

Submission to the Ministerial Council on Energy

Re: Review of the National Gas Access Regime



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1 Overview

AlintaGas Networks and Multinet (the companies) support the submission of the Energy Networks Association (ENA) but presents some additional matters in this submission to support the ENA submission.

The companies consider that a best practice national regulatory model for pricing and access can be developed at a minimum cost to society by adopting the Productivity Commission's (PC) package of reforms for the National Gas Code (NGC) and then using this as a base for electricity pricing in the context of a uniform approach to national regulation.

The companies are most concerned with the failure of the Standing Committee of Officials (SCO) paper to deal adequately with the responses to the Productivity Commission's proposed changes to the Gas Access Regime.¹ This is despite the PC concluding that the NGC with the recommended reforms was a best practice regulatory code:

“Adoption of the Commission’s recommendations would deliver more efficient outcomes, particularly in relation to investment in the gas sector and the development of a competitive energy market. The recommendations would reduce regulatory risk, potential for regulatory error and the time and cost of regulatory procedures and improved regulatory accountability. The recommendations are designed to achieve the benefits of the existing regime while reducing many of its costs.”²

The companies are most concerned that the SCO paper proposes a ‘clean slate’ review which would fail to adopt the only successfully operating national code (the National Gas Code) on the basis of “national uniformity” with electricity regulation when an alternative approach is available that utilises an evolutionary approach to national regulation with minimum costs to society.

The SCO paper assumes that a ‘clean slate review’ is necessary to achieve a best practice regulatory model however The companies consider this claim to be incorrect. The SCO paper on the response to the PC proposed that only pricing and regulatory processes required more consultation to develop a national framework. There are many other areas of both gas and electricity markets where common positions may be difficult (including metering, wholesale markets, greenfield policies, connections etc). This may mean that national consistency would be better served by having separate codes for gas and electricity with as many common areas as possible rather than a single national energy code.

The companies consider that clean slate review in the areas identified by the SCO paper is unnecessary because the pricing and regulatory processes for gas and electricity are identical (as they are both based on the Building Block’s regulatory model and the Capital Asset Pricing Model) and:

¹ Instead of adopting a best practice regulatory model the SCO paper only adopts around 17% of the PC's report on the basis that the remainder should be further consulted on in the interests of national uniformity.

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

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- If the gas regulatory model (as amended by the PC) is considered best practice and could be used for electricity pricing and regulatory processes then this must be best practice for electricity regulation;
 - the SCO proposal of a “clean slate” review requires further extensive consultation after the extensive review already undertaken by the PC and is unnecessary and constitutes a substantial cost to industry and stakeholders;
 - the SCO proposal for further review may mean that the regulatory framework for both gas and electricity suffers further delays in the development of a national framework and would further delay the movement of distribution businesses into the national framework;
 - the NGC is the only successfully operating national regulatory model, which has been extensively reviewed by the PC and the SCO paper proposes to largely ignore this best practice code; and,
 - in comparison, the National Electricity Code (NEC) (superseded by the National Electricity Rules (NER)) was developed in the early 1990’s and has never been extensively reviewed and state governments have substantively derogated its use.

The companies favour an approach that integrates the outcomes of the PC’s Review as a first step towards a consistent set of national energy access provisions including:

1. A full response and implementation of the PC recommendations into the National Gas Code to create a best practice approach to regulation which could be used as a template for national reform;
2. A decision of the Ministerial Council on Energy (MCE) to review the common areas between the two energy codes that could be quickly resolved to develop a best practice approach to a nationally consistent framework. This paper seeks to identify some possible candidates.
3. Consideration by the MCE of the review of the form of electricity access rules in light of the common areas identified above

The companies consider that this approach would be best practice regulation as it would:

- adopt a regulatory model that has been the subject of comprehensive review;
- take an evolutionary approach to national uniformity in energy;
- be relatively quickly delivered as an example of national uniformity;
- achieve the benefits of the existing gas regime whilst reducing its costs; and
- provide a minimum cost of developing a national approach to energy regulation.

