

GasNet Australia Response to the Expert Panel on Energy Access Pricing: Draft Report to the Ministerial Council on Energy

Executive Summary

GasNet Australia owns and maintains 1,930 km of high pressure gas transmission pipeline networks, which serve a total consumption base of approximately 1.4 million residential consumers and approximately 43,000 industrial and commercial users throughout Victoria.

GasNet Australia welcomes the opportunity to respond to the Expert Panel's Draft Report. While supportive of many aspects of the Draft Report by the Expert Panel there are some recommendations that cause GasNet Australia particular concern;

- GasNet Australia strongly supports the propose-respond model being made the default approach to deciding access arrangements.
- We are concerned that the Expert Panel is recommending the Australian Energy Market Commission (AEMC) review and develop Rules that permit the use of the Total Factor Productivity approach possibly at the expense of the fundamental principle of the recovery of efficient costs.
- We are also concerned that the Expert Panel has left open the possibility of including the rate of return and other important parameters in the statutory Rules beyond the reach of regulatory discretion and not subject to merits review.

1. General Comments

- 1.1. GasNet Australia strongly supports the comments made by the Australian Pipeline Industry Association (APIA) and the concerns that they raise in relation to the Expert Panel's Draft Report.
- 1.2. This response will outline some general comments of particular concern to GasNet Australia on the Expert Panel's recommendations as a whole and then will address the chapters of the draft report separately.
- 1.3. GasNet Australia support the concerns expressed by the Expert Panel in relation to the short timeframe available to it in undertaking this review.
- 1.4. We also have concerns about the timing of AEMC current Review of Electricity Transmission Revenue and Pricing Rules at the same time that this Panel is undertaking this review.
- 1.5. These two processes running concurrently may have one of two effects. It could either mean that the statutory Rules in electricity will have to be rewritten to be consistent with the recommendations of the Expert Panel or alternatively could result in the Expert Panel being constrained in its considerations of the issues before it. GasNet Australia thinks that the Ministerial Council on Energy (MCE) should reconsider the timeframe set for the AEMC's consideration of the statutory Rules for Electricity.

- 1.6. GasNet Australia is particularly concerned with the role of the AEMC as outlined in the Draft Report. It appears that the AEMC will be given broad scope and significant discretion in performing its role.
- 1.7. As the case in point, the AEMC has demonstrated an inappropriate exercise of its discretion in the recently published draft National Electricity Rules under the National Electricity Law (NEL). These Rules set out the basis for calculation and the parameter values of the Weighted Average Cost of Capital (WACC) to be applied to all electricity transmission companies. The level of the WACC is an issue of great importance to regulated companies.
- 1.8. The determination of the WACC in the statutory Rules is of concern because, as the Expert Panel is aware, there are differences in the nature of the regulated businesses that rationally would be expected to affect their risk profile and therefore rate of return. Matters such as whether the firm is a distribution or transmission company, whether it operates under contract carriage or market carriage and a host of other factors can be expected to affect a company's risk profile.
- 1.9. The determination of the WACC in the statutory Rules means that it is beyond the scope of regulatory discretion and may not be subject to merits review.
- 1.10. Given the importance of the WACC to the regulated companies the inability to have the decision reviewed could leave companies at significant risk of regulatory error.
- 1.11. It is also likely that frequent and possibly unpredictable changes will occur under the new statutory Rules regime. GasNet Australia's concern is that frequent change combined with broad discretionary powers for the AEMC will lead to considerable uncertainty for the regulated companies and, while it may not be the intention of the Expert Panel, may result in an intrusive regulatory regime at the AEMC's instigation. GasNet Australia notes that it has been our experience (albeit for the operation of a gas market) that changes to the Victorian statutory Market and System Operation Rules are occurring continually.
- 1.12. This makes the broad exercise of discretion available to the AEMC of even greater concern to GasNet Australia as there may be limited remedies available to regulated companies should the AEMC establish a rule that will have an unjustifiable negative impact on their business.
- 1.13. On a related matter, the MCE has yet to publish its report setting out the availability and form of appeal and review mechanisms. Therefore, it is not clear whether there will be merits review of decisions made by the AEMC in relation to the statutory rules which will govern the regulated gas industry. However, it is currently our understanding that the AEMC will not be subject to merits review. Given the broad scope of discretion to the AEMC, we believe merits review should be extended to the AEMC.

2. Legal and Regulatory Framework

- 2.1. GasNet Australia is of the view that the core principles of the new energy access pricing regime should be placed in the NGL. We are concerned that many

fundamental aspects related to operating a regulated business are being left to the discretion of the AEMC. In this respect we support the comments of APIA.

