1 March 2004

Mr Tony Hinton
Commissioner
Productivity Commission
Locked Bag 2 Collins St East
Melbourne VIC 8003

Dear Mr Hinton

Re: Draft Report – Review of the Gas Access Regime

Envestra has reviewed the Commission's draft report and is pleased with the progress made by the Commission in assessing key deficiencies of the regime. Envestra generally endorses the majority of the Commission's findings and recommendations. Where Envestra disagrees or has comments, we have provided the relevant information in the attachment. We have also provided some information in response to the Commission's request for further information as detailed on page "L" of the draft report. For further detailed commentary, we also refer the Commission to the response by the Energy Networks Association.

We believe there are two key areas where further work is required by the Commission:

(1) Cost of service approach – where this approach continues to apply, the Commission has not fully addressed all of the areas where improvements are necessary. For example, while the Commission acknowledged the "imprecision and subjectivity that occurs when regulators are required to approve reference tariffs" (Draft Finding 7.2), there is no recommendation that addresses this substantive issue. Envestra refers the Commission to recent appeal decisions (in relation to GasNet and Epic MAPS) that provide important guidance in this area. We suggest that the Commission specifically includes the principles established in these appeals in its recommendations on improvements to the Code.

(2) Implementation – once the Commission has completed its final report, it is imperative that its recommendations are able to be implemented in a timely manner, otherwise the opportunity to significantly reduce regulatory costs from forthcoming Access Arrangement reviews will be lost. Envestra urges the Commission to outline a framework that, as far as possible within its powers, will deliver the necessary reform in the shortest timeframe possible.

Implementation will also involve ensuring that the intentions of the Commission are correctly reflected in the detailed amendments to the Code/regime. This is because we

are cognisant that higher level principles, such as objects clauses and pricing prinicples, may not be translated by regulators into outcomes which truly reflect the aims being sought by the Commission. As far as possible, the scope for interpretation of the Code must be minimised by ensuring that Code amendments are adequately detailed, with sign-off by the Commission prior to implementation.

Envestra especially welcomes the Commission's recommendation that a price monitoring regime be available for covered pipelines. However, the real benefits of such a light handed regime will only come to fruition if it is applied to networks generally, as compared to its application in isolated instances. As noted in the attachment, Envestra believes that price monitoring should be the default regime applicable to networks, with the heavier-handed cost of service approach then only applying where necessary due to failure of the lighter-handed approach.

We look forward to the Commission progressing its report and extending it to cover the areas identified above.

Yours sincerely

A Staniford
Commercial Manager

ENVESTRA COMMENTS on the
PRODUCTIVITY COMMISSION DRAFT REPORT – REVIEW OF THE GAS ACCESS REGIME

Draft Recommendation 5.3

The following elements of s.2.24 of the Gas Code should be deleted:
(a) The Service Provider's legitimate business interests and investment in the Covered Pipeline
(d) The economically efficient operation of the Covered Pipeline
(e) The public interest, including the public interest in having competition in markets (whether or not in Australia)
(f) The interests of Users and Prospective Users
(g) Any other matters that the Relevant Regulator considers are relevant.

Comment

Envestra believes that part (a) above should be retained. We note the Commission's view that the "overarching objects clause encapsulates the possible tension between the interests of service providers and users and seeks to resolve it in an efficiency context" (page 152). However, it is important to recognise property rights and the significant investment which a Service Provider may have made in the Covered Pipeline, as the courts recognised in the Western Australian Epic Energy case. While we support principles that promote movement towards the "economically efficient" use of and investment in pipelines, recognition needs to be given to historical circumstances that constitute legitimate business interests of the Service Provider. This view is further supported by principles established as a result of the appeal under the National Gas Code by Epic Energy in relation to the Moomba-Adelaide Pipeline System[1].

Draft Finding 6.2

The coverage criteria need changing to ensure that the Gas Access Regime is applied to pipelines only when likely to improve economic efficiency significantly.

Comment
Envestra supports the finding of the Commission that coverage should only apply to pipelines when it is likely that economic efficiency will be significantly improved. The initial 'carte blanche' coverage of pipelines under the Code was made without consideration of the economic impacts of coverage. This has resulted in the consequential removal of coverage of a number of pipelines in a gradual and inefficient process.

The coverage test proposed by the Commission would, if applied correctly, provide a more balanced framework.

[1] Application of Epic Energy South Australia Pty Ltd [2003] ACompT5 [48]

Draft Finding 7.3

Regulators are currently seeking to have their powers extended so they can obtain information between access arrangement reviews. This extension has the potential to add unnecessarily to service providers' compliance costs.

