



EXECUTIVE OFFICE

Level 20, 175 Pitt Street  
Sydney NSW 2000

GPO Box 3648  
Sydney NSW 2001

Our ref: 62172  
Contact officer: Nicole Ross  
Contact phone: (03) 9290 1957

tel: (02) 9230 9133  
fax: (02) 9223 1092  
[www.accc.gov.au](http://www.accc.gov.au)

16 August 2017

Mr John Pierce  
Chair  
Australian Energy Market Commission  
PO Box A2449  
Sydney South NSW 1235

Dear Mr Pierce,

**ACCC submission on AEMC Review into the scope of economic regulation applied to covered pipelines issues paper**

The Australian Competition and Consumer Commission (ACCC) appreciates the opportunity to comment on the Review into the scope of economic regulation applied to cover pipelines issues paper (the Issues Paper).

The ACCC considers that the key issue of the review is how to amend Parts 8-12 of the National Gas Rules (NGR) to address concerns that pipelines subject to full regulation are able to exercise market power to the detriment of economic efficiency and the long term interests of consumers. The Australian Energy Market Commission's review provides an excellent opportunity for the AEMC to address these issues and promote more economically efficient outcomes.

The ACCC therefore suggests that changes to the NGR regarding:

1. The definition of reference services to ensure that all non-contestable services are represented,
2. The discretion over coverage of expansions to regulated pipelines to require that all expansions are covered,
3. The information disclosure and arbitration provisions so that they are the same across all pipelines, regulated and non-regulated.

Attached is the ACCC's submission to the Issues Paper outlining our recommendations in more detail.

Yours sincerely

Rod Sims  
Chairman



Australian  
Competition &  
Consumer  
Commission

# ACCC submission on Review into the scope of economic regulation applied to covered pipelines Issues Paper

August 2017

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# 1. Executive Summary

The ACCC supports the Australian Energy Market Commission's (AEMC's) review into the scope of economic regulation applied to covered pipelines outlined in its June 2017 Issues Paper.

The ACCC, in its 2015–2016 inquiry into the competitiveness of the wholesale gas inquiry, found that monopoly pricing by pipeline operators was having a detrimental effect on gas supply and pricing in the domestic market. The ACCC recommended that the COAG Energy Council ask the AEMC to review the economic regulation of covered (that is regulated) pipelines, which has led to the AEMC's current review.

From its review, the ACCC identified the following issues: monopoly pricing by pipeline operators, regulatory gaps that may allow pipeline operators to charge monopoly prices, information asymmetries, and issues with the existing arbitration framework. This AEMC review provides an excellent opportunity for the AEMC to address these issues and promote more economically efficient outcomes. Specifically, the ACCC notes that monopoly pricing is an issue that the National Gas Objective seeks to address and recommends that:

1. The NGR be amended so that a reference service is defined for each category of service (e.g. firm forward haul, backhaul, park and loan, etc.), giving a reference service for each non-contestable service. Users could then use then reference services to negotiate specific tailored services.
2. The Discretion to exclude expansions of a full regulation pipeline from the definition of the covered pipeline is removed. The ACCC recommends that the NGR be amended so that expansions to regulated pipelines are automatically subject to regulation, given that there is usually no effective competition for the provision of expanded capacity.
3. That the information disclosure and arbitration framework should be standardised across all pipelines. With the addition of Part 23 of the NGR, unregulated pipelines are now subject to more rigorous information disclosure requirements than pipelines subject to light regulation. Imposing similar information disclosure requirements on regulated pipelines would improve information available to pipeline users, improving their negotiating position with pipeline operators. Similarly, the ACCC recommends that the arbitration framework for regulated pipelines be amended to align with the framework in Part 23 to promote regulatory consistency.

## 2. Background

### ACCC East Coast Gas Inquiry

On 13 April 2015, the Minister for Small Business directed the ACCC to hold an inquiry into the competitiveness of the wholesale gas industry (the First Inquiry).<sup>1</sup> The ACCC's inquiry found that pipeline sector problems exacerbate gas supply and pricing issues in the domestic market.<sup>2</sup> During the First Inquiry, the ACCC was provided with evidence that a large number of existing pipelines (including regulated and unregulated pipelines) have been engaging in monopoly pricing, giving rise to higher delivered gas prices for users and in some cases, lower ex-plant prices for producers.

