GasNet Australia

Access Arrangements Application

Comments on ACCC Draft Decision
dated 14 August 2002

COMMENTS BY EUCV
SEPTEMBER 2002

EUCV: Comments on ACCC Draft Decision on GasNet Access Arrangement application

Executive summary

GasNet has submitted an application which seeks large increases in RAB, Capex, and Opex. Because of this, average tariffs, rather than falling as they should with the reduced WACC being sought, will increase in real terms.

Comparisons of average tariffs with other transmission networks show that the current GasNet tariffs are too high.

On review the EUCV considers the GasNet application to be extremely deficient, particularly in information disclosure, in analysis, and in justification. This is unacceptable in view of the claims for large increases in RAB, Capex and Opex being made. With these deficiencies identified, the EUCV considers that the ACCC cannot accept GasNet's claims in the absence of rigorous analysis, information disclosures and justification.

EUCV is seriously concerned with the draft decision of the ACCC. Despite the obvious deficiencies in the information disclosed, the review appears to be proceeding regardless of these deficiencies. Whilst the draft decision provides some additional information, this has proven to be insufficient for consumers to verify that the tariffs being sought are reasonable and comply with the Gas Code.

EUCV has noted concerns at the lack of rigor of the ACCC analysis of opex and that some of the conclusions drawn in the draft decision appear to be heavily biased towards GasNet, rather than reflecting a balance of consideration. EUCV considers this is probably related to inevitable asymmetry of information, and would be overcome by greater information disclosure. The EUCV will respond in more detail on the opex element of the draft decision after release of additional information by GasNet

In particular EUCV specifically comments that:-

- EUCV considers that when the changes suggested by it are made to the CAPM calculation, a result closer to returns being granted by regulators in overseas jurisdictions and achieved by industry in their competitive environment, will be arrived at. The EUCV considers the overseas regulatory WACC results are more reflective of the risk profile of the GasNet business, and that a WACC of 6% (using the ACCC methodology) is at the upper end of the acceptable range.

- The ACCC is correct in excluding the claimed “omitted assets” from the regulatory asset base (RAB), but the RAB must be adjusted for the

GST spike, and for previous capex incurred to be demonstrated as meeting the prudency and economic efficiency tests of the Code.

- The ACCC has erred in assuming that it is permitted to aggregate the benefits that may result from the roll in of the south West Pipeline into the PTS. Further the ACCC has not calculated whether the accepted tariff for the south West Pipeline will return the expected revenue based on the anticipated gas volume transferred, nor has it calculated the value of what the system wide benefits will be to users of the PTS.

- The ACCC must require
  a. The amount of capex rolled forward to be demonstrated to be prudent and economically efficient.
  b. There to be a mechanism for ensuring that capex allowed is or will be demonstrated to be prudent and economically efficient before it is allowed to be included in the RAB.
  c. Capex to be spent must achieve measurable benchmark performance criteria.

- The tariff path proposed by the ACCC is strongly supported. The ACCC must ensure GasNet provides more information to demonstrate that every tariff achieves cost recovery. Further, the tariffs must be reflective of the costs resulting from peak usage rather by average usage. A mechanism similar to that used in e electricity transport industry and the gas contract model will provide the simplicity and certainty required by consumers.

In summary, the EUCV notes that the ACCC has addressed a number of concerns of consumers in its draft decision, but it has particularly failed to quantify many of the supposed benefits GasNet claims will arise from its current proposal. In particular the approach to the so-called light-handed regulation by the ACCC has allowed GasNet to include costs into the new access arrangement which are clearly unjustified.

We are concerned that the ACCC has not been sufficiently rigorous in certain aspects of the application and as a result, has actively accepted that it has made decisions which explicitly favour GasNet. This bias must be addressed in the final decision.

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The Energy Users Coalition of Victoria (EUCV) is a major energy end-user group formed with the specific purpose of addressing the current applications for access arrangements by gas and electricity service providers in Victoria. Its members are Ford, Holden, OneSteel, Air International, Toyota and Unidrive.

Introduction

The EUCV the welcomes the opportunity to provide its views on the ACCC's draft decision on GasNet's Access Arrangement for the Principal Transmission System (PTS) in Victoria.

