Submission to the Productivity Commission's Review of the Gas Access Regime by GasNet Australia

September 2003

Introduction

GasNet welcomes the opportunity to contribute to the review of the gas access regime by the Productivity Commission. This submission highlights a number of problems with the Gas Code which GasNet believes should be corrected if the Code is to fulfil the underlying objectives of the energy reform process. This submission is made within the context of a more substantial submission from the Australian Pipeline Industry Association, which GasNet endorses. GasNet expects to make further submissions on specific issues as the opportunity arises.

GasNet believes that it has had more experience than most other transmission companies in Australia in working under the provisions of the current Gas Code. GasNet was the first gas transmission company in Australia to establish an Access Arrangement (1998-2002) under the Gas Code, and is the first gas transmission company to undertake a reset of that Access Arrangement, to apply over 2003-2007.

In addition, during the first Access Arrangement period, GasNet submitted two revision applications. The first application, in 1999, sought and achieved the roll-in of the Interconnect assets, which increased the Regulatory Asset Base by approximately 11%. A second application in 2001 sought the roll-in of the South West pipeline, but this was not approved by the ACCC. These assets were subsequently rolled-in to the asset base in 2003 as part of the reset application, and increased GasNet's Regulatory Asset Base by a further 19%. These two major projects have significantly increased the diversity of supply to Victorian gas consumers, and have led to increased gas-on-gas competition and enhanced security of supply.

Furthermore, in March 2003 GasNet appealed the reset decision of the ACCC to the Australian Competition Tribunal, and is currently awaiting the Tribunal's findings. However, the ACCC has already conceded error in its reset approval on two points raised in that appeal.

Background

GasNet owns and maintains approximately 1930 km of gas transmission pipelines in Victoria. The GasNet network supplies the major centres of demand in Victoria, and also allows gas to flow to and from NSW via the Interconnect. By the end of 2004, the GasNet network will source gas supplies from four distinct locations, these being the offshore Gippsland fields, the Otway fields, the Yolla (Bass Strait) field, and imports from NSW via the EAPL system. This diversity of supply will foster growing gas-on-gas competition which will ultimately benefit all end consumers in Victoria. The system is also connected to gas storage facilities at Dandenong and Port Campbell. With the completion of the SEAGas pipeline in 2004, and its connection to the GasNet system at Port Campbell, the GasNet system will have the ability to export gas from the Victorian gas fields to both NSW and South Australia.

GasNet operates under the unique market carriage regime in Victoria. GasNet owns and maintains the network and effectively leases the use of its assets to VENCorp, the government-owned independent system operator, which operates the pipeline and schedules the gas flows. However, GasNet collects its revenues directly from the shippers on the system, and unlike most other transmission pipelines in Australia, these revenues depend on the actual day-to-day

flows on the pipeline. Contracts underwrite less than 5% of GasNet's revenues. Moreover, under the terms of the agreement with VENCorp, GasNet must charge the Reference Tariff as approved by the ACCC to any shipper who so desires it, and therefore GasNet is immediately exposed to the outcome of a regulatory review.

Expansion and extension investments can be initiated by GasNet in response to the needs of the market. Although VENCorp provides planning information to the market, it does not have the ability to initiate system expansions or extensions at its own discretion.

The Victorian government recently initiated a review of the operation of the Victorian gas market, and included a reference to the adequacy of investment incentives under the market carriage regime. A further review of the market carriage regime is mandated for 2007. GasNet hopes the current review will address some of the existing concerns with investment incentives, but this review does not have the power to address issues which arise from the current construction and application of the Gas Code.

GasNet's Business Drivers

GasNet's core business is the maintenance and expansion of its existing pipeline and compressor assets. As the existing Victorian system will not be significantly constrained for a number of years, it is expected that expansion of the system will be driven by the need to increase capacity for exports to NSW and South Australia from the Gippsland fields and the new discoveries at Yolla and the Otways. GasNet also has an interest in investment in greenfields pipelines around Australia, and in the acquisition of existing pipelines.

Concerns with the Gas Code

GasNet has a number of concerns with the way the Code has been constructed and applied which have a detrimental impact on GasNet's business operations.

The specific impacts are:

1. GasNet's revenues as determined by the regulator do not adequately reflect the regulatory and commercial risks to which GasNet is exposed.

2. The uncertainty implicit in the regulatory determinations made at five yearly intervals leads to greater difficulties and potential costs in refinancing loans and in raising new capital than would be faced by a company operating in an un-regulated environment.

3. The Code imposes an additional layer of regulatory risk on top of those risks already present in pipeline development (this applies both to expansion of the existing system and to greenfields developments). The way in which the current Gas Code is applied by regulators has a "chilling" effect on new investment.

   The origin of these difficulties lies in certain aspects of the construction and interpretation of the Code, which are described briefly below. This is followed by our suggestions to improve the Code going forward.

