

**ELECTRICITY TRANSMISSION NETWORK** owners

# Exposure Draft of the National Gas Law

Submission to Ministerial Council on Energy

19 December 2006



## 1 Introduction

The Electricity Transmission Network Owners' Forum (**ETNOF**) welcomes this opportunity to make a submission on the exposure draft of the National Gas Law (the **Proposed Gas Law**). ETNOF notes that the Ministerial Council on Energy has also released Initial National Gas Rules (the **Proposed Gas Rules**) and that submissions on these rules close on 12 January 2007.

ETNOF represents electricity transmission network owners who operate within the national electricity market. The members of ETNOF are ElectraNet, Powerlink Queensland, SP AusNet, Transend and TransGrid. Between them, the businesses currently plan to invest around \$5 billion in electricity transmission infrastructure over the next 5 years.

*Why is ETNOF making a submission on the National Gas Law?*

The Ministerial Council on Energy has enunciated<sup>1</sup> convergence in the regulatory frameworks for gas and electricity as a desirable policy goal. ETNOF recognises, therefore, that regulatory reform of the National Gas Law has potential over the longer term to influence the regulatory framework of the National Electricity Law.

ETNOF notes with concern that in a number of respects the Proposed Gas Law represents a significant departure from recent reforms seeking regulatory best practice. Most significantly the Proposed Gas Law:

- provides relevant decision-makers, and in particular the Australian Energy Regulator (**AER**), with very broad discretion when making decisions under the Law and the Rules. In ETNOF's experience, this potentially amounts to providing the same agency with both Rule making and Rule administration functions;
- contains very wide and strong information gathering powers that, in a number of cases, do not balance the regulator's need for information with the rights of businesses (or individuals) to which the information gathering powers may be directed; and
- provides for classes of reviewable regulatory decisions to be prescribed by regulation, making the availability of merits review uncertain which, in turn, undermines regulatory accountability, regulatory predictability, and consequently investor confidence.

The matters identified above are generally concerning, as a matter of public policy, but to ETNOF more relevantly, they are concerning to the extent that the new National Electricity Law, set for release in early 2007, adopts elements of the Proposed Gas Law.

ETNOF was heavily involved in the recent development of the new National Electricity Rules concerning electricity transmission network revenue regulation. The new Rules were the first network regulatory framework to be finalised following the Expert Panel Report and the first to adopt the Panel's "fit-for-purpose" regulatory framework. ETNOF considers that the vast amount of work undertaken by policy-makers, regulatory bodies and industry participants as part of this transparent and lengthy consultation process has led to a balanced and robust framework that to a significant extent embraces regulatory best practice. This has been borne out by initial operating experience with this regime.

Accordingly, ETNOF is making this submission to inform the policy debate about the Proposed Gas Law and Proposed Gas Rules from its experience in electricity to help ensure that the final law and rules are reflective of good public policy and achieve the national energy market objectives.

## 2 A stock-take of reform upon which the Gas Law should build

The integrated structure of carefully balanced procedural, substantive and reviewable elements which together form the new Chapter 6 electricity transmission rules is the result of important public policy

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<sup>1</sup> Ministerial Council on Energy, Reform of Energy Markets, 11 December 2003.

lessons learnt after more than a decade of reform. It is important that these lessons are not forgotten in the framing of the new Gas Law.

At the time the old Chapter 6 of the National Electricity Rules was promulgated, it was itself a significant reform. Previously there had been disparate approaches to energy network regulation in each of the participating jurisdictions. It was only through the ACCC undertaking regulatory decisions for each business that the approach to regulation could be refined and the disparate approaches could converge.

Until the Ministerial Council on Energy's recent decision to adopt limited merits review and Australian Energy Market Commission's adoption of the new Chapter 6 rules for the electricity sector, the electricity transmission sector was subject to the most uncertain regulatory structure applying to any gas or electricity network sector. For example, the regulatory structure lacked explicit process requirements (for instance it was not even specified whether or not the process started with a proposal from the business), formal decision making rules and any merits appeal to hold the regulator accountable.

