes that affect gas spot markets.[7]

5) On what basis would a pipeline not be subject to economic regulation by the AER?

The criteria for determining whether a pipeline should be covered/regulated are outlined in Section 15 of the National Gas Law:

[redacted]

- access (or increased access) to pipeline services provided by means of the pipeline would promote a material increase in competition in at least one market (whether or not in Australia), other than the market for the pipeline services provided by means of the pipeline[8]

- it would be uneconomic for anyone to develop another pipeline to provide the pipeline services provided by means of the pipeline[9]

- access (or increased access) to the pipeline services provided by means of the pipeline can be provided without undue risk to human health or safety[10]

- access (or increased access) to the pipeline services provided by means of the pipeline would not be contrary to the public interest[11]

6) What are the barriers to the expansion of existing gas distribution networks in NSW to rural and regional areas?

There are no explicit barriers to rural and regional expansion for pipeline operators (i.e. laws or regulations). However it is generally less profitable for operators to expand into rural and regional areas due to the operating and capital costs of extending the network. A common occurrence is for gas operators to enter into partnerships where the cost of extending the network to the given region is partly funded by the customer and/or Government. The part that is funded by the customer and/or Government is typically not included in the gas operator's required revenue calculation.

The AER notes the Victorian Energy for the Regions Program which plans to expand natural gas to communities across rural and regional Victoria. SP AusNet and Multinet have agreed to extend their gas networks to several towns under this program.

7) What incentives can be provided to encourage service providers to expand existing gas distribution networks in NSW to rural and regional areas?

As discussed in answer to 6), expansion into rural and regional areas by pipeline operators is generally less profitable due to the operating and capital costs associated with such an expansion. To overcome this, as with the Victorian Energy for the Regions Program, the State Government has entered into partnership with operators to partially fund the expansion.

[redacted]