GasNet Draft Decision On
Proposed Victorian Gas Access Transmission Arrangements

Submission by the

Energy Users Association of Australia

September 2002

1 Information Deficiency

In our earlier submission we expressed our concern at the inadequacy of information disclosure and compliance with the Gas Code in respect of the GasNet Application. We are pleased to see that the number of confidential annexures has now been reduced from seven to one. In respect of the latter annexure, we remain of the view that it is inappropriate for this information to be withheld. However, if this remains the case, we would ask the Commission to require that GasNet provide a public version or summary of the Trowbridge report on the Valuation of Non-Insured Risks. This would assist interested parties in assessing this aspect of the Application.

We agree with the Commission that the format of the GasNet application could be presented in a stand-alone form that would assist parties in their evaluation of the proposed revised access arrangement information and also serve to reduce the level of complexity.

In our earlier submission we itemised a number of deficiencies in the GasNet application regarding its compliance with Attachment A of the Code. We remain concerned that the following Attachment A requirements do not appear to have been addressed in the Draft Decision.

- *Information regarding capital costs*

GasNet should be required to provide information in terms of Category 2, Attachment A of the Code. In particular, the asset values for each pricing zone, service, or category of asset, and data on depreciation and accumulated depreciation are required.

- *Rolling-in of Western Transmission System and the South West Pipeline*

GasNet has requested the "rolling-in" of the South West Pipeline (SWP) and Western Transmission System (WTS) into the Pipeline Transmission System (PTS). However, the ACCC should ensure that there is no underlying cross-subsidisation between WTS, SWP and PTS. Cross-subsidies would be inappropriate and inconsistent with regulatory reform in energy (as well as the ACCC's previous determinations on electricity and gas transmission). GasNet needs to detail how it prevents any under or over-run of revenue from these two elements.

- *Details of zones*

To recognise the zones proposed, a description or map is required. Overlaying this, there is a requirement for data on the demand of each zone (MDQ), the number of customers, the value of the capital assets involved, planned capex for each zone, the various elements of non-capital items (operations and maintenance, marketing costs, administration and overhead costs, etc), the age of the assets and the depreciation rate proposed. This information is required to be provided as detailed in Attachment A of the

Code. Based on this information, GasNet should prepare separate calculations underpinning the proposed tariffs in each zone.

- *Marketing Costs*

GasNet includes an allowance for marketing of gas. It does not, however, provide enough evidence of the need for this activity by GasNet (as distinct from other entities interested in the maintenance or growth of gas usage). Further, it should indicate what outcomes (or benefits) are expected from this activity. End-users, who will be forced to pay such costs through regulated charges have a legitimate right to be satisfied of the need and usefulness of such costs. GasNet has not provided it, nor does the ACCC appear to have requested an adequate justification.

2 Rolling Forward the Initial Capital Base

The EUAA strongly supports the Commission's view that the regulatory asset base should not be reopened and adjusted upwards. The Code does not allow the Commission any discretion in making an adjustment once the initial capital base has been determined. We agree that the valuation approved by the Commission in 1998 ($358million) was consistent with that proposed by the Victorian Government as owner, at the time, of the Principal and Western Transmission Systems. Moreover, the GasNet assets were clearly purchased in the full knowledge of the value of the asset base, the basis behind it and the fact that it was not possible to revalue it.

To revalue it now would be contrary to these factors, would expose gas users to an unjustifiable 'rate shock' and expose them to an unacceptable degree of 'regulatory risk'. It would also be inconsistent with the regulator's role of balancing the interests of the asset owner and end-users.

2.1 Southwest Pipeline Roll-in

The EUAA is disappointed at the Commission's draft decision to allow roll-in of the Southwest pipeline into the PTS access arrangement. In our view the arguments for rejecting the applicant's previous attempt in 2001 to have these assets rolled in are still valid and we are concerned that the Commission appears to have adopted a different (ie inconsistent) approach to this issue without any substantial input from the applicant that would support such a change in attitude. In its previous determination the Commission stated that:

> The Commission is not convinced that GPU GasNet's investment in the Southwest Pipeline would pass the system-wide benefits test. For this reason in particular, the Commission has now made a final decision under section 2.38(a)(ii) of the Code that it does not approve the revisions to the PTS access arrangement. The Commission also has reservations about the prudency of the investment and is uncertain as to the portion of the

> investment that would pass the economic feasibility test. In addition, the Commission considers that the proposed tariff structure is inconsistent with the principles of the Code.

The ACCC also stated that

> It is concerned that GPU GasNet's proposal to fund the majority of its investment in the Southwest Pipeline through increased Longford charges is inconsistent with cost allocation and cost-reflectivity principles and would be likely to distort investment decisions.

In our view, there is no justification why all consumers should pay for this augmentation to the Principal System. The Commission's draft decision on this matter is also inconsistent with the Code's requirements regarding cost reflectivity. We remain perplexed that the Commission firmly rejects the roll-in request on the basis of the Code's economic feasibility test and also on the system-wide benefits test, yet it is satisfied that the necessary criteria are met when a combination of these two tests is applied. The Commission needs to fully explain its actions and reasons on this matter, which amount to an 'about face'. It failed to do so in the draft decision.

