Issues Paper

Applications for revision lodged by GasNet Australia (Operations) Pty Limited and Victorian Energy Networks Corporation

19 April 2002

Contents

Abbreviations and glossary

access arrangement	An arrangement for third party access to a pipeline provided by a service provider and approved by the relevant regulator in accordance with the Code
access arrangement information	Information provided by a service provider to the relevant regulator pursuant to section 2 of the Code
access arrangement period	The period from when an access arrangement or revisions to an access arrangement takes effect (by virtue of a decision pursuant to section 2) until the next revisions commencement date
Code	National Third Party Access Code for Natural Gas Pipeline Systems
Commission	Australian Competition and Consumer Commission
contract carriage	A system of managing third party access whereby the service provider normally manages its ability to provide services primarily by requiring users enter into a contract that specifies a particular quantity of service
covered pipeline	A pipeline to which the provisions of the Code apply
CPI	Consumer Price Index
GasNet	GasNet Australia (Operations) Pty Limited
GIA	Gas Industry Act
GNS	GasNet System
GPAL	Gas Pipelines Access Law
market carriage	A capacity management system where the service provider does not normally require users to commit to a contract. Instead charges are based on actual usage
MSOR	Market System and Operations Rules
NCC	National Competition Council
prospective user	A person who seeks or who is reasonably likely to seek to enter into a contract for a service (including a user who seeks or may seek to enter into a contract for an additional service)
PTS	Principal Transmission System

queuing policy	A policy for determining the priority that a prospective user has, as against any other prospective user, to obtain access to spare capacity
reference service	A service which is specified in an access arrangement and in respect of which a reference tariff has been determined
reference tariff	A tariff specified in an access arrangement as corresponding to a reference service.
reference tariff policy	A policy describing the principles that are to be used to determine a reference tariff
revisions commencement date	The date upon which the next revisions to the access arrangement are intended to commence
revisions submissions date	The date upon which the service provider must submit revisions to the access arrangement
service envelope agreement (SEA)	An agreement between VENCorp and GasNet whereby GasNet makes the Gas Transmission System available to VENCorp
service provider	A person who is the owner or operator of the whole or any part of the pipeline or proposed pipeline
services policy	A policy detailing the service or services to be offered
VENCorp	Victorian Energy Networks Corporation
WTS	Western Transmission System

Executive summary

The Commission is currently conducting its first scheduled review of the GasNet Australia (Operations) Pty Ltd (GasNet) and the Victorian Energy Networks Corporation (VENCorp) access arrangements which it approved in 1998.

GasNet and VENCorp lodged substantial revisions documents with the Commission on 28 March 2002. This *Issues Paper* highlights a number of issues that are likely to be relevant to parties making submission to the review. The *Issues Paper* does not attempt to replicate these documents and should be read in conjunction with them. Submissions should be received by the Commission by 13 May 2002.

Under the market carriage capacity management system operating in Victoria, users pay tariffs to both the system owner, GasNet, and the independent system operator, VENCorp. Approximately 85 per cent of the combined tariff is paid to GasNet.

Proposed benchmark revenue over second access arrangement period ($ million)

	2003	2004	2005	2006	2007
GasNet[a]	93.92	94.96	96.11	96.53	96.67
VENCorp[b]	6.97[c]	15.55	15.68	15.73	15.71

Notes: (a) Year ending 31 December
(b) Year ending 30 June.
(c) Six months ending 30 June.

Key issues identified by the Commission include:

- the relationship between the two service providers and between their access arrangements, in particular GasNet's proposal that it not make any services available;
- GasNet's proposal to 'reopen' the capital base, increasing the 1 January 1998 value by $35.8 million;
- GasNet's proposal to include the cost of the Southwest Pipeline under the Code's economic feasibility test;
- the merger of the Principal Transmission System (PTS) and the Western Transmission System (WTS) access arrangements. GasNet refers to the combined system as the GasNet System (GNS) whereas VENCorp refers to it as the PTS;
- GasNet's proposed real tariff increase of over ten per cent over the second access arrangement period;
- the proposed introduction of prudent discounts;
- GasNet's proposed tariff restructure whereby injection charges would be levied on the ten peak days (rather than five) and the withdrawal charge would be solely levied on total volume (rather than one charge on peak and another on total volume);

- VENCorp's expected real tariff reduction of approximately ten per cent for metering charges and approximately four per cent for commodity charges over the second access arrangement period; and
- VENCorp's proposal to move from annual to five yearly budget approval for registration and commodity tariffs.

The Commission consulted with GasNet and VENCorp prior to their submission of revisions on a number of issues which would need to be determined during the course of the review. While the Commission cannot pre-empt its regulatory decisions it was able to provide guidance on its views on a range of substantial issues. In particular, the Commission is of the view that GasNet would be able to carry forward the amount unrecovered due to the K factor adjustment at the end of 2002. In addition, the Commission has emphasised its understanding that the gas access regime gives certainty to service providers as to the value of their regulated assets bases once they have been determined.

Submissions should be provided to the Commission's e-mail address for this review of victoriangasreview@accc.gov.au by 13 May 2002. Hard copies of submissions should be forwarded to:

Ms Kanwaljit Kaur
General Manager
Regulatory Affairs – Gas
Australian Competition and Consumer Commission
PO Box 1199
Dickson ACT 2602

1. Introduction

1.1 Background

On 16 December 1998, the Australian Competition and Consumer Commission (Commission) approved the following Victorian gas transmission access arrangements under provisions of the *Victorian Third Party Access Code for Natural Gas Pipeline Systems* (Victorian Code) with initial access arrangement periods ending on 31 December 2002:

- access arrangement by Transmission Pipelines Australia Pty Ltd and Transmission Pipelines Australia (Assets) Pty Ltd for the Principal Transmission System (PTS);
- access arrangement by Transmission Pipelines Australia Pty Ltd and Transmission Pipelines Australia (Assets) Pty Ltd for the Western Transmission System (WTS);
- access arrangement by Victorian Energy Networks Corporation (VENCorp) for the PTS;

Ownership of the PTS and WTS subsequently passed to GPU GasNet Pty Ltd and then to GasNet Australia (Operations) Pty Ltd (GasNet). VENCorp remains the independent system operator of the PTS.

The Victorian Government enacted the *Gas Pipelines Access (Victoria) Law*, effective 1 July 1997, which brought the *National Third Party Access Code for Natural Gas Pipeline Systems* (the Code) into force in Victoria (though certain provisions of the Victorian Code were grandfathered until the first scheduled review).

In accordance with the provisions of their access arrangements, GasNet and VENCorp submitted proposed revisions to their access arrangements and revised access arrangement information to the Commission on 28 March 2002. GasNet and VENCorp lodged substantial supporting documentation. These documents should be read in conjunction with this *Issues Paper* as it necessarily provides only a simplified account of the regulatory and contractual instruments, service providers' proposals, and the arguments advanced for them. The *Issues Paper* does not attempt to replicate these documents. In some cases the information available requires a degree of interpretation.

Under the market carriage capacity management system operating in Victoria, users pay tariffs to both the system owner, GasNet, and the independent system operator, VENCorp. Approximately 85 per cent of the combined tariff is paid to GasNet.[1]

On 19 August 1998 the Commission granted authorisation under Part VII of the *Trade Practices Act 1974* (TPA) of those chapters of the Victorian Market and System Operations Rules (the MSOR) that it considered to potentially breach the TPA. Authorisation was subject to a number of conditions, including that it be until 1 January 2003 so that it would coincide with the end of the initial access arrangement period. VENCorp has advised that it will seek reauthorisation of the MSOR in May 2002.

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[1] VENCorp submission, p. 4.

While the access arrangements revisions approvals and the re-authorisation are separate processes which will be conducted under different legislation, there are strong links between the PTS access arrangements and the MSOR. For example, clause 5.4.1 of VENCorp's access arrangement states that VENCorp will operate the PTS in accordance with the MSOR, and that users will need to register as market participants under the MSOR in order to access the PTS. Similarly, clause 5.1.1 of GasNet's access arrangement for the PTS currently states that it will comply with the MSOR. Further, clause 5.3.1 of the MSOR requires VENCorp and GasNet to have a valid service envelope agreement (SEA) in force between them which obliges GasNet to provide gas transportation services and pipeline capacity to VENCorp. Clause 5.4.1 of GasNet's access arrangement for the PTS states that it will make the PTS available to VENCorp in accordance with the SEA. Accordingly, the Commission will, where appropriate, take into consideration the linkages between these instruments and processes.

The purpose of this *Issues Paper* is to:

- briefly describe the background to the current review of the Victorian transmission access arrangements and the expected proposal for re-authorisation of parts of the MSOR;
- list a number of issues that the Commission has identified as relevant to its role in assessing the proposed revisions to the access arrangement and the associated revised access arrangement information; and
- invite interested parties to make submissions on these and other relevant issues that they consider the Commission should examine in its assessment of these revisions.

1.2 Access arrangement revisions

An access arrangement describes the terms and conditions on which a service provider will make access available to third parties. The initial access arrangement period ends on 31 December 2002. The second access arrangement period commences on 1 January 2003 and is proposed to end on 31 December 2007. However, service providers have the discretion to submit revisions earlier than a scheduled review.

