

Submission to the Ministerial Council on Energy Standing Committee of Officials

Re: Proposed response to the Productivity Commission review of the Gas Access Regime



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1 Key messages

Alinta Network Services (ANS) is making this submission on behalf of the following companies.

Company		Assets	Location
	Alinta Infrastructure Holdings	Gas Transmission Pipeline and Generator Owner	Tasmania, Victoria, NSW, Queensland, & Western Australia
	Alinta Gas Networks	Gas Distribution Networks	Western Australia
	Multinet Gas Networks	Gas Distribution Networks	Victoria
	United Energy Distribution	Electricity Distribution Networks	Victoria

This submission reflects the experiences and views of companies that operate in both the gas and electricity sectors, and across transmission and distribution networks. The companies also operate in five jurisdictions across Australia. ANS is the service provider to these companies and provides management and operational services under service agreements.

The companies warmly welcome the opportunity to comment on the Ministerial Council on Energy's (MCE) proposed response to the Productivity Commission's review of the National Gas Access Regime (the MCE's proposed response). The companies also acknowledge the work of the Standing Committee of Officials (SCO) in meeting with stakeholders and hearing submissions in Sydney on 23 November 2005. In terms of this latter meeting one SCO Official requested that the industry provide more details on the issue of the "regulatory ranges". The companies have provided this information in Appendix One.

The companies are pleased that the MCE's proposed response is substantially more appropriate than the earlier draft, dated August 2005. Whilst the companies believe that the proposed response would benefit from further changes, we welcome the advances that have been made to date. Some of further changes which the companies consider are required amount to fine-tuning the approach outlined in the MCE's proposed response in relation to the key policy areas discussed, namely:

- the overall objects for the regime;
- the test for coverage under the regime and the administration of that process;
- the introduction of a light-handed regulatory option; and
- measures to enhance regulatory certainty for greenfields projects.

The companies broadly support the points raised by the Energy Networks Association (ENA) in its presentation to the SCO on 23 November 2005. Further details of the companies' position on these policy matters are set out in this submission, and summary recommendations are also provided at the end of this submission.

In addition, the companies believe that other necessary changes can only be achieved if there is a subtle, but important change of emphasis in the MCE's approach.

In particular, the companies continue to believe that the work of the Productivity Commission is in danger of being overlooked by the MCE. In this regard, the companies are concerned that the suggested role of the Expert Panel, as described in the MCE's proposed response may effectively mandate a 'clean slate' review.

In finalising the MCE's response, the companies believe that the SCO should re-evaluate how best to use, and build on the work already completed by the Productivity Commission to deliver a workable, best practice approach to energy regulation. In making this comment, the companies have particular regard to two matters:

- the extensive consultation exercise already undertaken by the Productivity Commission; and
- the relatively hurried timetable contemplated for the work of the Expert Panel.

The MCE's proposed response appears to take the position that the Productivity Commission's work is less relevant today because the reform agenda is now energy-wide. The quest for consistency across the energy sectors is laudable, and no doubt has the potential to deliver benefits, to the extent that it is achievable. The Productivity Commission's work puts an important stake in the ground by defining the best practice regime for the gas sector. It follows that the Productivity Commission's model for gas is not an unreasonable starting point for energy reform.

The companies' view is that in the context of the wider reform process and the ambitious timetable, it is appropriate for the MCE to attach more weight, rather than less, to the Productivity Commission's findings. Notwithstanding the important policy details noted in the remainder of this submission, the companies urge the SCO to re-evaluate how best to use the Productivity Commission's work to deliver a workable, best practice approach to energy regulation.

2 Objects clause

The companies do not support the MCE proposal for an objects clause for the Gas Access Regime as it does not include the necessary reference to markets and, therefore, moves away from an access regime.

The companies consider that the policy goal should be to promote economic efficiency (through enhanced competition) in related markets first and ultimately for the broader community. Removing the link to markets reduces the objects clause to a price control objective not an access regime.

