

Hunter Gas Users Group:

Submission To The Productivity Commission's

Review Of The National Gas Access Regime

August 2003

Table of Contents

<u>1.Introduction</u>	3
<u>2.Structure of the New South Wales Gas Market</u>	4
<u>3.Information Disclosure By Network Service Providers To Interested Parties</u> ...	5
<u>4.Regulatory Rates Of Returns</u>	7
<u>5.By-Pass Pipelines</u>	8
<u>6.Penalties On Service Provider For Failure To Comply With Code Provisions</u> .	9
<u>7.Concluding Remarks</u>	9
8.Attachments:-	
Return on Equity Comparisons.....	11
Vanilla, Real, Post-Tax, WACC Comparisons.....	12

Hunter Gas Users Group: Submission To The Productivity Commission's Review Of The National Gas Access Regime

1. Introduction

The Hunter Gas Users Group (HUG) welcomes the opportunity to present its views to the Productivity Commission on the Gas Access Regime. The HUG represents medium-scale industrial gas users from the Newcastle and Hunter region and comprises the following entities:- Weston Aluminium, One Steel, Hydro Aluminium, Tomago Aluminium, Industrial Galvanisers, Orica, The Treloar Group, and Milltech. The HUG is Chaired by Mr Garbis Simonian, Managing Director, Weston Aluminium.

The HUG is supported by a number of regionally-based government and business entities such as the Hunter Economic Development Corporation, Hunternet, the Hunter Business Chamber and the Australian Industry Group.

An effective and competitive market for energy and energy infrastructure services is imperative for the HUG both for its own competitiveness reasons, but also for its customers, who include the major industrial companies located in the Hunter Valley.

The HUG entities are major contributors to the Newcastle and Hunter regional economy, (and by association, to the NSW and Australian economies) and together with its major industrial customers, are the largest employers in the region. The economic viability of HUG member companies, therefore, has significant implications for regional investment and employment opportunities, and for the viability of the Hunter regional economy.

The HUG, therefore, has a very strong interest in an efficient and effective National Gas Access Regime. HUG member companies are the most remote gas users and in effect are exposed to the longest supply chain of all users in the State. An effective and competitive market is required in each of the major components related to gas pricing – gas production, transmission and distribution. But security of supply is also very important. There is limited scope to switch from gas to electricity as an energy source, reflecting the nature of the industrial activities involved in HUG companies.

As part of the national energy reform agenda, the HUG saw the introduction of the national gas code as a mechanism to reduce the market power of the gas suppliers in the gas supply chain, and to generate a lower pricing regime by preventing the abuse of monopoly power. By doing so this would in part counter the impact of the reduction of import tariffs. Thus the energy reform was to balance the increased competition Australian industry faced by its tariff reduction program. So far the HUG members have not seen many cash benefits promised by the gas reform process.

In general, the HUG considers that the National Gas Access Regime has worked in providing conditions for more effective and competitive gas transportation tariffs, but much more needs to be achieved to provide gas users with the competitive pricing promised under the Regime. In this regard, the HUG is concerned with any moves to roll-back the provisions of the Regime under the guise of assertions about “regulatory uncertainty and intrusion”, “inadequate rates of return” and “investment deterrence”.

2. Structure of the New South Wales Gas Market

The NSW gas market is unique in Australia in that there are vertical ownership and contractual arrangements in the transmission, distribution, and retail elements in the gas supply chain.

The Australian Gas Light Company (AGL) has an interest in each element of the gas supply chain in NSW. AGL is the dominant retailer in the State, supplying gas through two retail arms – AGL Retail Energy Limited and AGL Energy Sales and Marketing Limited. These are, however, noncompeting retail businesses. Of the 14 parties licensed to sell gas in NSW, almost all are inactive or have limited supply activity. Many have not been able to establish and sustain retail activities to compete with the dominant retailer in the State. Energy Australia is the only gas retailer in Sydney independent of AGL although BHP Billiton does supply a limited amount of gas under contract.