The EUCV did not prepare a response to the ACCC's issues paper on for GasNet's application because by the time that responses were required the members had not formed group. However the group is taking this opportunity to provide some critique of the GasNet application as well as a detailed response to the draft decision

In general terms the EUCV considers that the information provided by GasNet in its application was insufficient for an informed response by stakeholders. The additional information provided in the draft decision does assist somewhat in providing stakeholders with a better view as to what GasNet is seeking, as well as providing the ACCC's views on the application. Despite the requirements of the Gas Code, it would appear that GasNet has not provided all the information required for an application of this nature. Because of this the application is confusing, thereby causing those directly interested in the application extreme difficulty in analysing the material. In particular, EUCV notes that GasNet did not provide previous years' budgets and actual costs to enable comparison.

However, the additional information provided as a result of the ACCC's draft decision still does not provide sufficient information for the ACCC and stakeholders to be satisfied that the costings claimed by GasNet, are appropriate to be incorporated into an Access Arrangement. In addition, the structure of the information provided by GasNet has made assessment of the application more difficult than it needed to be, thereby exaggerating the impact of the paucity of the data.

EUCV has noted with interest the reports on WACC (the Washusen report) and asset valuation (the Easement report) previously provided under separate cover to the ACCC. There is no doubt that both these reports add significantly to the debate on the GasNet application and they provide soundly based reasons why the WACC requested by GasNet is too high and why the inclusion of easements and other “omitted items” into the RAB by GasNet should be rejected by the ACCC. The EUCV also notes with interest that Pareto Associates has provided further information on WACC to the Victorian Essential Services Commission. The EUCV commends this additional Pareto Associates report to the ACCC.

The structure of the GasNet system

If in making this presentation the EUCV has recognised that the GasNet system has some quite unique features.

It is a very compact gas transmission system which also exhibits a number of features of a gas distribution network. It is relatively highly and consistently loaded, particularly in the winter time, and it has been operation for over 40 years with a high degree of reliability. With the increasing electricity demand spike now apparent in summertime, the previously lightly loaded off –season is now exhibiting significant increases in demand in summer due to large amount of new gas-fired generation electricity generation being introduced.

The system now serves to provide gas consumers in the Melbourne and regional areas access to the Gippsland gas basin and the Otway gas basin as well as an interconnection with the pipeline from the Cooper Basin. It is anticipated that shortly gas will come into the system from the Bass basin.

With all the benefits that the GasNet system has, it is surprising to gas consumers that the gas transportation tariffs GasNet levies on them, are as high a as they are now, and are anticipated to rise further.

As a result of the views noted above, we were pleased to see that the ACCC has in its draft decision, a requirement for significant reduction in the average tariff from that suggested in the GasNet proposal. However even after the ACCC had carried out a significant pruning of the costs GasNet had included in its application, the ACCC appears to have conceded that GasNet is still entitled to an increase in the average tariff; this increase is graphically shown in the draft decision as Figure 8.2.

Because the EUCV is of the view that the GasNet tariff should have reduced, it has examined the various aspects of the GasNet application, and the ACCC responses detailed in the draft determination. Arising from this review the EUCV presents below its assessment of various areas of concern which also lead to an increase in the average tariff.

The WACC draft decision

We read with great interest and number of the submissions to the ACCC's issues paper with regarded to what is an appropriate WACC. In particular we have noticed that the approach taken by the ACCC appears to be very mechanical and takes into a little account the sort of returns that maybe experienced by companies in the competitive arena.

On examination of the CAPM approach to setting a capital return (WACC), it appears that this mechanism requires a very subjective analysis of a number of the criteria that comprise the CAPM. In particular we note the extensive debate as to what constitutes a reasonableness in the risk free rate, market risk premium, the debt margin, the use of imputation credits and asset beta.

We concur with the ACCC approach to what constitutes a risk free rate and over what period the risk free rate should be set. We note the ACCC commentary that the appropriate period over which to assess the risk free rate should be compatible with the regulatory period under review. We agree with the ACCC that using the five-year bond rate appropriately reflects the risk free interest rate and inflation risk profile expected over the period of the Access Arrangement.

