

Response (No 2) to Submissions on ACCC Issues Paper - GasNet Australia

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1 Introduction

1.1 Background

On 27 March 2002, GasNet lodged with the Commission its proposed Access Arrangement and Access Arrangement Information for the period commencing 1 January 2003, together with a detailed submission (“**Submission**”) in support of its proposed Access Arrangement.

On 19 April 2002 the Commission published its issues paper relating to the proposed GasNet Access Arrangement and the proposed VENCORP Access Arrangement. As part of that issues paper, the Commission invited public submissions in relation to these Access Arrangements.

On 12 June 2002, GasNet lodged a response to the public submissions which had been received on or before 3 June 2002 (“**First Response**”).

This Response sets out GasNet’s response to the issues raised in further public submissions lodged with the Commission. A separate response will be lodged in relation to the BHP Billiton Submission dated 21 June 2002 and the Amcor/Paperlinx submission (undated).

1.2 Public Submissions

This Response addresses issues raised in the following public submissions to the Commission:

- (a) TXU Submission dated 31 May 2002 (“**TXU Submission**”);
- (b) Energy Advice Submission dated 30 May 2002 (“**Energy Advice Submission**”);
- (c) ExxonMobil Submission dated 5 June (“**ExxonMobil Submission**”);

GasNet reserves the right to make further submissions in relation to these or any other public submissions.

1.3 Terminology

Given the complexity of the gas industry, a number of the participants have used different expressions and definitions, even in relation to the same issues. For simplicity, this Response adopts the conventions established in GasNet’s Submission, in particular the glossary in section 11.1 of the Submission.

2 Reference Service Proposal

2.1 Summary of GasNet Proposal

In its Access Arrangement and Submission, GasNet described its proposals in relation to the Services Policy. The key elements of GasNet's proposal are as follows.

- (a) As the GNS is a market carriage system, Users and Prospective Users of the GNS are offered a single consolidated Reference Service comprising the transportation of gas through the GNS via the Market Carriage system under the MSO Rules (which is, in effect, a combination of the availability of the GNS, which VENCORP sources from GasNet under the Service Envelope Agreement, and the market and system operation services provided by VENCORP).
- (b) VENCORP, as operator of the GNS under the MSO Rules, is responsible for the provision of the Reference Service.
- (c) For the purpose of Reference Tariff calculation, the Reference Service comprises two components:
 - (i) the VENCORP Services, which VENCORP provides itself (these are dealt with in the VENCORP Access Arrangement); and
 - (ii) the Tariffed Transmission Service, being the benefit of the availability of the GNS. In order to provide this component, VENCORP relies on the Service Envelope Agreement with GasNet.

2.2 Issues raised in submissions

Description of reference service

TXU questioned the validity of GasNet's Access Arrangement on the basis that it sets out reference tariffs without providing a corresponding description of the services it offers. In particular, TXU suggested that GasNet's reference service proposal was inconsistent with:

- (a) the intention of the Code and the preference for unbundling services and tariffs wherever practicable;
- (b) clause 5.3.1(a) of the MSO Rules, which requires GasNet "to provide VENCORP gas transportation services and pipeline capacity" through a valid service envelope agreement;
- (c) the Service Envelope Agreement; and
- (d) the reasonable requirements of a significant part of the market (section 3.2(a) of the Code).

Relationship between Users and GasNet

TXU stated that “through the Gas Transportation Deeds and the Service Envelope Agreement, GasNet invoices TXU, and requires TXU to pay for Tariffed Transmission Services directly to GasNet”. TXU expressed the view that, consistent with GasNet’s current Access Arrangement, VENCORP is a User of GasNet’s services and that VENCORP’s ability to deliver the VENCORP reference services is dependent on GasNet providing capacity of its pipelines available for use by VENCORP under various stipulated operating conditions.

MSO Rules

TXU suggested that the MSO Rules do not of themselves impose a clear obligation on GasNet to ensure that GasNet maintains the system and provides the transportation and capacity services required by TXU and other users. On this basis, TXU believes that it is not enough for GasNet to assert that the terms and conditions will be the MSO Rules in force from time to time.

Access disputes

TXU expressed concern that, in the event of an access dispute, TXU could only pursue VENCORP and that VENCORP in turn would be limited to contractual remedies against GasNet.

2.3 GasNet’s response

A number of the issues raised by TXU have already been addressed in the First Response and in legal advice obtained by GasNet (a copy of which has been provided to the Commission). In response to some of the specific issues raised by TXU, GasNet makes the following comments.