The companies would therefore favour the alternative objects clause that states:

to promote the economically efficient investment in, and efficient operation and use of natural gas pipeline services **thereby promoting competition in related markets** and promoting the long term benefits of natural gas consumers with respect to price, service and security.

3 Coverage test

The companies support the MCE's proposal to adopt the coverage test as proposed by the Productivity Commission. The companies, however, do not support the coverage test being determined by the Australian Energy Markets Commission (AEMC) but rather favour the NCC for the following reasons:

- The AEMC is a policy and rule making body which, as a matter of good governance (being the key driver of the reform program), should be separated from the body with administrative responsibility for applying the rules. This is a fundamental principle of governmental organisational structures. For example:
 - there is potential conflict when the body that makes the rules then decides who should be subject to those rules; and
 - there is potential conflict when a rule making body may interpret (or re-interpret) rules it has made, in a way that affects the application of the rules but which avoids the discipline, accountability and transparency of the rule change process.
- The National Competition Council (NCC) has substantial experience in the administration of the existing coverage test as a specialist body with skills in the application of competition principles. The AEMC, on the other hand, has a lack of experience in such matters, and is a specialist body in the implementation of energy market policy. In addition,
 - problems of coordination would arise if responsibility for the coverage decision was separated from the responsibility for determining declaration of access generally; and
 - considerations of efficiency in the administration of sound public policy suggest that the assessment of coverage decisions should be linked with the associated issue of assessing the effectiveness of access regimes overall.

The companies urge the SCO to reconsider this issue.

4 Price monitoring

The companies support the MCE's proposal to introduce a monitoring option into the gas access regime. In particular, the MCE proposal correctly recognises that there should be an option for covered networks to be subject to light-handed regulation, whilst uncovered networks should not be subject to any form of price regulation.

The companies note that the MCE's position is now substantially improved from its earlier view that uncovered networks may be subject to price monitoring. This earlier proposed approach would have added to the regulatory burden, rather than lessened it, and would not have yielded net benefits. As such, the proposed approach would therefore have been at odds with the Productivity Commission's advice. The companies are pleased that the MCE has been able to reconsider its position and develop an alternative proposal that is now more robust.

However, the companies are opposed to the Australian Energy Regulator determining whether price monitoring should be adopted. The proposed approach does not effectively separate decision-making over the scope of regulation from the enforcement of regulation, as required by considerations of good governance, and as recommended by the Productivity Commission.

The companies would prefer to see the criteria for the adoption of price monitoring to be enshrined in the Gas Law. This approach will provide investors with greater certainty that the criteria will be followed in practice. The companies do not have a strong view as to which body should apply the criteria. There may be benefit in requiring the NCC to undertake the task, perhaps with the relevant Minister making the final decision after advice from the NCC. The Gas Law would need to make clear the circumstances under which the relevant Minister could reject the advice of the NCC. The companies suggest that the following criteria might provide the certainty required by all stakeholders:

1. if a covered pipeline has been through two building block price reviews there should be a presumption that price monitoring could apply given that their efficient costs would be known;
2. the degree of counterveiling power in the market (ie large and well resourced customers, by-pass threat);
3. the degree of horizontal and vertical integration in the market;
4. the level of competition from other pipelines or sources of gas;
5. the nature and extent of any entry barriers to the market; and,
6. the costs of regulation exceed the benefits.

The decision criteria should be that if a company meets the first criteria they should only have to meet one other criteria for price monitoring to be approved.

5 Greenfield projects

The companies support the service provider to have the choice of a binding no-coverage ruling or a price regulation holiday as set out in Option 4 of the Regulatory Impact Statement (RIS).

The MCE's proposed response envisages a process whereby the proponent of a pipeline must apply to the Relevant Minister in writing for a decision on whether the pipeline or part of the pipeline is a Greenfield Pipeline. The Relevant Minister will be the same Minister who would normally decide on the coverage of the pipeline.