The First Inquiry found that pipeline operators are using market power to obtain above-efficient prices, and this monopoly pricing behaviour is affecting the achievement of economically efficient outcomes.<sup>3</sup> The First Inquiry also found that the coverage criteria used to determine if a pipeline should be regulated are not designed to address the market failure that was observed.<sup>4</sup>

The First Inquiry identified a number of gaps in the regulatory framework that allow covered pipelines subject to full regulation to engage in monopoly pricing. Specifically the First Inquiry identified issues with the definition of reference services and how expansions to regulated pipelines are regulated. The First Inquiry also noted that while in principle the threat of arbitration should impose a constraint on pipeline operators' ability to charge monopoly prices, market participants had informed the ACCC that the costs and resources associated with an access dispute and the uncertainty surrounding the final outcome can discourage shippers from triggering these provisions.<sup>5</sup> Information asymmetries add to the issue, limiting the ability of shippers to identify any exercise of market power and to negotiate effectively with pipeline operators.<sup>6</sup>

The First Inquiry therefore recommended the COAG Energy Council ask the AEMC to review Parts 8-12 of the National Gas Rules (NGR) and to make any amendments that may be required to address the gaps identified by the Inquiry and the concern that pipelines subject to full regulation are able to exercise market power to the detriment of consumers and economic efficiency. The First Inquiry also suggested that the AEMC consider if any changes to the dispute resolution mechanism in the NGL and the NGR were necessary to make it more accessible to shippers, and therefore would provide a more effective constraint on the behaviour of pipeline operators.

To address the First Inquiry's finding that the coverage criteria are not addressing the market failure observed, the Inquiry recommended that the COAG Energy Council review the current test for regulation, with a recommendation that a new test around market power be implemented.<sup>7</sup>

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<sup>1</sup> ACCC, *Inquiry into the East Coast Gas Market*, April 2016.

<sup>2</sup> ACCC, *Inquiry into the East Coast Gas Market*, April 2016, p. 8.

<sup>3</sup> ACCC, *Inquiry into the East Coast Gas Market*, April 2016, chapter 6.

<sup>4</sup> ACCC, *Inquiry into the East Coast Gas Market*, April 2016, p. 134.

<sup>5</sup> ACCC, *Inquiry into the East Coast Gas Market*, April 2016, pp. 134-135.

<sup>6</sup> ACCC, *Inquiry into the East Coast Gas Market*, April 2016, p. 121.

<sup>7</sup> ACCC, *Inquiry into the East Coast Gas Market*, April 2016, p. 141.

On 19 April 2017, the Treasurer directed the ACCC to hold an inquiry into measures to improve the transparency of gas supply arrangements in Australia; the supply and demand for gas in Australia; and the supply and demand for gas transportation services in Australia (the Second Inquiry).<sup>8</sup> As part of the Second Inquiry, the ACCC continues to monitor the behaviour of regulated and unregulated pipeline operators and its impact on the market for gas transportation services and gas prices paid by consumers.

### **Dr Vertigan's Examination and the Gas Market Reform Group**

In response to the ACCC's recommendation that the coverage test be reviewed, the COAG Energy Council directed Dr Michael Vertigan to conduct an 'Examination of the current test for the regulation of gas pipelines' (the Examination).<sup>9</sup>

In short, Dr Vertigan found that:

- pipeline operators have market power, the exercise of which, in some instances, results in inefficient outcomes that do not promote the National Gas Objective (NGO), or facilitate the achievement of the Council's Australian Gas Market Vision; and
- the coverage test does not appear to be posing a credible threat to pipeline operators.<sup>10</sup>

While a change to the coverage test was explored with stakeholders, most shippers made it clear they were not looking for a traditional regulatory solution. Rather, most shippers wanted to find a way to reduce the imbalance in bargaining power they can face when seeking access to pipeline services.<sup>11</sup> To address this power imbalance, the Examination recommended steps be taken to strengthen the negotiating position of shippers.