Description of Reference Service

TXU submitted that the description of the Reference Service is inconsistent with the MSO Rules which provide that VENCORP and GasNet must enter into a service envelope agreement under which GasNet, amongst other things, agrees to provide VENCORP gas transportation services and pipeline capacity. It also suggested that the description of the Reference Service is inconsistent with the Service Envelope Agreement, although no explanation is given as to how this alleged inconsistency arises.

This argument proceeds on the assumption that the “gas transportation services” referred to in the MSO Rules and the services provided by GasNet under the Service Envelope Agreement constitute “Services” within the meaning of the Code.

For the reasons outlined in the First Response, GasNet considers that it does not provide “Services” to VENCORP within the meaning of the Code. This view is supported by legal advice obtained by GasNet which concluded that the proposed treatment of the Services Policy complies with the requirements of the Code.

TXU also suggests that the failure by GasNet to include a full description of the Tariffed Transmission Service is inconsistent with the reasonable requirements of a significant part of the market (section 3.2(a) of the Code) in that Users need to know that the system will be available and that technical performance standards relating to the system will be applied.

GasNet submits that the description of the Reference Service contained in its Access Arrangement (ie. the availability of the GNS, which is sourced by VENCORP from GasNet through the Service Envelope Agreement) is not inconsistent with the requirement in section 3.2(a) of the Code. As noted in the First Response, the requirement to make the GNS available to VENCORP is clearly and unequivocally dealt with in the Service Envelope Agreement. Information about the GNS, its operating capabilities and constraints, is also contained in the Service Envelope Agreement.

Relationship between Users and GasNet

As discussed in the First Response, GasNet rejects the view that it provides a "Service" (within the meaning of the Code) to VENCORP. The revisions to the Access Arrangement are aimed at reflecting the actual underlying commercial and regulatory arrangements.

Although the Gas Transportation Deed requires TXU to pay for Tariffed Transmission Services directly to GasNet, this does not create a direct relationship with GasNet. GasNet is not empowered to charge Users directly. VENCORP has the direct relationship with Users under the Gas Transportation Deeds pursuant to which VENCORP directs Users to pay GasNet. GasNet has no other independent right to charge Users.

MSO Rules

GasNet's obligations to maintain the system and to make the system available to VENCORP are clearly set out in the Service Envelope Agreement. The obligation to make the system available to VENCORP is a separate issue to that of the terms and conditions on which Users obtain the Reference Service.

As noted in GasNet's Submission, the terms and conditions on which Users obtain the Reference Service are those set out in the MSO Rules. The current GasNet Access Arrangement does not provide Users with any terms or conditions of supply.

Access disputes

As noted in the First Response, GasNet's proposed changes to the Services Policy will have no material effect on the access of Users to an enforceable dispute resolution process.

Access disputes are likely to arise in one of two ways - between GasNet and VENCORP (ie. as owner and operator respectively) or disputes involving third party Users (ie. shippers using the GNS).

In relation to disputes between GasNet and VENCORP, the Service Envelope Agreement sets out a detailed dispute resolution process that is binding on both GasNet and VENCORP. Indeed, overlaying a regulatory access dispute

mechanism may simply serve to complicate any dispute resolution at this level.

In relation to disputes involving third party Users, these disputes would involve one or more of the MSO Rules, the Gas Transportation Deeds between Users and VENCORP or the VENCORP Access Arrangement. The current GasNet Access Arrangement only addresses services as between GasNet and VENCORP, and therefore is not and cannot be relevant to disputes involving third party Users. The Extensions and Expansions Policy contained in GasNet's Access Arrangement deals with coverage of new facilities and VENCORP's rights to obtain access to any additional capacity. Third party connection rights are dealt with under the MSO Rules.

3 Merging the PTS and WTS

3.1 Summary of GasNet's proposal

GasNet is proposing to merge the PTS Access Arrangement and the WTS Access Arrangement into a single Access Arrangement from 1 January 2003. The steps for merging the two Access Arrangements are set out in GasNet's Submission. One of the steps will require the termination of the WTS Agreement between GasNet and TXU.

3.2 Issues raised in submissions

Contractual arrangement with TXU

Energy Advice expressed concern that the proposed Access Arrangement indicates that the conditions for termination of the WTS Agreement will involve VENCORP granting AMDQ credits to TXU which would maintain TXU's current monopoly position on firm capacity.