Under the Code, the Commission is required to:

- inform interested parties that it has received the proposed revisions to the access arrangements and the associated access arrangement information (parties were notified by letter on 5 April 2002);
- publish a notice in a national daily paper which at least describes the covered pipelines to which the access arrangements relate; states how copies of the documents may be obtained; and requests submissions by a date specified in the notice (the notice was inserted in the *Australian Financial Review* and the *Age* on 8 April 2002);
- after considering submissions received, issue a draft decision which either proposes to approve the revisions or proposes not to approve the revisions and states the amendments (or nature of the amendments) which would have to be made to the revisions in order for the Commission to approve them. Submissions will be sought again following release of the Commission's draft decision;

- after considering any additional submissions, issue a final decision that either approves or does not approve the revisions (or amended revisions) and states the amendments (or nature of the amendments) which have to be made to the revisions (or amended revisions) in order for the Commission to approve them; and
- if the amendments are satisfactorily incorporated in amended revisions, issue a final approval. If the Commission is satisfied that the amended revisions either substantially incorporate the amendments specified or otherwise address to its satisfaction the matters which led it specifying the amendments in its final decision, either approve or not approve the amended revisions. In any other case, the Commission must draft and approve its own revisions.

1.3 Victorian gas industry structure and regulatory framework

Relevant aspects of the Victorian gas industry structure include:

- GasNet owns the PTS in Victoria which until recently solely transported gas supplied from the Esso-BHP Billiton fields in the Gippsland Basin. VENCorp is independent system operator for the PTS. The recent completion of the Interconnect Pipeline and the Southwest Pipeline also allows Cooper Basin and Otway Basin gas to be supplied via the PTS;
- GasNet also owns the WTS which until recently solely transported gas supplied from the on shore Otway Basin gas fields. Since completion of the Southwest Pipeline, Gippsland Basin gas has been supplied via the WTS. GasNet proposes that the WTS and the Southwest Pipeline be included from the start of the second access arrangement period in a single access arrangement with the PTS;[2]
- Since July 1998 the Interconnect Pipeline has linked the PTS with the Moomba to Sydney Pipeline (MSP) which is operated by East Australian Pipeline Ltd (EAPL). GasNet owns and operates the section of the Interconnect Pipeline from Barnawartha to Culcairn and EAPL owns and operates the remainder from Culcairn to Wagga Wagga. It allows southward flows of gas supplied by the Cooper Basin producers to Victoria and for northward flows of Gippsland Basin gas to NSW; and
- Duke Energy International (DEI) owns and operates the Eastern Gas Pipeline (EGP) which commenced operations supplying Gippsland Basin gas to customers in NSW in 2000. In 2002, DEI commenced construction of a pipeline that will deliver Gippsland Basin gas to Tasmania.

The main legislation and relevant documents regulating access to the Victorian gas transmission industry are:

- the Code, under which transmission service providers are required to submit access arrangements to the Commission for approval;
- the Gas Pipelines Access (South Australia) Act 1997; and
- the Gas Pipelines Access (Victoria) Act 1998.

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[2] GasNet generally refers to the combined system as the GasNet System (GNS) while VENCorp refers to it as the PTS. For the sake of consistency, the convention is adopted in this *Issues Paper* of referring to it as the PTS.

In addition, certain provisions of the Victorian Code under which the Commission approved the PTS access arrangement in December 1998 have been 'grandfathered'. Sub-section 24A(3) of the Gas Industry Acts (Amendment) Act 1998 provides that access arrangements approved under the Victorian Code (such as the access arrangements for the PTS and WTS) continue to be subject to sections 3 and 8, and 9 (so far as it applies to sections 3 and 8) and to sections 2.33 and 2.48A of the Victorian Code. These sections are not subject to the corresponding provisions of the Code until the first scheduled review of the access arrangements under section 2 of the Code. The convention has been adopted in this *Issues Paper* of identifying relevant Victorian Code provisions where they differ from current provisions of the Code.

The Code and appeals bodies in Victoria with respect to transmission pipelines are:

- the Commission – regulator and arbitrator;
- the National Competition Council – Code advisory body;
- the Commonwealth Minister – coverage decision maker;
- the Federal Court – judicial review; and
- the Australian Competition Tribunal – administrative appeal.

Reflecting institutional arrangements imposed by the Victorian Government at the time of its reform and privatisation of the formerly Government owned integrated gas supply business in 1998 and 1999, parts of a number of regulatory instruments are currently included in the access arrangements. Further, while GasNet owns and operates the PTS and the WTS, the Victorian Government gave VENCorp the role of independent system operator for the PTS. Under the terms of the Code, both GasNet and VENCorp are service providers. Their access arrangements allocate responsibility between them for complying with the obligations imposed by the Code.

1.4 Criteria for assessing revisions to access arrangements

The Commission may approve revisions to an access arrangement only if it is satisfied that the access arrangement as revised would contain the elements and satisfy the principles set out in sections 3.1 to 3.20 of the Code, which are summarised below. Revisions to an access arrangement cannot be opposed solely on the basis that the access arrangement as revised would not address a matter that section 3 of the Code does not require it to address. Subject to this, the Commission has a broad discretion in accepting or opposing revisions to an access arrangement.

An access arrangement, or a revised access arrangement, must include the following elements:

- a policy on the service or services to be offered which includes a description of the service(s) to be offered;
- a reference tariff policy and one or more reference tariffs. A reference tariff operates as a benchmark tariff for a particular service and provides users with a right of access to the specific service at the specific tariff. Tariffs must be determined according to the reference tariff principles in section 8 of the Code;

- terms and conditions on which the service provider will supply each reference service;
- a statement of whether a contract carriage or market carriage capacity management policy is applicable;
- a trading policy that enables a user to trade its right to obtain a service (on a contract carriage pipeline) to another person;
- a queuing policy to determine users' priorities in obtaining access to spare and developable capacity on a pipeline;
- an extensions/expansions policy to determine the treatment of an extension or expansion of a pipeline under the Code;
- a date by which revisions to the arrangement must be submitted; and
- a date by which the revisions are intended to commence.

The Code (section 10.2) provides that, where there is more than one service provider in connection with a covered pipeline, with one the owner and the other the operator, responsibility for complying with the obligations imposed by the Code is allocated among them by their access arrangement(s) and each service provider is responsible for complying with the responsibilities allocated to it.

In considering whether a revised access arrangement complies with the Code, the Commission must take into account the provisions of the access arrangement and, pursuant to section 2.24 of the Code, the following factors:

- the legitimate business interests and investment of the service provider;
- firm and binding contractual obligations of the service provider or other persons (or both) already using the covered pipeline;
- the operational and technical requirements necessary for the safe and reliable operation of the covered pipeline;
- the economically efficient operation of the covered pipeline;
- the public interest, including the public interest in having competition in markets (whether or not in Australia);
- the interests of users and prospective users; and
- any other matters that the Commission considers are relevant.

The Appendix to this *Issues Paper* sets out the access arrangement information that a service provider must disclose to interested parties (Attachment A to the Code).

1.5 Broad issues

The following two chapters of this *Issues Paper* respectively consider issues relating to the GasNet and VENCorp access arrangements. While different issues arise for the two access arrangements, there is some duplication in the text so each chapter can be read by itself. The fourth chapter provides some background on the MSOR

authorisation. This section focuses on a number of issues that impact on the wider process.

1.5.1 Content of the GasNet and VENCorp PTS access arrangements

As noted earlier, while GasNet owns and operates the PTS and the WTS, VENCorp has the role of independent system operator for the PTS. Users deal directly with VENCorp which in turn deals with GasNet. The SEA places obligations on GasNet to make the PTS available to VENCorp so that it can provide gas transmission services to third parties.

Under the terms of the Code (sections 10.1 and 10.2), GasNet and VENCorp are 'multiple service providers' with responsibility for complying with the Code. Their PTS access arrangements allocate responsibility between them for complying with the obligations imposed by the Code. Currently, the GasNet and VENCorp PTS access arrangements each contain all the minimum elements set out in section 3 of the Code other than that responsibility for extensions and expansions is solely allocated to GasNet and responsibility for the queuing policy is allocated to VENCorp. GasNet's proposed extensions and expansions policy is discussed in Chapter 2. As VENCorp does not propose to alter its queuing policy, it is not discussed further in this *Issues Paper*.

VENCorp proposes to maintain the status quo for the second access arrangement period with regard to its relationship with GasNet. In contrast, GasNet proposes a number of changes. In particular, GasNet states that it is VENCorp that is responsible for the provision of the reference service and that GasNet does not propose to make any services available to users or prospective users under its access arrangement.

Clause 5.2.2 of the GasNet access arrangement currently states that it will make the tariffed transmission service available to VENCorp on the terms and conditions and in accordance with GasNet's reference tariff policy. GasNet's terms and conditions (Clause 5.4.1) state that GasNet will make the PTS available to VENCorp as user in accordance with its obligations under the SEA and that VENCorp will then provide services to users of the PTS in accordance with the MSOR. GasNet proposes that its terms and conditions will instead state that the terms and conditions on which the reference service is supplied are as set out in the MSOR.