2.2 Depreciation of Longford Assets

The EUAA supports the Commission's view that the economic life of the Longford pipeline extend to 2030 and its rejection of GasNet's proposal to reduce the life to 2023. We consider that the basic assumptions that were originally used to determine the economic life of this pipeline in 1998 have not changed.

GasNet's proposal is based upon an assessment of asset life by Saturn Resources that is largely dependent upon the reserves of the Gippsland Basin. Since the report was prepared, Esso-BHP have announced an extensive seismic survey and drilling program in Bass Strait costing some $320 million and, given the history of gas exploration in that area, there is an expection of substantial new reserves being established. It is well known that gas producers around the world understate reserves in order to affect the price obtained for gas in negotiations with customers.

We note that both Esso and BHP-Billiton disagree with the findings of the Saturn report in respect of both the potential reserves of natural gas to meet demand in the south-eastern states and the expected demand for gas in the eastern states.

We feel that each pipeline should be able to stand alone in terms of the justifiable tariffs to be applied to it, and thereby disagree with the concept of increasing the rate of depreciation on the Longford pipeline in order to reduce the relative costs of the Southwest pipeline assets.

3 Benchmark Rate of Return

The EUAA remains concerned at the lack of in-depth assessment exercised by the Commission in its evaluation of the appropriate WACC for the GasNet application.

The WACC awarded should be sufficient only to maintain the normal economic return of the regulated businesses, and not be set at a level that demonstrates excessive concern for the regulated business or any degree of conservatism. It would appear that the Commission is (once again) erring on the side of the applicant where there is any doubt as to the precise level of any parameter to be used in assessing the appropriate WACC.

We note that BHP Billiton commissioned a report from Pareto Associates Pty Ltd in response to the GasNet access application. The report reviewed regulatory decisions on WACC in Australia and overseas with a view to determining what the comparative outcomes of WACC are, and where there is significant disparity, to investigate the causes. The findings of the report are extremely insightful and are supported by the EUAA. In our view, they provide very strong evidence why regulators in Australia have, in fact, continued to set excessive rates of return for (low risk) regulated businesses, therefore saddling gas users with excessive pipeline haulage charges. This is contrary to our understanding of the obligations on regulators to take proper account of and balance the needs of network owners and users, as well as to produce outcomes that mimic competitive ones. Clearly, the Commission's approach in the Draft Decision is not achieving such a balance and (if implemented) would require gas users to pay the cost of this generosity.

Pareto Associates have recently been commissioned by several organizations, including the EUAA, to investigate comparative rates of return for regulated utilities in Australia, United Kingdom and the United States of America. The report is attached to this submission and we expect the Commission to fully consider its findings in its final decision and outline its response to each of them.

We are very disappointed at the cursory way the Commission treated the initial Pareto work in its draft decision, where it rated virtually no mention. This work is a serious and well-researched contribution to the debate on WACC. We expect more serious consideration of it from a genuinely independent and transparent regulator like the ACCC. Again, we request that the ACCC provide a substantive response to these matters in its final determination.

The Pareto report provides strong justification for a reduction in the applied WACC for regulated utilities in Australia to a level of about 5.4% as opposed to the Commission's proposed WACC of 6.4% and the applicant's proposal for a WACC of 8.22%.

In respect of the ESC review of the Victorian gas distribution arrangements, the report shows that an appropriate range for rates of return should lie within 4.7 and 5.4% . The difference against the ESC proposed rate would reduce consumer costs over five years by between $280 and $435 million and, when combined with Opex and Capex improvements, would result in reductions in consumer bills within the range of 6.5 and 10.9%.

A major reason for this is the uncritical adoption by Australian regulators of a cost of equity that is well above that used by overseas regulators without any explanation for why they continue to do so. This is despite the monumental evidence that regulated businesses will survive very well with much lower rates (meaning lower prices for gas users who typically operate in far riskier markets and cannot afford to pay gas haulage charges based on excessive returns).

The value of the report is that it has application to regulated utilities generally (gas, electricity, water) and sets a new benchmark for regulators to consider. Importantly, it uses benchmarks that are well and truly adequate to ensure continued capital investment from financial markets for regulated businesses. Its success in being adopted by Australia's regulators is crucial to Australia's international competitiveness.

There are important questions that are raised in the report that need to be urgently addressed by regulators:

- What is it about the Victorian and Australian gas distribution industry (and other utilities) that supports the judgement of regulators that financial markets see the industry as very much less efficient than either the UK or US industry?
- If there is a reason for this – and evidence to support that reason (e.g. the Australian economy is seen by financial markets as less efficient), why are capital-intensive Australian firms operating in internationally competitive markets so successful?

In short, there is nothing in the ESC Draft Determination, the ACCC draft decision on GasNet, or any other decision by anyAustralian regulator, to explain why return on equity and WACC must be higher for Australian utilities than that required for utilities in the UK and US.