

Energy Action Group
Brief Submission to the ACCC
GasNet/VENCorp Access
Arrangements
May 31st 2002.

Introduction

This submission would have been timelier, if Victorian gas consumers had access to some resources!

It is clear that both the VENCorp and the GasNet Submissions need to be considered in parallel. There is a case to consider rationalisation between the two businesses. There is, for instance substantial duplication of resources in both organisations. The current arrangement ensures that there is reduced accountability because VENCorp plans and manages, and GasNet can only follow. If anything goes wrong GasNet takes proportion of the blame!

A single Independent System Operator/Asset Manager may provide significant cost economies when compared to the current VENCorp/GasNet arrangements. The question needs to be asked as to whether the current market dispatch and system balance arrangements give the best outcome for consumers and retailers (particularly independent retailers). The possibility of splitting the Independent System Operator and Market Operator should be considered as part of the joint review of the arrangements.

It is now reasonably clear that the restructuring of the Victorian gas industry was designed to protect the interests of the incumbent distribution and retail companies. The Market System Operating Rules have some benefits for new entrant large consumers as they do not have to source pipeline capacity MDQ unless they cause congestion on peak days. This is in marked contrast to consumers in the Contract Carriage Market. However the Market Carriage Model appropriates the possibility of risk to retailers and consumers. In the end consumers pay for this risk even though they don't understand the market rules or access arrangements. The addition of a significant volatile load - gas fired electricity generation to the Victorian gas market and the GasNet transmission system further compounds the risk associated with the market and access arrangements. This issue has to be addresses in this determination.

The reality of the Victoria market carriage model is that consumers underwrite the risk. So far Victorian consumers have experienced a no blip (little movement from week to week) market. Since its inception the Victorian gas market has not been subject significant temperature/consumption forecast errors or the consumption of un-ordered gas by a gas-fired generator. The most significant Ancillary Service Payment event so far, was based on a

NEMMCo direction to the two gas fired Jeeralang and Newport generator to run. This event occurred on 9th of November 2000 for two hours due to industrial action by the Latrobe Valley generation workers. This action resulted in the largest Ancillary Service Payments spike in the Victorian gas market so far. What will happen if all the gas fired generation is run for longer than two hours if gas hasn't been ordered for the gas day!

If this event occurs then there are likely to be high pool prices and significant ASPs'. Unfortunately the Victorian gas market is designed that consumers only find out their liability well after the event!

EAG joins Energex, Origin, TXU and BHP Billeton in commenting on the failure of GasNet disclose some of their Annexures and Appendices in their submission to ACCC. All of these organisations are, market participants, customers or both of GasNet and have a strong interest in cost minimisation. EAG believes that the failure to make the submission fully transparent fails any reasonable test of transparency and fails to explain reasons GasNet full revenue application.

EAG was particularly amused to see the Victorian Department of Natural Resources, Energy Policy Unit trying to explain the Service Net Agreement by providing two opinions as evidence of the content of the Service Agreement. Both of the legal opinions came from a party that was strongly involved in the development of the arrangements between GasNet and VENCORP. These two opinions do not constitute adequate disclosure of the arrangements between the GasNet and VENCORP. Unfortunately the number of confidential Annexures and Appendix have made it difficult for EAG to evaluate the GasNet /VENCORP Applications. It is clear that there needs to be disclosure to ACCC and other interested parties about the ongoing development of Bass Strait /Otway Basin this is to ensure a stable regulatory environment and consistent market development over time.

It is clear that adding the Western Trunk System (WTS) into the Principal Transmission System (PTS) will add to the diversity of gas supply sources available to the Victorian market. Two issues that do not appear to have been effectively addressed in the GasNet/VENCORP applications. The first issue is how WTS is to be integrated into the pipeline systems supplying gas from either the Cooper, Otway and Bass Strait basins so as to increase the linepack associated with the PTS.

The second issues then becomes how to integrate two different market arrangements so as to ensure that we develop an integrated source of gas supply on the east coast and a single simple market arrangement with more than just the 3 host retailers (Origin, Pulse and TXU) in both Victoria and South Australia.

VENCORP Efficiency

This Determination and the ACCC annual review of budget provide the only efficiency drivers on VENCORP. Whilst the Energy Action Group has some regard to the in-house expertise within VENCORP, the organisation has been

remarkably slow in solving a significant number of issues of concern to the market participants around the Victorian gas market. VENCORP has for instance failed to adequately involve gas consumers in market development.