As noted below, both GasNet and VENCorp have proposed to continue under the market carriage capacity management system. Consequently neither access arrangement is proposed to include a trading policy (section 3.9 of the Code).

Is the allocation of responsibilities between GasNet and VENCorp appropriate to service the Victorian gas market?

1.5.2 Market carriage

The Victorian Government proposed the adoption of a market carriage capacity management system for the PTS as part of its reforms of the Victorian gas industry. The Commission considered opposing views from interested parties on the merits of this system as part of its approval of the transmission access arrangements in 1998. For example, supporters considered that market carriage could provide retailers and their

customers with a sufficient degree of certainty of access to transmission services and that it would facilitate entry and exit by participants. In contrast, opponents suggested that the proposed approach was novel, untried and complex, and that it would inhibit interstate trade in natural gas as other States would adopt the alternative contract carriage approach.

The Commission concluded that the Victorian market carriage approach is consistent with the Victorian Code's guiding principles and criteria. It also concluded that interstate trade was unlikely to be hindered by the different systems in Victoria and other States. Accordingly, it approved the PTS access arrangements incorporating the market carriage capacity management system.

Both GasNet and VENCorp have proposed to continue under the market carriage capacity management system. Pursuant to section 3.8 of the Code, the Victorian and NSW Ministers have given notice to the Commission permitting use of the market carriage model for the second access arrangement period for those parts of the PTS in their respective jurisdictions. In addition, the Commonwealth Minister certified the Victorian gas access regime as effective in accordance with section 44N of the TPA in March 2001.

The Commission understands that the review to be conducted under section 205 of the GIA by 31 December 2007 will examine the overall market structure and operations in Victoria, including the market carriage capacity management system and the role of VENCorp as independent system operator. It does not propose to assess the relative merits of the two capacity management systems as part of the current review.

1.5.3 Prudent discounts

The Code (section 8.43) recognises that there can be situations (for example, credible by-pass threat) where it is prudent for a service provider to offer reference services to a user or prospective user at a discount to the reference tariff. With the approval of the regulator, some or all of a prudent discount may be recovered from other users of the reference service or of some other service(s).

As both GasNet and VENCorp tariffs apply for use of the PTS, either service provider or both could offer a prudent discount to a user or prospective user. However, the two service providers may form different judgements as to the need for a proposed discount and on how the cost of a discount might be shared between them. In practice, as the VENCorp reference tariff makes up a comparatively small part of the combined charge, VENCorp may not in itself have the capacity to offer a sufficient discount. GasNet has proposed to offer prudent discounts. VENCorp has also proposed to be able to introduce prudent discounts in the form of a new commodity tariff during the access arrangement period subject to regulatory approval under the MSOR.

What portion of a prudent discount should be recovered from other users?

How should GasNet and VENCorp share the cost of a prudent discount?

1.5.4 Differences in demand forecasts

Both GasNet and VENCorp base their demand forecasts on those published in the VENCorp *Annual planning review*. However, GasNet proposes to adjust these estimates to account for a warming trend in Melbourne which it says arises from a combination of an enhanced Greenhouse effect and an urban heat island effect.[3] GasNet states that the effect of this adjustment is to reduce the forecast annual load in 2007 by approximately 1.2 PJ.

1.6 Public consultation

The *Issues Paper* identifies a number of issues raised by GasNet's and VENCorp's proposals. It is not intended to be exhaustive or to replicate the proposals. Interested parties are invited to make submissions to the Commission on any issues raised by, or relevant to, these revisions by Monday 13 May 2002. After considering these submissions, the Commission will issue its *Draft Decision*. It will then hold a public forum on the issues raised in that decision and the Commission's proposed approach. After considering further submissions, the Commission will issue its *Final Decision*.

Submissions will be made available from the Commission's website (www.accc.gov.au). They will also be placed on the public registers held by the Commission and the Code Registrar. Submissions should be supplied in electronic format compatible with Microsoft Word to the review e-mail address below. In addition, one original signed document should be mailed to the postal address below. Any information considered to be of a confidential nature should be clearly marked as such, and the reasons for seeking confidentiality should be provided. Under the terms of the Code, the Commission must not disclose such information unless it is of the opinion that disclosure would not be unduly harmful to the legitimate business interests of the service provider, a user or prospective user.

The Commission's e-mail address for this review is victoriangasreview@accc.gov.au. Hard copies of submissions should be forwarded to:

Ms Kanwaljit Kaur
General Manager
Regulatory Affairs – Gas
Australian Competition and Consumer Commission
PO Box 1199
Dickson ACT 2602

Copies of the revisions applications and this *Issues Paper* are available from the Commission's website. Copies of the *Issues Paper* may be obtained from the Commission by contacting Ms Rebecca Khair telephone (02) 6243 1233, fax (02) 6243 1205, e-mail: rebecca.khair@accc.gov.au. Copies of the revisions applications on computer disk can also be obtained from Ms Khair.

Any other inquiries should be directed to Mr Michael Walsh on (02) 9230 9156.

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[3] GasNet Submission, p. 106.

2. GasNet access arrangement

2.1 Broad issues

2.1.1 Merging of the GasNet access arrangements

GasNet proposes to merge the PTS access arrangement and the WTS access arrangement into a single GasNet access arrangement with effect from 1 January 2003. GasNet proposes the following process[4]:

- terminate the WTS Agreement between GasNet and TXU;
- revise the PTS and WTS access arrangements to merge them;
- VENCorp exercises its right under the WTS Approved Connection Deed to declare the WTS to be part of the "gas transmission system", with effect from 1 January 2003. GasNet states that the WTS would be automatically covered by the PTS access arrangement; and
- apply the principles contained in section 8.9 of the Code to determine the capital base of that part of the enlarged PTS constituted by the current WTS.

2.1.2 Inclusion of the Southwest Pipeline

GasNet proposes to include the $85.0 million cost of the Southwest Pipeline in its capital base from 1 January 2003 under the Code's economic feasibility test (section 8.16(b)(i)).[5] GasNet proposes that the costs of the Southwest Pipeline will be reflected in a new stand-alone injection tariff ($4.0860/GJ, based on 10 day peak injections).

GasNet states that it is confident that, notwithstanding the stand-alone tariff, sufficient volumes are likely to flow on the SWP (particularly from the new discoveries in the Otway basin such as Thylacine and Geographe) to recover the cost of the Southwest Pipeline. Nonetheless, GasNet submits that, if the Commission concludes that the Southwest Pipeline does not pass the economic feasibility test, it does pass the system-wide benefits test. Further, GasNet contends that, if the Commission concludes that only a portion of the investment passes each of the economic feasibility and system-wide benefits tests, the Code allows those amounts to be aggregated and included in the capital base. Finally, GasNet suggests that if its investment in the Southwest Pipeline does not pass the tests set out in sections 8.15 and 8.16 of the Code it could be treated as a new pipeline under section 8.12 and that GasNet could submit a separate access arrangement for the Southwest Pipeline. However, GasNet states that it does not propose that the Southwest Pipeline be subject to a separate access arrangement.

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4 GasNet Submission, p. 24.

5 GasNet Submission, Schedule 3.

2.1.3 Regulation of GasNet's Dandenong LNG facility

Clause 4.2 of the MSOR governs the obligations of VENCorp, GasNet and retailers in relation to GasNet's Liquefied Natural Gas (LNG) storage facility located at Dandenong. In particular, GasNet is required to make available to VENCorp 3 000 tonnes of LNG storage capacity for use by VENCorp to meet its operational requirements and to ensure the security of the gas transmission system. VENCorp pays GasNet $1.4 million a year for LNG storage which it recoups from its users through a commodity based charge. The balance of the facility's 12 000 tonne capacity is currently contracted to the three foundation retailers. The LNG facility is regulated under the Tariff Order until 31 December 2002.

2.2 Reference tariff methodology

2.2.1 Proposal

Section 8 of the Code establishes pricing principles for setting the prices of transportation services. While these principles provide considerable flexibility, they are designed to achieve the key objectives listed in section 8.1 of the Code.

In broad terms, tariffs need to be cost reflective to promote economic efficiency in the use of the system. The Code recognises the dulling effect revenue constraints can place on efficient pipeline operations and provides for the inclusion of mechanisms to provide incentives for the service provider to strive for efficiency improvements.

The methodology proposed for the setting of reference tariffs is contained in the access arrangement and access arrangement information. GasNet proposes to continue setting tariffs based on the building block approach while setting a price path that acts as an incentive mechanism to encourage it to achieve greater than forecast performance.