There is considerable risk to network businesses, associated with billions of dollars of transmission network investment, if the regulatory environment which provides the returns for that investment lacks process and substantive certainty and predictability to undertake long-term efficient investment decisions.

To begin to provide additional clarity of regulatory approach the ACCC announced that it would publish a "Statement of Regulatory Principles" setting out its approach to the use of its extensive and unconstrained regulatory powers. The document underwent several iterations – two drafts and a final document over a period of six years. Significantly, the document had no legal status and the ACCC's powers continued to be as broad and unspecified as the language of the old Chapter 6 rules provided. As well as the changes to the Statement, significant changes were also made as part of the regulatory decision making process that applied to the businesses.

Significant changes included:

- In its revenue cap proposal of March 2003, Transend proposed a series of "variable projects" to be included in its revenue cap. At the time Transend's system was not yet interconnected with the mainland and it was very difficult for the business to predict what additional load or generation projects might connect to take advantage of interconnection.

At the time the concept of "variable projects" was unknown in the Draft Statement of Regulatory Principles but Transend had no explicit mechanism to trigger a change to the Statement. The ACCC declined Transend's proposal on the basis that it was inconsistent with the draft Statement and inappropriate as being akin to rate of return regulation (rather than CPI-X regulation).

However, by 2005 when the ACCC came to consider the revenue caps for TransGrid and EnergyAustralia to apply from 2004-05 to 2008-09, the ACCC did recognise that the appropriate regulation should include the concept of "excluded projects" or "contingent projects" which were essentially the same concept as Transend's original "variable projects". The framework was adopted in the amended final Statement of Regulatory Principles.

- Nor was TransGrid and EnergyAustralia's revenue cap process a smooth and predictable one.

Prior to the finalisation of the Statement of Regulatory Principles, the ACCC's revenue cap determinations regulated capital expenditure through "ex post" evaluations of whether the expenditure in the previous period had been prudent and efficient. Amounts were disallowed for inclusion in the regulated asset base if the expenditure was found to be inefficient. At the time the Draft Statement of Regulatory Principles reflected that practice and, further, indicated that at any time in the future the asset base could be subject to a process of "optimisation" in which unused assets could be removed from the asset base.

In 2003 TransGrid and EnergyAustralia submitted their revenue cap applications under those provisions of the draft Statement but, during the process, the approach switched to an “ex ante” form of regulation for capital expenditure under which an allowance for capital expenditure was made for the next period and it was left to the business to determine whether and how to spend that allowance. The final Statement of Regulatory Principles confirmed that changed approach.

- In several instances under the “ex post” review framework, expenditures that the businesses had actually incurred and which the businesses themselves regarded as efficient were disallowed by the ACCC. There was no practical means by which those decisions could be reviewed, not only because there was no merits review, but also because the Code’s provisions were so broad and unspecified that very few actions of the ACCC indeed could ever be said to be inconsistent with, or fall outside, the broad discretion granted to the ACCC.

Each of the above issues were very significant in relation to capital investment decisions yet there was no explicit process by which either change was initiated or could be opposed by the businesses concerned or by any other party. The broad discretion of the ACCC enabled it to effectively write its own approach to decision making with no effective means of review impacted all transmission network service providers by creating an uncertain and unpredictable investment environment.

The problems were exacerbated by the lack of separation of rule making and rule administration. Generally ETNOF members enjoyed a relatively harmonious working relationship with the ACCC. Nevertheless, it is inevitable that any effective regulatory decision making process has a degree of contention between the regulator and the regulated business. If there was ever to be a dispute as to the meaning or application of the Statement of Regulatory Principles, the ACCC was necessarily in a commanding position compared with that of the regulated business. A key reform which is necessary to instil investment confidence is the separation of rule making and rule administration. The AEMC and the AER were established and the AEMC was tasked with reforming the most uncertain regulatory structure then in existence – the electricity transmission rules. Meanwhile, the MCE decided to adopt strictly limited merits review under which if a regulator’s decision could be shown to be seriously flawed (i.e. containing error or unreasonable) it could be reviewed and remedied.