Incomplete/ Inconsistent Market Development - A General Cause for Concern

The current Applications leave the most important issue undiscussed. The ACCC's Access Arrangement determination process under Part 3A of the TPA has underwritten a significant part of Australia's 5 different jurisdictionally based gas market/access arrangements. This can only be described as a very inefficient outcome and at the end of the day not in the national, the industries nor consumers interests. There are huge diseconomies with the different arrangements. There are significant differences between jurisdictional *System Balance* arrangements, for example. These differences make it difficult for a retailer to manage a national business without significant Information Technology and human resource investment. This problem has significantly reduced the ability of retailers gain any economies of scale in developing expensive gas trading, settlement and customer information systems for a national market. The net outcome adds to customer costs! The ACCC's objective should be to make clear, consistent, and non-gameable determinations for the pipeline access arrangements for which VENCORP has carriage.

There needs to be more synergy between the Victorian gas market and NEM. This ACCC GasNet pricing determination needs to provide the principals of how the Victorian GasNet D customer pricing arrangements deal with a high level of consumption by a generator over one or two day over summer. Given that there is a recommendation to change from a five day to a ten day AMDQ.

What happens if the same generator consumes gas over one or two days (or even eight or nine days) over the Victorian gas markets winter peak consumption days? The VENCORP/Victorian gas market allocation of AMDQ to peak load electricity generation needs to be sorted out. There are similar issues around surprise and constraint uplift Ancillary Service Payments that need to be clarified and as a matter of urgency retailers and consumers need to be made aware of the outcome of changes to the MSOR arrangements.

DORC

The last 6-month round of electricity and gas applications to ACCC has a number of common themes associated around proponents trying to increase the size of their asset base. This is a critical issue for consumers given that the regulatory building block approach puts such a strong emphasis on return of and return on assets and contributes around 80% of the total revenue income to the business.

One of the most significant changes has been the attempt to roll in easements into the asset base. The EAG endorses the argument put by David Johnstone (2001) *Replacement Cost Asset Valuation and Regulation of Energy*

Infrastructure Tariffs. The Problems with DORC. Department of Accounting and Finance, University of Wollongong, December. The problem with DORC, Department of Accounting and Finance, University of Woolongong. December, paper that a strong critical analysis of the DORC methodology used in the ACCC building block approach to pricing regulation.

EAG believes that ACCC should reject the applicants request to include easements and land into their application, after particularly when easements were not included in the opening asset value and was not factored into the purchase price for the business by the owners. If GasNet had factored in the easements into the purchase price, then they were attempting to game this ACCC determination.

It is unusual for easements to depreciate in value: in most cases they actually appreciate. There are a number of examples where easements have been used by the asset owner to increase their revenue stream by leasing part of their easements to third parties.

The addition of unvalued assets from the corporate establishment and from the first regulatory to the asset base period is a further attempt to increase the size of the asset base at some cost to consumers. The purchasers or renter of the DORCed assets were supposed to carry out due diligence before they bought or rented those assets/business. Discovering that some assets were not on the register at the time of sale should be discounted in this and future regulatory determination. The initial/opening asset base should be the line in the sand in making regulatory determinations if consumers are to get close to a fair deal!

The Energy Action Group has serious concerns around the gas industry skills base. The use of contracting out has a short term cost benefit that is creating a significant longer-term problem of the sustaining of the industry skills base. EAG want to see this issue specifically recognised in the DORC with the addition of (\$ 2 to 3 m) into the asset base for the purpose of recognising the industry skills base. EAG further believes that the determination should further support the development of the industry skills base with an addition of a further \$ 200,000/a contribution to Opex expenditure to ensure that GasNet employ an number of graduate engineers and apprentices to sustain the industry skills base. The Determination needs to add an additional industry performance requirement, based on criteria that assess skills level and training of appropriate skills. Eg the number employed engineers and number of new graduates and apprentices.

Some observations on WACC determinations

The new game in town is regulated business hiring hotshot consultants to game the WACC equation makes good sense. Currently a number of the regulated businesses can spend several hundred thousand dollars to increase the return from the WACC determination the business by many millions over the regulatory cycle.

The GasNet, plus the current SPI PowerNet and ElectraNet applications all appear to have adopted the same strategy.

The SPI PowerNet submission to ACCC, contained an appendices by Officer R. R. (2002), *A Weighted Average Cost of Capital for a Benchmark Australian Electricity Business*, A Report to SPI PowerNet, 28 February, Table 5 illustrates infrastructure and utility beta's whilst Table 7 on page 23 indicates the various regulatory differences in WACC over a recent period.

Whilst the ElectraNet submission contained an attachment NECG (2002) *Analysis of the weighted average cost of capital for ElectraNet SA*, Submission to the ACCC by Network Economics Consulting Group April 11, Table 5 page 24 provides a similar analysis.

Change in WACC of 0.1% on a \$ 1 b asset base will yield a business \$10m/a, so over the regulatory cycle the organisation will be \$ 50 m better off. If one increases the DORCed asset base by \$ 40 m and the WACC by 0.1% then the business will be \$400,000/a better off. This constitutes another \$ 2 m/5 year ACCC revenue reset.