- 2.2. GasNet Australia supports the Expert Panels recommendation to elevate the coverage provisions to the NGL.
- 2.3. GasNet Australia is also concerned that the Expert Panel is proposing that the Australian Energy Regulator (AER) be required to have regard to the Rules and the Objective but not required to have regard to the NGL. Where the Rules are unclear it is appropriate for the AER to obtain guidance from the law or the policy principles of the MCE.
- 2.4. The Expert Panel also recommend that the AEMC review and revise Chapter 8 of the National Gas Rules within 12 months following the enactment of the AGL. There is no prior discussion of this issue in the Draft Report. Therefore, it is unclear as to which parts of Chapter 8 are for consideration in that review.
- 2.5. GasNet Australia views that such a review would provide the ideal opportunity to revisit the investment tests and the investment approval process. These issues deserve a high priority.
- 2.6. The emphasis of any review of the investment process should be on applying the appropriate processes to each business recognising the differences between electricity and gas, transmission and distribution, market and contract carriage, and the importance of certainty for businesses undertaking significant investment.

3. Objectives for the Energy Access Regimes

- 3.1. GasNet Australia's supports APIA's comments in relation to the objective for the energy access regime being based on the formulation by the Productivity Commission:

“promote the economically efficient operation and use of, and economically efficient investment in, the services of transmission pipelines and distribution networks, thereby promoting effective competition in upstream and downstream markets.”
- 3.2. GasNet Australia supports APIA's view about the inclusion of references to competition in the upstream and downstream markets in the object clause. This is because it complements the framework National Access Regime.

4. Scope and Form of Regulation

- 4.1. GasNet Australia supports the Expert Panel's recommendation that greater consideration be given to the role of monitoring.
- 4.2. In relation to this recommendation, GasNet Australia note that the original policy discussion paper by the MCE¹ recommended a broader scope for monitoring, and implied a higher threshold would be applied before a price

¹ Review of the National Gas Pipelines Access regime: Proposal for Consultation, Ministerial Council on Energy, November 2005, Appendix 1.

control would be implemented on utilities. GasNet Australia refers the Expert Panel to its earlier submission to the MCE Consultation Paper².

- 4.3. However, GasNet Australia is concerned as the Expert Panel is proposing that consideration of the criteria for monitoring be undertaken by the AEMC. It is GasNet Australia's view that the criteria to apply in deciding which form of control should be used needs to be specified by the Panel, and these criteria elevated to the NGL.
- 4.4. This is because under the Expert Panel's recommendation the AEMC has been delegated considerable discretion in making criteria. Given that statutory Rule changes would be easier to make than changes to the National Gas Law, this introduces significant regulatory uncertainty.
- 4.5. It is GasNet Australia's view that the Expert Panel should amend its recommendation so that there is additional emphasis on price monitoring as the default position in the NGL.
- 4.6. Under this philosophy, the regulator would apply monitoring in the first instance where it was determined that direct regulation was required. A price or revenue control would only be applied if there is a demonstrated abuse of market power. This option would be supported by self regulation e.g. a voluntary code of conduct. The advantages of this approach are that:
 - it is cheaper
 - it is more flexible
 - and it interferes less with commercial relationships.
- 4.7. The Panel lists a set of objective criteria to determine the extent of market power³. We wish to emphasise that the over-arching criterion should not be the ability (in the abstract) to exercise market power, but demonstrated evidence that market power has been abused.
- 4.8. In relation to the actual decision made under the price control criteria, it is GasNet Australia's position that such decisions should not be made by the AEMC but should be made by the coverage body, currently the National Competition Council. This is because the decisions would be based on similar analysis and considerations as are already undertaken by that body on areas of coverage, including those criteria identified by the Expert Panel.

5. *Framework for Regulatory Decision Making*

- 5.1. The majority of the Expert Panel recommended that the AEMC should set the standard for AER decision making in relation to network pricing principles. The majority of the Expert Panel also recommended that guidance for the AEMC should be provided in the form of an MCE statement of policy principles.
- 5.2. It is GasNet Australia's view that this still gives too much discretion to the AEMC and, given the statutory Rules can be amended through a flexible change

² GasNet Submission on the MCE Response to the Productivity Commission Review of the Gas Access Regime, GasNet Australia, 14 September 2005.

³ Draft Report to the Ministerial Council on Energy, Expert Panel on Energy Access Pricing, March 2006, p51

procedure, provides uncertainty for investors. Therefore, it is our view that the standard should be included in the legislative framework.

- 5.3. The move away from a light handed regulatory approach is evident in relation to the recommendations made in sections 5.5.2 and 5.5.3. GasNet Australia is concerned because the majority of the Expert Panel recommends that the regulatory decision-making environment be changed away from a default propose-respond model and left up to the discretion of the AEMC in the statutory Rules. This may lead to uncertainty.
- 5.4. Given the importance of the framework of regulatory decision making this is a matter that should be decided by the Expert Panel and incorporated into the NGL. It should not be left to the discretion of the AEMC.
- 5.5. If the AEMC chooses to implement a consider-decide approach this would have the effect of replacing the judgement of the regulated entity with that of the regulator or the AEMC.
- 5.6. GasNet Australia has some concerns in relation to the analysis supporting the Expert Panel's recommendation. The Expert Panel state that for a propose-respond model to be demonstrated to be superior to conventional consider-decide regulatory model it must be shown to be both superior to alternative means of addressing regulatory risks and capable of practical implementation.
- 5.7. The propose-respond model is the status quo in gas. The Expert Panel seems to have taken an approach in this Draft Report of requiring retention of the status quo to be justified rather than requiring the new model display additional benefits. It seems strange that the arguments in favour of retaining the current decision making model are cross-examined in detail in section 5.4.6 and yet there is no equivalent evaluation of the proposed benefits of the consider-decide decision making model undertaken in the draft report. It is GasNet Australia's view that the Expert Panel has not displayed the superiority of the consider-decide decision making model in this report.
- 5.8. Because of the risk and cost associated with change, principles of good policy design require that it is the model that is requiring change that needs to be shown to be clearly and materially superior.
- 5.9. Some recommendations made by the Expert Panel do not seem to be giving sufficient weight to the downside risk. In particular the Expert Panel notes that determination of the appropriate level of cost and return for a regulated company is a matter of judgement⁴. The Expert Panel also notes that both of the models under consideration may lead to systematic bias. The propose-respond model may lead to a bias in over estimating the returns to investors⁵.

