



TXU Australia

Submission to the Productivity Commission

Review of the Gas Access Regime

29 August 2003



INTRODUCTION

TXU Australia (TXU) welcomes the release of the *Issues Paper* prepared by the Productivity Commission (the Commission) for the *Review of the Gas Access Regime* (the Review). The gas access regime and its application have critical impacts on regulated gas businesses, particularly gas network businesses that transmit and deliver gas to Australian households and businesses.

TXU considers the Commission has identified the range of critical issues to be addressed in the Review.

TXU understands the Australian Gas Association will make a detailed submission to the Commission that includes advocated changes to the existing Gas Code. TXU supports that submission and the advocated changes.

The National Third party Access Regime for Natural Gas Pipelines (the Gas Access Regime) is the principal mechanism for the management of efficient gas supply in Australia. The appropriate implementation and sound management of the Gas Access Regime is critical to a viable and efficient gas and electricity industry in Australia and the viability of those industries is dependent on these forms of energy.

OVERVIEW

TXU considers the priority issues to be

- coverage of transmission pipelines where more than one transmission pipeline has the ability to service the market should **only** occur where a clear long-term public benefit has been independently identified and quantified as significant and clearly in excess of the public cost.
- improvement of governance, particularly the current lack of access to full merits appeals
- the creation of sufficient investment incentives to allow efficient reticulation of areas that do not currently have access to reticulated natural gas
- the creation of sufficient investment incentives to facilitate efficient renewal and expansion of existing gas networks

DISCUSSION

The timing of this review is highly appropriate due to the dynamic nature of the changes occurring in the gas industry at this time and the need for energy regulation to be amended accordingly. Since the establishment of the Gas Access Regime in 1997 there have been substantial changes in the operating environment. Previously characterised by State based supply chains, gas was sourced from monopoly producers via single, purpose built pipelines to tightly held franchise retail markets.

Initial reform occurred in South Australia where the State privatised the gas system infrastructure in the mid 1990s. This separated the ownership of the transmission assets from the retail / distribution businesses.

The most fundamental changes occurred in Victoria with the development of the VENCORP operated Victorian gas market in the late 1990's. This was brought about by the reregulation of the gas transmission infrastructure and created the only transparent market for incremental gas supply in Australia.

In conjunction with these developments, the liberalisation of competition and access laws led to the development of key interconnecting infrastructure (the EAPL / GasNet interconnector, the Eastern gas pipeline, VICHUB and SW Pipeline / SEAGAS).

The South Australian government set about its own long term leasing of key infrastructure and sale of retail assets in its own electricity system in early 2000. This saw the sale of several separate generation assets, the electricity distribution system and the electricity retail company.

The NSW gas business was already privately owned but through a restructure spun off the key transmission asset, retaining the retail/distribution businesses as ringfenced businesses.

More recently a gas pipeline has been built between Victoria and Tasmania. At this time, gas from this pipeline is used principally for power generation and will be an integral component in the three cornered Tasmanian power generation strategy of hydro, gas and imported (and exported) power (via Bass Link).

With some exceptions, the upstream oil and gas exploration business has generally been privately held in Australia.

The reform of the Australian energy industry has also allowed companies to expand out of their original markets leading to an overall increase in complexity of their portfolio.

Companies are now dealing with gas and electricity markets in several States and the demands in these States vary by energy source by season. For example, the peak gas requirements in Victoria are based around winter heating load whilst the South Australia gas load peaks on the basis of the summer electricity generation.

With highly competitive markets, market interconnectivity, wholesale market price volatility (electricity) and companies seeking to achieve reductions to costs through efficiency, wholesale energy supply strategies are no longer as simple as one market one supply. For instance, companies can no longer contract peaking gas from the underground gas storage facility at Port Campbell for the Victorian winter gas market without giving consideration to the use of the same capacity to respond to peak prices in the South Australian power generation market in summer.

The development of locational pricing signals in the electricity market, the diversity of players, a greater degree of commercial focus and a movement away from

traditional markets are all factors in the growing complexity of the eastern Australian energy market. The interconnection of these markets and the increased use of gas for power generation has meant that parties in the wholesale energy market cannot develop supply strategies without taking into account the interdependence of gas and electricity. This will become even more apparent as an integrated wholesale gas market evolves throughout eastern Australia.

ABOUT TXU

TXU Australia considers it is qualified to comment on the Gas Access Regime in Australia.

TXU is a major energy company with operations in North America and Australia, based in Dallas, Texas (USA). TXU manages a diverse energy portfolio with a strategic mix of over US\$31 billion of assets.