GasNet has proposed a number of changes from the access arrangement as it currently stands which may impact on tariffs. These include:

- a 'pass through' mechanism whereby tariffs could be increased to reflect higher costs incurred during a regulatory period (resulting from tax increases, increased regulatory requirements and increased insurance premiums) without assessment under the review process set out in section 2 of the Code. The mechanism does not require the pass through of decreases in these costs. GasNet proposes that the Commission would have 20 business days to approve a proposed increase, which, in the absence of a decision by the Commission, would then be deemed to be approved;
- modification to the tariff formulae to remove impediments to GasNet recovering the K factor carry-over which it estimates will amount to $14.0 million as at 1 January 2003;
- the introduction of prudent discounts (LaTrobe Zone, Wodonga, Western Zone, Dandenong Bypass);
- a decrease in the estimated life of the Longford pipeline from 2030 to 2023. The expected life of the Southwest Pipeline (until 2052) would be much longer, while that of the remainder of the system would be unchanged (2033); and

- change its capital redundancy policy so that it only applies to fully redundant assets.

GasNet recognises that the Commission has adopted a post-tax revenue approach for its recent regulatory decisions, but proposes to use a pre-tax approach to determine target revenue.[6] GasNet states that its pre-tax real WACC figure is based on a post-tax nominal model with normalisation.[7] GasNet proposes to retain the benefits of tax pre-paid during the first access arrangement period, and that the benefits of accelerated depreciation would accrue to GasNet rather than users.

How would these proposals affect the relative risks of GasNet and users of the PTS? What impact do the recent discoveries of new sources of gas supply have on the economic life of the GNS?

2.3 Capital base

2.3.1 Proposal

As envisaged by section 8.9 of the Code, GasNet proposes to roll forward its inflation adjusted initial capital base by adding new facilities investment and subtracting depreciation and redundant capital. However, GasNet also proposes to reopen the asset base (mainly to recognise the value of easements) and adjust it upwards by $35.8 million (to a January 1998 value of $399.5 million). It is the Commission's understanding that the Code does not allow for such an adjustment.

Table 2.1: GasNet's proposed roll forward of the capital base ($ million)

Year ending 31 December	1998	1999	2000	2001	2002
Opening capital base[a]	399.5	431.2	518.1	537.7	542.3
Depreciation allowance	-13.8	-15.2	-17.0	-18.1	-18.3
Capital expenditure	39.0	93.3	6.2	4.5	0.6
Disposals/redundancies	-0.2	-0.2	-1.4	-0.1	-0.03
Inflation	6.6	9.0	31.8	18.4	15.2
Closing capital base	431.2	518.1	537.7	542.3	539.7

Source: GasNet Access arrangement information, p. 14.
Note: (a) Includes an upwards adjustment of $35.8 million in 1998 proposed by GasNet.

Is GasNet's proposed roll forward of the capital base consistent with the requirements of the Code? In particular, does the Code allow for the capital base to be reopened?

Forecast capital expenditure for the second access arrangement period is set out in Table 2.2 below. Substantial expenditure is proposed, especially in the latter half of the second access arrangement period.

6 GasNet Submission, p. 103.

7 GasNet Submission, p. 50.

Table 2.2: Estimated capital expenditure (nominal $ million)

Year ending 30 June	2003	2004	2005	2006	2007
Brooklyn Loop	-	-	-	-	20.70[a]
Gooding compressor refurbishment	-	-	6.49	8.13	7.95
Lurgi pipeline refurbishment	2.05	2.10	1.55	5.83	5.97
City gate upgrades[b]	-	2.36	2.53	4.41	-
Wollert automation	-	1.50	1.82	-	-
Small laterals	1.54	1.58	1.62	1.66	1.70
Maintenance capex	1.90	1.43	0.51	0.59	1.12
Total	5.49	8.97	14.52	20.62	37.44

Source: GasNet Access arrangement information, p. 12.
Notes: (a) This represents the recoverable portion of the Brooklyn Loop capital expenditure.
(b) Includes the gas heaters at Wollert, Dandenong and Tyers.

Is the forecast capital expenditure prudent and is it consistent with the other assumptions in the access arrangement?

2.4 Rate of return

2.4.1 Proposal

Table 2.3 below sets out the weighted average cost of capital (WACC) parameters accepted by the Commission in 1998 and those now proposed by GasNet. The post-tax nominal cost of equity would rise from 13.2 per cent to 14.19 per cent and the pre-tax real WACC would rise from 7.75 per cent to 8.22 per cent.

Table 2.3: WACC parameters

WACC parameter	Current	GasNet proposal
Real risk-free interest rate	3.43%	3.20%[a]
Nominal risk-free interest rate	6.00%	5.78%[a]
Bond maturity period	5 years	10 years
Expected inflation	2.5%	2.5%
Inflation selection period	5 years	10 years
Debt margin	120 basis points	120 basis points
Cost of debt	7.20%	6.98%
Market risk premium	6.00%	6.00%
Gearing ratio	60%	60%
Value of imputation credits	50%	50%
Asset beta	0.55	0.60
Debt beta	0.12	0.06
Equity beta	1.20	1.40
Return to equity	13.2%	14.19%
Pre-tax real WACC	7.75%	8.22%

Source: ACCC, *Final Decision*, 6 October 1998, p. 63; GasNet Access arrangement information, p. 5.
Note: (a) GasNet states that these amounts are indicative only as the final amounts will be determined by reference to market observations prior to the *Final Decision*. GasNet proposes that the relevant bonds rates will be selected in consultation with the Commission on an *ex ante* basis.

As GasNet has noted, values shown for the risk-free interest rate are only indicative as the actual values will be determined prior to the Commission's *Final Decision.* Expected inflation will be also be determined then. GasNet proposes that the relevant bonds rates will be selected at that stage in consultation with the Commission on an *ex ante* basis.

The Commission determined the WACC parameter values in 1998 after carefully considering available information. It has applied this approach consistently across subsequent regulatory decisions consistent with industry benchmarks. The Commission has considered arguments to depart from this approach but has not found them persuasive. In particular, it has assessed the *ex ante* rate of return outcomes against relevant benchmarks and found them to be reasonable. For example, a 2001 study by NERA for the Commission concluded that Australian utilities' regulated post tax rates of return compared favourably with those in North America and the UK.[8]

GasNet states that, although the asset beta (0.6) is higher than that approved in recent Commission decisions (such as 0.5 for the Moomba to Adelaide Pipeline System access arrangement), it is justified by GasNet's unique circumstances. GasNet states that the market carriage regime and the price cap tariff methodology[9] mean that GasNet's revenues are very sensitive to changes in GDP.[10]

GasNet also notes that its proposed use of 10 year bond rates departs from the Commission's usual approach which is to use five year bonds. GasNet comments that State regulators have generally used 10 year bond rates and submits that the maturity term should match the long-term nature of the investment. GasNet further argues that five year bond rates exhibit excessive volatility.

Does GasNet face unique circumstances that justify a high asset beta? Is an asset beta of 0.6 compatible with the industry benchmarks used by the Commission when selecting parameter values?

Would the proposed changes to GasNet's average revenue control tariff methodology (to allow recovery of amounts not currently recoverable due to the K factor adjustment) affect GasNet's risks going forward?

2.5 Revenue elements

2.5.1 Proposal

Table 2.4 sets out GasNet's proposed revenue requirements under the building block methodology, and its components, for each year of the second access arrangement period. It also shows the smoothed forecast revenue for each year.

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8 NERA, *International comparison of utilities' regulated post tax rates of return in: North America, the UK, and Australia*, March 2001.

9 GasNet labels the tariff methodology here as 'price cap'. However, the mode of regulation currently in operation and also proposed by GasNet is an average revenue control.

10 GasNet Submission, p. 62.

Table 2.4: Components of the revenue requirement, forecast revenue ($ million)

Components of revenue requirement	2003	2004	2005	2006	2007
Return on assets	45.73	45.62	45.72	46.02	46.17
Depreciation	19.28	20.04	21.16	21.91	22.16
Non-capital costs	42.91	23.69	23.43	25.25	25.66
Total	107.92	89.35	90.31	93.18	93.99
Forecast revenue	93.92	94.96	96.11	96.53	96.67

Source: GasNet Submission, p. 104.

Reflecting the capital intensive nature of gas transmission services, return on capital (return on assets) is the largest component of the revenue requirement. The Commission understands that this component increases in size substantially from 2002 because of proposed increases to the capital base (for example, as a result of including the Southwest Pipeline and easements) and to the rate of return.[11]

Similarly, return of capital (depreciation) represents a substantial component of revenue. Table 2.5 below sets out GasNet's proposed depreciation allowance by asset category.

Table 2.5: Proposed depreciation allowance by asset category ($million)

Asset category	2003	2004	2005	2006	2007
Pipelines	13.7	14.3	14.9	15.6	15.6
Compressors	4.2	4.4	4.8	4.7	4.1
System control facilities	0.9	0.9	1.1	1.2	1.3
Odorisation	0.01	0.01	0.01	0.01	0.01
Gas quality	0.02	0.02	0.02	0.02	0.02
General land and building	0.2	0.2	0.2	0.2	0.2
Other	0.3	0.2	0.2	0.2	0.2
Total	19.3	20.0	21.2	21.9	21.4

Source: GasNet Access arrangement information, p. 7.

Forecast operating costs and their components (for GasNet's regulated activities) are shown in Table 2.6 below.