The Gas Market Reform Group (GMRG) developed and consulted on an information disclosure and arbitration framework to implement the recommendations of the Examination. This framework applies to pipelines that are not subject to economic regulation under Parts 8-12 of the NGR. The GMRG developed initial NGR that require pipeline operators to disclose certain information about pipeline services costs, pricing and contract terms and contain a binding commercial arbitration framework for when shippers and pipeline operators are unable to reach agreement on pipeline access.<sup>12</sup> These rules commenced on 1 August 2017.<sup>13</sup>

These rules require pipeline operators to publish information that enables shippers to successfully negotiate access with pipeline operators by reducing the information asymmetry between the parties. Where commercial negotiations fail, the rules provide for a commercially-oriented arbitration mechanism to resolve disputes. The arbitrator must have

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<sup>8</sup> For the terms of reference for the Second Inquiry, see: <https://www.accc.gov.au/system/files/Gas%20market%20transparency%20measures%20Terms%20of%20reference.pdf>.

<sup>9</sup> Dr Michael Vertigan AC, *Examination of the current test for the regulation of gas pipelines*, 14 December 2016.

<sup>10</sup> Dr Michael Vertigan AC, *Examination of the current test for the regulation of gas pipelines*, 14 December 2016, pp. 9-10, 12-13.

<sup>11</sup> Dr Michael Vertigan AC, *Examination of the current test for the regulation of gas pipelines*, 14 December 2016, p. 12.

<sup>12</sup> Gas Market Reform Group, *Gas Pipeline Information Disclosure and Arbitration Framework: Initial National Gas Rules: Explanatory Note*, 2 August 2017.

<sup>13</sup> See the AEMC website for rules: [http://www.aemc.gov.au/Energy-Rules/National-gas-rules/Rules-made-by-SA-minister/National-Gas-\(Pipelines-Access-Arbitration\)-Amendm.aspx](http://www.aemc.gov.au/Energy-Rules/National-gas-rules/Rules-made-by-SA-minister/National-Gas-(Pipelines-Access-Arbitration)-Amendm.aspx).

regard to principles within the rules so that outcomes are consistent with the outcomes of a workably competitive market.

### **AEMC Review into the scope of economic regulation applied to covered pipelines**

In May 2017, the COAG Energy Council tasked the AEMC with reviewing Parts 8-12 of the NGR in line with the ACCC's recommendation from the First Inquiry.<sup>14</sup> In June 2017, the AEMC released its Issues Paper: Review into the scope of economic regulation applied to covered pipelines.<sup>15</sup> The AEMC's Issues Paper sets out five broad areas for comment:

- efficient and effective regulatory framework
- efficient investment in gas pipelines
- efficient operation and use of gas pipelines
- incentives to provide access to pipeline services
- tariff and non-tariff terms and conditions of access.<sup>16</sup>

The ACCC's submission to the Issues Paper focuses on the issues outlined in the ACCC's First Inquiry, that is, monopoly pricing, gaps in the current regulatory framework, and information disclosure and the arbitration framework.

## **3. Monopoly pricing and the National Gas Objective**

The national gas objective (NGO) is 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, quality, safety, reliability and security of supply of natural gas.<sup>17</sup>

In the Issues Paper, the AEMC sought comment on whether the objectives of the current regulatory framework are still relevant or whether they should focus on different issues such as monopoly pricing.

The First Inquiry found that a large number of small and large pipelines servicing supply centres, capital cities and regional areas on the east coast are pricing above levels that would be expected in a workably competitive market.<sup>18</sup> The pipelines investigated were a mix of pipelines that are unregulated, subject to light regulation, and subject to full regulation. The First Inquiry therefore concluded that regulation was not adequately constraining pipeline operators.<sup>19</sup>

As evidence of monopoly pricing, the First Inquiry found that pipelines expected to earn high returns on equity for various incremental investments, in the range of 1.4 to 20 times higher than the return on equity benchmark estimated by the Australian Energy Regulator (AER).

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<sup>14</sup> See the AEMC website for the COAG Energy Council terms of reference: <http://www.aemc.gov.au/getattachment/bbd99022-6d33-4e4b-919b-2456eb4223a0/Terms-of-reference.aspx>.

<sup>15</sup> AEMC, *Issues Paper: Review into the scope of economic regulation applied to covered pipelines*, 27 June 2017.

<sup>16</sup> AEMC, *Issues Paper: Review into the scope of economic regulation applied to covered pipelines*, 27 June 2017, p. 41.

<sup>17</sup> Section 23 of the National Gas Law.

<sup>18</sup> ACCC, *Inquiry into the East Coast Gas Market*, April 2016, p. 102.