TXU's distinctive business model for competitive markets integrates generation, portfolio management and retail into one single business.

The regulated electric and natural gas distribution and transmission businesses complement the competitive operations, using asset management skills developed over more than a hundred years to provide reliable energy delivery to consumers and stable earnings and cash flow for stakeholders.

In its primary market of Texas, TXU's portfolio includes 19,000 megawatts of generation with a fuel mix of coal/lignite, natural gas/oil, nuclear power and wind. TXU serves five million customers in North America and Australia, including 2.7 million competitive electric customers in Texas where it is the leading energy retailer.

TXU entered the Australian market in 1995. TXU Australia's assets include the following:

TXU owns and responsibly manages an energy network in Victoria delivering electricity and gas to nearly one million customers. TXU Networks operate the distribution side of our business. With the electricity distribution system covering the eastern half of Victoria and the gas distribution system covering the west, TXU Networks manages over A\$4 billion worth of assets, including 45,000 km of electricity distribution wires and 8,000 km of gas pipes.

TXU Trading is part of our integrated energy group in Australia. It is dedicated to managing energy risk and maximising opportunities for our clients.

The Torrens Island Power Station in Adelaide generates electricity for south east Australia.

The generator has eight steam turbines that generate 1280MW. Burning either natural gas or fuel oil, generation is split across two sections at the Torrens



Island Power Station, both of which are dual fuel capable. It's South Australia's largest generator and Australia's largest single end user of natural gas – and is an efficient and highly flexible generator supplying power to local markets and delivering load following, cycling and peaking capability to the National Electricity Market (NEM).

TXU owns and operates a significant underground gas storage facility at Port Campbell, Victoria (12PJ of storage capable of injecting gas into storage at 100TJ/d and withdrawing from storage at 320TJ/d)

This traditional storage product allows the buyer to purchase physical storage volume as well as a Maximum Daily Withdrawal Quantity (MDWQ). It provides the opportunity to inject gas into storage when the buyer has surplus supply and withdraw gas from storage when it is required in the market place.

DISCUSSION

COVERAGE [Page 16]

Issue: *Is the current coverage test and its application appropriate? If not, why and how could the coverage test be improved?*

TXU considers that transmission pipelines should not be covered where more than one transmission pipeline has the ability to service the market

The current coverage test under Section 1.9 of the National Gas Code has resulted in a level of coverage of assets under access pricing regulation for gas distribution networks and transmission pipelines that is inappropriate

The key outcomes that TXU would ultimately like to see from this review would be the:

- Maintenance of Australia's relative international competitiveness in delivered gas prices,
- Improved access to gas at both the wholesale and retail customer level,
- Growth in the use of gas versus less greenhouse efficient energy sources.

These outcomes should be delivered with as much reliance as possible on a well structured light handed market mechanisms allowing for well defined regulated outcomes in specific circumstances where parties are unable to deliver a fair market outcome or the market breaks down due to some form of emergency.

ACCESS REGULATION AND NEW INVESTMENT [Page 20]

Issue: *Has the Gas Access Regime led to a level of investment in gas pipelines that is inefficient? Do the impacts differ between reinvestment in existing networks and the construction of new pipelines?*

TXU is not aware of any inefficient investment. There are strong incentives on transmission and distribution businesses in the Gas Access Regime to discourage any inefficient investment.

TXU considers that there are insufficient positive incentives on transmission and distribution businesses in the Gas Access Regime to ensure commitment to invest in efficient investments.

The possible options identified by the Commission in 2001 and the Australian Competition and Consumer Commission (ACCC) in 2002 are appropriate and the minimum changes necessary to allow transmission and distribution businesses to commit to efficient investment for new pipelines.

To facilitate investment it is appropriate for the Code to provide specific measures to facilitate new investment. The current regulatory approaches and the nature of the



regulatory framework represent a significant barrier to new gas distribution network and transmission pipeline developments

Incentives for investment in existing infrastructure

Under the current gas access regime there has been a lack of strong incentives for ongoing efficiencies by regulated gas businesses.

The existing gas access regime has three significant deficiencies in relation to the treatment of efficiency gains. These deficiencies mean that the existing regime:

- permits the lowering of access prices on the basis of forecast rather than actual efficiencies
- does not lead to the fair sharing of efficiency gains over time with consumers
- provides scope for significant inconsistency between Federal, State and Territory regulatory authorities

Fair sharing of efficiency gains

Regulated businesses should have an opportunity to share at least equally in the benefits of efficiency gains made through regulatory periods. This is consistent with the understanding of regulated businesses of the concept of a fair sharing of efficiency gains through time. At least an equal sharing in net present value terms of efficiency gains would promote stronger incentives to achieve efficiencies, leading to increased consumer benefit over the medium to long term.

