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19 December 2006

Manager, MCE Secretariat,
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Dear Sir / Madam

Submission on National Gas Law and National Gas Rules

Thank you for the opportunity to comment on the exposure drafts of the new national laws and rules for gas.

VENCorp's comments are provided in the attached report, combining our comments on the drafts of both the Law and the Rules. We have limited these comments to those areas of particular interest to us, and have made five recommendations in respect of these areas to assist the reform group in addressing our concerns.

We look forward to working with the reform group on these matters. If you have any questions on the comments or other matters arising from this submission, please contact Mr Craig Price on 03 8664 6614.

Yours sincerely

A handwritten signature in black ink that reads "M. Zema".

Matt Zema
Chief Executive Officer

Submission on National Gas Law and National Gas Rules

VENCorp, 19 December 2006

This report provides VENCorp's combined comments on the exposure drafts of the new national laws and rules for gas¹, and our recommendations to the reform group on how to address the issues raised.

VENCorp's comments are structured as follows:

1. The excessive level of prescription in the draft Law

Recommendation: The MCE should urgently review the amount of detail that has been uplifted from the old Code into the draft Law, with a view to transferring detail into the Rules whilst retaining the essential policy matters in the Law.

2. Practical issues with the capital investment criteria proposed for the draft Rules and a recommended alternative.

Recommendation: We propose that s27 of the Rules be re-drafted to be consistent with MCE policy decisions in respect of energy and increased convergence of gas and electricity, and align it with AEMC decisions on the regulatory test applied in electricity by the National Electricity Rules.

3. The unnecessary continuation of distinction between market and contract carriage in the draft Law.

Recommendations: We propose that:

- a) *The terms "market carriage" and "contract carriage" are removed from the draft Law.*
- b) *The draft Law is amended to apply requirements for provision of access to services on covered pipelines more generally and applicable across all covered transmission pipelines, with potential for exclusion of some elements (such as capacity notification or trading/release schemes) not relevant to covered distribution pipelines.*

4. Interface with existing and future gas markets

We request that the MCE clarify how the state-based market arrangements in NSW, SA and Victoria are to be applied under the national framework, and if the National Gas Law or Rules are to be modified accordingly, to what extent industry will be consulted in light of the currently targeted date of implementation on 1 July 2007.

5. Practical issues with definitions developed for the draft Law.

We recommend that:

- a) *The draft Law and Rules be amended to ensure that all definition terms be provided in a central glossary section in each instrument*
- b) *The reform group urgently undertake a thorough review on all definitional changes in the draft Law for consistency and application with the provisions carried over from the Code to ensure that changes do not have unintended consequences of any major significance.*

¹ National Gas Law Exposure Draft, 3 November 2006;
National Gas Rules Exposure Draft 21 November 2006

1. Level of prescription in the draft Law

A large amount of the Code has apparently been uplifted into the draft Law as opposed to the Rules. It appears that when attempting to uplift the elements with policy implications that the corresponding detail from the Code has also been uplifted.

Commentary:

VENCorp expected a more selective uplifting of the framework, policies and guiding principles to Law, with the detailed implementation aspects left to the Rules. This would have struck a better balance between placing control of policy with MCE (by inclusion in Law) and control of implementation with AEMC (by inclusion in Rules).

A more selective approach has much greater long term benefits, as the AEMC will be in a much better position to respond more effectively to developing market requirements on matters of detail and implementation. We are concerned about the ability of the national arrangements to respond effectively to market requirements if the current extent of detail is retained in Law and requires changes to national laws to make amendments. We are also concerned that the current problems with amendment of the Code will be continued unless a more selective approach is adopted.

We have provided further evidence of issues arising from the current drafting approach in the following sections.

Recommendation #1:

The MCE should urgently review the amount of detail that has been uplifted from the old Code into the draft Law, with a view to transferring detail into the Rules whilst retaining the essential policy matters in the Law.

2. Planning criteria in the draft Rules

Most of the existing Code s8.16 (New Facilities Investment) has been transferred to the draft Rules as section 27 with little change. Section 27 of the draft Rules relates to criteria for rolling new capital investment into the capital base:

- Most of s8.16(a) of the Code on New Facilities Investment has been transferred, with minor definitional changes, into s27 of the Rules.
- Section 27(2)(b) of the draft Rules (refer s8.16(a)(ii) of the Code) requires satisfaction of at least one of three conditions for the inclusion of new capital investment in the capital base:
 - the first of these tests inquires whether the investment is financially viable, and the regulator must be satisfied that the anticipated revenue generated is likely to exceed the cost of the investment (presumably, but un-stated, in present value terms);
 - the second test inquires whether the investment will provide system-wide benefits, and the regulator must be satisfied that the new facility has system-wide benefits that justify the approval of a higher reference tariff for all users; and
 - the third test requires that the regulator must be satisfied that the investment "is necessary to maintain or improve the safety and integrity of services" or maintain the "capacity to meet contractual obligations or provide services".