We also note that the ACCC has introduced into the debt margin and the return on equity, some of the costs claimed by GasNet as being asymmetric risks. While we do agree with the ACCC that the asymmetric risks should not be included as separate costs we do not agree with the ACCC that they should be included in a number which we consider to be all-inclusive. For example we consider that the debt margin of 1.20 adequately recompenses GasNet for its debt acquisition costs.

With regard to the figure for market risk premium, we note that the ACCC has elected to follow the advice of those who are well known to support increasing the rates of return to regulated industries. As a counter (and independent) view we have read with interest the paper commissioned by the Victorian Essential Services Commission by Mercer Investment Consulting[1] who considers that an equity risk premium for all companies listed on the Australian Stock Exchange would be about three per cent. This is half the market risk premium that ACCC has included in the draft decision as appropriate to give GasNet. We recommend that this independent view of equity risk premium should be utilised by the ACCC.

We note that the ACCC considers that an appropriate equity beta for GasNet is 1.0. As we understand it, an equity beta of 1.0 replicates the risk profile applying to a company which has an average risk profile. We are at a loss to understand why the ACCC would consider that GasNet could ever be seen as

[1] This report is available on the ESC website under "Gas" dated 28 August 2002

an “average risk” company. With microscopically little competition and such a consistent demand for the product to that it carries, this puts GasNet into a very low risk business. On this basis, to grant GasNet average risk status would appear to be totally inappropriate.

We have reviewed the paper by Pareto Associates appended to the BHP Billiton submission to the ACCC regarding the GasNet application. We were intrigued to note that the ACCC makes no reference at all to this report in its draft decision, as to what might constitute an appropriate WACC. We have also reviewed the paper Pareto Associates submitted to the Victorian Essential Services Commission on behalf of the Customer Energy Coalition[2].

What both these reports reveal, reinforces that the regulator should benchmark the rate of return calculated by the CAPM to verify whether the calculated number is comparable to both competitive industry returns and decisions reached by other regulators. The EUCV is of the view that if the ACCC had utilised the numbers for debt margin and risk premium noted above, and used a reduced equity beta replicating the low risk profile of GasNet, the resultant WACC would be in the realms of the values implied by the Pareto Associates reports.

We note the WACC is to be applied by the ACCC to asset figure which is calculated based on a “replacement cost” of the GasNet assets. The EUCV members all utilise a return based on the depreciated actual cost of their assets. This different approach causes us concern when comparing rates of return applying to an “actual cost” asset base versus the rate of return which applies to a “replacement cost” a base. We therefore they believe that the rate of return which is to apply to a “replacement cost” asset based should be seen to be lower than a return rate of return which applies to work on an “actual cost” basis.

Conclusion. The EUCV is of the view that a WACC of about six per cent real would appear to be a reasonable rate of return for the GasNet business. It should be noted that a number of the members of the EUCV would be pleased to have a guaranteed real (excluding inflation) rate of return on their asset base of this amount.

The Capital Base draft decision

The EUCV has reviewed the draft decision with regard to the capital base. We agree with the ACCC that the omitted items listed by GasNet should not be included in a capital base. We have reviewed the commentaries provided by

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[2] document number 12 - 2002 on at the Victorian Essential Services Commission website related to the gas distribution pricing review

other stakeholders as well as the additional commentary by GasNet. There is no doubt there are is no basis for GasNet to be permitted to include these omitted items.

In our review of the draft decision by the ACCC we note the passing reference to the impact of the GST spike in calculating the present day value of the asset base, but there was no observation or commentary by the ACCC as to why they have ignored the GST spike issue. We have observed that GasNet has applied the full CPI as part of its revaluation of the RAB. The introduction of the GST in 2000, introduced a tax driven “spike” in this calculation. Under the “GST” legislation the impact of this spike must be deleted. It should be noted that if the RAB includes the GST spike in the CPI, then the “RABxWACC” calculation therefore includes for the GST effect. The “RABxWACC” element is over 40% of the total revenue. As GasNet is required to add GST to its bills, if the GST spike effect is left in the “RABxWACC” calculation then it is effectively charging customers GST at a premium above the basic GST. The best way to eliminate this “double dip” is to eliminate the GST effect in the RAB.