Incentives for investment in new infrastructure (greenfields)

Greenfields projects possess a number of key features which mean that separate regulatory treatment from existing regulated assets is warranted.

These include:

- asymmetric regulatory risk
- contestability in the construction and design phase
- countervailing market power on the part of potential users
- strong commercial incentives to maximise throughput

In situations where some form of coverage under the gas access regime is judged appropriate (or sought by a service provider), the regime should contain specific measures to facilitate new investment.

Treatment of new investment under the existing gas access regime

The gas access regime has not adequately addressed the particular risks, features and circumstances of greenfields investments in gas distribution networks and transmission pipelines. While a proportion of potential greenfields projects may always be uneconomic on a stand alone basis, the weight of experience under the gas access regime indicates that significant modifications are needed to ensure the current framework does not have the effect of deterring efficient new investment.

The weaknesses of the current regime in dealing with greenfield projects include

- the exposure of greenfield projects to ‘asymmetric’ regulatory risk – where the potential upside of a project is effectively capped by access regulation, but the downside risks of project failure remain borne entirely by the investor¹
- extremely limited exclusive franchise periods which do not allow effective partnerships between gas distributors and energy retailers to cooperatively develop new regional markets for gas
- inadequate rates of return which do not compensate investors in gas infrastructure assets for the higher levels of risk assumed in greenfield developments – for example significant regulatory access pricing parameters such as the ‘beta’ measurement of risk may change several times through the life of the project²
- the high cost of competitive tender arrangements under the current National Gas Code and the preparation of Access Arrangements for small regional networks
- uncertainty over regulatory treatment of ‘sunk’ capital investments where predicted demand does not eventuate
- the risk of significant forecasting errors being made about the costs of the project, gas demand or achievable efficiency gains
- access pricing regulation is imposed where unnecessary or where the costs outweigh the benefits³

Two other core weaknesses of the existing competitive tender arrangements are a restrictive focus on the lowest cost service provision and the high costs of tenders which due to the requirement of some local government authorities for recovery of tender costs against the successful tenderer, may significantly impact on the economic viability of the project.

These weaknesses have contributed to a significant number of greenfield project cancellations, deferrals or delays over the first six years of the gas access regime.

The record of the regime in respect of greenfield distribution developments is poor:

- no competitive tender process for a greenfield distribution projects under the National Gas Code has so far resulted in project completion

¹ Productivity Commission (September 2001), p.299

² Productivity Commission (September 2001), p.299

³ See Productivity Commission (September 2001), p.94

- seven proposed greenfield gas distribution projects with estimated project values in excess of \$390 million serving nearly 370 000 potential gas consumers have been deferred or shelved since 1999
- in respect of the two distribution projects that have proceeded, one has been provided with significant government assistance to fund the ‘user’ surcharge component required under the regime to make the project economically feasible, and the second was exempted from being required to hold a competitive tender under the Code.

Since the introduction of the National Gas Code there has been a significant number of deferred and cancelled gas network extension projects across Victoria in particular. This has led to the Victorian Government offering substantial direct government funding under a tender process outside of the provisions of the National Gas Code (as the competitive tender provisions in the National Gas Code have failed to result in any successful projects completions) and pressing for reform of the National Gas Code’s greenfield provisions as a longer-term solution. The Victorian Energy Industries and Resources Minister recently emphasised the need for amendments to the gas access regime to provide relief for new gas infrastructure in the start-up phase and encourage investment in greenfields gas networks and pipelines.⁴

Recommendation

TXU supports amendments to the National Gas Code to provide scope for the separate regulatory oversight of any greenfields distribution network extensions and expansions, or transmission pipelines, found to meet either the existing or any amended coverage test. The TXU supports these optional mechanisms being made available to all potential investors in greenfields projects, including service providers that have not been assessed as meeting the coverage criteria.⁵

This recommendation could be implemented by the development of a separate section of the National Gas Code (which could include revised sections improving the existing Code provisions on competitive tenders) for new greenfields projects. This section could set out a variety of potential mechanisms as options for service providers who wish to undertake significant greenfields projects. This could include the following mechanisms:

- **‘Economic regulation free periods’ or ‘access holidays’** – where a service provider is guaranteed an access holiday for at least 20 years (commensurate with normal gas infrastructure project financing timelines)
- **Voluntary non-discrimination open access agreements** – such as in place for the Eastern Gas Pipeline
- **‘Ex ante regulatory compacts’** - where key regulatory parameters (such as third party access tariffs, beta values of the weighted average cost of capital or the