2 The SCO paper - Introduction

The companies consider that key elements of the SCO paper are based on incorrect assumptions which calls into question the value of the paper as an consultation document that contributes to the development of a national energy framework. Energy network businesses have been waiting some 4 years for the PC' report to be finalised and to this date this has not occurred despite the conclusion that the reforms proposed by the PC would lead to a best practice regulatory code.

The SCO paper is short of evidence for its approach and the areas of incorrect assumptions include:

- that key provisions of the gas access regime need further review after the extensive reviews that have already been undertaken;
- that developing a national approach to regulation requires a “clean slate’ review given the areas consulted upon are common across electricity and gas;
- the current propose/response model in the current NGC may create uncertainty and involve additional time than the model used in electricity; and
- the alternative monitoring scheme is a more efficient and effective approach than the PC recommendations.

This section of the paper comments on the areas set out by the SCO paper.

2.1 The Overarching Objective

The companies are concerned with the attempt to meld an overarching objective in the NGC with a similar objective from the National Electricity Law (NEL). The NGC is concerned with efficient access and upstream and downstream competition in light of this access.

It could be persuasively argued that the “efficiency” objective would take into account the long term interests of consumers and under these circumstances the addition to the PC objective is probably redundant. The objective should reflect the PC recommended version as it would therefore reflect best practice regulation and it would minimise legal disputes if the courts considered them to be separate objectives.

Recommendation 1

The companies consider that the SCO should revert to the PC recommended efficiency objective for the National Gas Code and for the new nationally consistent framework for electricity.

2.2 Deletion of Objectives

The SCO proposed that three additional objectives be used in the national regulatory framework. However these objectives were strongly criticised in the PC Review on the basis of inconsistency with the overarching objective.

Recommendation 2

That these objectives be deleted from the National Gas Code and not be used in the new national uniform regulatory framework for electricity.

3 The Common set of Provisions for Electricity and Gas

In the SCO paper the issue of national uniformity is raised and the SCO paper argues that:

“An important factor in responding to the Productivity Commission’s Review of the Gas Access Regime is to ensure that the response in the specific context of the Gas Access Regime is integrated with the broader reforms being undertaken in the energy sector. The implementation details of these reforms, and in some cases, the direction of the reforms themselves, were proceeding concurrently and subsequent to the Commission’s review. While the MCE should preserve the broad themes emerging from the Commission’s report, integration would require a number of the Commission’s original recommendations to be extended or modified, and for consideration of some recommendations to be deferred to future, energy-wide review processes.”

The companies question why any additional consultation is required on the PC Gas Inquiry recommendations when the PC recommendations for pricing and process could be equally applied to electricity transmission and distribution regulation.

The SCO paper advises that there are matters of detail that would be subject to a “clean slate” national development. However, this misses the point that pricing and access issues are common across the energy codes. Indeed the immediately common elements between gas and electricity regulation include:

- an objects clause;
- High level revenue and tariff setting principles
- Regulatory procedures and processes; and
- Appeal and review mechanisms

The SCO paper proposes to develop a national approach to energy regulation by consulting on areas of the NGC which have been subject to detailed review by the PC. Given the problems with the NEC (and its replacement – the NEL and the NER) the use of this as a best practice code for national reform is misplaced.

The NEL and the NER are hardly a best practice approach to regulation as it has not been comprehensively reviewed since the NEC’s establishment in 1998 and is subject to many of the criticisms that the PC made of the NGC namely³:

- A mix of objectives
- Objectives that are not consistent with Part III A of the Trade Practices Act
- Too much regulatory discretion
- No clear pricing principles
- Lack of best practice pricing principles.

³ The AEMC has been charged with reviewing the electricity transmission pricing options in the National Electricity Rules. This review has led to some confusion in terms of developing a national approach to regulation in light of the SCO paper and the PC Review.

Many governments have derogated activities away from the NEC given its lack of best practice principles. For example, Victoria has derogated away pricing powers from the Electricity Code and has also allowed for merit review.

The SCO could substantially simplify its work program if it used the NGC as amended by the PC recommendations as the basis of a new energy code for pricing and access for both electricity and gas.