Comment

Envestra advises the Commission that regulators are not only "seeking" to have their powers extended but have already decided that their powers do extend to the collection of information between reviews and have already begun to implement such arrangements. Our experience indicates that the information being sought extends beyond that required for an Access Arrangement review (ie Attachment A to the Code). We urge the Commission to develop its finding into a firm recommendation that limits the collection of information to the time of regulatory review. This should be the underlying principle for any light handed regulatory regime.

The current regime is also susceptible to regulatory creep through the ability of regulators to circumvent Code limitations on regulators' powers. This predominantly occurs where the regulator is also the distributor's licensing authority. Licensing authorities generally have very broad powers to impose licence conditions upon distributors, which usually include adherence to any codes, guidelines, information provision requirements, etc, that the regulator formulates (eg ESC[2] and ESCOSA[3]).

There must be a clear separation of powers in relation to licensing and the Access Code. In this regard, Envestra supports the Queensland regime whereby the Queensland Competition Authority, as the relevant regulator under the Code, is a separate body from the licensing authority – the Office of Energy. Envestra believes this model should be adopted in other States to eliminate and avoid future overlap of regulatory powers and regulatory creep.

Draft Recommendation 7.3

The Gas Code should be amended to ensure that regulators' requirements for establishing and maintaining information are standardised across jurisdictions and are as close to existing gas industry accounting or record keeping practices as possible.

Comment

Envestra supports the standardisation of information requirements across jurisdictions. However, the Code already provides for standardised information in Attachment A. Should such requirements

[2] licence clause 4(a) "The Distributor must comply with … all other codes, standards, rules and guidelines which are specified by the Commission to apply to the Distributor"
[3] licence clause 4.3(c) "The licensee must comply with any industry code or industry rule made by the Commission from time to time relevant to the licensee"

not be adequate, then it is appropriate that Attachment A be amended. Incorporation into the Code is the only means of ensuring standardisation and eliminating the possibility of regulatory creep.

Draft Recommendation 7.4

Section 3.16 of the Gas Code should be amended so that any expansion of a covered pipeline will be treated as part of the covered pipeline, unless the service provider nominates otherwise and the regulator agrees.

Comment

Expansions should not be covered unless an application for coverage is made and consequent due process follows, ie proper market analysis. This view is supported by the outcome of the Epic MAPS appeal[4], where the Australian Competition Tribunal rules against the ACCC's requirement that the Pelican Point expansion of the Moomba to Adelaide Pipeline be automatically 'covered'.

Draft Recommendation 8.1

The Gas Access Regime should be amended to provide for a lighter handed form of regulation whereby the application of the alternative regulation involving an access arrangement with reference tariffs would only occur in the more extreme circumstances. The lighter handed alternative should be a monitoring regime. It is important that the monitoring regime not develop into an intrusive and costly form of regulation.

Comment

Envestra supports the Commission's recommendation for a monitoring regime as a lighter handed means of regulation. In the same way that all pipelines were initially covered under the Code, the heavy-handed prescription of reference tariffs was also adopted as a standard, with little regard for alternative approaches. The market has therefore had no opportunity to perform under a less prescriptive and more efficient regime. As the Commission has found (Draft Finding 3.1):

> *"The Gas Access Regime is a form of price regulation based on a cost-of-service model. It is, therefore, at the more intrusive end of regulation"*

We also note the Commission's finding (Draft Finding 4.5) that:

> *"Generally, regulation involving access arrangements with a reference tariff should be considered only where service providers have substantial market power."*

It needs to be considered here that the existence of substantial market power and the use of that market power are different things. In a workably competitive market, there are players that have substantial market power but that still operate in a competitive environment that inhibits the abuse

[4] Application of Epic Energy SA (2003) AcompT5[48]

of that market power. In relation to gas distribution networks, distributors will always need to compete with electricity and other fuels. Gas is a fuel of choice, and unless it is competitively priced, penetration rates will decrease. Due to the fixed infrastructure costs, this results in increased costs per customer, which in turn promotes a downwards-spiraling effect on consumption. Distributors are therefore well aware of the importance of maintaining gas penetration and maintaining a competitive service, evidenced by the considerable sums of money spent by gas distributors on network marketing.

It is therefore appropriate that a price monitoring regime be established as the default standard regime for all networks, with a reference tariff applying only where price monitoring fails. With reference tariffs now in place for all major networks, there is an unambiguous baseline upon which to interpret trends in prices and services, and regulators will be well positioned to monitor the market. In the event that it is found that a distributor has substantial market power and is abusing that market power, then the more intrusive form of regulation can be applied.

