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21 February 2022

Mr Sean Sullivan
Chair
Energy Senior Officials
By email EnergyMinisters@industry.gov.au
Cc: michael.bradley@aemc.gov.au; robert.pullella@erawa.com.au

Dear Mr Sullivan

Re: Advice on Gas Ring-Fencing for Hydrogen and Renewable Gas Blending

Thank you for the opportunity to provide advice on the ring-fencing arrangements under the National Gas Law and Rules related to the proposed extension of the regulatory framework to hydrogen blends and renewable gas blends.

The AER has reviewed the adequacy and effectiveness of the existing ring-fencing arrangements having regard to the broader objectives of the reforms to accommodate renewable gas into existing gas networks, including to:

- expedite amendments to ensure that regulatory barriers do not restrict proposed investments in projects involving the supply of natural gas equivalents and related activities; and
- ensure that existing regulatory arrangements and protections, such as ring-fencing, continue to operate as intended where natural gas equivalents are supplied.

In particular, we understand there is a clear policy intent that pipeline service providers are to be ring-fenced from their associates involved in producing natural gas equivalents and blending activities.

Over the past few months we have focused on understanding the potential market for hydrogen blends and ensuring the ring-fencing framework is adaptable yet robust enough to respond to these emerging markets.

At present, there is little competition in relation to producing and/or injecting renewable gases or hydrogen blends into gas networks. It is possible that competition for blending in gas networks may start to emerge as the number of hydrogen and renewable gas production projects increases. Whilst this new market does not fundamentally change how ring-fencing should operate and the harms that it guards against, the uncertainties that surround whether (and how) competitive markets will develop justifies an agile and fit-for-purpose framework for the assessment of ring-fencing issues.

In particular, we found limitations in the current framework, which include inflexibility in the exemption assessment criteria and a lack of oversight and rigour in our ability to critically review associate contract arrangements. For example, current hydrogen and renewable gas trials being undertaken by gas distribution network businesses would be unlikely to be eligible to apply for an exemption under the current framework. We also identified other processes which impede the AER's ability to respond to emerging issues efficiently.

Given the uncertainty that exists around the nature and pace of the market development, we believe allowing for greater flexibility in relation to exemptions will increase the ability of the AER to respond to market developments in a targeted and proportionate way. To supplement this approach to the exemptions framework the AER would also be able to provide additional non-binding guidance on how the exemption criteria will be applied.

We are therefore recommending changes to improve the operation of the framework and future proof the laws and rules with respect to gas ring-fencing. Our approach was to provide the gas framework with enhanced flexibility and adaptable tools to promote the National Gas Objective in the face of uncertainty in the market's development. As a result, we suggest implementing these changes now rather than waiting for market development to occur and require a separate and lagging law and rules change process in the future.

Accordingly, our recommendations to the ring-fencing framework aim to:

- as noted above, provide the AER with flexibility and clarity regarding its powers to issue exemptions (including class exemptions) from minimum ring-fencing requirements to accommodate different market development scenarios in appropriate circumstances (**recommendations 1 and 2**);
- provide the AER with powers to impose additional ring-fencing requirements addressing market-wide competition harms that may not be evident at the current stage of the market development (**recommendation 3**); and
- improve the efficiency and reduce the administrative burden in the AER's decision-making process where possible and appropriate (**recommendations 4 and 5**).

In addition, and where appropriate, we have included recommendations which will align the gas ring-fencing framework with the approach taken by the AER in the Electricity Distribution Ring-fencing Guideline. Since its inception in 2016, the AER has conducted a number of reviews of the Guideline to ensure that the ring-fencing framework remains a targeted, proportionate and effective regulatory response to the potential harm consumers may face as the energy market transitions. We have leaned on this experience in considering the necessary reforms to the gas ring-fencing framework.

Our recommendations and reasons are set out in **Attachment 1**.

Next steps

I understand that the AER's advice will be considered as part of the draft legislation and rules that will extend the gas regulatory frameworks to natural gas equivalents and will be the subject of public consultation in March 2022. I would like to take the opportunity to thank the Officials, AEMC and ERA staff who have collaboratively engaged with us during the development of this advice. In particular, the regular engagement ensured that our work was aligned with other parts of the reform process and allowed us the opportunity to feed in our recommendations as early as possible.

From a regulatory transparency perspective, the AER considers that its advice should be published on the AER website. We would be grateful for officials' advice on this including the timing of publication.

We look forward to any further engagement in this reform process. If you have any questions please contact Mark Feather, General Manager, Strategic Policy and Energy Systems Innovation, on 03 9290 6958 or email [AERring-fencing@aer.gov.au](mailto:AERring-fencing@ aer.gov.au).