<sup>19</sup> ACCC, *Inquiry into the East Coast Gas Market*, April 2016, pp. 110-111.

These returns form the basis for setting the transportation charges payable by users.<sup>20</sup> The First Inquiry also found that prices charged by pipelines that have already recovered the cost of construction are higher than would be the case under full regulation.<sup>21</sup>

Monopoly pricing by pipelines adversely affects economic efficiency in a number of ways. It can affect gas prices, efficiency in the gas market, and downstream and upstream market efficiency. Higher pipeline charges can lead to lower ex-plant prices for gas as producers lower their prices to remain competitive, which may lead to less gas being produced. It can also lead to higher delivered prices of gas for users, which may lead to less being used.<sup>22</sup>

Higher pipeline charges on some pipelines can also have an indirect effect on gas prices in southern states even if users don't utilise those pipelines. Gas prices in Queensland are now shaped by LNG netback prices. With the tightening of gas supply on the east coast, the price that users pay for gas in the southern states is now influenced by the price of gas from Queensland plus the cost of transportation from Queensland, regardless of whether a user actually purchases gas from Queensland. Higher pipeline charges on the pipelines from Queensland south therefore increase the price of gas in the southern states.<sup>23</sup>

Monopoly pricing by pipelines can also reduce the volume of gas delivered. This leads to an inefficiently low level of gas use because monopoly pricing has the effect of restricting use only to those users with a willingness to pay at least that (monopoly) price. Further this leads to an inefficient allocation of the economy's resources across sectors and firms as the level of economic activity making use of gas will be below its efficient level. Alternatively, where demand for gas is highly inelastic such as when it is used as a feedstock or energy source and substitutes are not easily available, high pipeline charges may not have an impact on demand for gas. In these situations, high pipeline charges bring about a wealth transfer between pipeline users and pipeline operators.<sup>24</sup>

As noted above monopoly pricing of pipeline services affects downstream market efficiency by leading to an inefficiently low level of gas usage. It also affects downstream market efficiency by reducing downstream investment via hold up, that is the risk that, once sunk investments are made, the pipeline will raise its charges, expropriating the value of these investments. Pipeline prices also affect whether or not gas gets to its highest value use. Where pipeline prices exceed long run average costs they can lead to an inefficient allocation of resource between the domestic use of gas and the export of LNG.<sup>25</sup>

Monopoly pricing of gas pipelines also affects upstream efficiency. As noted above, higher pipeline prices are likely to reduce the price of gas received by producers as they lower their prices to remain competitive. This could lead to lower investment in production and exploration as it makes marginal gas supplies uncommercial. Also high pipeline prices may reduce upstream investment via holdup.<sup>26</sup>

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<sup>20</sup> ACCC, *Inquiry into the East Coast Gas Market*, April 2016, pp. 104-105.

<sup>21</sup> ACCC, *Inquiry into the East Coast Gas Market*, April 2016, pp. 106-108.

<sup>22</sup> ACCC, *Inquiry into the East Coast Gas Market*, April 2016, pp. 112-113.

<sup>23</sup> ACCC, *Inquiry into the East Coast Gas Market*, April 2016, pp. 113-115.

<sup>24</sup> ACCC, *Inquiry into the East Coast Gas Market*, April 2016, pp. 115-117.

<sup>25</sup> ACCC, *Inquiry into the East Coast Gas Market*, April 2016, pp. 117-119.

<sup>26</sup> ACCC, *Inquiry into the East Coast Gas Market*, April 2016, pp. 119-120.

Monopoly pricing by pipeline operators has a clear impact on economic efficiency across the gas supply chain and the long-term interests of consumers, which is what the NGO seeks to promote.

As the previous discussion highlights, monopoly pricing can result in both inefficient investment in upstream and downstream activities and inefficient use of gas pipelines services, both of which are contrary to the economic efficiency requirements of the NGO and the long-term interests of consumers. No changes are therefore necessary to the NGO to incorporate monopoly pricing because it is implicitly reflected in the economic efficiency and long-term interests of consumer elements of the objective. However, the focus of pipeline regulation should be adjusted to address the issues raised by monopoly pricing.