The companies believe that greater certainty and national consistency could be achieved by involving the NCC on these issues as if they remain responsible for coverage the issue of which are "greenfield pipelines" is closely linked.

The companies note that in order to encourage efficient investment in new pipelines there must be clear criteria to guide the Minister, as well as an administrative process that is free from red-tape and unnecessary delay. The companies therefore welcome the proposal that the Minister will be required to make a decision within 28 days. It is not clear, however, what criteria the Minister will apply or whether some work should be undertaken by the NCC in the first instance in order to advise the Minister.

6 Expert Panel

Contrary to accepting the Productivity Commission's model for gas as a starting point, the MCE's proposed response is to appoint an Expert Panel to advise the MCE on a model to achieve a common approach to revenue and network pricing across the energy market. As already noted, there is a risk that this may result in the re-visiting by the Expert Panel of matters already addressed thoroughly by the Productivity Commission's recent work.

Apart from the obvious inefficiency that would result from a re-visitation of those matters, it will not be possible in practice for the thinking on revenue and network pricing across the energy market to start with a "clean slate". The AEMC has already embarked upon its review of the transmission pricing Rules (Chapter 6) which is focused almost exclusively on electricity transmission issues, and is required under the National Electricity Law to conclude that review by the middle of 2006. In addition, there is a further MCE-led workstream focused on developing a national framework for energy distribution and retail regulation. The timetables for these processes does not allow for the Expert Panel to "start afresh".

As already noted, the companies believe that the SCO should reconsider how best to make use of the Productivity Commission's work in developing further the national framework for energy regulation. We understand from statements made at the recent SCO consultation that the SCO will limit and prioritise the tasks of the Expert Panel and in this regard the companies suggest the following:

MCE need to provide a national energy policy statement to the AEMC.

We believe this statement could come from the expert panel in three areas:

- Regulatory Framework
 - NGC adopted as National Energy Code (NEC) for pricing and access
- Pricing Principles
 - Adopt PC recommendation for Gas Code and the NEC
- Pricing Models
 - Amend law and rules to allow for other pricing models (eg TFP) rather than requiring the Expert Panel to deal with this issue

7 Summary of recommendations

The companies' recommendations in relation to the MCE's proposed response are summarised below.

Recommendation 1 – Objects Clause

The MCE should carefully consider adopting the following objects clause that is more appropriate for a gas access regime:

to promote the economically efficient investment in, and efficient operation and use of natural gas pipeline services **thereby promoting competition in related markets** and promoting the long term benefits of natural gas consumers with respect to price, service and security.

Recommendation 2 – Coverage

The MCE should adopt the proposed response in relation to coverage, with one important exception: the NCC, rather than the AEMC, should conduct the coverage test.

Recommendation 3 – Price Monitoring

The MCE should require that the criteria for adopting price monitoring should be enshrined in the Gas Law. The MCE should consider whether the NCC is best placed to apply the criteria and to provide advice to the relevant Minister as there are efficiencies to be gained by linking coverage decisions with an assessment of which pipelines are greenfield pipelines. In addition, the SCO should recommend the companies proposed criteria to assess price monitoring proposals.

Recommendation 4 – Greenfield Projects

The MCE should consider whether it should provide clearer guidance on the criteria that should be applied by the relevant Minister in determining whether a project is a Greenfield Pipeline. The MCE should also consider whether the NCC is best placed to provide advice on the Minister on these matters in the first instance.

Recommendation 5 – Expert Panel's deliverables

The MCE should provide clear guidance to the Expert Panel about what is its expected output (e.g. proposed rules or advice), and provide initial policy direction by focusing the review on the generic applicability of the Productivity Commission's recommendations across electricity and gas transmission and distributions (without re-reviewing their application to gas).