Yours sincerely

A handwritten signature in black ink, appearing to be 'CS', with a long horizontal flourish extending to the right.

Clare Savage
Chair
Australian Energy Regulator
Sent by email on: 21.02.2022

Attachment 1: Recommended changes to gas ring-fencing framework

We have set out below the AER's recommended changes to the gas ring-fencing framework set out in the National Gas Law (**NGL**) and National Gas Rules (**NGR**).

1. Exemption criteria relevant to minimum ring-fencing requirements

Current arrangements

Section 146 of the NGL allows a service provider to apply for an exemption from one or more of the minimum ring-fencing requirements, with rule 31 of the NGR setting out the matters the AER must be satisfied of before granting an exemption.

In particular, if the exemption is sought in respect of:

- the prohibition on carrying on a related business, rule 31(3) provides that an exemption is to be granted if the AER is satisfied that:
 - either: (i) the pipeline is not a significant part of the pipeline system for any participating jurisdiction; or (ii) the service provider does not have a significant interest in the pipeline and does not actively participate in the management or operation of the pipeline; and
 - the cost of compliance for the service provider and its associates would outweigh the public benefit resulting from compliance; and
 - the service provider has, by arrangement with the AER, established internal controls that substantially replicate the effect that would be achieved if the related business were divested and dealings between the service provider and the entity were subject to the controls applicable to associate contracts.
- Marketing staff segregation and accounting separation requirements, rule 31(4) provides that an exemption is to be granted if the AER is satisfied that the cost of compliance for the service provider and its associates would outweigh the public benefit resulting from compliance.

The AER has limited discretion when determining whether to grant an exemption from the minimum ring-fencing requirements (in particular, the prohibition on carrying on a related business), preventing the AER from considering all relevant factors in granting an exemption.

The criterion about whether the pipeline is not a significant part of the pipeline system for any participating jurisdiction may significantly limit the group of service provider participants who are capable of ever being granted an exemption.

For example, it may prevent distribution pipeline service providers from being granted an exemption to carry on a related business, which may be appropriate in limited circumstances. It may be appropriate to grant an exemption to enable a distribution business to carry on a related business associated with a transition-compliance plan, a short-term or small-scale trial, where a service provider may be concerned about operational or safety issues when engaging in that activity or where competition does

not emerge in relevant markets related to producing and/or injecting renewable gases or hydrogen blends into gas networks.

In addition, the AER can only grant exemptions with respect to a specified service provider and cannot grant class exemptions.

Proposed changes

The AEMC acknowledged the need for the criteria in rule 31(3) to be more flexible, noting that:¹

the criteria [in rule 31(3)] could be amended to allow pipeline service providers to produce, purchase or sell natural gas equivalents or constituent gases if a trial is being undertaken, potentially under certain limits on the volume they can produce, purchase or sell.²

We agree with the AEMC that it would be appropriate for the exemption criteria in rule 31(3) to be amended to afford the AER more discretion in deciding whether to grant an exemption (including on a conditional basis, as discussed further below).

We consider this could be facilitated by amending the existing requirement that the AER is satisfied of certain matters, to instead require the AER to “have regard” to more high-level criteria. In this way, the AER would be required to give fundamental weight to each of the criteria, but no one matter would be determinative. This is the same approach to granting waivers from ring-fencing obligations under the AER’s Electricity Distribution Ringfencing Guideline.

Specifically, electricity ring-fencing sets out high-level criteria that enables the AER to grant exemptions/waivers having regard to relevant circumstances. Under the Electricity Distribution Ring-fencing Guideline, the AER assesses waivers having regard to:

- whether the waiver would better achieve the NEO;
- the potential for cross-subsidisation and discrimination if the waiver is granted;
- the benefits of the relevant obligation for the long-term interests of consumers;
- the costs to the DNSP of its compliance with the obligation;
- the effect of granting a waiver on the development of competition in markets for contestable electricity services; and
- such other matters as the AER considers are relevant.

A flexible framework for granting waivers has enabled the AER to respond to emerging energy transition issues in a targeted and proportionate way. For example, recognising that network companies may have an important role in the development of the community battery market, the AER introduced a new, streamlined waiver process for eligible projects that address the risk of cross-subsidisation and potential discriminatory behaviours. In this way, the AER exercised its discretion to create a

¹ AEMC, Review into extending the regulatory frameworks to hydrogen and renewable gases consultation paper - 21 October 2021, 3.2.2.

² AEMC, Review into extending the regulatory frameworks to hydrogen and renewable gases consultation paper - 21 October 2021, p 14

mechanism for low-risk projects to proceed without adversely impacting competition in this emerging technology.