## 4. Gaps in the current regulatory framework

The ACCC's First Inquiry identified three gaps in the current regulatory framework that allow full regulation pipelines to exercise monopoly power: definition of reference services, coverage of expansions, and information disclosure and arbitration (which will be discussed in section 4).<sup>27</sup> The AEMC's review provides an opportunity for the AEMC to address these issues and help promote more economically efficient outcomes.

### *Reference services*

Currently the NGR only requires the AER to approve on an ex ante basis the price of access to the 'reference service(s)' offered by the pipeline. A reference service is defined as a service sought by a significant portion of the market. In contrast, the electricity regulatory regime identifies regulated services by reference to the service's contestability. The current rules mean that a number of non-contestable services are excluded from the AER's ex ante review. However because there is no competitive constraint on the provision of non-contestable services, these services would usually be the primary target of regulation.

In the market for pipeline services, the services sought by users are often highly customised so that it is not likely to be possible to regulate every service that a user might want. For this reason, the reference service concept is still useful. Reference services and their associated reference tariffs are used by users to negotiate with pipeline operators for the customised services that users seek. Given the non-contestability of the pipeline and the services on it, it is critical that the services that form the basis of negotiations are included as reference services (and appropriately defined) to ensure the success of the negotiate-arbitrate model.

The ACCC suggests that reference services should be developed for each type of service offered by the pipeline (e.g. firm forward haul, backhaul, as available, park and loan). Market participants could then negotiate specialised services on the basis of these reference services. This is consistent with the standing offer approach adopted by the GMRG in drafting Part 23 of NGR, for unregulated pipelines. By expanding the number and type of reference services, users would be better able to negotiate with pipeline operators for the services they seek.

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<sup>27</sup> ACCC, *Inquiry into the East Coast Gas Market*, April 2016, pp. 134-135.

## Coverage of expansions

Under the NGR there is discretion to exclude expansions of a full regulation pipeline from the definition of the covered pipeline. This can result in tranches of capacity on some full regulation pipelines not being subject to regulation even though there is no effective competition for the provision of the expanded capacity that would constrain the behaviour of the pipeline operator. Where the AER allows expansions to be excluded from the covered pipeline, the only remedy that users have is to apply to the National Competition Council for the expansion to be covered. The First Inquiry concluded that given these difficulties, pipeline operators may be able to engage in monopoly pricing on the expanded capacity in a relatively unconstrained manner.<sup>28</sup>

The ACCC suggests that this discretion in NGR r. 104 should be removed and that all expansions of capacity of covered pipelines should be subject to regulation. Where a pipeline has previously been subject to a coverage decision, we can see no logical reason that an expansion to that regulated pipeline should not also be subject to regulation given there is no effective competition for the provision of expanded capacity.

## 5. Consistency across pipelines subject to different forms of regulation

The First Inquiry found that while the threat of arbitration should constrain pipeline operators from charging monopoly prices, this has not occurred. Market participants suggested that the costs and resources associated with access disputes and the uncertainty of the outcome of arbitration can discourage users from triggering these provisions. The information asymmetries mean that users are unable to determine what is an 'appropriate' price may also be contributing.<sup>29</sup>

As noted in the First Inquiry, there is little publicly available information on the costs incurred by pipeline operators in providing services and the relationship between these costs and prices for services. In other jurisdictions, such as the United States, detailed financial reporting is seen as critical to allowing users to determine if prices are reasonable and to enable them to negotiate with pipeline operators.<sup>30</sup> In the Second Reading Speech for the National Gas Law in 2008, the Hon. Patrick Conlon noted the importance of cost information, saying:

...customers can only negotiate with service providers when they have adequate information to determine whether or not payments required of them accurately reflect the efficient cost of providing the service. In a competitive market, the efficient cost is revealed as competing providers seek to outbid each other down to the point where they are covering their costs plus a normal profit. Where a business is a natural monopoly this does not occur and it can be difficult for consumers and regulators to access information from natural monopoly service providers.<sup>31</sup>

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<sup>28</sup> ACCC, *Inquiry into the East Coast Gas Market*, April 2016, p. 135.

<sup>29</sup> ACCC, *Inquiry into the East Coast Gas Market*, April 2016, p. 135.

<sup>30</sup> ACCC, *Inquiry into the East Coast Gas Market*, April 2016, p. 136.

<sup>31</sup> South Australian Hansard 2008. National Gas (South Australia) Bill 2008, Legislative Assembly, 9 April 2008. p. 2890.