3.3 GasNet's response

Contractual arrangements with TXU

Section 2.47 of the Code provides that in the Commission must not approve revisions to an Access Arrangement that would deprive any person of a contractual right in existence prior to the date the revisions to the Access Arrangement were submitted.

GasNet is bound by the terms of the WTS Agreement, which provides TXU with certain capacity rights on the WTS. Both the terms of the WTS Agreement and the section 2.47 of the Code require that TXU's pre-existing rights be preserved.

As indicated in the First Response, VENCORP, GasNet and TXU have been engaged in discussions to ensure that this requirement is satisfied.

4 Inclusion of SWP

4.1 Summary of GasNet's proposal

GasNet proposes to increase its Capital Base from 1 January 2003 to include the capital costs associated with the SWP by employing the economic feasibility test in the Code. GasNet has proposed a stand-alone tariff that recovers the actual capital costs over the life of the SWP.

4.2 Issues raised in submissions

Economic feasibility test

TXU suggests that the SWP fails the economic feasibility test specified in section 8.16(b) of the Code because the anticipated incremental revenue generated by the SWP would not exceed the capital cost of the SWP. This view is based on the assertion that the stand alone tariff is too high to support the forecast flows.

System wide benefits test

TXU expresses the view that the SWP should be included in the Capital Base on the basis that it satisfies the system wide benefits test set out in the Code.

ExxonMobil suggest in their covering letter that GasNet has conceded that the materiality of any system wide benefits to non-SWP users is such that it is unlikely to justify recovering any SWP costs from non-SWP users.

Allens Report on Incremental Pricing

ExxonMobil commissioned a report from the Allens Consulting Group (“**Allens Report**”) on the implementation of incremental pricing on the SWP. The report makes the following comments/recommendations.

- (a) The K-factor leads to a cross-subsidy from the SWP users to non-users if the SWP volumes are less than forecast. On this basis, it is suggested that a separate price control should apply to the SWP tariffs and any K factor in the price control should be quarantined to future SWP tariffs.
- (b) In future price reviews, the SWP should be written down to the extent that this is necessary to ensure that only SWP users pay for the SWP costs.
- (c) GasNet should be required to include a fixed principle in its access arrangement to ensure that the SWP is effectively quarantined in future periods.

4.3 GasNet's response

Economic feasibility test

GasNet acknowledges that it is difficult to forecast flows on the SWP with a high degree of certainty, given the scope for users to switch from one source of supply to another. This difficulty is compounded by the uncertainty as to

whether development of the Yolla gas field will proceed. However, GasNet considers that forecast flows are a reasonable forecast at the proposed tariff.

The assumptions underlying GasNet's volume forecasts are set out in detail in its Submission. The bulk of the forecast peak flows are WUGS injections. GasNet considers that, although there is spare capacity (in MDQ terms) at the Longford processing plant and on the Longford pipeline, there are minimal incentives to commit this capacity to peak injections alone, as this provides little revenue to the producers. The incentives on the Longford producers are to seek base load contracts, and if these are not forthcoming, to reserve capacity for growth in the New South Wales and Tasmanian loads. Evidence that the Longford producers are not inclined to inject gas to meet peak demand comes from actual behaviour to date in 2002. Despite the availability of spare capacity, the Longford producers have not injected higher volumes on peak days, whereas Iona has, on occasions, injected up to 215 TJ/day. On this basis, GasNet considers that the forecast SWP flows are reasonable.

System wide benefits test

GasNet rejects ExxonMobil's assertion that GasNet has conceded that the materiality of any system wide benefits to non-SWP users is such that it is unlikely to justify recovering any SWP costs from non-SWP users. GasNet clearly states in its Submission that it considers that the SWP does pass the system wide benefits test, and sets out a series of arguments to justify this position.¹

GasNet agrees with the detailed arguments advanced by TXU that since the Commission's Final Decision regarding the SWP, the system wide benefits are now sufficiently certain to justify the roll-in of the SWP into the Capital Base.

Allens Report on Incremental Pricing

GasNet rejects the views expressed in the Allens Report that a separate price control should apply to the SWP tariffs and that future K-factor carryovers should be quarantined to the SWP.

The K-factor is a fundamental pillar of the method for the recovery of revenue from the GNS. The K-factor methodology reflects the fact that services are provided to all parts of an integrated network. As shown below, any impact on Users associated with the application of the K-Factor to the SWP is minimal.

GasNet contends that there is nothing in the Code to require that incremental assets must be quarantined. This view is put forward in the Allens Report without any apparent justification, and goes well beyond the requirements of the Code. GasNet believes it is not appropriate to quarantine the pipeline, as this would not recognise the system-wide benefits provided by the South West Pipeline (even if those benefits do not cover the whole pipeline).