The above approach will

(a) Ensure that the default form or regulation is even-handed approach

(b) Provide for more stringent regulation where there is evidence that this is required (as opposed to the reliance on theoretical suppositions of competitive outcomes)

(c) Avoid a rush of applications for movement of networks from the current cost of service regulation to price monitoring. It is envisaged that such applications could take considerable time to progress and result in protracted delays to the implementation of a new regulatory regime. The implications of this is that, in the meantime, further Access Arrangement reviews under the current regime will have taken place, further compounding the inefficiencies which the Commission is seeking to avoid.

In relation to the Commission's concern regarding the monitoring regime developing into an intrusive and costly form of regulation, the probability of this can be minimised by ensuring that the framework for price monitoring is set out in a manner that leaves little discretion for regulators in developing additional guidelines, methodologies or reporting arrangements. Regulatory certainty promotes efficient costs and investment, and a significant impediment to date has been the uncertainty surrounding the application of the Access Code by regulators. This has engendered a 5-year focus for regulated businesses to minimise business risk. For example, the alignment of funding arrangements to coincide with the date set by a regulator for the determination of the regulatory WACC reduces regulatory risk, but the outcome for the market may not be efficient. Such perverse outcomes reinforce the need for a lighter-handed and less prescriptive regime.

Draft Finding 8.1

Information disclosure under the monitoring regime would be assisted by disclosure guidelines. The National Competition Council (rather than a regulator) would need to develop and update such guidelines. Ideally, this would involve a consultative process that is open and transparent with interested parties.

Comment

Envestra supports the transparent formulation of guidelines under the auspices of a party other than a regulator. However, it is questionable as to whether the role of the NCC should extend to such issues as the development of guidelines. We believe it more appropriate that the development of those guidelines should be overseen either by the Commission or the body that replaces NGPAC.

Draft Recommendation 11.1

The Gas Access Regime should be amended, whereby the regulator would:

- *be able to extend the period for approval of an access arrangement by two months only once*
- *have the discretionary power to backdate reference tariffs.*

Comment

While the backdating of reference tariffs may be of benefit to service providers and users, the implementation of such a proposal is fraught with difficulty. The Commission has alluded to several considerations in this regard. Of paramount importance would be the need to reduce uncertainty, both from a legal and regulatory perspective. Unless such arrangements are adequately defined, the benefits of backdating may be negated by prospects of disputes and legal challenges concerning the quantum amounts, interest charges, relevant dates and parties, etc. This is further compounded if the regulatory has discretionary powers in this area.

In the event that backdating is implemented, there would need to be no discretionary power by the regulator. Experience suggests regulators would tend to use discretionary power where this errs on the side of users. (For example, in setting reference tariffs, the Victorian Essential Services Commission prefers to truncate tariffs to the lowest decimal point, rather than round numbers to the nearest decimal point).

Draft Recommendation 11.3

The Gas Access Regime should be amended whereby the 'further final decision' should be removed from the approval process for access arrangements.

Comment

Envestra is concerned that the Commission has been misinformed concerning the further final decision. This stems from the misnomer "further final decision". Envestra views this step in the process as one that confirms that the documentation submitted by the service provider is generally

in accordance with the requirements of the final decision. This "document approval" or "Access Arrangement approval" step should not be linked with the final decision, as the name implies.

This final step is important in practice, if only because final decisions can (and have been known to) contain material errors, which can only be rectified by the submission of an Access Arrangement that "substantially" incorporates the amendments specified by the relevant regulator, in accordance with section 2.41 of the Code.

Removal of the "further final decision" will not shorten the process, as the regulator will still need to perform a quality assurance check on the final delivered product and issue a formal endorsement that the product, in this case an Access Arrangement, is compliant, within certain tolerances, with the 'specification'.

Envestra therefore disagrees with

(a) the portrayal of the further final decision as a further opportunity to address the regulator;
(b) the assertion by the ACCC that the final approval causes several months of delay, since the service provider must submit revisions to the Access Arrangement by a date specified by the regulator (section 2.41 of the Code).

Draft Recommendation 11.4

The Gas Access Regime should be amended so regulators can specify a date by which the service provider must submit proposed amendments to an access arrangement.