- Consistently, Code s8.17, which currently guides the AER in applying the criteria of Code s8.16, has also been transferred to Rules as s27(3) to guide the AER in applying s27(2).
- A new condition, s27(3)(c), has been added to the decision making of the AER, requiring the AER to now also consider whether the investment is “prudent” when it makes a decision whether or not the criteria (s27(2)) are satisfied.

Commentary:

The approach is not aligned with policy or convergent with that applied in electricity

The draft Rules, by continuing the Code, is confusing to apply and likely to inhibit future prudent investments, and is misaligned with both MCE policy and the AEMC’s current views.

The essential intent of s27 is that an investment be prudent and efficient². The Rules, as drafted, confuse matters of investment justification with allocation of the costs, and are inconsistent with both MCE policy and the AEMC’s decisions on the same matters in electricity.

It is our view that the nation would be better served where the Rules provided for much greater convergence between the gas and electricity industries on fundamental matters such as planning criteria for inclusion of investments in the regulated capital base. This could be better achieved if the Rules were more aligned with the regulatory test as set out in the national electricity arrangements (specifically, in the National Electricity Rules). The electricity regulatory test is satisfied as long as the benefits of an investment exceed the costs of that investment. The electricity test does not consider distributional issues such as who benefits, or which classes of users benefit from the investment. The regulator only needs to be satisfied that the overall net benefit can be proven for the investment to be included in a regulated asset base.

We note that this regulatory test was recently the subject of a review by the AEMC following changes proposed by the MCE which discussed the form of the regulatory test and distributional issues associated with the benefits of the test.

One of the MCE’s proposals was that the regulatory test should be based on the principles of cost-benefit analysis. The generally accepted economic doctrine requires that the measurement of economic benefits is based on the consideration of both the producer surplus (the difference between what someone can earn from producing a good or service and the opportunity cost of producing that good or service) and consumer surplus (the difference between what a consumer is willing to pay for that good or service and what someone actually does pay) equally.

The AEMC concluded that in order for the regulatory test to satisfy the MCE’s proposal it must consider benefits accruing to both producers and consumers equally to ensure that it is consistent with the NEM objective which specifies ‘efficient investment’ as one of the key elements of meeting the long term interest of consumers.³

The AEMC’s determination also discusses distributional impacts in relation to whether the regulatory test should consider benefits accruing to consumers higher than to producers. On this issue, the AEMC concluded⁴ that

“...distributional considerations (transfers) are a matter for policy makers and are not an economic issue. However, in the view of the Commission, *such distributional considerations relate to questions about who*

² The objective of the national gas law is to promote efficient investment in, and efficient operation and use of, natural gas services for the long term interests of consumers of natural gas with respect to price, quality, reliability, and security of supply of natural gas.

³ The national electricity market objective is to promote efficient investment in, and efficient use of, electricity services for the long term interests of consumers of electricity with respect to price, quality, reliability, and security of supply of electricity and the reliability, safety and security of the national electricity system.

⁴ AEMC, National Electricity Rule Amendment, Reform of the Regulatory Test p 55; (emphasis added)

should pay for transmission augmentation, rather than whether or not it would be efficient to under the augmentation in the first place."

The second test in s27(2)(b, transported from the Code, confuses the issues of justification (for investments) and cost allocation (from those investments).

This provision is of particular interest to VENCORP, as the ACCC/AER has interpreted this test such that *all* users (e.g. industrial, residential, commercial etc) across the entire covered pipeline (i.e. the Principal Transmission System, PTS) must benefit from the new investment. While the ACCC/AER has said in its decisions that the benefits do not have to accrue equally or simultaneously, it has said that they must be enjoyed by *all* users. Apart from a minor error in law in relation to the application and definition of the term "users" under the Code⁵, this interpretation nevertheless leads to problems for future investment in the PTS.

While this generally has not been a problem so far for the construction of new facilities which provide an increase in network capacity to Melbourne, this is only because the ACCC/AER has accepted that all users will benefit from maintaining the supply of gas into Melbourne because of its flow on effects in both market and operational terms.

However, this interpretation can inhibit investments on lateral pipelines because only users who transport gas on the lateral pipeline are able to benefit from the investment and therefore not *all* users.

The problems are inherent under a requirement for "system-wide" benefits, and the additional requirement that the benefits must accrue to "all" service users. This may well hinder future investment in major transmission augmentation on one side of the system or in interconnection capability, as not all users will benefit.