⁴ Draft Report to the Ministerial Council on Energy, Expert Panel on Energy Access Pricing, March 2006, p73

⁵ Draft Report to the Ministerial Council on Energy, Expert Panel on Energy Access Pricing, March 2006, p61

On the other hand, the consider-decide model may have a systematic bias in under estimating the returns as the result of self justification by the regulator.⁶

- 5.10. As noted in the report there is a relationship between the regulatory return and the perceived risk of future investment⁷. The Expert Panel notes the asymmetric consequences arising from regulatory error⁸. However, the Expert Panel then proceeds to reject the “propose-respond” model in large part on the basis that it believes that it creates an upward bias in price determinations. It is GasNet Australia’s concern that the Expert Panel may be underestimating the significant consequences of a downward bias in returns.
- 5.11. The Expert Panel then goes on to criticise the proposed “range of plausible estimates” wording for implementing a new propose-respond model as suggested by the Productivity Commission.
- 5.12. GasNet Australia is concerned that Expert Panel may have been distracted by the alleged flaws in the wording as proposed by the Productivity Commission. GasNet Australia remind the Expert Panel that the current test is not a “plausible range”. The Australian Competition Tribunal indicated that where the service provider proposes an access arrangement “within the range of choice reasonably open and consistent with the Reference Tariff Principles” the regulator must accept the proposal. This means the test is one of “reasonableness” not “plausibility”. As noted in the Expert Panel’s report, the test of reasonableness is one well established in law.⁹
- 5.13. It may be this focus on the Productivity Commission’s proposed wording, rather than the current model, that has led the Expert Panel to have concerns about whether the propose-respond model can be applied.
- 5.14. On other Framework issues, GasNet Australia supports the recommendation for removal of price regulation from greenfield sites. However, we are of the view that the removal of price regulation could be expanded to apply to significant augmentations of the existing network as the same investment dynamics apply to these sites.

6. Guidance on the Application of the Price Control

- 6.1. In section 6.5.2 the Expert Panel recommends that the NEL and the NGL include common network pricing principles based on section 35 of the NEL.
- 6.2. GasNet Australia wishes to emphasis that the recovery of efficiently incurred costs is a fundamental principle for any regulated business which must be clearly and unambiguously guaranteed by the MCE. It is GasNet Australia’s view that this fundamental principle should be clearly outlined in the National

⁶ Draft Report to the Ministerial Council on Energy, Expert Panel on Energy Access Pricing, March 2006, p68

⁷ Draft Report to the Ministerial Council on Energy, Expert Panel on Energy Access Pricing, March 2006, p68

⁸ Draft Report to the Ministerial Council on Energy, Expert Panel on Energy Access Pricing, March 2006, p70

⁹ Draft Report to the Ministerial Council on Energy, Expert Panel on Energy Access Pricing, March 2006, p81

Gas Law. The Council of Australian Governments formulated the principle as follows:

“so as to generate expected revenue for a regulated service or services that is at least sufficient to meet the efficient costs of providing access to the regulated service or services and include a return on investment commensurate with the regulatory and commercial risks involved”

- 6.3. Such a formulation would be consistent with investors expectations that the business could recover efficient costs.
- 6.4. The Expert Panel expresses concern with the current wording of 8.1(a) and of the amendments recommended by the Productivity Commission and recommends that the AEMC consider revised wording which will be consistent with Total Factor Productivity (TFP). GasNet Australia does not believe there is any necessary inconsistency between the use of TFP and the recovery of efficient costs. In our view, the application of TFP simply is an alternative approach to identifying what are the true efficient costs.
- 6.5. However, the recovery of efficient costs is of such a fundamental nature to successful regulation of pipeline networks, that should TFP conflict with this objective then the fundamental principle should take precedence over the selection of alternative forms of regulation.

7. Information Requirements

- 7.1. GasNet Australia join with APIA in supporting the Expert Panel’s recommendation for a common framework for information gathering powers across the energy industry.
- 7.2. However, information requirements are another area where GasNet Australia is concerned about the wide level of discretion that is available to the AEMC and the possibility on increasing levels of regulation over time.