Table 2.6: Forecast operating costs, (nominal $million)

Operating cost	2003	2004	2005	2006	2007
Pipeline maintenance	5.9	6.8	6.2	7.4	7.4
Compressor maintenance	3.3	3.6	3.7	3.7	3.8
G&A	8.0	8.4	8.6	8.9	9.1
Fuel gas	1.2	1.3	1.4	1.6	1.7
Total	18.4	20.1	19.9	21.6	22.0

Source: GasNet Access arrangement information, p. 9.

[11] GasNet has not provided data for years before 2003.

The total in Table 2.6 does not equate to the non-capital costs figures in Table 2.4. GasNet also proposes to include amounts carried forward from the first access arrangement period of $14.0 million (K factor carry over) and $5.4 million (benefit sharing allowance). As well, it proposes to include an annual allowance of $2.4 million for capital raising costs and $0.752 for asymmetric risks.

Included in the operating costs are 'Regulatory/Utility charges' of $1.3-1.4 million a year,[12] reset costs of $0.5 million in 2002, $1.0 million in 2006 and $0.6 million in 2007, insurance charges of $1.7 million per year (compared to $0.3 million previously), marketing costs of $0.4 million a year and listing and governance costs of $1.2-1.4 million a year.[13] GasNet states that reset costs incurred in 2006 and 2007 are not included for the second access arrangement period.[14]

Are these costs consistent with those which would be incurred by a prudent operator?

2.6 Demand forecasts

Table 2.7 below sets out GasNet's annual demand forecasts. These are based on the VENCorp *Annual planning review* but GasNet advises that it has modified the estimates to further reflect regional warming. This adjustment results in a reduction to VENCorp's forecast annual load in 2007 of approximately 1.2 PJ.[15] As a result, the forecasts proposed for the two access arrangements are inconsistent. Any effect from GasNet's proposed increase in marketing expenditure is not reflected in the demand forecasts.

Table 2.7: GasNet's forecast demand

Demand and volume	2003	2004	2005	2006	2007
Peak demand (TJ/day)	1132	1174	1209	1235	1257
Annual volume (PJ)[a]	216.2	225.3	232.7	237.2	241.3

Source: GasNet access arrangement information, p. 15.

Note: (a) Excludes storage refills of 3.6, 3.6, 4.3, 3.2 and 3.4 PJ over this period. See GasNet Submission, p. 105.

Is GasNet's proposed modification to the VENCorp Annual planning review forecasts reasonable? Should the demand forecasts be consistent across the two access arrangements?

12 GasNet access arrangement information p. 9.

13 GasNet Submission p. 95.

14 GasNet submission, p. 84.

15 GasNet Submission, pp. 105-106.

2.7 Reference tariffs

GasNet proposes an injection tariff levied on the 10 peak injection days (currently it is the five peak days) and a withdrawal tariff based on volumes delivered (currently there are two components to withdrawal tariff: one based on volumes delivered and one based on peak: five peak withdrawal days for Tariff D and peak period withdrawals for Tariff V). A separate injection tariff is proposed for each of the five injection points (currently two), for each of the 15 withdrawal zones (currently 12) and within each withdrawal zone separate tariffs for Tariff V and Tariff D customers. As well, there is a new transmission refill tariff, a cross system withdrawal tariff, matched withdrawal tariffs and prudent discounts for certain customers based on location (this being GasNet's response to perceived by-pass threats).

Are the proposed changes likely to enhance the efficiency and effectiveness of the tariff structure? Do the proposed tariffs meet the objectives of the Code?

In allocating costs to users there is a question of how usage is defined. In the current proposal, for the allocation of 60 per cent of costs, usage is defined by users' peak usage (being forecast peak 1 in 2 winter flows). For the other 40 per cent of costs, usage is defined by total annual demand. This differs from the allocation currently in the access arrangement of 65 per cent based on forecast 1 in 20 peak winter flows and 35 per cent total annual usage. The 60:40 split is achieved by allocating all injection pipeline costs on the basis of peak and withdrawal pipeline costs on the basis of 45 per cent to peak and 55 per cent to annual.

Is the cost allocation approach appropriate?

GasNet states that 'the proposed average tariffs … increase by 11% in real terms from the 2002 published tariffs to the discounted weighted average tariff to apply over 2003 to 2007.'[16] This calculation excludes the Southwest Pipeline.

The Commission calculates that, for GasNet's regulated assets as a whole, the proposed average revenue in 2003[17] is approximately 38 per cent higher than the average revenue for 2002.[18] It then increases at a rate of CPI*(1-0.045) per year (that is, a real annual decrease of 4.5 per cent,[19] which is a smoothing mechanism, not an incentive mechanism). The real average revenue[20] for the 2003-2007 period is approximately 23 per cent higher than the 2002 average revenue.

Is a 38 per cent increase in 2003 and then a real decrease of 4.5 per cent in each subsequent year of the access arrangement period an appropriate average revenue path?

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16 GasNet Submission, p. 3.

17 Based on proposed tariffs and forecast volumes.

18 Based on current tariffs and forecast volumes.

19 The 4.5 per cent is the weighted average of all the X factors applying to each tariff (labelled the PPT in GasNet's access arrangement and submission). The X factor is five for most tariffs and zero for the rest, for example injection at Port Campbell and Dandenong, and withdrawal at Murray Valley.

20 Calculated by converting the average revenue for each year in the 2003-2007 period into $2002 and then calculating a simple average.

GasNet proposes to recover all the costs associated with the Southwest Pipeline through the injection tariff on the Southwest Pipeline. Consequently the cost allocation methodology referred to above would not apply to the Southwest Pipeline tariff. Further, to promote demand growth on the pipeline, GasNet is proposing a relatively low initial tariff. This has been achieved by setting the economic life to end in 2052 (compared to 2023 for the Longford pipeline and 2033 for the rest of the system); and levelising the revenue requirement over the first 20 years at a flat real rate (which will involve negative depreciation in the early part of the asset's life). In addition, the X factor for the Southwest Pipeline in the CPI-X formula will be zero for the second access arrangement period.[21]

Is it appropriate to determine the economic life of an asset on the basis of the desired tariff profile? Is the proposed tariff path for the Southwest Pipeline appropriate?

GasNet proposes to continue with regulation by average revenue control. Thus, as in the access arrangement at present, a K factor would be included in the price control formula which adjusts each year's tariffs on the basis of whether the target average revenue for the previous year was under or over achieved.[22] Thus, risk associated with gas being injected at injection points (which have different tariffs) in different proportions to those forecast is passed from GasNet to users. One outcome of this is that if the volumes used in the calculation of the 'full cost recovery' tariff for the Southwest Pipeline are sourced from another (cheaper) injection point then users on the rest of the GNS will contribute to the shortfall in average revenue.

Is the operation of the K factor consistent with the aim that the costs of the Southwest Pipeline be fully recovered from users of the Southwest Pipeline?

In the current access arrangement there is a limit on the increase in any individual tariff (the Y factor) so that no individual tariff can increase more than one percentage point above the increase in CPI-X. A consequence of this is that GasNet cannot recover all the benchmark average revenues whenever the K factor is more than one percentage point above the CPI-X increase. GasNet proposes that the limit on individual tariff increases be two percentage points above the figure obtained by increasing the current tariff by CPI minus the X applicable to that tariff plus the K factor. This will limit the rebalancing of tariffs available to GasNet.[23]

Is this limitation to the annual rebalancing of tariffs from those currently proposed appropriate?

2.8 Performance and incentives

The price path approach adopted in GasNet's access arrangement acts as an incentive mechanism as tariffs are not reviewed during an access arrangement period to reflect

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21 GasNet access arrangement information p. 23.

22 GasNet access arrangement p. 33-36.

23 GasNet access arrangement p. 38.

actual performance. Accordingly, GasNet retains the benefits during that period of outperformance. GasNet proposes to retain a price path approach.

A fixed principle currently applying to the GasNet access arrangement is that the Commission must 'ensure a fair sharing between [GasNet] and its *Customers* of the benefits achieved through efficiency gains if, *in the initial regulatory period*, [GasNet] has achieved efficiencies greater than' anticipated.[24] The fixed principle does not provide any further guidance on the calculation of benefits or on how they might be shared. In consultations prior to GasNet's submission of revisions, the Commission proposed usage of an efficiency sharing mechanism of the type adopted by the Essential Services Commission (ESC) with respect to the Victorian electricity distribution businesses and which it proposes to adopt for the Victorian gas distribution businesses.

GasNet does not favour the ESC approach, and states that it proposes to include in its revenue requirement an allowance reflecting operating costs efficiency gains made in the first access arrangement period.[25] GasNet does not propose to include capital costs in the benefit sharing mechanism.

GasNet proposes that the benefit that users gain from operating efficiencies made during the first access arrangement period will be calculated as the difference between the average forecast of operating costs for the second access arrangement period and the last year of the original forecast of operating costs (with the latter adjusted to reflect additional workload).

GasNet does not propose that its actual performance will be considered when determining efficiency gains, and GasNet's submission does not generally provide details of performance achieved during the first access arrangement period. However, GasNet does provide a number of costs ratios in its submission.[26] Pipeline maintenance/km fell dramatically (from $5.145/km to $3.324/km) between 1998 and 1999, then to $2.789/km in 2000, before rising. The figure shows no pigging costs for 1998 to 2000, followed by substantial pigging costs into the second access arrangement period. Compressor maintenance as a percentage of capital investment more than halved between 1998 and 2001, then is forecast to rise moderately. The change in adjusted general and administrative costs per GJ is more moderate, falling from $0.024/GJ in 1998 to $0.018/GJ in 2000, then increasing to a plateau of $0.023/GJ to $0.024/GJ.