⁴ Media Release, Theo Theophanus, Minister for Energy Industries and Resources, 4 June 2003

⁵ Note: Availability of these mechanisms could potentially be broadened to include instances of existing assets in competitive market environment (e.g. competing pipelines)

regulatory asset base) are predetermined and guaranteed over a number of years or regulatory periods

- **Price monitoring-** a non-interventionist price-monitoring approach to significant greenfields network or pipeline developments
- **Make provision for binding pre-investment rulings on proposed expenditure**
 - the current National Gas Code provides insufficient upfront certainty for proposed capital and non-capital expenditure, leaving an unacceptable (and uncompensated) regulatory risk of cost or asset optimisation for service providers in future regulatory price reviews

It is envisaged these mechanisms would be optional for the service provider. This would mean, for example, that distribution network service providers would retain the current option of seeking to have the proposed capital expenditure for specific network extension or augmentation projects 'rolled-in' to the capital base at the next regulatory reset, or to have significant projects treated on a stand-alone basis.

INSTITUTIONAL AND GOVERNANCE ARRANGEMENTS (Page 30)

Are the current and proposed institutional arrangements appropriate?

TXU considers that the current arrangement should be improved. That will facilitate efficient investment in gas pipelines.

The current gas access regime does not have a clear objects clause which defines the objectives sought by access regulation of gas infrastructure. This has resulted in a lack of clarity about the policy objectives of regulation, which has led to a lack of appropriate emphasis on incentives for medium term investment in existing and new assets.

There are two areas that TXU advocates be improved

- **Insert a clear and appropriate objects clause in the regime**
- **Include access to full merits review –**

A clear objects clause for the gas access regime would:

- replace inconsistent and contradictory guidance in the existing regime
- ensure regulatory authorities adequately considered the medium term interests of existing and potential gas users in ongoing investment in new and existing networks when making access pricing decisions
- facilitate efficient commercial negotiation on terms and conditions of access by giving greater guidance and certainty to asset owners, access seekers and other interested parties
- reduce the risk of regulatory error or inappropriate intervention, and increase regulatory accountability.

Recommendation

This proposal would incorporate the text of the objects clause for Part IIIA proposed by the Commonwealth Government in the interim response to the Productivity Commission *Review of the National Access Regime*.

This option would see a binding objects clause such as set out below included in the National Gas Code:

‘The objective of the National Gas Code is to:

- (a) promote the economically efficient operation and use of, and investment in, essential infrastructure services, consistent with that which would occur in a workably competitive market, thereby promoting effective competition in upstream and downstream markets;

- (b) provide a framework and guiding principles for commercial arrangements and regulatory determinations; and
- (c) not to seek to replicate outcomes which would occur in a perfectly competitive market.

Access to effective appeal mechanisms

The Productivity Commission has previously resolved that as a core principle, third party access regimes must feature effective appeal mechanisms.⁶ TXU strongly concurs with this position.

Role of effective appeal arrangements

Appeal mechanisms play a critical role in administrative and legislative frameworks across society. Robust and effective appeal mechanisms (including both judicial and merits-based review) are critical components of effective third party access frameworks for a number of reasons. Appeal mechanisms:

- improve accountability in regulatory decision-making and frameworks
- assist in the transparency of regulatory decisions and decision-making processes
- reduce the risks to the community and service providers of regulatory error and failure
- recognise the continuing property rights of owners of sunk capital investment
- underpin private sector decisions to invest in new and existing long-lived capital assets

Appeal mechanisms under the gas access regime

Current appeal mechanisms under the gas access regime are inconsistent between jurisdictions, and the right to merits-based review is potentially limited until well past substantive elements of the regulatory decision-making process have been completed.

Current merit appeal arrangements are subject to unwarranted divergences and delays due to inconsistent approaches and inappropriate provisions of the Gas Pipeline Access Law. The current regime does not allow fully effective or timely merits review on regulatory decisions, especially for gas network businesses

Access to effective appeal arrangements is a fundamental element of any effective access regime.⁷ The current gas access regime does not provide effective merit appeal arrangements, particularly for gas network businesses.

⁶ Productivity Commission (September 2001), p. 245 and p.273

⁷ See Productivity Commission (September 2001), p. 245 and p.273

Grounds of appeal need to be clear

A key part of effective appeal mechanisms are clearly defined grounds of appeal. Under the gas access regime there is a lack of national clarity and consistency regarding the grounds of merits review of a decision not to approve the Access Arrangement of a service provider.