The Sydney gas distribution network is owned by AGL Gas Networks (AGLGN), a wholly owned subsidiary of AGL. In addition, the Moomba to Sydney Pipeline System is owned by EAPL. The legal owner of EAPL is APL, and the beneficial owner of EAPL is the Australian Pipeline Trust. AGL holds 30% of the units in Australian Pipeline Trust. The ownership arrangements and corporate structure are complex, detailed analysis of the implications of this ownership structure is and are beyond our expertise. However, these arrangements and the corporate structure have been closely assessed by the National Competition Council¹, which has also been provided with confidential information, and therefore in a position to comprehensively assess the issue of competition in downstream and upstream markets in NSW. It seems useful here to refer to the NCC's conclusion when assessing criterion (a) ("... that access ((or increased access)) to Services provided by means of the Pipeline would promote competition in at least one market ((whether or not in Australia)), other than the market for the Services provided by means of the Pipeline".):-

"1.74 The Council concludes that coverage of the MSP Mainline and Canberra Lateral:

- a. would promote competition in upstream and downstream markets as a consequence of the ability and incentive of the pipeline to charge monopoly prices for transport services.
- b. would promote competition in downstream markets as a consequence of the ability and incentive of the pipeline to distort competition in those markets through vertical leveraging. (Our under-lining).

1.75 The Council therefore finds that the MSP Mainline and Canberra Lateral satisfy criterion (a)." (Pages 20 and 21).

The HUG considers that the Productivity Commission must proceed carefully in its review of the National Gas Access Regime. Any roll-back of provisions in the Regime which reduces the ability of regulation to achieve effective and economically efficient outcomes (and promote downstream competition), in the light of the gas market structure in New South Wales, would

¹ Moomba to Sydney Pipeline System: Revocation Applications Under The National Gas Code. Final Recommendations. November 2002.

potentially expose gas users in this State to the exercise of market power and the possible abuse of monopoly power. The HUG recommends that:-

1. **The reality of the structure of the gas market in New South Wales (vertical integration and a predominant gas retailer) renders it imperative that the key provisions of the National Gas Code are not diluted, and in particular, Section 1 relating to coverage, be retained, in order to seek to promote competition in downstream markets.**

3. Information Disclosure By Network Service Providers To Interested Parties

NSW gas users have, to date, participated in a number of gas access reviews – the current ACCC review of the Moomba Sydney Pipeline System and the 1997 and 1999 IPART AGLGN reviews. In all of these reviews, and in particular, the 1997 and 1999 IPART reviews, information disclosure was a significant issue and problem for gas users.

The NSW IPART had stated in a draft determination in 2000 that:-

“Amendment 1 - Information disclosure in AGLGN's Access Arrangement information (chapter 3)

1.1 AGLGN must amend its Access Arrangement Information to provide information separately for the following Covered Pipelines in Schedule A, Schedule 2 of the Code:

- (a) Wilton to Newcastle;
- (b) Wilton to Wollongong; and
- (c) NSW distribution system including the Central West distribution system.

1.2 Subject to 1-3, AGLGN must present the Access Arrangement Information in a format consistent with Attachment A of the Code, including the six categories of information and the specific items of information listed under each category.

1.3 Information regarding- operations and maintenance costs under category 3 of Attachment A of the Code may be aggregated by AGLGN as follows:

- (a) labour costs
- (b) non labour costs comprising cost of services by others including rental equipment, materials & supply and property taxes.

Amendment 2 - Separation of transmission pipelines (chapter 3)

In its Access Arrangement, AGLGN must establish and list Reference Services and Reference Tariffs for each of the Covered Pipelines

- (a) Wilton to Newcastle; and
- (b) Wilton to Wollongong,

separately from the Reference Services and Reference Tariffs that it must establish and list for its NSW distribution system including the Central West distribution system.”

The above clearly show the reluctance of the service provider to provide relatively basic information, including the prices it wished to charge for reference services! In fact, regulators and gas users in particular, face a resource and information asymmetry problem in all access reviews and much of the delays caused are due to withholding of information.

The only protection afforded NSW gas users (who have to negotiate with a dominant gas retailer who also owns the gas distribution networks) is transparency through information disclosures, in order to fully understand the derivation of network tariffs, and satisfy themselves that tariffs are efficient and that legitimate regulated costs have been properly allocated to them.

Even the very large companies, with substantial technical resources available to them, have difficulty in assessing tariff levels in the face of failures to disclose information.

Thus, BHP in a submission to the NSW IPART (dated 16th March 1999), stated that:-

“Despite engaging the best advice on the subject matter, information anomalies and missing data in the information provided by AGLGN have prevented BHP from making a complete and precise recommendation as to what the required revenue and detailed pricing should be. The information anomalies and missing data have been compounded by approaches which have been adopted by AGLGN that are inconsistent with the Code.