A similar scenario has already occurred in the gas market. In particular, major pipeline operators currently conducting hydrogen and renewable gas trials may not be eligible to apply for an exemption under the current criteria. This could hinder innovative work by service providers who may be well placed to perform trials on the safety and reliability aspects of transporting renewable gas (compared to a third party or associate). This may not be in the long-term interests of consumers.

Having regard to the electricity ring-fencing guideline framework, we consider that similar high-level criteria can be applied to appropriately guide the AER's function in granting exemptions from the minimum gas ring-fencing requirements. Such criteria would also permit the AER to relevantly have regard to whether the service provider's associate is capable of providing the related business.

If this approach was adopted, the same decision-making criteria could apply to exemptions from any of the minimum ring-fencing requirements (rather than having separate criteria for the prohibition on carrying on a related business).

We further recommend an additional power for the AER to grant class exemptions to respond to the dynamic nature of the emerging renewable gas market. This once again aligns the gas and electricity ring-fencing frameworks and provides flexibility in the face of uncertainty.

Additional guidance can be provided by the AER through non-binding guidelines on the application of the criteria for the minimum ring-fencing arrangements and the use of class exemptions.

Recommendation: Amend rule 31 of the NGR to afford the AER with greater discretion to grant exemptions from the minimum ring-fencing requirements having regard to high-level criteria and flexibility to grant class exemptions

2. Exemption conditions

Current arrangements

The NGL and NGR do not explicitly provide that the AER may impose conditions when granting an exemption from the minimum ring-fencing requirements (as they do with associate contract approvals).³

Proposed changes

We consider that the AER's powers need clarification for the AER to use the exemption mechanisms effectively. For example, it may be appropriate to grant exemptions on a conditional basis such as, but not limited to, the following:

- Scope limit – an exemption condition could prohibit any changes in the scope, type or nature of the activity under the exemption;
- Volume limit – an exemption condition could specify a limit on the volume pipeline service providers should be able to produce, purchase or sell;

³ Rule 32(4) of the NGR provides that the AER's approval of an associate contract may be subject to conditions the AER considers appropriate.

- Time limit – an exemption condition could limit the duration of the exemption, such that compliance will be expected from a specified date (in particular, for when businesses are transitioning to compliance);
- Requirements to divest – an exemption condition could include a requirement to divest the related business once the market has become large enough to attract commercial entry; or
- Findings to be made to public – under this condition, key findings and observations resulting from the permitted activity or trial would be made to the public.

Recommendation: Amend the NGR to allow the AER to impose conditions to exemptions granted, as the AER considers relevant.

3. Additional ring-fencing obligations on classes of service providers and associates

Current arrangements

Under sections 143 to 145 of the NGL, the AER may impose additional ring-fencing requirements. The provisions contemplate that additional ring-fencing requirements will be made for named service providers and named associates. For example, s 143 reads:

*Subject to the other provisions in the relevant Division of the NGL and subject to and in accordance with the Rules, the AER may make a determination requiring a service provider or associate of a service provider **named in the determination** to do, or refrain from doing, a thing specified in the determination (an additional ring-fencing requirement). (Emphasis added)*

We consider that the requirement that the determination refer to a “named” service provider or associate may limit our ability to issue generally applicable (i.e., class) determinations, in addition to determinations applying to specific named entities.

Proposed changes

In theory, when issuing a determination under the existing arrangements, the AER could name all pipeline service providers and/or associates so that it applies on a class-basis. However, in our view, this may not be appropriate as we could inadvertently miss a service provider or an associate in a determination. In addition, relevant associates may change over time requiring a variation to such a determination.

The AER considers that the provisions of the NGL and/or NGR should be amended, or a new provision added, to allow the AER to determine additional ring-fencing requirements with respect to service providers and associates identified as a class (e.g., all service providers for distribution pipelines and all of their associates engaged in the sale of gas). This will enable the AER to address market-wide concerns efficiently.

Recommendation: Amend the NGL and/or NGR to allow the AER to impose additional ring-fencing obligations on classes of service providers and associates.

4. Flexibility in the consultation process to be followed for the varying or revoking of additional ring-fencing obligations or exemptions

Current arrangements

Currently the rules require that in the making of a ring-fencing determination or granting of an individual exemption, the expedited consultative process needs to be followed.

Clause 20 in Schedule 2 of the NGL provides that the power to make a decision includes the power to repeal or vary. The clause also states that any variation needs to be done in the same way as the power to make the decision. As a result, the expedited consultative process will again need to be followed if a determination or exemption is varied or removed.