Table 2.8 below illustrates GasNet's approach to benefit sharing. The notes to the table indicate a number of adjustments made by GasNet.

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[24] Victorian Gas Industry Tariff Order, clause 9.2(a)(4).

[25] GasNet Submission, p. 99.

[26] GasNet Submission, pp. 85-88.

Table 2.8: GasNet's proposed calculation of efficiency gains ($ million)

Efficiency gain calculation	$m
Tariff model operating costs for 2002 adjusted for additional workload[a]	18.86
Less average operating cost forecast 2003-2007[b]	-16.64
Benefit to customer	2.22

Source: GasNet submission, p. 99.

Notes: (a) GasNet states that the original tariff model forecast operating cost for 2002 was $17.2 million (in 2003 dollars) adjusted for actual inflation, after deducting an amount of $0.8 million for regulatory expenses which were budgeted for but not levied. It further states that this figure has been adjusted upwards by $1.6 million per year to take into account the additional workload associated with new pipelines (the Southwest Pipeline and Interconnect) and further investment in compressors (Springhurst and Iona).

(b) Excludes reset costs, increase in insurance costs and the ESSO litigation costs.

GasNet extrapolates the calculated gains as a perpetuity over the life of the assets, which it estimates gives an NPV of $27.0 million. GasNet proposes that it retains 20 per cent of this benefit, or $5.4 million in 2003 (NPV). GasNet proposes to recover this share over the second access arrangement period and has included in its tariff calculations an additional allowance of $5.4 million in 2003 reflecting the benefit sharing allowance. This allowance would be distributed over the period 2003 to 2007 by the tariff levelisation procedure.

GasNet proposes a fixed principle such that this approach to a benefit sharing mechanism would be applied when determining tariffs for the third access arrangement period.[27] Efficiencies would be calculated as the difference between the forecast operating costs for the last year of the second access arrangement period (adjusted to account for additional workload) less the average operating costs forecast for the third access arrangement period (with all amounts expressed in 2008 dollars). A share of the benefit would only be included in GasNet's tariff calculations if the calculation resulted in a positive amount.

Is it reasonable to calculate efficiencies solely on the basis of forecast operating costs, and for GasNet to retain a share of gains but not losses?

Would GasNet's proposal provide appropriate incentives and a fair sharing of efficiencies? How does GasNet's proposal compare with the ESC approach?

GasNet provides in its access arrangement information five KPIs for itself and other regulated transmission pipelines in Australia. In each case, GasNet either performs well compared to the other pipelines or is in the middle of the range (in these cases it provides relevant background to its apparent performance). GasNet also provides a summary of a confidential international benchmarking study it commissioned.

Are the KPIs provided and the benchmarks chosen the most appropriate ones, and has GasNet correctly interpreted the results?

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[27] GasNet access arrangement p. 10, GasNet Submission, p. 114.

2.9 Extensions and expansions policy

GasNet proposes to continue the current arrangement whereby it is solely responsible for the PTS extensions and expansions policy. Proposed changes to the policy include:

- GasNet would be able to decide whether any new extension would be covered by the access arrangement. Currently small extensions (and all expansions) are automatically covered but GasNet may decide that a significant extension will not be covered; and
- less restrictive provisions to apply when an extension or expansion is proposed to be included in the capital base.

Is it appropriate for GasNet to have complete discretion over whether an extension is covered?

2.10 Information

The Code requires that a proposed access arrangement must be supported by access arrangement information. Section 2.6 specifies that access arrangement information must contain such information that in the opinion of the regulator would enable users and prospective users to understand the derivation of the elements in the proposed access arrangement and to form an opinion as to the compliance of the access arrangement with the provisions of the Code. Section 2.7 states that the access arrangement information may include any relevant information but must include at least the categories of information described in Attachment A to the Code (refer to the Appendix to this *Issues Paper*) which provides examples of the minimum disclosure obligations.

GasNet provided extensive documentation in support of its revisions. This includes a substantial proportion for which confidentiality has been claimed. The Commission has not yet formed a view on whether disclosure of this information would be likely to be unduly harmful to the legitimate business interests of GasNet or a user or prospective user. At this stage it has only disclosed information for which confidentiality has not been claimed. The Commission will consult with GasNet on these claims before deciding whether further information should be disclosed. Any further information disclosed will be posted on the Commission's website.

GasNet provided detailed financial modelling information to the Commission on 10 April 2002 to assist its assessment.

GasNet states that the purpose of its proposed access arrangement information is 'to assist Users and Prospective Users to understand the derivation of the elements of GasNet's proposed Access Arrangement.'[28] GasNet states that the access arrangement information addresses the categories of information in Attachment A of the Code with the exception of customer numbers which it says it understands are being provided by VENCorp.

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[28] GasNet access arrangement information, p. 2.

GasNet's proposed access arrangement information includes forecasts such as for costs and demand which are reproduced elsewhere in this *Issues Paper*. It also describes GasNet's pricing proposal. GasNet's submission contains additional information, including the revenue requirement. Limited zonal information is provided. GasNet has not quantified its operations and maintenance costs for the first access arrangement period.[29] As envisaged by section 2.9 of the Code, the Commission will review the access arrangement information provided by GasNet and determine whether changes need to be made.

Is all Attachment A information provided?

Are users and prospective users able to understand the derivation of the elements in the proposed revised access arrangement and form an opinion as to the compliance of the access arrangement with the provisions of the Code?

Has GasNet satisfied the access arrangement information requirements of the Code?

[29] Partial information is provided in the form of costs ratio graphs, GasNet Submission, pp. 85-88.

3. VENCorp access arrangement

3.1 Reference tariff methodology

Section 8 of the Code establishes pricing principles for setting the prices of transportation services. While these principles provide considerable flexibility, they are designed to achieve the key objectives listed in section 8.1 of the Code.

In broad terms, tariffs need to be cost reflective to promote economic efficiency in the use of the system. The Code recognises the dulling effect revenue constraints can place on efficient pipeline operations and provides for the inclusion of mechanisms to provide incentives for the service provider to strive for efficiency improvements.

The methodology proposed for the setting of reference tariffs is contained in the access arrangement and access arrangement information. In brief, VENCorp states that it has applied the following principles in developing its proposed reference tariffs:

- operation on a non-profit, full cost recovery basis;
- certain tariffs are subject to a five year price path with re-balancing constraints while others are set annually; and
- application of Ramsey pricing principles to commodity charges.

Essentially, the main revision in the reference tariff policy relates to the five year price path for certain reference tariffs.

Is there a more appropriate structure to recover efficient costs of providing the reference service that meets the objectives of the Code?

3.2 Reference tariffs

VENCorp currently imposes four charges on market participants:

- registration charges;
- commodity charges (Tariff D or Tariff V);
- meter data management charges (transmission and distribution);[30] and
- LNG system security charges.

[30] The distribution meter data management tariff is paid by each market participant who is connected to a distribution system, or whose customers are connected to a distribution system at a connection point at which there is a metering installation. VENCorp contracts out the reading of the distribution supply point meters. The transmission meter data management tariff is paid by each market participant who withdraws gas from or injects gas into the transmission system, or whose customers are connected to the transmission system at a connection point at which there is a metering installation.

The registration fee is currently charged at a rate of $30 per day to each market participant. VENCorp proposes to maintain the registration charge at this level for the second access arrangement period.

Both the system security service and the distribution meter reading function of the meter data management services are provided to VENCorp under contract by external agencies. The contract charges for these services are passed directly on to market participants through the LNG system security charges and metering charges. VENCorp is proposing a reduction of over 10 per cent in the metering charges commencing July 2002.

In order to provide the system security service, VENCorp has a contract in place with GasNet to reserve storage space of 3 000 tonnes in GasNet's LNG facility. This service has been regulated under the Victorian Tariff Order at $1.4 million per annum until 31 December 2002. There is, however, a contract in place between GasNet and VENCorp which runs until May 2004. There is uncertainty as to the subsequent system security tariff beyond May 2004 as the amount will be dependent on commercial negotiations with GasNet and potential alternative suppliers. VENCorp does not consider that there are any suitable alternative suppliers in the short term.

All costs not allocated to the registration, meter data management and system security services are recovered through commodity tariffs. VENCorp states that these tariffs are determined using Ramsey pricing principles. The outcome of these principles is that higher levies are imposed on the part of the market that has the lowest price elasticity. Specifically, Tariff D customers are charged less than Tariff V customers. VENCorp is proposing an immediate reduction in commodity tariffs of 4.0 per cent which would be instituted six months prior to the commencement of the second access arrangement period.