The development by the Expert Panel of the “fit-for-purpose” regulatory structure (discussed in the next section) also significantly contributed to the richness of finely honed incentive regulation which was finally adopted by the AEMC.

All the above initiatives are important in providing the investment certainty required by the electricity transmission sector to undertake the imperative reliability investments and to adopt other investments that are also of net benefit to customers.

### **3 “Fit-for-purpose” model under the Proposed Gas Law and Rules**

The “fit-for-purpose” approach to regulation advocated by the Expert Panel involves a considered analysis of each element of the regulatory decision making framework which, at a broad level, identifies whether the best public policy outcome is one in which:

- incentives are provided for the business to propose an efficient and prudent proposal and the regulator must accept that proposal unless it is flawed in identified respects;
- the regulator makes a decision unconstrained by the plans of the business identified in a revenue proposal; or
- a combination of, or variation on, the two.

Even more important, in practice, is to recognise that the above models do not apply in a vacuum. Rather, the overall performance of the regulatory structure depends on the decision making rules, the incentive properties of the other accompanying Rules and the accountabilities and disciplines contained in the Rules.

In the case of the new national electricity transmission rules, there is a sophisticated combination of “consider-determine” elements of the regulatory framework (e.g. the efficiency benefit sharing provisions) and “propose-respond” elements of the regulatory framework (eg the provisions by which the operational and capital expenditure budgets in revenue proposals are considered).

There is no accident to the difference of approach. While the regulator may be well placed to assess how benefits of efficiency can be shared, network owners are, of course, much more familiar with the engineering of their own networks than a regulator ever could be and it is the operators who are best able to identify the optimal operational and capital expenditure plans.

The new National Electricity Rules for transmission have therefore been developed with a package of incentives to encourage the business to provide a prudent and efficient operational and capital expenditure proposal. The key features of the incentive package are:

- in preparing and lodging their operational and capital expenditure proposals there is an explicit enforceable obligation in the Rules that the proposals reflect efficient and prudent costs;
- the businesses’ Board of Directors must certify that the expenditure proposals are efficient and prudent; and
- the fact that if the proposals are found by the AER not to reflect efficient and prudent costs, the AER may substitute its own proposal that it regards as efficient and prudent. That is, there is a very strong incentive for the service provider to ensure that proposals are efficient and prudent because if they are found not to be, the outcome of the regulatory process is in the AER’s hands. This is viewed by most businesses as a “high risk” proposition, particularly in setting capital and operating expenditure targets for regulatory purposes.

In addition it is important to note that the structure is also consistent and coherent with the broader regulatory obligations applying to energy network operators. No draconian information gathering powers are needed. From a public policy viewpoint, even more significant than fine adjustments to prices and revenues is the paramount importance of reliability of supply to almost all electricity customers (businesses and households). Energy network operators are legally responsible for the reliability of network services. If the energy network business itself is also responsible for developing expenditure proposals which (provided they reflect prudent and efficient costs) are to be accepted then the business is able to manage its expenditures to meet its regulatory reliability and other obligations.

By contrast, if the regulator can impose an expenditure regime that has no “buy-in” from the business, it is less clear how the network business should be held accountable were the level of permitted expenditure proves inadequate to maintain reliability.

Further, there is a strong incentive to provide full disclosure of information to support a finding by the AER that the proposal reasonably reflects efficient and prudent expenditure. This incentive derives in large part from the desire of the businesses to avoid passing the control of the outcome to the AER with the material attendant risks of regulatory error.