By calling for the SWP to be quarantined, the Allens Report is effectively asking that the SWP be treated as an independent, Greenfields pipeline

¹ See section 3.8 of Schedule 3 of GasNet's Submission.

investment. Under these conditions, GasNet would be justified in applying special conditions to this asset. Based on the alleged entrepreneurial status of the pipeline, and ignoring the system-wide benefits argument, GasNet would be justified in applying the principles addressed in the ACCC Greenfields guidelines, such as capitalisation of under-recoveries, a higher WACC, a longer Access Arrangement period etc.

The Allens Report contends that the K-Factor leads to a cross subsidy from the SWP users to non-users if the SWP volumes are less than forecast. To support this argument, Allens attempts to calculate the impact of a reduction in the SWP volumes below the forecast level. In calculating the impact of a reduction in SWP volumes, Allens incorrectly assumes the SPW tariff is \$12/GJ, which leads it to deduce a significant cross subsidy to non-users.

In fact, the Access Arrangement states that the SWP tariff is \$4.09/GJ on the 10 peak day injections. The calculation of the impact of the injection charge on a given customer is identical to the calculation which applies to the Longford injection charge (which is familiar to users from the current Access Arrangement). It requires an estimate of the customer consumption on the days when the injection pipeline delivers the 10 highest flows. The contribution of the SWP tariff to the annual price of a user who is totally supplied from the South West Pipeline is calculated to be²:

Load Factor	South West Pipeline Tariff
80%	\$0.13/GJ
60%	\$0.17/GJ
40%	\$0.26/GJ

The tariff impact on non-users arising from a reduction in flows on the SWP is significantly less than suggested by Allens. GasNet has analysed two scenarios to test the magnitude of the potential increase in tariffs for non-users from a reduction in forecast flows (note that the quid pro quo is that an increase in flows on the SWP will lead to a reduction in tariffs for non-users of the SWP):

(a) *General reduction in Tariff-D gas consumption in Metro Zone*

Example: Customer Load factor = 60%

Assume the Tariff-D customer is totally supplied from Port Campbell.

South West Pipeline tariff	\$0.17/GJ
<u>Metro withdrawal tariff</u>	<u>\$0.26/GJ</u>
Total Tariff	\$0.43/GJ

Hence the loss of this customer would lead to a reduction in GasNet revenues of \$0.43/GJ. However, the price control method would allow GasNet to recover revenue from the market as a whole to the

² This calculation assumes that the customer consumption on the 10 peak injection flows is 93% of the customer MDQ, based on the average load profile. In reality the injection volumes would be lower since LNG would be used to shave the peak day consumption within a prudent supply mix policy.

extent that the average price of the lost revenue exceeds the system average price, which (by chance) is \$0.434/GJ. Hence the correction to tariffs in the next year due to the K-Factor would be negligible.

- (b) *Shift in injections from Port Campbell to Longford (assuming no change to delivered volumes)*

If delivered volumes are unchanged, the revenue allowed by the price control is unaffected by the location of the injection volumes. Hence a shift in injections from the SWP to the lower priced Longford pipeline would lead to a reduction in revenue, which could be made up by GasNet in the next year through a small increase in general tariffs.

Example: A 10% reduction in flows on the SWP is equivalent to a reduction of approximately 20 TJ/day. Assuming the injections are transferred to the Longford pipeline, the impact on revenues is:

Loss of South West Pipeline revenue	\$0.82m
<u>Gain in Longford revenue</u>	<u>\$0.47m</u>
Net Loss of revenue	\$0.35m

The required increase in general tariffs is less than \$0.002/GJ or 0.4% (total over 5 years, not cumulative each year).

The maximum shift in volumes from Iona to Longford, given the capacity limits on the Longford pipeline, is $990-845 = 145$ TJ/day (ignoring certain contractual rights to use the SWP which would put a floor on the likely reductions in utilisation of the SWP). The required increase in all tariffs under this scenario is approximately \$0.01/GJ or 2.7% (total over 5 years, not cumulative each year). In our opinion this is the most extreme scenario.

5 Dandenong LNG facility

5.1 Summary of GasNet's proposal

GasNet owns and operates the liquefied natural gas (LNG) storage facility at Dandenong, Victoria. Services provided by means of the LNG facility (including liquefaction and gasification services) are not covered by the current GasNet Access Arrangement. However, the current Tariff Order regulates:

- (a) LNG services provided to VENCORP for system security purposes (this is defined as a "scheduled excluded transmission service", for which a fixed annual fee is payable); and
- (b) other LNG services provided to retailers (these are regulated as excluded transmission services, for which GasNet must charge on a "fair and reasonable basis").