In short, BHP cannot understand the derivation of key elements of the proposed revisions. For example:

- ↪ For detailed prices there is little that would enable a user to both understand how the prices are derived, replicate the calculations or otherwise determine whether the Code has been complied with in deriving the prices.
- ↪ For the high pressure system there is no evidence of the DAC valuation or the derivation of DORC.
- ↪ In 1997 the network DAC valuation for July 1996 was stated as being \$700 million. In the 1999 network DAC valuation, the valuation for July 1996 has been restated at \$967 million without explanation.
- ↪ The capex forecast is inconsistent with the JP Kenny unit rates. If the capex forecast is correct, the JP Kenny ORC estimate may be substantially overstated.
- ↪ For the high pressure system, there is no transparent allocation of opex and G & A expenses by pricing zone.
- ↪ The asset valuations refer to negative working capital of \$199 million in July 1999 as part of the ICB (AAI p.17). The nature of the negative working capital that will be operative in July this year is not explained and is not readily understood.
- ↪ The disaggregated operating costs include a category of "other cost (including customer connections)" which is shown as a negative cost of \$23.1 million in 1999 (AAI p.66). This has not been explained and is not readily understood.

In determining whether to accede to this request, IPART should recall that there were a substantial number of "mistakes" of fact made by AGLGN in the last review process. The level of non-disclosure by AGLGN in 1996 and 1997 meant that users (and potentially IPART) were not in a position to fully identify those errors. The extent of those mistakes was material, even drastic in magnitude (\$300 million according to AGLGN, AAI p. 15)."

It is also important to emphasise that the information sought was not unreasonable: during the 1999 IPART Access review, AGLGN changed its pricing structures three times – from post codes to zones, and then back to post codes. And it should be emphasised that the 22 months' review benefited the network service provider, as the (unreasonable) delays meant that the previous (higher priced) access regime was extended. Lest it be suggested that regulatory gaming over information disclosures is a NSW phenomenon, we would suggest that it has been a common feature in access reviews in other jurisdictions, e.g. the 2003 South Australian distribution pricing review took some four years!

The HUG considers that transparency and information disclosure are the only sure way of protecting gas users' interests and rather than weakening the Code provisions, we strongly consider that the Code should be strengthened to provide for:-

- ↪ regulators to be able to arrive at agreement with the network service provider a (nationally) uniform chart of accounts that should be submitted in an Access Arrangement Information documentation (this is not an unreasonable request as some jurisdictional regulators (eg Victoria with its major gas distribution businesses) have reached agreement on a standard and comprehensive chart of information provision;
- ↪ a defined period in which any relevant information appropriate to the regulator determination be specified and fully complied with to prevent unreasonable gaming, with an associated penalty for non-compliance; and
- ↪ relevant powers for regulators' access to related party and non-related party transactions to establish that relevant costs of the regulated business are robust and are at 'arms-length', given the establishment of complex corporate structures involving network service providers and their owners and other parties.

4. Regulatory Rates Of Returns

It is well known over recent years that regulated network businesses in Australia have asserted that they faced intrusive regulatory regimes that deliver inadequate returns which have:-

- ↪ resulted in lack of investments in pipeline infrastructure;
- ↪ increased cost of doing business; and
- ↪ perceived sovereign risks.

In reality, there is an increasing body of evidence supporting the fact that rates of return approved by Australian regulators are not ungenerous.

The HUG would draw the Productivity Commission's interest to the attached return on equity and WACC comparisons between Australian and UK and USA regulatory decisions. The two charts are drawn from Pareto Associates, which had prepared it on behalf of the Customer Energy Coalition in its comments on the ESC draft decision on the Victorian Gas Access Arrangements, 2003-07. In fact, the HUG considers that picture is not very pretty, as it overwhelmingly shows that Australian regulated entities are treated more generously than their equivalent counter-parts in the UK and USA. . If, as is alleged by the pipeline investors, a low WACC will reduce the incentive to invest in new and needed gas pipelines, why is there

continuing investment in gas pipelines in these other jurisdictions despite the supposed low WACC's? The ACCC in its greenfields pipelines issues paper highlights that there has been continuing major investment in gas pipeline assets since the introduction of the Gas Code, with major ones being the Tasmanian gas pipeline, the SEAGas pipeline to SA and the NSW Central West system, together with the major capex allowances approved by regulators in the many previous reviews undertaken.