This problem does not exist in the national electricity market, as the AEMC has managed to clearly distinguish between the form of the regulatory test and distributional issues associated with the benefits of the test, two fundamental issues which inhibit the use of the system wide benefits test.

Given that the national gas objective⁶ also requires consideration of 'efficient investment', and that a test which is based on cost-benefit principles is considered to be consistent with this objective, it is our view that the system wide benefits test, as currently designed, is inconsistent with the gas law objective and is unlikely to lead to efficient investment.

As the current draft of the Rules explicitly *includes* distributional considerations, it is our view that it is inconsistent with generally accepted economic practices and with the gas law objective, and should be aligned with the electricity regulatory test.

In light of these considerations, VENCORP believes that there is substantive justification to rethink the approach in the Rules and align it better with MCE policy and current AEMC position.

Recommendation #2

We propose that s27 of the Rules be re-drafted to be consistent with MCE policy decisions in respect of energy and increased convergence of gas and electricity, and align it with AEMC decisions on the regulatory test applied in electricity by the National Electricity Rules.

⁵ "Users" under the Code (and now the draft Law) are *not* end users of gas, rather users of the services for transmission access. Both the Law and the Code separately define end users. These tests therefore relate only to users of the services provided by the service provider(s) for access on the covered pipeline(s). Specifically, these parties are the market participants under the MSOR, rather than end users.

⁶ The objective of the national gas law is to promote efficient investment in, and efficient operation and use of, natural gas services for the long term interests of consumers of natural gas with respect to price, quality, reliability, and security of supply of natural gas.

3. Contract / Market carriage definition in the draft Law

The draft Law has uplifted the definitions of contract carriage and market carriage from the Code with little change⁷, and in so doing has transferred some long running deficiencies of the Code into the Law.

The definition of market carriage is only applied in s165, which has the only function of requiring the service provider to make a statement as to whether the covered pipeline is a market carriage pipeline.

The definition of contract carriage is only applied in sections 5, 130, 165 and 167, which are subsidiary provisions placing additional requirements on parties for capacity trading and delivery and receipt notification requirements as contents of an access arrangement.

The requirement for prior Ministerial consent from the participating jurisdiction for application of market carriage has been dropped.

Commentary:

We do not consider that it is either practical or desirable to attempt to make a distinction between approaches to “managing supply of pipeline services”, and in particular, contract carriage and market carriage, for the purposes of the Law.

This is because any such distinction is at best artificial and a question only of detail of implementation. In practice, the specific differences of each approach to access to and supply of pipeline services are becoming more blurred and are a matter purely of implementation detail rather than importance.

To further highlight these points:

- Market carriage was a term constructed at the final moments of completion of the Code to distinguish the Victorian transmission arrangements from elsewhere. However, the last minute additions were not complete. The Victorian wholesale market arrangements include well defined and tradeable transmission rights that can be underpinned by contracts for capacity⁸. Yet the description in the Code (and now uplifted to the Law) portrays market carriage as a third party access system that does not normally⁹ include transmission rights. This error has continued to cause significant misunderstandings throughout the last 9 years.
- If Stage 2 or Stage 3 of the Victorian market reforms (endorsed by the state government) are progressed, contracted capacity rights will be directly introduced into the Victorian arrangements for market carriage. Under the Code (and now, the Law) definitions, Victoria could then qualify to be classified equally as either “contract carriage” or “market carriage”, as either classification would be satisfied.
- Any proposed new short term trading arrangements for the national gas market must encompass all approaches to access and systems for supply of pipeline services, further minimising the apparent differences between the various approaches to provision of pipeline services.
- There is no functional application of the term market carriage in the draft Rules, and the only purpose of the term contract carriage is to apply requirements for contents in

⁷ With only minor alterations, such as replacement of the word “normally” with the word “usually”, and replacement of the defined term Services with the defined term “pipeline services” (with an equivalent definition).

⁸ And have done so since market commencement.

⁹ The Law has altered “normally” to “usually”, but this minor change misses the essential issue.

an access arrangement (s165 of the Law) which are better applied more generally across all covered transmission pipelines.

It is our view that the essential policy requirements for third party access should be distilled and incorporated in the Law, such as the requirement for a system of open access to capacity and a capacity release program. The Law should require service providers have arrangements for queuing, trading, voluntary/mandatory requirements for release of spare capacity, and publication of information on capacity availability¹⁰. This should apply to all covered transmission¹¹ pipelines. However, specifics relating to implementation of these policy requirements is better left to the Rules.