Recommendation 3

That the MCE simplify its work program by implementing the PC recommendations in the National Gas Code and use this best practice code as the basis of a new nationally uniform framework for electricity.

4 Regulatory Processes and Discretion

4.1 The Propose/Respond Model

The SCO Proposal

The SCO consultation paper makes a number of comments about the process arrangements that the regulator must follow in assessing regulatory issues. The processes adopted by the gas and electricity codes are quite different. In light of this the SCO Consultation paper advances the proposition that the objectives of the energy market reforms imply that a common position on these matters ultimately should be adopted across electricity and gas industries unless there are good reasons not to do so.

The differences in the regulatory processes between the current energy codes are significant. For example under the NGC the process is based on what has been termed a “propose/respond” model, which is described in the Gas Code as:

- “The Service Provider submits a proposed Access Arrangement, together with the Access Arrangement Information, to the Relevant Regulator.
- The Relevant Regulator may require the Service Provider to amend and resubmit the Access Arrangement Information.
- The Relevant Regulator publishes a public notice and seeks submissions on the application.
- The Relevant Regulator considers the submissions, issues a draft decision and then, after considering any submissions received on the draft, makes a final decision which either:
 - approves the proposed Access Arrangement; or
 - does not approve the proposed Access Arrangement and states the revisions to the Access Arrangement which would be required before the Relevant Regulator would approve it; or
 - approves a revised Access Arrangement submitted by the Service Provider which incorporates amendments specified by the Relevant Regulator in its draft decision.”⁴

In electricity regulation the NER does not adopt the “propose/ respond model” and instead leave the process up to the regulator. The SCO Consultation Paper proposes that the process for national regulation might adopt the following:

“Regarding the process the regulator should follow when assessing regulatory applications, the rules should include at least:

- a right for the regulated entity to submit a comprehensive price-service proposal to be considered by the AER;
- a requirement to issue a draft decision;

⁴ The National Gas Code, Section 2 Access Arrangements, p. 8

- minimum time-lines for parties to make submissions; and
- a reduction in the complexity of the process requirements currently set out in the Gas Code.”⁵

Comments on the SCO Proposal

It is difficult to determine from these brief comments whether it is the intention of the SCO proposal to implement the same as the propose/respond model that currently exists in the NGC. The right of a regulated entity to submit a price service proposal is a central aspect of a propose/respond model such as in the NGC.

The Propose/Respond model is considered best practice by the PC and it should therefore form the basis of the national regulatory model for gas and electricity. It is considered best practice because:

- The PC in its review of the National Gas Access Regime reviewed the propose/respond model and enhanced its operation concluding that the benefits of the Regime had been retained while its costs had been reduced.
- It reflects common regulatory practice in electricity where both draft and final reports are used which is a key part of a propose/respond model even though this is not formally required in electricity regulation under the NER;
- It has been adopted as the basis of the new access arrangements for the electricity industry in Western Australia;
- It best protects the private property rights of asset owners by laying down formal process requirements on both the business and the regulator; and
- It best clarifies the rights of all parties and leads to a more certain, timely and predictable regulatory regime.

The SCO Consultation paper makes some comments on the issue of timelines for regulatory processes. In this context it is important to consider the most efficient regulatory processes for the national regulatory model. For example, under the ‘propose-respond’ model operating under the Gas Code the last round of price reviews took on around 12 months on average, compared to a longer 19 months for electricity decisions based on a ‘regulatory determination’ model featuring wider regulatory discretion.⁶ This data suggests that the SCO concern about the complexity of processes in the NGC is misplaced and that it is a better regulatory model than in electricity.

Conclusion on the SCO Proposal

The companies consider that to develop a new national energy code without using the NGC as the basis of such a national model would fail the best practice requirement laid down by the SCO.

⁵ Ministerial Council on Energy Standing Committee of Officials, Consultation Paper, Review of the National Gas Access Regime, August 2005, p.18

⁶ Data provided by the Energy Networks Association.