The HUG considers that there is no substance to the 'investments at risk due to intrusive regulation' assertion about the implementation of the National Gas Access Regime and would argue against any dilution of Code provisions that protect consumer interests and seek a balance on the information and resource asymmetry problems faced by regulators and gas users.

5. By-Pass Pipelines

The National Gas Access Regime is explicitly silent on the issue of by-pass pipelines and, in particular, provision for a dispute resolution process for access by a competing by-pass pipeline. However the issue of pipeline bypasses should be further developed. As we see it unless there is a pipeline which is fully utilised there should be no justification for a competing pipeline asset to be built – it would be a waste of investment capital which would be better used elsewhere.

However, we have seen exactly this circumstance with regard to the Wilton to Sydney (Horsley Park) pipeline. With the construction of the Eastern Gas Pipeline sense would have deemed EGP to terminate at Wilton, saving the investment of building it to Horsley Park. However, the tariff required by AGLGN for this section was greater than the cost of constructing the new sector.

It was always anticipated that the threat of by-pass pipeline proposals would have the potential of providing competitive pressure on monopoly network service providers to negotiate tariffs other than the reference tariffs. They have the potential of increasing downstream gas competition.

That a duplicated pipeline has been built by Duke Energy to Horsley Park, reflected the difficulties in gaining access to an existing pipeline at appropriate tariffs. Unfortunately the tariff structure for the AGLGN pipelines is such that consumers effectively pay for both the pipelines as the tariff reduction that AGLGN could have provided by having greater volume on this pipeline section has not been forthcoming, and users of the EGP are paying for the new pipeline.

This was not the intention of the Hilmer reforms but reflected the perceived deficiencies in the existing Code.

The HUG considers that there is a probable deficiency in the current National Gas Access Regime and recommends that provisions for access negotiations by any competing or by-pass pipeline proponent with an incumbent pipeline be clearly developed (and problems such as tariff reloading be removed), including the incorporation of provisions for a dispute resolution mechanism.

6. Penalties On Service Provider For Failure To Comply With Code Provisions

In our experience with the National Gas Access Review, several features stand-out. These are:-

- ↪ extensive regulatory gaming by the network service providers resulting in unreasonable delays, and possible non-compliance of Gas Code provisions. These have had the effect of raising transportation costs for gas users;
- ↪ failure by AGLGN to seek the approval of IPART for associate contracts until after IPART's 2000 Final Determination. The effect was that it foreclosed potential retail competition for many gas retail contracts that fell due during the access review; and
- ↪ "concerns" with record keeping by AGLGN of past capital contributions by users which the IPART subsequently decided would not be allowed in setting reference tariffs (therefore denying the legitimate claims of users).

The HUG considers that penalties should be specifically provided to protect users against any breaches of the National Gas Access Regime, including in the areas identified in this submission viz. regulatory gaming, associate contracts by network service providers, and past capital contributions by users, where users' interests were clearly compromised by regulators.

There appear to be a coordinated approach by the gas transmission pipeline providers to undermine the Gas Code. Almost every decision of State and national regulators regarding the transmission pipelines regulated by them has been appealed. Countering this, the appeals on regulatory decisions on distribution networks using the same code have been accepted. The Productivity Commission should assess the potential of such a coordinated campaign and if seen to be real, then this should be taken into account in its review.