VENCorp proposes real price changes for service tariffs as shown in the following tables. Price change has been measured between consecutive years as:

$$((\text{Price Yr 2})/[(\text{Price Yr 1}) \times (\text{CPI Yr2}/\text{CPI Yr 1})]-1) \times 100$$

Table 3.1: Real VENCorp tariffs

Reference tariff	Actual year ended June 2001	Target for year ending June 2002
Tariff D commodity	$0.03383	$0.03383
Tariff V commodity	$0.08391	$0.08391
Registration	$30.00000	$30.00000

Source: VENCorp access arrangement information, p. 34

Table 3.2: Real tariffs proposed by VENCorp

Reference tariff	Target (in 2002$) for year ending June				
	2003	2004	2005	2006	2007
Tariff D commodity	$0.03167	$0.03076	$0.03006	$0.02937	$0.02870
Tariff V commodity	$0.07861	$0.07631	$0.07455	$0.07287	$0.07119
Registration	$29.3100	$28.6500	$27.9900	$27.3600	$26.7300
Real estimated cumulative reduction	2.3%	4.5%	6.7%	8.8%	10.9%

Source: VENCorp access arrangement information, p. 34

To what extent are the reference tariffs likely to replicate the outcomes of a competitive market? Are VENCorp's proposed charges fair and reasonable?

Will the proposed tariff structure and principles encourage investment decisions congruent with a competitive market? Does the proposed level and structure of tariffs provide incentive for the efficient utilisation of the system?

Is there a better methodology for the allocation of costs (other than the Ramsey pricing model) that meets the Code requirements?

3.3 Approval and reporting process

Under VENCorp's access arrangement as it currently stands, the Commission approval and reporting process for all VENCorp tariffs occurs yearly. One issue arising from the approval process is that current tariff approval mechanisms are set to apply for the 12 month period concluding 30 June 2003 while the current access arrangement period concludes at the end of the 2002 calendar year.

VENCorp proposes that system security and meter data management tariffs will continue to be approved annually using the current process.. However, VENCorp proposes to replace the yearly approval process for registration and commodity tariffs with a five yearly access arrangement review approval process. This would mean that registration and commodity tariffs would be set for the regulatory period, with the ability for VENCorp to re-balance within certain parameters where under or over-recovery exceeds the tolerance levels. However, for the first 6 months of the second access arrangement period, the current annual approval process would apply (as discussed above).

VENCorp has provided the forecast costs associated with the commodity and registration tariffs and the proposed tariffs over the second access arrangement period in the access arrangement information.[31] VENCorp has also proposed tolerance levels of $1.5 million for the cumulative under or over-recovery.[32]

[31] VENCorp Access arrangement information, p. 7.

[32] VENCorp Access arrangement information, p. 15.

The following re-balancing constraints are proposed to be in place during the second access arrangement period in order to alter rates where the surplus or deficiency exceeds the specified tolerance level:

- an annual re-balancing mechanism at VENCorp's discretion to increase its tariffs by up to the greater of CPI or two per cent for annual accumulated aggregate under-recovery of at least $1.5 million but less than $3 million;
- for annual accumulated aggregate under-recovery in excess of $3 million VENCorp would be able to seek a variation to this access arrangement under section 2 of the Code for an increase in tariffs to recover that part of an under-recovery in excess of $3 million;
- for an annual accumulated aggregate over-recovery above $1.5 million, VENCorp would reduce its tariffs by at least two per cent.[33]

The method by which the annual accumulated under-recovery or annual accumulated over-recovery at the end of each financial year would be determined is described in the revised access arrangement as follows:[34]

- VENCorp will determine the accumulated net revenue at the end of each financial year by deducting from the revenue derived through the commodity and registration tariffs the associated costs of providing the services over the period from the beginning of the access arrangement period to the end of the relevant financial year;
- if the annual accumulated aggregate cost is greater than the annual accumulated aggregate revenue then there is an annual accumulated aggregate under-recovery; and
- if annual accumulated aggregated revenue is greater than the annual accumulated aggregate cost then there is an annual accumulated aggregate over-recovery.

The accumulated aggregate revenue over or under recovery at the end of the access arrangement period would be carried forward in determining tariffs for the subsequent access arrangement period according to the fixed principle described in Section 5.2.2(c) of the revised access arrangement.

In order for the re-balancing mechanism to work, there must be a sufficiently large window in order to minimise review processes.

VENCorp submits that this proposal to extend the approval period for registration and commodity tariffs to five years will achieve a degree of price stability over the access arrangement period.

Should the current annual approval process be replaced with the five yearly access arrangement review approval process for registration and commodity tariffs?

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[33] VENCorp Access arrangement, p. 9. Refer to appendices 3 and 4 of the access arrangement for further information.

[34] VENCorp Access arrangement, p. 9.

Is the re-balancing window associated with registration and commodity tariffs appropriate?

3.4 Demand assumptions

Forecast average daily and peak demand at city gates and total annual delivered volume from 2003 to 2007 are set in Table 3.3 below:

Table 3.3: VENCorp forecast transmission volume

	6 months to 30 June	Forecast year ending 30 June				6 months to 31 Dec
Demand and volume	**2003**	**2004**	**2005**	**2006**	**2007**	**2007**
Average demand (TJ/d)	596.5	610.3	638.5	658.0	672.5	684.7
Peak demand (TJ/d)	1 103.6	1 132.5	1 169.9	1 207.5	1 236.4	1 265.7
Annual volume (TJ/d)	98 539	223 364	233 049	240 176	245 474	137 008

Source: VENCorp access arrangement information, pp. 25-27.

The above forecasts were determined through the VENCorp *Annual planning review*.

Given the importance of volume in deriving tariffs, are the forecasts in the table above reasonable?

3.5 Costs and revenues

VENCorp's forecast operating costs for providing its reference services are summarised in Table 3.4 below.

Table 3.4: Summary of VENCorp's forecast operating costs

	Forecast financials (in 2002 $m) for					
	6 months to 30 June	Year ending 30 June				6 months to 31 Dec
Reference services	**2003**	**2004**	**2005**	**2006**	**2007**	**2007**
Market and system operational services[35]	6.5	12.5	12.6	13.0	12.6	6.1
Information services[36]	0.1	0.1	0.2	0.2	0.2	0.1
Metered data management services	0.6	1.3	1.3	1.3	1.3	0.7
System security services	1.0	2.1	2.1	2.1	2.1	1.0
Total	**8.2**	**16.0**	**16.2**	**16.6**	**16.2**	**7.9**

Source: VENCorp access arrangement information, p. 4.

VENCorp's proposed initial reference tariffs for the second access arrangement period are shown in Table 3.5 below.

Table 3.5: Initial VENCorp reference tariffs

Reference tariff	Forecast financial ($) for		
	6 months to 30 June	Year ending 30 June	6 months to 31 Dec
	2003	**2004-2007**	
Tariff D commodity tariff	$0.03248/GJ		
Tariff V Commodity Tariff	$0.08055/GJ		
Registration Tariff	$30/day/participant		
Transmission Meter Data Management Tariff $/day/meter	$7.00	Yet to be determined	
Distribution Meter Data Management Tariff $/day/meter	$2.62965	Yet to be determined	
System Security Tariff per GJ	$0.00751	Yet to be determined	

Source: VENCorp access arrangement information, p. 5.

3.6 Access arrangement contents

The required contents of an access arrangement were listed in broad terms in Chapter 1. The Commission must be satisfied that VENCorp's revised access arrangement will meet the content requirements of the Code before it can approve the revised access arrangement. It must also be satisfied that the terms and conditions on which reference services will be offered are reasonable.

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[35] Includes the cost of competitive services (i.e. telecommunications) and consultancy services, which in turn includes the reimbursement of the costs associated with conducting emergency exercises. Revenue associated with these services of approximately $100,000 per annum has been offset against these costs.

[36] Reflects revenue associated with provision of service given difficulty in isolating associated costs.

VENCorp has included the following Code elements in its access arrangement:

- Service policy
- Reference tariffs
- Terms and conditions
- Capacity management policy
- Queuing policy
- Review and expiry dates

Due to the unique responsibilities of VENCorp and its relationship with GasNet, elements such as the extensions and expansions policy are included in the GasNet access arrangement rather than that of VENCorp.

There is no trading policy in the access arrangement because it is not applicable to the market carriage system under which the Victorian gas market operates.

VENCorp has also submitted an access arrangement information document that forms part of the access arrangement. The access arrangement information is discussed in section 3.10 of this *Issues Paper*.

3.7 Performance and incentives

Performance monitoring and benchmarking

As part of its on-going role as regulator of transmission pipelines, the Commission is working to identify and develop appropriate efficiency and productivity indicators to use as benchmarks for the regulated utilities. The measures should be both financial and non-financial and look to internal and external comparators.

VENCorp has developed a set of corporate key performance indicators (KPIs) against which it reports monthly to its Board including:

- standard financial indicators such as expenditure against budget;
- corporate indicators such as completion of employee performance reviews, employee training effort, lost time through absences; and
- operational indicators such as accuracy of demand forecasts, timeliness of issuing operational schedules, availability of IT systems, and code compliance.