Finally, the more unguided and inaccessible discretion a regulator has, the less predictable the outcome of the regulatory process and therefore the more uncertain the investment environment. Therefore, as well as undermining the achievements of reliability based investments (as explained above), a “consider-determine” structure tends to strongly discourage discretionary investments.

Under the Proposed Gas Law and Rules, ETNOF is concerned that the starting position through the adoption of section 24 of the Law (by expressly negating an obligation for the AER to accept a network’s proposal unless the Rules provide otherwise) and Clause 23 of the Proposed Gas Rules (which adopt a “best estimate” approach) effectively provides that all decisions are to be of a “consider-determine” form. Unlike the electricity transmission rules, no considered process such as the AEMC review in electricity is envisaged for a “fit-for-purpose” analysis.

Indeed, even if an industry participant were to propose a “fit-for-purpose” rule change package, in many respects the AEMC may be precluded from adopting key elements. For instance,

clauses 170(3)(c)(i) and 178(3)(a) of the Proposed Gas Law could *implicitly* entrench “consider-determine” by, for example, enabling the AER to always replace proposed estimates with its own “best estimates”.

In relation to the practical effect of an ability for the AER to adopt a “best estimate” of expenditures as provided for in clause 23 of the proposed Initial Gas Rules, ETNOF obtained advice from Stephen Gageler SC concerning the effect of that very “best estimate” standard in the context of the electricity transmission rule making process. In particular, ETNOF was interested in whether, in the context of seeking a stable and predictable investment environment, the term was one that imported an objective and predictable standard for decision making. The advice from Stephen Gageler made the following comments:

29. The reference to the possibility of the AER being required to determine whether the total forecast proffered by a [network business] is the “*best estimate that is reasonably possible in the circumstances*” appears in the last of the questions addressed in the AGS advice.
30. To require the AER to determine whether the total forecast proffered by a [network business] is the “*best estimate that is reasonably possible in the circumstances*” would be to adopt a fundamentally different model from that which currently appears in the Draft Rule. It would be to require the AER to determine whether it considered the estimate proffered to be the most preferable or appropriate and to go on to substitute its own estimate which it considered to be less than the most preferable or appropriate.
31. The AER would no longer be asking whether the forecast proffered was the product of sound judgment but whether it was the product of a right judgment in the sense of it being a judgment which coincided precisely with its own.
32. In effect, the AER would be empowered simply to make its own estimate.<sup>2</sup>

In summary, ETNOF is concerned that:

- unless there is a change to Rule 23 of the Proposed Gas Rules, the Proposed Gas Rules essentially provide for a “consider-determine” model, and not a “propose-respond” or “fit-for-purpose” model; and
- even if a rule change did seek a “fit-for-purpose” model or make a case for particular elements of the decision making process to adopt an incentive based “propose-respond” model, it is not clear that such a model would necessarily be permitted by the Gas Law. In particular, where it was inconsistent with sections 170(3)(c) and 178(3) of the Proposed Gas Law which, to some degree, would entrench “consider-determine” elements in the framework.

#### **4 Unnecessary and wasteful compliance burden**

Even before the draft Gas Law was published, ETNOF was concerned that the weight of information requests from the regulator had become counter-productive.

One of the benefits that incentive based regulation should have over rate of return regulation is that information requirements should be more limited, more relevant to the decision making process and more transparent to interested stakeholders. However, there has been a very significant increase in the volume of informational requirements, as distinct from the quality and relevance of informational requirements in recent ACCC decisions. A typical revenue cap decision now involves thousands of pages of basic documentary evidence and many hundreds of pages of expert material. The potential consequences for the business of the content of the material lodged by the business are so great that each item of information needs to be carefully verified, even when not relevant to the decision process.