We note that the ACCC has modified the amounts of past capex that may be included in the asset base. We concur with the ACCC on those elements of past capex they require GasNet to exclude. However we also note that the ACCC has permitted the actual amounts of specific capex incurred by GasNet, regardless of the amounts of capex GasNet had approval to expend under the present Access Arrangement. We strongly believe that the only past capex that GasNet should be permitted to roll into the asset base, is that amount budgeted in the current Access Arrangement, or an amount which has been demonstrated to comply a with the prudency and efficiency tests included in the Gas Code. Neither the ACCC nor GasNet have provided any substantiation as to whether these higher amounts than budgetted of capex do in fact comply with these tests.

In its application GasNet requested that the depreciation rate for the existing assets between Longford and a Melbourne should be increased to reflect an apparent shortening of the life of the Gippsland basin gas field. GasNet also requested that the depreciation rate for the south West Pipeline should be increased to reflect an expected greater life of the Otway basin gas fields. Our examination of the issues would indicate that the life expectation of the two gas fields is more likely to be the reverse to that claimed by GasNet, and this view is supported by the third submission made by BHP Billiton whom we believe would have substantial knowledge in this area. In its draft decision the ACCC has indicated that the Longford to Melbourne assets should be depreciated at the rate used in the current Access Arrangement, but the depreciation of South West Pipeline assets can reflect technical life even though there maybe doubt as to the life of the Otway basin gas fields. On balance we concur with the ACCC assessment of asset depreciation rates.

Conclusion. We agree with the ACCC that the so-called omitted items should not be permitted to be rolled into the asset base, and we agree with the ACCC assessment on depreciation rates. We consider that the GST spike effect should be deleted from the RAB calculation and we consider that all past capex which is to be included in the RAB must be demonstrated to comply with the prudency and efficiency tests.

The South West Pipeline draft decision

Consumers are concerned that when investment decisions are made by GasNet, should there be an error made, consumers will be required to pay for the mistakes made by GasNet. The EUCV is concerned that in building the south West Pipeline GasNet has not sought the most cost-effective solution to providing for the winter peaks of gas demand which occur in the state. Because of the relative magnitude of the investment (the south West Pipeline increases the RAB of the PTS by 25%) the EUCV expects the ACCC to be extraordinary rigorous in assessing whether such a large investment by GasNet should be automatically rolled in to the asset base. Our review indicates significant concern that the ACCC has not been sufficiently diligent in this matter.

The ACCC notes that the roll in of the south West Pipeline into the PTS could not be accomplished under the current Access Arrangement rules as these appear to prevent the aggregation of benefits that may accrue from incorporation of an extension to the system. In the draft decision, the ACCC comments that they are able to permit the aggregation of these benefits at this review. The EUCV is not convinced that the ACCC has this power under the Gas Code.

Under the Gas Code there are three alternatives for assessing whether an extension can be permitted to be rolled in to the asset base[3]. Our examination of the Gas Code's applicable clauses (sections 8.16 to 8.18) would indicate that each of the tests is separate and there is no clear definition that aggregation of benefits was contemplated or in fact is permitted. As both the current Access Arrangement and the Victorian Gas Code were written to be complementary (they were drafted by the same legal firm at the same time) and further as the Victorian Gas Code was modelled on the on an early draft of the National Gas Code we believe that there is a clear connection running between each of these three documents with regard to this issue. Therefore, if

[3] These are listed as items (i), (ii) and (iii) of Section 8.16(b) of the Gas Code

the current access arrangement precludes aggregation of benefits, then it follows that the other two documents probably have the same construction.
We strongly believe that the ACCC has erred in assuming that it is permitted to aggregate benefits when permits the aggregation of the benefits of the south West Pipeline.

The ACCC has noted that it considers an appropriate tariff for the south West Pipeline is the Longford Pakenham tariff plus 10 per cent. However the ACCC provides no calculations demonstrating that this is appropriate or will even recover the implied capital amount of $45 million plus opex and overhead when assessed in conjunction with the expected volumes of gas to flow on the south West Pipeline. We do note that GasNet has included only marginal costs in its calculation of the south West Pipeline. The ACCC has not commented that this does not constitute cost reflectivity, and so needs to be addressed.