Equivalent requirements should be placed on service providers for pipeline services regardless of the manner by which third party access to those services is managed, such as requirements for queuing policies, and where rights or contracts are present, trading policies for those rights. This can be done by redrafting sections of the Law / Rules to directly address these requirements whilst removing the artificial distinction presently in the draft Law between contract and market carriage.

For example, specific drafting amendments could be:

- Amend the definition of spare capacity in section 5 of the Law to generalise the definition applied by part (b) to be generally applicable to all pipelines.
- Amend s129 relating to Definitions to remove the definitions of market carriage and contract carriage and replace with a more general term.
- Amend s130 relating to specific requirements of delivery and receipt notification requirements, replacing the requirements with a general requirement for processes and shifting the detail to the Rules, and this detailed re-drafting to cover all requirements for forms of pipelines.
- Amend s165 relating to contents of an access arrangement, to remove the s165(1)(b) requirement for stipulation as either market carriage or contract carriage, and generalise the requirements of s165(1)(e) and s167 for capacity release.

Recommendation #3

We propose that:

- a) The terms "market carriage" and "contract carriage" are removed from the draft Law.
- b) The draft Law is amended to apply requirements for provision of access to services on covered pipelines more generally and applicable across all covered transmission pipelines, with potential for exclusion of some elements (such as capacity notification or trading/release schemes) not relevant to covered distribution pipelines.

4. Interface with existing and future gas markets

The drafts are silent on the treatment of the jurisdictional specific arrangements. At present the Law and Rules only relate to access elements. It has been mooted that the market arrangements, and in particular jurisdictional specific Rules, will be covered in the 2007. It is not clear whether these arrangements will be dealt with via application acts in each state, or as suggested at the public forum in Melbourne via either the Law or Rules.

¹⁰ Notably, in the US, FERC also requires publication of prices, which does not seem to have any support in Australia.

¹¹ Requirements for capacity release and/or trading schemes are not directly compatible with distribution networks, some of which are also covered pipelines. This is the case regardless of whether contract or market carriage is in operation.

These interfaces are very important to industry. It would seem appropriate that the MCE provide direction and clarification as to how and when the arrangements are to be resolved, given the current target date of implementation of July 2007 and that the MCE is currently consulting on the draft arrangements in law and rules.

It would be highly useful for the MCE to clarify how it intends that its recommendations in this regard be implemented, particularly if the Law or Rules are to be further modified to make provisions for these arrangements.

Recommendation #4

The MCE should clarify how the state-based market arrangements in NSW, SA and Victoria are to be applied under the national framework, and if the National Gas Law or Rules are to be modified accordingly, to what extent industry will be consulted in light of the currently targeted date of implementation on 1 July 2007.

5. Practical issues with definitions developed for the draft Law.

The style adopted by drafters of the Law transfers definitions from a central place in the Code into a combination of partly in one general section and also partly into each chapter, both at the start of a chapter, and in some cases, located throughout the Law.

There have also been minor changes to definitions applied in the Code in the transferral, whilst in many cases the existing Code has also been transferred.

Commentary:

Whilst the proposed style adopted in the draft Law is perfectly valid in law, the approach is confusing and unhelpful to those to whom the Law applies and who have to apply it. It is our view that a continuation of past practice of consolidating all definitions in one section for ease of reference is far more transparent and user-friendly and will lead to much less confusion and risk of technical non-compliance in the future. We have noted several instances of definitional changes for which there does not appear to be any benefit. In addition, and more concerning, we have noted some instances where the definitional changes have more significant consequences.

For example:

- The draft Rules appear to have dropped the definition of New Facilities Investment, previously supplied by Code s8.15, which had an apparent benefit of providing guidance to the AER on allowable capital to be included. Rules s27(2)(b)(i) has instead applied a general reference to capital expenditure, leaving it to the AER to determine whether costs associated with the new investment that were previously covered by s8.15 (e.g. development and acquisition) will be continue to be allowable for inclusion as capital expenditure.
- The draft Law has amended the definition of capacity expansion. In s129, a capacity expansion is defined as the expansion of the capacity of an *access dispute pipeline* (emphasis added). VENCORP believes that the definition should be 'capacity of a **covered pipeline**', rather than capacity of an access dispute pipeline.

This leaves us with some concern over the amount of subtle change that has been undertaken and whether there are other unintentional consequences of the redrafting.

Recommendation #5

We recommend that:

- a) The draft Law and Rules be amended to ensure that all definition terms be provided in a central glossary section in each instrument

b) The reform group urgently undertake a thorough review on all definitional changes in the draft Law for consistency and application with the provisions carried over from the Code to ensure that changes do not have unintended consequences of any major significance.