Recommendation 4

The companies recommend that the regulatory processes used in the National Gas Code that set out the “propose/respond” model in detail be retained in the National Gas Code and that this model form the basis of the new nationally consistent regulatory framework in electricity.

4.2 Rate of Return Ranges Issue

The SCO Proposal

The SCO made some detailed comments about the “Rate of Return Ranges” issue in its Consultation paper where they indicate some concern with the PC’s recommendation:

“Such a criterion for decision-making may imply more disputes and cost in the future, and may counteract the objective of improving the degree of certainty over the outcomes of future regulatory decisions. It may be more appropriate to empower the AER to make the best decision it can, and to use the rules governing the process and detail of its assessment to provide the necessary certainty of outcomes.”

The SCO therefore listed this for additional consultation, despite the fact that the pricing models in gas and electricity are identical and that the issues of the “ranges” were extensively considered by the PC in its review of the National Gas Access Regime.

Comments on the SCO Proposal

The PC in its major review strongly supported the process in the NGC as it recommended an enhancement of the “propose/respond” model. This includes the recommendation that the regulator in assessing the service provider’s proposals must approve a proposal where the rate of return parameter values used lie within a range of plausible estimates or that a propose method has a plausible conceptual basis.

All experts and commentators on the rate of return as given by the Weighted Average Cost of Capital (WACC) and the ‘Building Blocks’ model state that the values are uncertain and when values are uncertain they obviously have possible ranges. This has been supported by the PC who has stated that:

“The Gas Code (s 8.4) specifies three methods that can be used to determine target revenue. There are many technical issues involved in using these methods, such as the appropriate rate of depreciation, how to apportion fixed costs between different services and time periods, the appropriate rate of return on capital, and the value of the capital base. As a result, it is possible to generate a range of values for the target revenue, even using a single method. In other words the most efficient revenue cannot be known with any certainty.”⁷ (underline added)

The issue raised by the SCO Consultation paper that such a criterion for decision-making may imply more disputes and cost in the future, and may counteract the objective of improving the degree of certainty over the outcomes of future regulatory decisions is not supported by the evidence. For example, one state regulator in three recent gas industry decisions has already successfully used the “ranges” model. This has presented no

⁷ Productivity Commission, op cit. p.264.

problems for the regulator, as it is easier to justify a range than it is to justify a point estimate.⁸

Even the ACCC have been recently concerned with the uncertainty in the WACC variables and have proposed a “ranges” methodology to rectify the problem:

“Because each WACC parameter cannot be known with certainty, there is a *range* of input parameters which could be termed ‘reasonable’. This seems to be an area of common agreement. A literal application of this argument, however, may allow a regulated firm to take a high, but reasonable, value for all input parameters and generate a WACC which is unreasonably high. A more defensible approach to determining the range of possible WACCs is to use a Monte Carlo (MC) simulation, an approach also advocated by Professor Bowman.”⁹

The issue of the WACC ranges was also considered by the Australian Competition Tribunal (ACT) in a review of the ACCC’s decision on GasNet. The ACT strongly argued that the requirement of the regulator under the Code is to only propose an alternative Access Arrangement when that proposed by the Applicant (in this case GasNet) does not comply with the Code. In paragraph 42 of its decision, the ACT noted:

“Contrary to the submission of the ACCC, it is not the task of the Relevant Regulator under s 8.30 and s 8.31 of the Code to determine a ‘*return which is commensurate with prevailing conditions in the market for funds and the risk involved in delivering the Reference Service*’. The task of the ACCC is to determine whether the proposed AA in its treatment of Rate of Return is consistent with the provisions of s 8.30 and s 8.31 and that the rate determined falls within the range of rates commensurate with the prevailing market conditions and the relevant risk.”