Given the unique structure, position and responsibilities of VENCorp in the Victorian gas industry it is difficult to determine appropriate parties against whom to benchmark performance. VENCorp states that it has sought assistance from the industry in determining methods in which to benchmark performance against external comparators. In light of these challenges, VENCorp proposes to conduct internal benchmarking activities based upon historical and forecast expenditure.

Incentive mechanisms

The Code promotes the use of incentive mechanisms within the reference tariff policy that encourage the service provider to seek additional returns that exceed the level of returns expected at the beginning of the access arrangement period.

Incentive mechanisms have been omitted from VENCorp's access arrangement due to its non-profit basis of operations and its requirement to return all gains. Nevertheless, incentive mechanisms can be an important means to promote efficient and effective operations.

Are the supplied performance indicators relevant? Are more appropriate measures available?

Are there any external organisations that could be usefully used to benchmark VENCorp's performance?

Are incentive mechanisms for performance improvement feasible? Should some form of penalty be introduced for non-performance?

Are there any incentive mechanisms that would be appropriate for VENCorp to use to encourage efficient and effective operations?

3.8 Services policy

Sections 3.1 and 3.2 of the Code require an access arrangement to include a services policy which must include a description of one or more services that the service provider will make available to users and prospective users. The policy must contain one or more services which are likely to be sought by a significant part of the market, and any service or services that in the regulator's opinion should be included in the services policy.

To the extent that is practicable and reasonable, a service provider should make available only those elements of a service required by users and prospective users and apply a separate tariff for each element if this is requested.

VENCorp has proposed the following reference services:

- Information services;
- Market and system operational services;
- Meter data management services; and
- System security service.

The proposed services policy does not differ from the current policy.

Are there any other services that are likely to be sought by a significant segment of market participants that should be included in the service policy?

Are there any services currently contained in the service policy that should be ceased?

3.9 Terms and conditions

Section 3.6 of the Code requires an access arrangement to include the terms and conditions on which a service provider will supply each reference service. To be approved, these terms and conditions must be considered reasonable by the regulator.

In the VENCorp's access arrangement as it currently stands, terms and condition are contained in the MSOR, Victorian Tariff Order and pro-forma Gas Transportation Deed.[37] On the 31 December 2002, many of the provisions of the Victorian Tariff Order will expire. Changes have been proposed to the MSOR in order to include relevant terms currently contained in the Victorian Tariff Order. This will result in self-containment of all terms and conditions within the Gas Transportation Deed (as attached as Appendix 2 of VENCorp's revised access arrangement) and the MSOR.

Does the proposed revised access arrangement (in conjunction with the MSOR) clearly identify the relevant terms and conditions so that they enable users and prospective users to be sufficiently informed before making an access request?

Are the proposed terms and conditions reasonable?

3.10 Information

The Code requires that a proposed access arrangement must be supported by access arrangement information. Section 2.6 specifies that access arrangement information must contain such information that in the opinion of the regulator would enable users and prospective users to understand the derivation of the elements in the proposed access arrangement and to form an opinion as to the compliance of the access arrangement with the provisions of the Code. Section 2.7 states that the access arrangement information may include any relevant information but must include at least the categories of information described in Attachment A to the Code (refer to the Appendix to this *Issues Paper*).

While ensuring sufficient information is available to users and prospective users, the Commission must also ensure that any information disclosed is not, in its opinion, unduly harmful to the legitimate business interests of the service provider, users or prospective users.

VENCorp's proposed access arrangement information contains actual and forecast data combined with detailed information including costs, tariffs, incentive structures, capacity and volume assumptions, key performance indicators, a detailed assessment of how VENCorp considers the proposed reference tariffs comply with principles set out in Section 8.1 and 8.2 of the Code, and VENCorp's financial statements. None of this information has been supplied on a confidential basis.

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[37] The pro-forma Gas Transportation Deed is a document between VENCorp and gas shippers directing gas shippers to pay transmission tariffs directly to GasNet.

Is all Attachment A information provided?

Are users and prospective users able to understand the derivation of the elements in the proposed revised access arrangement and form an opinion as to the compliance of the access arrangement with the provisions of the Code?

Has VENCorp satisfied the access arrangement information requirements of the Code?

4. Authorisation of MSOR

The MSOR performs two basic roles in relation to the transmission of natural gas in Victoria. Firstly, the rules govern the operation of the PTS. Secondly, they govern the operation of Victoria's wholesale gas spot market, which is an integral part of Victoria's market carriage system.

The MSOR is a statutory instrument passed pursuant to section 48N of the GIA. The MSOR was enacted by Order in Council on 2 February 1999. Certain provisions of the MSOR came into force on that date; those provisions dealing with the establishment of the operation of the wholesale spot market came into force on 15 March 1999.

The MSOR provides for a SEA between GasNet and VENCorp, under which GasNet agrees to make all its capacity on the PTS available to VENCorp. The SEA was reached between VENCorp, TPA and TPA (Assets) in 1998. It underpins the operation of the market carriage system by making pipeline capacity available to VENCorp, allowing the spot market to take place.

The MSOR has the following functions:

- regulating the operation and administration of the wholesale market for natural gas;
- regulating the activities of parties using the principal gas transmission system and wholesale market;
- providing for open access to the PTS; and
- providing for the management of system security and safety.

Given that there is a market carriage system in Victoria, with an independent system operator (VENCorp), it was recognised by VENCorp that the operation of the spot market could potentially give rise to anti-competitive conduct and accordingly might breach provisions of the TPA. To address this risk, VENCorp applied to the Commission for authorisation of the MSOR under Part VII of the TPA.

Part VII of the TPA allows the Commission to authorise conduct that might breach certain provisions of Part IV of the TPA, if it can be established that the public benefit arising from the conduct outweighs any public detriment resulting from competition being lessened. On 19 August 1998 the Commission conditionally authorised the MSOR. This authorisation remains in force until 1 January 2003.

VENCorp has indicated to the Commission that it will shortly submit an application for re- authorisation of the MSOR. Following receipt of this application, the Commission will seek the views of interested parties as to any public benefits or detriments that have arisen or are likely to arise from the operation of the spot market in Victoria. Since the MSOR has been authorised for in excess of three years, interested parties should now be well placed to put forward such views. During this period the Commission has authorised a number of minor changes to the MSOR proposed by VENCorp. Since the Commission and VENCorp both undertook a public consultation process in relation to each rule change, interested parties should be well informed about the nature and effect of these changes.

Having considered any submissions it might receive, the Commission will assess VENCorp's application under Part VII of the TPA and issue a *Draft Determination* that proposes to either authorise or not authorise the MSOR.

Following issue of the *Draft Determination* the Commission will once again seek the views of interested parties. The applicant or any interested party dissatisfied with the draft determination can request a pre-determination conference. Following the conference, or if no conference is requested, the Commission will reconsider the application and publish its *Final Determination*.

Applications for review of Commission determinations may be made to the Australian Competition Tribunal.

Appendix

ATTACHMENT A - INFORMATION DISCLOSURE BY A SERVICE PROVIDER TO INTERESTED PARTIES

Pursuant to section 2.7 the following categories of information must be included in the Access Arrangement Information.

The specific items of information listed under each category are examples of the minimum disclosure requirements applicable to that category but, pursuant to sections 2.8 and 2.9, the Relevant Regulator may:

- *allow some of the information disclosed to be categorised or aggregated; and*
- *not require some of the specific items of information to be disclosed,*

if in the Relevant Regulator's opinion it is necessary in order to ensure the disclosure of the information is not unduly harmful to the legitimate business interests of the service provider or a user or Prospective user.

Category 1: Information Regarding Access & Pricing Principles

Tariff determination methodology
Cost allocation approach
Incentive structures

Category 2: Information Regarding Capital Costs

Asset values for each pricing zone, service or category of asset
Information as to asset valuation methodologies - historical cost or asset valuation
Assumptions on economic life of asset for depreciation
Depreciation
Accumulated depreciation
Committed capital works and capital investment
Description of nature and justification for planned capital investment
Rates of return - on equity and on debt
Capital structure - debt/equity split assumed
Equity returns assumed - variables used in derivation
Debt costs assumed - variables used in derivation

Category 3: Information Regarding Operations & Maintenance

Fixed versus variable costs
Cost allocation between zones, services or categories of asset & between regulated/unregulated
Wages & Salaries - by pricing zone, service or category of asset
Cost of services by others including rental equipment
Gas used in operations - unaccounted for gas to be separated from compressor fuel
Materials & supply
Property taxes

Category 4: Information Regarding Overheads & Marketing Costs

Total service provider costs at corporate level
Allocation of costs between regulated/unregulated segments
Allocation of costs between particular zones, services or categories of asset

Category 5: Information Regarding System Capacity & Volume Assumptions

Description of system capabilities
Map of piping system - pipe sizes, distances and maximum delivery capability
Average daily and peak demand at "city gates" defined by volume and pressure
Total annual volume delivered - existing term and expected future volumes
Annual volume across each pricing zone, service or category of asset
System load profile by month in each pricing zone, service or category of asset
Total number of customers in each pricing zone, service or category of asset

Category 6: Information Regarding Key Performance Indicators

Industry KPIs used by the service provider to justify "reasonably incurred" costs
Service provider's KPIs for each pricing zone, service or category of asset