Recommendation 6 – Expert Panel's use of source documents and reports

The Expert Panel should also be required to take into account a number of sources and developments not referenced in the draft Terms of Reference. These sources should include the recent PM's Infrastructure Taskforce Report, relevant and recently implemented regulatory models such as the *WA Electricity Networks Access Code*, as well as the foundation competition reform documents such as the *Competition Principles Agreement* and the Hilmer Report.

APPENDIX ONE

At the SCO Forum the issue of the "ranges approach" was raised by a member of the SCO in the context of the PC's recommendations on scope of the regulator's decision, including whether a legal bias should exist in favour of the regulator accepting a proposal.

In Australian energy regulation, use of the Capital Asset Pricing Model (CAPM) is universal in establishing an appropriate weighted average cost of capital (WACC) for revenue and pricing of regulated pipeliners. A key limitation of CAPM is that it requires estimates of a number of inputs, some of which are unobservable in the market and these require estimation that introduces further uncertainty into the values.

A range of commentators acknowledges the "ranges" approach to WACC estimation. For example the ACCC has argued that:

"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."¹

The issue of regulatory ranges was also dealt with in appeals before the Australian Competition Tribunal (ACT) in the decision on the *GasNet* appeal in December 2002 where the ACT recommended:

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.*² (Emphasis added)

Therefore under the existing gas access regime there is already a recognition that a range of reasonable values can exist for WACC input parameters, and the Gas Code places the onus on the service provider to propose access prices which are based on reasonable values.

The Productivity Commission (PC) in their Review of the Gas Access Regime made a recommendation that codified the legal position of the ACT decision into the National Gas Code.

Regulators operating under the "ranges" approach have indicated that they have faced no difficulties in complying with the approach. For example, the WA regulator has made three recent decisions, which have used the regulatory ranges approach

¹ ACCC Assessment of Telstra's ULLS and LSS monthly charge undertakings, Draft Decision, Public Version, August 2005, p.62

² Application of GasNet Australia (Operations) Pty Ltd [para 42]

without any particular concerns and the Chairman of the WA Economic Regulation Authority (ERA) publicly supported the approach at the recent SCO forum.

The apparent concern with the PC's recommendations on the "ranges" approach has been that it might permit a business to propose higher rates of return. An associated concern is that this could leave a regulator without the power to reject an inappropriately high rate of return.

These concerns are unfounded for the following reasons:

- while plausible ranges exist for a number of key parameters any values proposed by a pipeline would still need to be based on reasonable evidence;
- the argument that a pipeline will be awarded a rate of return outside of the range considered reasonable by the regulator is not supported by recent regulatory decisions as discussed above (e.g. WA ERA approval on the following pipelines; Dampier to Bunbury Gas Pipeline, Alinta Gas Networks, and the Goldfields Gas Pipeline);
- regulated pipeliners will have a strong incentive to propose reasonable cost of capital ranges given continuing discretion under the PC's recommendation for a regulator to reject either unreasonable models or values being used, and impose their own in the final stage of any pricing decision; and
- the argument that regulator point estimates of WACC input parameters - are more correct (i.e. closer to 'true values') is unsupported by appeal outcomes and the view of key commentators.

In addition, an important consideration in assessing the potential costs and benefits of the PC's proposed approach is the finding on the asymmetric consequences of regulatory error. The PC's finding in the review of the gas access regime was that the key risk facing infrastructure regulation was that access prices could be set too low.³

The PC recommended that the costs of access prices being set too low far outweighed the costs of access prices being set too high as this would result in appropriate long term infrastructure investment for the long term benefit of consumers.⁴

The companies therefore strongly support the "ranges" approach recommendation of the PC being implemented in the National Gas Law and Rules and as the basis of a national approach to energy regulation.

³ Productivity Commission Media Release *Better Regulation of Infrastructure Needed*, 14 February 2002

⁴ Productivity Commission Review of the National Access Regime – Draft Report, March 2001, p.128