The ACT also noted that consistent with the West Australian Supreme Court decision on Epic, any decision on an Access Arrangement should reflect the underlying uncertainty of the parameters, and that the application of Reference Tariff Principles involves “issues of judgement and degree”.¹⁰ Given this uncertainty, plus the need to assess the proposed Access Arrangement, the ACT stated that the onus was on the regulator to best resolve any tensions in ways that were consistent with the legislation. In paragraph 29 of the decision the ACT states:

“It is clear in the reasoning in Michael that there is no single correct figure involved in determining the values of the parameters to be applied in developing an applicable Reference Tariff. The application of the Reference Tariff Principles involves issues of judgement and degree. Different minds, acting reasonably, can be expected to make different choices which nonetheless remain consistent with the Reference Tariff Principles. Where the Reference Tariff Principles produce tension, the Relevant Regulator has an overriding discretion to resolve the tensions in a way, which best

⁸ The West Australian Economic Regulatory Authority (ERA) has made three recent decisions where the “ranges” approach has been utilised. The ERA also used a point in the range at the 90th percentile to set regulated rates of return. These include the Final Decision on Alinta Gas Networks, the Final Decision of the Goldfields Gas Pipeline and the Draft Decision on the Proposed Access Arrangements for the Dampier to Bunbury Pipeline.

⁹ ACCC Assessment of Telstra’s ULLS and LSS monthly charge undertakings, Draft Decision, Public version, August 2005, p.62. Note that a simple range with a point estimate in the 90th percentile is a simpler and more easily understood method to adjust for uncertainty than the MC technique.

¹⁰ Full Court of the Supreme Court of Western Australia in *Re Michael Ex parte Epic Energy (WA) Nominees Pty.Ltd* (2002) 25 WAR 511.

reflects the statutory objectives of the Law. However, where there are no conflicts or tensions in the application of the Reference Tariff Principles, and where the AA proposed by the Service Provider falls within the range of choice reasonably open and consistent with Reference Tariff Principles, it is beyond the power of the Relevant Regulator not to approve the proposed AA simply because it prefers a different AA which it believes would better achieve the Relevant Regulator's understanding of the statutory objectives of the Law."

The companies conclude that the "ranges" model should be used in the new nationally consistent energy framework because it is:

- best practice as it is supported by the empirical evidence and has been recommended after a detailed inquiry by the PC;
- based on a strong legal decision by the ACT and the Supreme Court of Western Australia that a "ranges" model is required in pricing decisions by regulators; and it is
- supported by the ACCC who is the key national regulator on competition policy

The companies consider that there are strong reasons to adopt the NGC as the basis for a national approach to energy regulation. This includes the reason that the NGC is the only currently successfully operating national energy code in Australia. In addition, the courts have regularly reviewed the Code, which has reduced uncertainty for both regulators and investors and kept the Code up to date in legal tradition.

The companies consider that to base the new nationally consistent framework for energy on the NGC would save this sound legal tradition which is vital for both investors and regulators. A 'clean slate' review would lose this valuable legal tradition.

Recommendation 5

The companies recommend that the PC recommendations for the WACC and cost ranges are implemented in the National Gas Code and used to form the basis of the new national framework for electricity.

5 Price Monitoring

The SCO Proposal

The PC proposed a price-monitoring model based on the concept of the coverage test and two levels of regulation – a light handed and a heavy-handed form of regulation. As part of a coverage application the National Competition Council (NCC) would assess which level of regulation would generate the greater net benefits taking into account a wide range of costs and benefits and recommend to the relevant Minister which level of regulation was appropriate.

The SCO Paper makes the observation that there are a number of potential reservations about the price-monitoring model proposed by the PC, which give rise to a number of implications:

“...Moreover, modification to the Commission’s proposals still may be required to produce an effective regime. As a result it is questionable whether it is appropriate to apply a truly light-handed model a default regulatory regime...to pipelines that have substantial market power...”