Prescriptive Provisions

In GasNet's view, the original intention of the Code was to create a light-handed regulatory regime which allowed service providers to tailor service offerings to their customers based on their own special circumstances. This is indicated by the construction of the Code, which is based upon the concept of a proposal being put forward by the service provider, for subsequent approval by the regulator according to a set of high level principles. That is, the role of the regulator is to ask "is this proposal acceptable according to the principles in the Code", rather than to impose its own view of an Access Arrangement. However because the Code includes a number of prescriptive policies in addition to high level policies, regulators have in practice evolved towards a "template" approach, whereby a set of prescribed policies and methodologies are imposed on the service provider.

These policies, moreover, have not been developed in consultation with the industry or with policy makers. It appears that they have been generated by processes internal to the regulatory authorities. It is not our point to debate the merits of these policies here. Our point is that the effect of these policies and procedures developed by the regulators has been to increase the level of prescription in gas regulation.

For example:

- the ACCC has developed a set of "Draft Regulatory Principles" for the electricity industry which are also being applied to the gas industry;
- the regulators use a "benchmark" approach to assess Access Arrangement proposals, rather than looking at the actual circumstances of the company;
- the ACCC resets the Regulatory Asset Base at the end of a regulatory period using the original forecast of depreciation, rather than depreciation of the actual capital expenditure;
- the ACCC and the ESC have imposed a highly prescriptive methodology for calculating the way that efficiencies generated by a service provider are to be shared with customers;
- the regulators have argued for the introduction of mandated accounting guidelines and procedures, similar in concept to the FERC reporting templates.

Coverage

Coverage appears to have been applied without discrimination or identification of the need for regulation. When the Gas Code was originally formulated, it covered virtually all existing pipelines without any attempt to determine whether coverage was warranted on each pipeline.

The situation of gas transmission pipelines has changed dramatically since the Code was initiated. The transmission system in eastern Australia is more akin to an inter-connected network than a series of dedicated point-to-point pipelines. This means that competition between pipelines will increase over time, further diminishing the need for regulation.

The inconsistent nature of coverage is apparent in Victoria. Whilst the GasNet system is regulated by the ACCC, there are four other transmission pipelines within the state which are not regulated, these being the Eastern Gas Pipeline, the Tasmanian Gas Pipeline, the Coastal pipeline lateral to Horsham, and the soon-to-be-completed SEAGas pipeline. This situation can place GasNet at a competitive disadvantage in respect of system expansion, since an unregulated pipeline has greater flexibility in meeting the needs of potential customers.

One Size fits All Approach

The Code is a mixture of high level principles and general policies on the one hand coexisting with highly prescriptive policies on the other. The original creators of the Gas Code appear to have fallen between the two stools of light-handedness and prescription. The danger of prescription is that the prescribed policies may not apply in all circumstances.

For example, the construction of the Code appears to be predicated on a contract carriage regime, which is not meaningful in common carriage regimes on distribution networks. The Code requires policies for trading and queuing of capacity, when in reality capacity is not usually contracted for on common and market carriage pipelines.

In general, the prescriptive elements of the Code fail to discriminate between pipelines with very different circumstances, for example between transmission and distribution pipelines, greenfields and mature pipelines, and pipelines with significant foundation contracts and those without.

There are significant differences between transmission and distribution pipelines which may warrant a different regulatory approach. For example:

- transmission investments tend to be large and require underwriting by foundation contracts, whereas distribution investments are generally incremental and are not covered by foundation contracts;

- transmission investments are not only large in dollar terms but lumpy in capacity and often involve significant initial overcapacity due to the strong economies of scale;

- distribution systems are not typically at risk from reserves depletion at a specific location as are transmission systems;

- distribution systems are less reliant on individual customers to support their investments;

- distribution charges are typically very much higher than transmission charges; and

- distribution companies deal with very large numbers of connected customers, whereas transmission companies have a handful of shippers who trade in the wholesale market (the implication is that it is possible for transmission companies to negotiate individually with transmission shippers).

Ex-post application

A regulated pipeline company will endeavour to roll-in a new facility investment to the Regulatory Asset Base. However the Code stipulates certain tests that must be satisfied before this can be done. These tests are applied after the investment is made, via a lengthy and time-consuming public consultation process. This process denies the company the certainty it requires before a new investment is made.

For example, the ACCC rejected the first application by GasNet to roll-in the South West pipeline. This rejection was based on concerns that the investment was not "prudent" in a general economic sense, despite the fact that the ACCC accepted that the design and costing of the pipeline was prudent. The South West pipeline, which was constructed for $75 m, was a sizeable investment, and allowed for the opening up of gas-on-gas competition between the Otway and Gippsland gas fields, and for access to an underground gas storage facility at Port Campbell. There was also a substantial improvement in security of supply to consumers in Victoria. The regulatory difficulties experienced by GasNet in rolling-in this asset are indicative of the "chilling effect" that regulation can have on future investment.