That the ACCC has not provided this calculation is typical of its whole approach to the issue of individual tariff assessment. The Gas Code explicitly requires the service provider to provide sufficient information so that users can be assured that the tariffs provided by the service provider are indeed cost reflective and will in total recover the amount of revenue permitted by the regulator at the time of the access review. GasNet has not provided this tariff development information and neither has the ACCC required this information to be provided. This is a major flaw within the draft decision. Until consumers can be assured that the tariff for the south West Pipeline will recover its full costs then the EUCV cannot agree to the automatic role in of the south West Pipeline.

However the ACCC has noted that the tariff will not recover the reasonable costs of the south West Pipeline. To overcome the resultant cash shortfall, the ACCC has assumed that the under-recovery of the revenue will be balanced by a system wide benefit that the south West Pipeline will provide to all users of the PTS. Surprisingly though the ACCC has not attempted to quantify these system wide benefits that the South West Pipeline will provide but instead declares that by using its “regulatory judgment” they have assessed the investment, by aggregating both the cash and system benefits, to be prudent.

For the ACCC to be seen to be carrying out appropriately its regulatory functions it must provide more information than that included in the draft decision. It is quite clear that there are alternatives to the south West Pipeline which may provide equal or even better system wide benefits that supposedly flow from the presence of the south West Pipeline, but the ACCC has not even required GasNet to investigate what these alternatives may be or what the costs involved with them are. This failure throws significant doubt on whether the ACC has diligently investigated this issue.

GasNet has requested that the present arrangement of the K factor adjustment should be permitted to continue into the new Access Arrangement. Whilst in principle this appears to be not an unreasonable request, the EUCV has serious concerns as to whether the future application of the K factor adjustment will ultimately provide an even greater but unseen contribution to any under recovery of the south West Pipeline. The EUCV has noted the commentary provided by other stakeholders on this issue, and can understand why they have taken such an exception to the roll in of the south West Pipeline, unless the financial activity of the south West Pipeline is strictly ring-fenced.

Conclusion. The ACCC has erred in assuming that it is permitted to aggregate the benefits that may result from the roll in of the south West Pipeline into the PTS. Further the ACCC has not calculated whether the accepted tariff for the south West Pipeline will return the expected revenue based on the anticipated gas volume transferred, nor has it calculated the value of what the system wide benefits will be to users of the PTS.

The Capex draft decision

The EUCV commends the ACCC for the rigour it has applied to the capex requested by GasNet, and we support the decisions made by the ACCC. We concur that the capex excluded by the ACCC needs to be further substantiated if it is to be automatically rolled into the RAB.

However we are concerned that the ACCC has not required GasNet to quantify the benefits of the capex approved, and to make GasNet aware that the amount of capex actually used and the benefits flowing from the investment need to be sustained, following good business practice. This benchmarking of performance of capex is an essential tool for administering the applicability for the inclusion of capex in the RAB.

Conclusion. The EUCV supports the rigour of review of future capex, and the conclusions reached by the ACCC. The ACCC needs to advise GasNet that the cost/benefit after the investment is made, needs to be proven.

The Opex, benefit sharing and benchmarking draft decision

As GasNet is to provide more information regarding its opex requirements and benchmarking, EUCV will respond to the aspects of opex, benchmarking and benefit sharing of the draft decision after the additional information is made available to stakeholders.

The new AA terms and conditions

The ACCC has recognised that there is concern and a high degree of confusion surrounding the proposed changes by GasNet to its Access Arrangement terms and conditions. Under the market carriage model users of the GasNet system also have to comply with the complex arrangement of the MSOR administered by VENCorp. Because GasNet is effectively protected from direct (legal) contact with users by the requirement for users to contract with VENCorp, there is potential for consumers to be disadvantaged by the high degree of complexity and multitude of different contractual arrangements between the many parties involved; namely retailer, consumer, VENCorp and GasNet. The ACCC must ensure these various arrangements are streamlined and made consistent.

The requirement noted by the ACCC for GasNet to ensure that their Access Arrangement is seamless between VENCorp and GasNet is supported by the EUCV.