“The coverage test contained in the Code operates by comparing the prospects for competition ‘with coverage’ against the prospects for competition ‘without coverage’”. The uncertainty introduced into the form of regulation that applies ‘with coverage’ would complicate substantially the assessment of which pipelines should be covered.”¹¹

The SCO therefore proposed an alternative to the PC model as set out in the final report of the Gas Access Review:

“An alternative option is to adopt a price monitoring regime for pipelines that have *some* market power, albeit not necessarily sufficient to pass the new test for coverage under the regime.”¹²

“...A simple rule for the application of monitoring could be considered – for example, one that is based upon a threshold for the materiality of the pipeline (that is, to exclude projects for which the administrative costs are high relative to the size of the pipeline). Other simple rules may be possible.”¹³

Comments on the SCO Proposal

5.1 The Issue of the Additional Regulation in the SCO Model

The companies support the economically valid proposition that regulation should be strictly limited to circumstances where it can be clearly shown that the benefits of regulation outweigh the costs. Therefore, the companies are seriously concerned that the SCO Paper proposes the imposition of additional regulation in circumstances where service providers have already shown that access regulation is not warranted. Price monitoring is a form of

¹¹ Ministerial Council on Energy Standing Committee of Officials, op cit pp. 11-12

¹² ibid p.12.

¹³ ibid, p.13

regulation albeit a light handed form given its introduction was consistent with such principles.

Further, there is a risk that the additional impost would be applied to all or nearly all service providers irrespective of their market power especially given the problem of determining which are “greenfield” pipelines.

The companies also do not support the imposition of additional regulation in circumstances where service providers have already shown by legal means based on the old coverage criteria that access regulation by is not warranted.

The companies have concerns over both the likely benefits from applying such a model as well as the inevitable costs associated with regulatory reporting requirements together with the very real risk of increasing regulatory intervention as regulators have an incentive to progressively seek additional information. The PC argued that such costs could be substantial even in the context of a price monitoring regime.

Recommendation 6

That the original PC recommendations for price monitoring are implemented and included in the National Gas Code and that this recommendation also forms the basis of the new nationally consistent framework for electricity.

5.2 Administration of The Coverage Test

The SCO Consultation paper request comment on who should perform the administration of the coverage test in the NGC and include two options – the National Competition Council (NCC) or the Australian Energy Market Commission (AEMC).

The PC favoured the NCC to determine if a change to coverage or regulatory status was needed and the companies support this position. The AEMC has no experience in the coverage test in comparison to the NCC and the companies support the expert body retaining all aspects of the coverage decisions.

Recommendation 7

That the body responsible for coverage tests including the decision on the level of regulation should remain the NCC.

6 Merit Review and the Propose/Respond Model

The other essential aspect of a “Propose/Respond” model is the availability of an appropriate structure of appeals against regulatory decisions. Under the National Gas Code gas firms are able to access both merit (qualified) and judicial appeals. In electricity regulation there is only judicial review and no administrative review under the National Electricity Rules. The case for national uniformity therefore has two options and the issue of what is best regulatory practice is important in determining the national approach to appeals.¹⁴

The MCE is considering the role of appeals against regulators’ decisions in the electricity and gas sectors in another work stream, however the companies make some comments in the response to this paper as it considers merit review to be an essential component of a best practice “propose/respond” model.

The issue of merit review in the new national energy code is another case of determining what is best practice regulation. In box 4.1 of the PC Review of the National Gas Access Regime the Commission set out its requirements for best practice regulation, which must be:

“Open to appeal and review”¹⁵

In addition, in the PC review of the National Access Regime they also commented on the importance of effective appeal arrangements that:

“As the Commission emphasised in the Position Paper, appropriate protection for property rights must be the pre-eminent consideration in formulating a system of appeal rights for access regimes”¹⁶

The PC obviously considers that effective appeal arrangements including both judicial appeal and merit review are a key part of a best practice regulatory model. If the SCO also have this objective they should implement effective appeal arrangements as part of a best practice national regulatory model.

Recommendation 8

The companies recommend that full merit appeal arrangements must be a part of a best practice nationally consistent regulatory framework.

¹⁴ Some states do allow for merit review of electricity companies. For example, in Victoria who has derogated Chapter 6 of the old national Electricity Code allows for qualified merit review of electricity pricing decisions under the Victorian Essential Services Act.

¹⁵ Productivity Commission, op cit, p. 86.

¹⁶ Productivity Commission , Review of the National Access Regime, (September 2001), Canberra p. 396