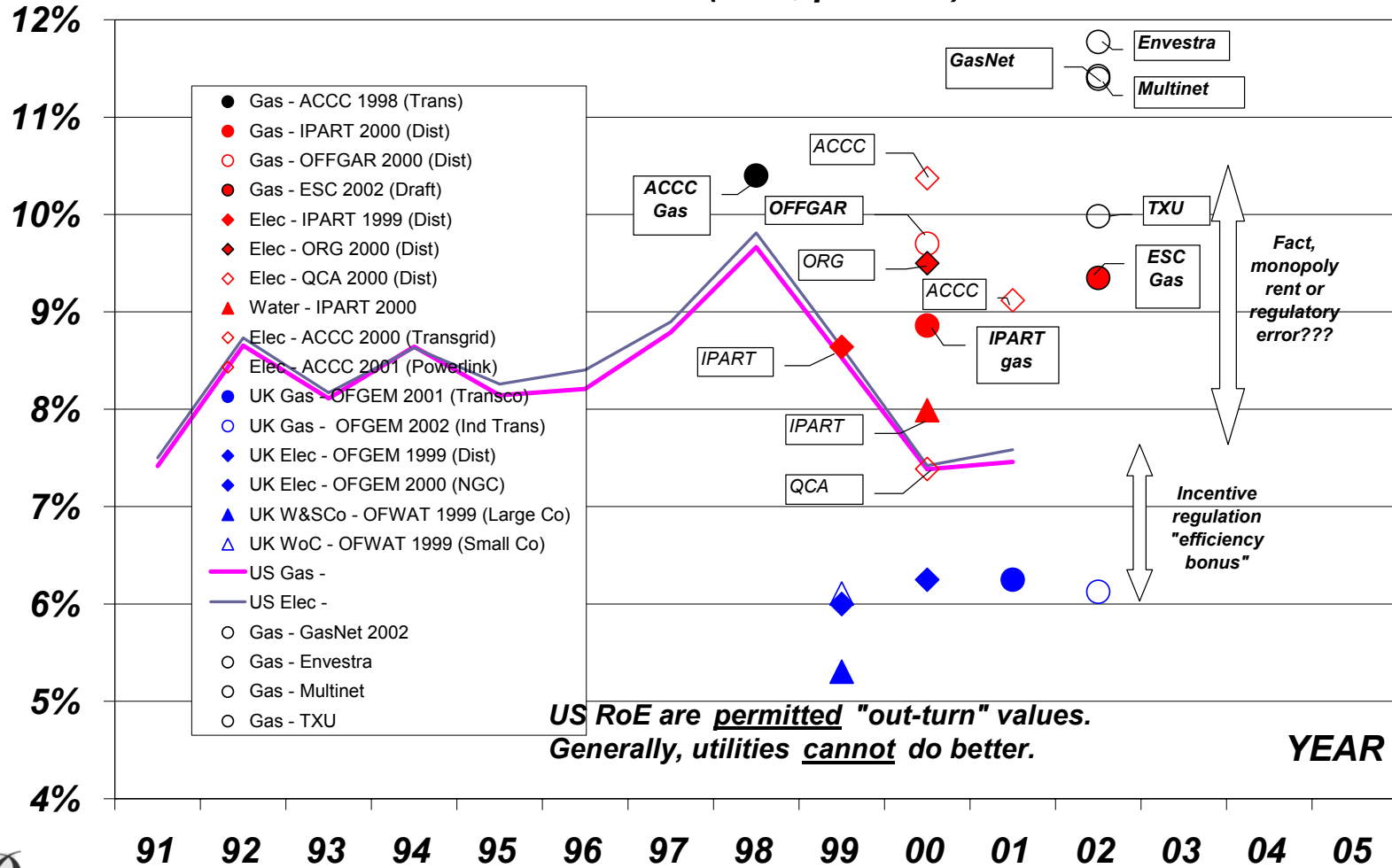
7. Concluding Remarks

The HUG considers that the National Gas Access Regime has been effective in achieving an environmental for providing more effective and competitive transportation tariffs. But much more could have been achieved except for very pervasive regulatory gaming on the part of network service providers and particularly, deficiencies in information disclosures, ring-fencing and the related issue of associated contracts, and in the non-recognition by NSW regulators of past capital contributions by users.

In the current Review by the Productivity Committee, the HUG is reminded of the need to recognise the particular structure of the NSW gas market, especially the potential for vertical leveraging and the market dominance of the key retailer. Any assertions about sovereign risks, inadequate returns and investment deterrence must be carefully assessed and the facts and analysis established and made available for public scrutiny. Similarly, any predilection for 'light-handed' regulation must be factually established and not be part of monopoly network service providers' latest regulatory gaming gambit.

Return on equity comparisons

ESTIMATED RETURN ON EQUITY (Real, post-tax)



US RoE are permitted "out-turn" values.
Generally, utilities cannot do better.

Incentive regulation
"efficiency bonus"

Fact,
monopoly
rent or
regulatory
error???



"Vanilla, real, post-tax WACC comparisons