The current NGR do not adequately address this information gap between pipeline operators and users. The First Inquiry noted that the AER has the power under the NGL to gather financial and operational information from pipelines that are subject to full and light regulation, but the AER has not imposed such obligations. In contrast, the AER has imposed annual reporting obligations on electricity networks. The ACCC suggested that similar obligations should be imposed on all open access transmission pipelines requiring the pipelines to report information on an individual pipeline basis. This information would allow shippers to determine whether or not offered prices are cost reflective. Further, the First Inquiry suggested that the AEMC should consider if there are any changes needed to the dispute resolution mechanism to make it more accessible to users, and therefore a constraint on the behaviour of pipeline operators.<sup>32</sup>

As noted above, the GMRG, after consultation with industry, has drafted Part 23 of the NGR which requires unregulated pipelines to publish certain information about pipeline services costs, pricing and contract terms. This information is intended to facilitate negotiations between users and pipeline operators. Where those negotiations fail, Part 23 also provides for binding commercial arbitration of access disputes. Part 23 commenced operation on 2 August 2017.

In arbitrations under Part 23, the arbitrator must have regard to the pricing principles, which state that the value of the pipeline is to be determined, consistent with the outcome of a workably competitive market, and as the cost of construction of the pipeline, plus any additional capital expenditure, less the return of capital (depreciation) and asset disposals (depreciated construction costs).<sup>33</sup> This asset valuation is different to the method of asset valuation in NGR rule 77 for regulated pipelines. Rule 77 specifies that pipelines commissioned prior to the commencement of the Gas Code (1998) should be valued by balancing 11 factors in the Gas Code. This leads to uncertainty regarding how a pipeline will be valued. For all pipelines commissioned after the commencement of the Gas Code, rule 77 specifies that depreciated construction costs should be used to value assets. Part 23 adopts this methodology for all pipelines, providing users with certainty over asset valuation methodology.

Now, pipeline operators that currently own and operate pipelines are potentially subject to one of three different regulatory regimes: unregulated pipelines (Part 23 information disclosure and arbitration), light coverage pipelines (light regulation under Parts 8-12), and full coverage pipelines (full regulation under Parts 8-12). To transport gas in the east coast market, users may need to access pipelines that are subject each of the three regulatory regimes, even if negotiating with only one pipeline owner.

Consistency of information disclosure across all pipelines would allow users to better be able to negotiate for access with pipeline operators. With the new Part 23 of the NGR, unregulated pipelines are subject to more stringent reporting obligations than pipelines subject to light regulation. It would be logical to impose reporting requirements and an arbitration mechanism on regulated pipelines that is at least as rigorous as those on unregulated pipelines.

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<sup>32</sup> ACCC, *Inquiry into the East Coast Gas Market*, April 2016, p. 141.

<sup>33</sup> Rule 569, Part 23, NGR.

The ACCC suggests that information disclosure requirements for regulated pipelines should be aligned with those in Part 23 for unregulated pipelines. By having the same information available, users would be able to better identify what is an 'appropriate price' across each of the different pipelines that they need to access. It would improve the useability and consistency of the regime, promoting economically efficient outcomes for the use of all pipelines. It would also prevent perverse and inconsistent regulatory outcomes.

The GMRG has conducted extensive consultation with industry on its information disclosure and arbitration framework. In developing the binding financial reporting guideline under Part 23, the GMRG and AER will continue to consult with industry. The AEMC could conduct further consultation to determine if there are any aspects of the Part 23 information disclosure that are not applicable to regulated pipelines.

The arbitration process for regulated pipelines in the NGR has never been activated by users. In the First Inquiry, the ACCC found that users did not have confidence in the current arbitration mechanism.<sup>34</sup> Along with aligning the information disclosure framework, the ACCC sees value in having a consistent arbitration framework across all pipelines. As the framework in Part 23 has been extensively consulted on, the ACCC suggests adopting this framework, or one which is substantively the same, for regulated pipelines. In particular, the ACCC suggests adopting the asset valuation methodology specified of depreciated construction costs. Adopting the Part 23 framework would make arbitration outcomes more certain and make arbitration more accessible to users.

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<sup>34</sup> ACCC, *Inquiry into the East Coast Gas Market*, April 2016, p. 135.