Comment

The Code already contains adequate procedures in relation to time frames. Following a draft decision, the service provider (and any other party) can make submissions to the regulator up to the date specified by the regulator (section 2.37 of the Code). The Code then provides for the regulator to issue a final decision (section 2.38), and parts (a)(ii) and (b)(ii) of section 2.38 allow the regulator to specify a date by which the service provider must submit revisions.

Further Information Sought by the Commission

The Commission has invited participants to provide further information and comment on a number of matters. The Commission's issue and Envestra's response if provided below.

(1) Appropriate ways for access seekers to demonstrate 'best endeavours' in negotiating access (chapter 6)

The supply of the following information to the regulator would seem appropriate in assisting the regulator to determine whether best endeavours have been used in negotiating access:

(a) copy of access request submitted to service provider;
(b) copy of reply to access request;
(c) from each of service provider and prospective user, chronological summary of process and correspondence, and reason(s) why negotiations have failed.

(2) *Its proposed framework for who can apply for coverage and revocation of coverage (chapter 6)*

Envestra supports the Commission's proposed framework, with the exception of the involvement of the regulator in movement from a monitoring regime to Access Arrangement regime, ie a regulator should not have the role of instigating a heavier-handed regime. The regulator must be restricted to applying the applicable regime, as determined by an independent party. An application for this transition should come from a genuine access seeker. While Envestra acknowledges the issue raised by the Commission in relation to access seekers using such applications as commercial leverage, the same situation applies in relation to the movement from non-covered to covered pipeline. We believe this issue is best handled by proper analysis of applications with a view to dismissing those that appear to be frivolous or non-genuine.

(3) The specific nature of the non-financial information that service providers could maintain and provide that is essential for regulators in understanding the derivation of elements of a proposed access arrangement and for forming an opinion as to its compliance with the Gas Code (chapter 7)

Envestra believes that the current information requirements as set out in Attachment A of the Code are sufficient, and does not believe that non-financial information is essential to understand the derivation of elements of a proposed Access Arrangement.

(4) The possible implications of introducing use-it-or-lose-it rules for unutilized contracted capacity. If such rules were introduced, how should owners of contracted capacity be compensated? (chapter 7)

As this issue is only pertinent to transmission pipelines, and better commented on by users, Envestra provides no comment on this issue.

(5) How ring fencing and associate contract requirements could be implemented under the proposed monitoring regime that does not involve the prescription of reference tariffs (chapter 8)

The fundamental elements of the ring fencing provisions of the Code could be implemented simply by adopting the current section 4 of the Code but with the following sections omitted - 4.1(c), (d) and (e), 4.2 - 4.11, 4.13.

(6) What data items should be reported under the proposed monitoring regime, the level of disaggregation that should be involved and how data should be presented (chapter 8)

Table 8.1 (p269) in the Commission's draft report presents possible data items. Envestra is keen to work with the Commission and other industry participants to establish data items that are relevant to price monitoring regime once there is a better understanding of how such a regime would operate in the gas industry. It appears though, that in order for a monitoring regime to be regarded as light-handed, there would need to be a focus on prices and outputs rather than inputs.

In the meantime, Envestra believes the Commission is well placed to extend the work it has currently undertaken in this area, with a view to establishing a model suitable for industry consultation.

(7) Introducing a Gas Code provision for a dedicated truncation premium. In particular, the Commission welcomes suggestions on the most practical way to implement such a premium (chapter 9)

While the introduction of a truncation premium is laudable, there is a danger that regulators will compensate for this in other areas, ie, rely on the truncation premium as a panacea, instead of adequately assessing risks and uncertainties in relation to service providers' investments.

We believe that the most practical way of implementing a truncation premium is for the Commission to set a figure or figures (as opposed to a range), with clear guidelines for their use such that regulatory discretion is minimised.

(8) ***Whether a regulator should have the power to examine the costs of an asset management business (wholly owned by a service provider) as part of a service provider's access arrangement review (chapter 10); on alternative mechanisms to address the potential for transfer pricing between a service provider and its wholly owned asset management business (chapter 10).***

The Code currently provides very broad powers to the regulator in respect to the collection of information. In assessing revisions to an Access Arrangement, the regulator is able to request information pertaining to the costs incurred by a service provider, which by definition includes a wholly owned asset management business.

(9) Whether an asset management business should be required to comply with the ring fencing obligations under ss4.1(a), (b), (g) and (h) of the Gas Code. (chapter 10)

The Code requires service providers to comply with stringent ring fencing obligations. There is no evidence that implementation of the current requirements is insufficient to deliver desired ring fencing outcomes. For this reason, additional ring fencing obligations are not required in the Code.