Rule 9 of the NGL states that the expedited consultative process requires the AER to; publish a draft decision, invite written submissions within 15 business days, and then make a final decision within 20 business days of considering the decision.

Proposed changes

The expedited consultation process would need to be followed if the AER wants to vary or remove a ring-fencing determination or exemption.

This may not be appropriate for minor or uncontroversial changes or repeals.

The AER considers that these provisions should be amended to allow the AER more discretion to determine whether the expedited consultation process is required. This will enable more flexibility to have discretion in the consultation process the AER adopts. For example, the AER may choose to do minimum consultation with only the impacted service provider and/or associates, and other relevant persons as it considers appropriate. However, the AER retains the option to consult more broadly if appropriate.

In addition, the option to conduct more efficient and targeted stakeholder consultation reduces costs and facilitates timely decisions.

***Recommendation:* Amend the NGR to allow the AER more discretion to determine the appropriate level of consultation required depending on the circumstances.**

5. Approval of associate contracts

Current arrangements

Rule 32 of the NGR requires the AER, on application of a service provider, to approve an associate contract or variation if it is satisfied that the contract or variation:

- does not have the purpose, and is unlikely to have the effect, of substantially lessening competition in a market for natural gas services; and
- is not inconsistent with the competitive parity rule (defined in s 148(2) of the NGL as a pipeline service provider must ensure that any pipeline services provided to an associate of the pipeline service provider are provided to that associate as if that associate were a separate unrelated entity).

If the AER is not satisfied these criteria are met, it may still approve the contract if it is satisfied the public benefit would outweigh any public detriment.

The AER is required to make a decision with respect to the approval of the associate contract within 20 business days after receiving the application.

Proposed changes

Given the potential for increased complexity in assessing associate contracts with the introduction of natural gas equivalents, and information asymmetries which exist between the AER and market participants in these developing markets, the AER considers that the associate contract approval regime could be improved by:

- Providing the AER with a power to require that service providers with associate contracts of a certain class or kind, seek the AER's approval before entering into the associate contract. Specifically, this recommendation seeks to provide the AER with the power to determine a class of associate contracts required for pre-approval in limited circumstances. For example, where certain associate contracts pose a high risk of discrimination or cross subsidisation. This power would not require that all associate contracts be approved by the AER.

As the renewable gas market is constantly changing it will be increasingly important for the development of the competitive market that the AER review certain associate contracts and provide more transparency into the relationship between a service provider and associate. For example, the AER may consider it appropriate to review contracts between a service provider and its associate with respect to the provision of blending services.

- Requiring the service provider, as part of its application, to substantiate why the criteria in Rule 32 relevant to approving the contract (or variation) is satisfied. Currently there is no requirement on service providers to provide the information relevant to the AER's assessment of the associate contracts. We note that the AER would only approve the associate contract if the AER was satisfied with the information provided by the service provider.
- Enable the AER to request further information from the service provider if their application is incomplete or requires clarification.
- Amend the AER's decision-making process for the approval of the associate contract – to instead require that the AER must approve the associate contract, ***if the service provider has demonstrated to the reasonable satisfaction of the AER***, the criteria set out in Rule 32. This makes clear to service providers that they need to provide sufficient information to persuade the AER of the validity of their associate contracts.
- Extend the timeframe within which the AER must make its decision and/or introduce a “stop-the-clock” provision if the AER requests further information or clarification from the Service Provider in support of its application.
- Provide more guidance on the application of the competitive parity rule. The current arrangements only require an arm's length relationship between the service provider and associate. A helpful guide is set out in the discrimination provisions (clause 4.1) in the Electricity Distribution Ring-fencing Guideline, which state that a distribution business in dealing with an associate must:

- treat the associate as if it were not an associate and had no connection or affiliation with the distribution business;
- deal or offer to deal with an associate and a competitor (or potential competitor) on substantially the same terms and conditions;
- provide substantially the same quality, reliability and timeliness of service to an associate and a competitor (or potential competitor);
- not disclose to an associate information the distribution business has obtained through its dealings with a competitor (or potential competitor) where disclosure would provide an advantage to the associate.

More detailed criteria around the competitive parity rule would assist in clarifying expectations for service providers' dealings with associates.

Recommendation: Amend the NGR to:

- **require the service provider to seek the AER's approval before entering into certain classes or kinds of associate contracts;**
- **specify that service providers need to demonstrate, to the AER's reasonable satisfaction, the validity of the associate contract sought to be approved;**
- **extend the AER's timeframe to make a decision on the approval of an associate contract; and**
- **provide additional criteria on how the competitive parity rule is applied.**