The new tariff structure

The EUCV is aware that the Victorian government is considering part subsidisation of GasNet expansions into areas which are considered to be marginally economic at best. Whilst we do not oppose such an approach we are concerned that close analysis of many of the tariffs developed by GasNet would demonstrate that they too are not fully recovering the costs which should be applied to them.

The very fact that GasNet opposes providing the detailed information necessary to verify that each locational tariff is close to its cost recovery position, makes the major users of gas infer that they may be providing a significant cost subsidy to less heavily used parts of the PTS through their tariffs. The ACCC has connived with GasNet to perpetuate this concern by not requiring a full disclosure of the information necessary to develop each tariff. This full disclosure is required by the Gas Code and the ACCC must require GasNet to provide this information.

A gas system is designed to provide for the peak demand required by consumers at any one time. Thus, to ensure that each user contributes their fair share of the revenue to maintain the system, users must contribute in proportion to their peak demand[4]. By doing so this encourages consumers to levelise their gas demand and in doing so provides further capacity for other users of the system. The GasNet proposal which has been accepted in the

[4] Recent applications by electricity transmission companies show a strong trend to revenue recovery based on peak demand by each customer. The ACCC has approved this approach based on the Code requirement for cost reflectivity. We can not understand why the ACCC considers that the PTS should be treated differently!

ACCC draft decision moves away from the concept of paying for peak usage by its supposed attempts to provide a simpler system using its “anytime gas tariff”. The ACCC has assumed that the prime purpose of charging for peak usage of the system is to provide signals to users to modify their usage pattern. This is an incorrect assumption. The prime purpose of having a peak tariff relationship is a cost reflective one; one that is explicitly required by the Gas Code.

The ACCC appears to accept the GasNet proposition that by removing peak usage as the prime cost allocator is the only way to provide a simple and forecastable costing arrangement for consumers. What GasNet failed to do and what the ACCC has overlooked, is there are other mechanisms available which provide both the simple mechanism desired together with ones which allow consumers greater certainty of their future costs. These mechanisms are used extensively in gas contract carriage models and in the electricity transport industry. It should be noted that the electricity system is based on a market carriage transport model similar to the one GasNet operates under. Thus there is no need for the removal of a tariff approach which is cost reflective of peak demand. We do not understand why the ACCC will allow GasNet to move tariffs so far away from the cost reflectivity established in the current Access Arrangement and required by the Gas Code.

We note that GasNet appeared to under-recover its allowable costs in the current Access Arrangement (the K factor adjustment). Whilst we are of the view that GasNet is indeed fortunate that its poor forecasting is underwritten in part by consumers, we accept that the rules applying to GasNet, permit the K factor carry forward amount to be included in the new Access Arrangement. We would however note that this ability to partially underwrite the GasNet revenue should be taken into account when assessing the appropriate WACC. We observe that this has not been done by the ACCC.

However what concerns consumers is the magnitude of the K factor carry forward and the fear that such an amount maybe carried forward into the next Access Arrangement. The EUCV believes that the ACCC has a responsibility to ensure that the tariffs structured by GasNet are close to full cost recovery in each element of the network and so there will be a much smaller carry forward adjustment into the next Access Arrangement.

The requirement of the ACCC to have a tariff path which has a zero or small increase at 2003, and only small deviations for the access arrangement period, is strongly supported.

Conclusion. The tariff path proposed by the ACCC is strongly supported. The ACCC must ensure GasNet provides more information to demonstrate that every tariff achieves cost recovery. Further, the tariffs must be reflective of the costs resulting from by peak usage rather by average usage. A mechanism similar to that used in electricity transport industry and the gas contract model will provide the simplicity and certainty required by consumers. Tariffs must be closely examined to ensure the K factor carry forward is minimised in the new access arrangement.

Summary

In summary, the EUCV notes that the ACCC has addressed a number of concerns of consumers in its draft decision, but it has particularly failed to quantify many of the supposed benefits GasNet claims will arise from its current proposal. In particular the approach to the so-called light-handed regulation by the ACCC has allowed GasNet to include costs into the new access arrangement which are clearly unjustified.

We are concerned that the ACCC has not been sufficiently rigorous in certain aspects of the application and as a result, has actively accepted that it has made decisions which explicitly favour GasNet. This bias must be addressed in the final decision.