Regulatory Risk

Regulatory risk arises from the uncertainty in the regulator's assessment of the Access Arrangement at each review period. The uncertainty could pertain to any or all of the following:

1. The setting of the WACC. The ACCC shifted the GasNet equity beta from 1.2 to 1.0 between 1998 and 2003. Moreover, the text accompanying the GasNet Final Decision discusses the possibility that other parameters such as the market risk premium may be shifted down at the next reset, which would have a significant impact on the rate of return.

2. Write-downs for redundancy. The current redundancy policy is so vague as to give no certainty of the value of the Regulatory Asset Base at the beginning of future regulatory periods.

3. Approval of capital expenditure. All capital expenditure incurred during the preceding regulatory period is subject to an *ex post* prudent investment test.

4. The forecast of demand. Approximately 95% of GasNet's revenues are tied to actual gas flows, hence the setting of forecast volumes is a major risk for GasNet. During the 1998-2002 regulatory period, actual volumes were significantly below the original forecast. For the 2003-2007 regulatory period GasNet commissioned a study from the CSIRO which demonstrated the existence of a warming trend in Victoria, which was used to justify a lower demand forecast for gas space heating. Whilst the ACCC accepted this forecast, the ESC, presented with the same report by the gas distributors, did not accept the forecast.

In all these cases GasNet is exposed to error on the part of the regulator, and to changes in the "regulatory paradigm" which may be outside GasNet's influence. To the extent that an asset owner is regulated, some of these risks may be unavoidable (although they can be minimised

with an improved Code). However, asset investors must receive some recognition and compensation for these risks, and this point has not been recognised by regulators.

Improving the Code – GasNet Recommendations

Coverage

Coverage or the threat of coverage (and the consequent prescriptive regulation) can be a disincentive to investment. The presumption in the Code should be that regulation of significant new investment is a last resort, which should require the demonstration of significant market power attaching to the pipeline, and significant benefits flowing from regulation.

The coverage decision should also recognise that greater benefits flow through to the economy from having an unregulated investment than from going without that investment. It should also recognise the increasingly competitive nature of transmission pipeline development, particularly in South Eastern Australia. Underlying these contentions is the premise that pipeline investment encourages gas-on-gas competition in end-user markets, which is the only practical way to reduce market power currently in the hands of producers.

An objects clause

The current Code lacks a clear expression of the over-arching principles that should guide the regulator, and against which the decisions of the regulator can be judged. In GasNet's view, the proposal for an objects clause put by the Productivity Commission in the Review of the National Access Regime is an appropriate way forward.

"The object of the Code is to promote economically efficient use of, and investment in, essential infrastructure services."

This proposal recognises that an over-arching goal for the Code is to promote investment in pipelines, rather than simply to eliminate monopoly profits. The current Code relegates this principle to a clause in section 8.1, which simply requires that regulation "not distort investment" in pipelines.

A negotiate/arbitrate model for transmission assets

The Code has not succeeded in establishing a flexible framework which encourages commercial negotiation. The regulated tariff dominates, and has become the default template for all dealings with customers.

A negotiate/arbitrate model is feasible on transmission systems, since there are relatively few shippers who are likely to desire access to pipelines, and these shippers have considerable market power in their own right. Given the relative balance of negotiating positions, the negotiate/arbitrate model is likely to generate satisfactory solutions without resort to expensive litigation as occurs under the current Gas Code.

In order to ensure that smaller shippers have commensurate rights, GasNet refers the Commission to the Code of Conduct which is discussed in the Australian Pipeline Industry Association Submission.

The Code of Conduct specifies terms and conditions of access that ensure fair and non-discriminatory access to capacity. It is supplemented by disclosure principles and an arbitration model for disputes if they eventuate.

Access Arrangement Revisions

As discussed in the Introduction, GasNet has submitted two applications for revision of the Access Arrangement during the term of the first Access Arrangement period. These applications were necessary because GasNet had made two significant investments in the system which required adjustment to the Reference Tariff.

However it was clear at the time of these applications that the ACCC held the view that a revision application could open up all aspects of the Access Arrangement. The ACCC did not exercise this discretion in these cases, but it is an option at their disposal.

GasNet believes that revisions to an Access Arrangement may be required from time to time, which cannot wait till the date of the next Access Arrangement reset. However, it is not appropriate that all aspects of the Access Arrangement be at risk of revision, as this is a disincentive to making a revision which may be in the interests of both the service provider and the users. Alternatively, the risk of opening up an Access Arrangement at the time of a revision may act as a disincentive to making major investments, or may alternatively lead to a delay in making the investment till the end of an Access Arrangement period.