The point that EAG wishes to make is that changes in the WACC and the DORCed asset base provide a useful yield to the regulated business for a small investment in consultant's fees.

It is worth mentioning that the consultancy expenses are likely to be covered off in the generous Opex determination. Consumers not have the privilege of paying the extra contribution from changing WACC but they also pay for the privilege for the business to participate in the regulatory process The more ACCC plays with the WACC equation, the more the businesses can game the equation and ACCC and other regulators. At the risk of stating the obvious- a clear statement of one WACC formula across regulated businesses will set in place the parameters for debt and an assessment of business and regulatory risk.

The businesses can respond to the drivers present in the determination and behave accordingly. If the Commission continues to change the WACC formulation then the businesses will continue to game the determination process.

The use of a real WACC on a real DORCed asset base end-up giving the regulated business an extremely good nominal rate of return by almost any standard. Currently over 10%. A decision to add \$40m worth of easements into the asset base will cost consumers \$20m over the regulatory period and a substantial sum into the future.

Over 80% of GasNet revenue is derived from the regulatory asset base and from retailer who have access to the BHPP/Gascor contract. This provides a very low risk environment for GasNet and VENC Corp revenue stream. The major revenue risks are associated load forecast.

Forecasts

It has never been easy to forecast energy consumption. The Victorian gas industry Effective Degree Day approach has been able to deliver reasonably accurate day of use gas forecasts over many years. The major problem in the VENCORP and GasNet applications is to predict the impact of electricity generation on the gas transmission system and the MSOR.

The imponderable issue on forecasting is what happens with gas-fired generation and how are the costs going to be allocated by both the transmission system and by the market.

The \$10,000 VoLL in the electricity market has given the gas generator significant latitude on how they consume gas. What needs some clarification in the MSOR is how or whether the costs are to be allocated to other consumers using the system at the time!

One of the more extreme consumption scenarios is for a NEMMCO direction to a large gas fired station (around 1000 MW) to run to provide system security to the Victorian electricity network. In this case the generator is compensated for O&M. The question needs to be answered as to who pays all the costs incurred as there is the possibility to VoLL the gas system and to incur surprise and constraint uplift Ancillary Service Payments to the gas market. Are other consumers going to pay because they were consuming on the gas day?

In the short term the operation of new open cycle gas fired generation in the Victorian energy market will occur during the summer periods. *"A bet against the weather"*. The EDD? approach used by the Victorian gas industry was not designed to predict the effects of summer electricity consumption. However given the current annual load growth in electricity consumption, there is the strong possibility that gas plant will also run over the winter months putting pressure on the Victorian gas market AMDQ arrangements. The Determination needs to take account of the impact of a change from the 5 day AMDQ to a 10 day AMDQ particularly on gas fired generation.

The determination on AMDQ also has the potential to strongly influence Victorian electricity prices!

The small volume of line pack and the risks inherent in the gas and electricity market make load/demand forecasting a difficult issue. The last price determination load forecast was higher than the actual gas consumption therefore GasNet would have under recovered revenue clarified this sentence. It is therefore arguable that GasNet should have included this risk into their purchase price of the business. The forecast (bet) by the business is based on factors that GasNet has absolutely no control over-the weather and consumer behaviour and the installation of gas generation. EAG suggest that we would not be adverse to the notion that there be some revenue recovery or revenue reduction on the regulated price cap in the next financial year. If actual level of consumption is above the forecast GasNet is financially

rewarded. However if the actual consumption is below the forecast then they are penalised. A lot can happen over the 5 year ACCC regulatory cycle.

It interesting to note that in the case of the Victorian electricity actual sales were higher than the forecast whilst GasNet had actual sales lower than forecast over the regulatory cycle.

ACCC should consider a forecast/actual balance arrangement option, which will either compensate or penalise the utility for overs or unders in forecasts vs. actual consumption. In an endeavour to minimise the errors between forecast consumption and AMDQ against the actual consumption and AMDQ. One effect of this approach is that it minimises the risk to GasNet revenue stream. This arrangement has the potential to minimise applicants attempting to game the WACC equation and further, acts as a driver for a lower WACC.

Conclusion

The VENCorp and GasNet Determinations need to make a strategic set of decisions -

- to ensure that linepac between the various transmission systems is integrated and readily available.
- that simplifies linepac management and the allocation of costs.
- aim towards simplifying the access and market arrangements of the 5 jurisdictions (SA, Vic, NSW, ACT and Qld) that have the potential to access Victorian gas so Australia can develop a National Gas Market.
- ensure that upstream competition develop between the various upstream sources of gas in an interconnected system.