That process is quite at odds with the principle that the regulator should limit itself to setting the correct incentives and the business should then be responsible for managing its own business without every planning, management and procurement decision being “second guessed”. As noted above,

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<sup>2</sup> Opinion from Stephen Gageler SC provided to the Electricity Transmission Network Owners Forum dated 25 October 2006, pp 14 – 15.

important reforms that are part of the new Chapter 6 transmission rules structure are to incentivise the business to volunteer the relevant information at an early stage of the process for stakeholder review, and to require the business to self certify the accuracy of the material upon which applications for revenue caps are based.

The next wave of reform, should, therefore be to review the informational requirements and streamline them on a “fit-for-purpose” basis.

It is of concern, therefore, that the Gas Law moves significantly in the opposite direction by:

- imposing new types of information gathering powers (eg warrants and notices requiring the regular production of material);
- significantly broadening the scope of existing mechanisms (eg expanding the AER powers in respect of which information can be gathered and expanding certain provisions to cover associates in addition to the service provider themselves);
- increasing the stakes for even inadvertent non-compliance (eg the potential for merits review to be lost where inadvertent or mistakenly a business fails to fully comply with informational requirements); and
- expensive and complicated duplication with the same information potentially available under up to four different powers.

These changes are likely to have the following effects:

- increase the internal costs of complying with the request itself, as well as external advisors’ costs to ensure that service providers strictly comply with the requirements;
- increase the costs of analysis and debate during the revenue reset process with many interested parties too poorly resourced and inadequately informed at the appropriate stage in the process to engage properly;
- create further disincentives to take business risks for fear of a regulator judging the actions with the benefit of hindsight; and
- create disincentives for service providers to enter cost effective capital funding and contracted service provision initiatives. This is because the equity, debt or contract service providers would be at risk of becoming an “associate” subject to regulation as if these parties were monopoly service providers themselves.

## **5 Is it already time to review the merits?**

ETNOF participated in the merits review reform debate and, under the then regulatory decision making structure, agreed that limited merits review was appropriate. However, ETNOF’s participation was based on two premises:

- that the regulator’s task would be well specified so that the regulator could be readily held to account under an “unreasonableness” test; and
- that the information requirements placed upon businesses were reasonably capable of being complied with.

If the National Electricity Law were to adopt the broad regulatory discretion and extensive information powers in the proposed Gas Law, neither of the above premises would hold and the merits review question would need to be reopened. Although the decision could still be somewhat limited the avenues would need to be significantly less limited to achieve effective accountability and investment certainty. In particular, the “unreasonableness” ground for review would be too limited and the ability

for the Tribunal to decline to entertain a review application simply because an information request had not been complied with would each need to be relaxed.

Much of the value of merits review both to businesses and the public interest is to significantly improve regulatory certainty, predictability, and accountability. It is an important “pressure valve” which enables regulatory decisions that contain errors or are unreasonable to be corrected. The certainty that merits review provides is, however, significantly devalued if it can easily be removed or removed without an explicit process. It would be considerably more effective as a means of providing regulatory certainty if, rather than the regulations specifying which types of decisions are susceptible to merits review, these were specified in the law itself.

## **6 Summary**

ETNOF is concerned that the draft Gas Law adopts a relatively crude approach with “consider-determine” decision making both as the starting point for the package once it is adopted and as a concept that is partly entrenched. No provision is made to seek (or even to permit) a more sophisticated “fit-for-purpose” approach as has only recently been implemented for electricity transmission under the National Electricity Law.

Broad decision making discretion across whole of the regulatory decision making field is, in ETNOF’s experience tantamount to providing the same agency with rule making and rule administration functions and these issues significantly undermine investment certainty for gas networks.

The legislative package appears not to have built on the key reform decisions that have been made following considerations by the Expert Panel, the AEMC and the MCE itself.

With a stated policy principle of convergence between electricity and gas regulation, ETNOF is concerned that the approach may be extended to the electricity sector and the reforms in that sector may be lost. Accordingly, we seek assurance that this is not the case and encourage an extensive review of this draft legislation, followed by another round of public consultation, before seeking parliamentary assent.