Section 39 of the *Gas Pipelines Access Law* principally governs the appeal arrangements for core decisions under the gas access regime. It provides that appeals may be made on the basis of:

- error of fact
- incorrect or unreasonable exercise of discretion
- exercise of discretion where none exists.

These elements have been materially influenced and limited through legislative action in at least one State associated with the introduction of independent economic regulatory authorities with a broader range of operation than simply the gas access regime. As an example, the Victorian Essential Services Commission (established in 2002) is governed by the *Essential Services Commission Act* which provides that appeals on determinations of the Commission may *only* be made on the basis of:

- bias
- decisions made on a material error of fact.⁸

As a matter of legal construction, these terms are considerably narrower than the three elements identified in the primary *Gas Pipeline Access Law*.⁹ In a gas access regime in which regulatory discretion substantially impacts on fundamental private property rights, the exclusion of those elements related to incorrect or unreasonable exercises of discretion, or the exercise of discretion where none exists, are critical shortcomings in need of addressing.

Substitutability of decision-making

A final element of effective merits appeal arrangements is the capacity for an appeals body to effectively implement its findings, through the ability to clearly direct a remedying of deficiencies in the primary decision, or the substitution of its decision for those parts of the primary decision affected by errors.

To allow this, effective merits appeal arrangements should allow the primary decision to be either:

- affirmed in full
- set aside to be remade by the primary decision-maker
- varied according to findings of the merits review body.

⁸ See *Essential Services Commission Act 2001* Section 55 (2)

⁹ cf *Gas Pipelines Access Law* Section 39 (2) (a) (i)-(iii)

For this to be possible, the merits review body should be in a position to exercise all the powers and functions of the primary decision-maker, and substitute its decision for that of the primary decision-maker.¹⁰ The AGA understands that it is not clear whether merits appeal under the current Gas Pipelines Access Law allows unconstrained re-arbitration of the initial decision. Provisions that clearly facilitate both the substitutability of the decision of a merits appeal body for that of the primary decision-maker and full consideration of the merits of a regulatory decision should feature in appeal mechanisms under a revised gas access regime.

Recommendation

This proposal would strengthen existing limited appeal rights for service providers under Part 6 of the *Gas Pipelines Access Law*. This would involve appeal provisions for a revised gas access regime based on the following five key principles:

- **Principle 1** - consistency of access to merits and judicial review between owners of distribution and transmission assets
- **Principle 2** - consistency or harmonisation of bodies responsible for conducting merits and judicial review between Commonwealth, State and Territory regimes
- **Principle 3** - capacity to seek merits review at the substantive decision-making point – the issuance of a Final Decision – rather than only following the final formal stage of the drafting and imposition of an Access Arrangement (or revisions) by a regulatory authority
- **Principle 4** - consistency and clarity in the grounds for merits and judicial review between Commonwealth, State and Territory regimes
- **Principle 5** - an ability on the part of merits review bodies to set aside, vary, or substitute their own decision for that of the original decision, and to exercise all the powers and functions of the original decision-maker.

For example, the appeals provisions could take the following form:

PART 6 - - APPEALS

Application for merits review

38. (1) A person whose interests are affected by a decision to which this section applies may apply to the relevant appeals body for a review of the decision.

(2) The application must be made, in accordance with this Part and any applicable law governing the practice and procedure of the relevant appeals body, within 14 days after the decision is made.

(3) The relevant appeals body must make its determination on the review within 90 days after receiving the application for review.

(4) The relevant appeals body may extend, or further extend, the period referred to in subsection (3) by a period of 30 days if it considers that the matter cannot be dealt with properly without the extension either because of its complexity or because of other special circumstances.

¹⁰ See for example *Trade Practices Act 1974* Section 44ZP which sets out the operative provisions for merits review which apply in respect of reviews by Australian Competition Tribunal of ACCC determinations.

- (5) If the relevant appeals body extends the period, it must, before the end of the period, notify the applicant of the extension and the reasons for it.
- (6) On the application of a party to the proceedings under this section, the relevant appeals body may conduct the proceedings in the absence of the public.
- (7) The relevant appeals body may require the relevant Regulator to give information and other assistance, and to make reports, as specified by the appeals body.
- (8) In proceedings under this section, the relevant appeals body may make a decision affirming, or setting aside or varying immediately or as from a specified future date, the decision under review and, for the purposes of the review, may perform all the functions and exercise all the powers with respect to the subject matter of the decision as may be exercised with respect to that subject matter by the person who made the decision.
- (9) The relevant appeals body may make such orders (if any) as to costs in respect of a proceeding as it thinks fit.
- (10) A determination by the relevant appeals body on the review of a decision shall be taken to be a decision of the person who made the original decision.