Consistent with the current Access Arrangement, GasNet's proposed Access Arrangement does not include the LNG services.

5.2 Issues raised in submissions

Should the LNG facility be regulated?

TXU expressed the view that, depending on the outcome of the commercial negotiations targeted for June 2002, it may be necessary for the Commission to consider regulating the LNG security reserve. TXU suggested that the LNG service is a “service” within the meaning of the Code on the basis that it is ancillary to services provided by users of a covered pipeline and is likely to be sought by a significant part of the market (at least until an alternative means of providing system security is available).

5.3 GasNet’s response

As discussed in the First Response, GasNet considers that the LNG service is a competitive service and should not be regulated under its Access Arrangement. The LNG service is not a core transportation service and competes with other “peak” load services, including underground storage, incremental injections under the MSO Rules (for example by producers or retailers) and customer load shedding.

Furthermore, gas liquefaction and storage technology has advanced significantly in recent years (particularly in the case of ‘mini-LNG’ systems), and any barriers to the construction of new LNG facilities are low.

In any event, GasNet considers that the LNG service is outside the scope of the National Gas Code. The National Gas Access Law specifically excludes from the definition of “pipeline” any “tanks, reservoirs... used to... change natural gas (other than odourisation facilities) such as a processing plant”. GasNet considers that the process of liquefaction is a “change” to natural gas.

6 Tariff Design

6.1 Summary of GasNet’s proposal

GasNet proposes to retain the Cost of Service Methodology for revenue determination, which is the methodology used in the current PTS and WTS Access Arrangements. Under this approach, the revenue to be generated from the sales (or forecast sales) of all services over the regulatory period is, subject to the Code, equal to the costs (or forecast costs) of providing all the services, where the costs in this instance include a return to capital. In addition, GasNet proposes to retain the existing “price path” form of regulation.

The proposed discounted weighted average tariff to apply over 2003 to 2007 shows an increase of 11%³ in real terms over the 2002 published tariffs. This increase is due primarily to:

- (a) an increase in the underlying WACC parameters;
- (b) rectification of errors in the Capital Base;

³ This excludes the SWP which is charged on a stand alone basis.

- (c) the carry-forward of the accumulated K-factor carryover relating to the First Access Arrangement Period; and
- (d) the benefit sharing allowance arising from efficiencies made in the First Access Arrangement Period.

GasNet proposes injection tariffs levied on the 10 peak injection days and withdrawal tariffs based on volumes delivered. A separate tariff is proposed for each of the five injection zones and for each of the 14 withdrawal zones. Within each withdrawal zone there are separate tariffs for Tariff V and Tariff D customers. GasNet is also proposing a new storage refill tariff, a cross-system withdrawal tariff, matched withdrawal tariffs and prudent discounts for customers in certain geographical locations.

6.2 Issues raised in submissions

Injection charges

TXU asserted that injection point tariffs are inappropriate. In particular, TXU argues that the proposed methodology makes it difficult to determine the correct transmission tariff to pass through to users. Concern was also expressed that the matching of injection and withdrawal charges creates complexity and inhibits customer churn. It was also suggested that any intended price signalling is not passed on to customers to minimise consumption on peak days as the maximum injections are determined retrospectively.

Energy Advice suggested that the move to injection tariffs levied on 10 peak injection days rather than 5 makes it more difficult for users to avoid peak injection days.

Cross-system withdrawal tariffs

TXU expressed the view that the introduction of cross-system tariffs was unwarranted on the basis that:

- (a) the nature of the tariffs will increase costs for gas injected outside an injection zone and hence inhibit competitive downstream and upstream market development;
- (b) it adds further unnecessary charges for distance; and
- (c) it introduces another level of unnecessary complexity.

Matched rebates

TXU argued that the matched rebates increase complexity and inhibit customer churn.

Annual wash up

TXU argued that the annual wash-up process is still required in relation to injection charges. It also suggested that the current wash-up process will become extremely complex in a fully competitive market.

Longford versus Port Campbell gas

TXU argued that the differential injection charges create perverse incentives to source gas from Longford rather than Port Campbell.

Average revenue control (K-Factor)

TXU expressed concern that the K-factor correction could lead to retail price shocks unless limited by rebalancing constraints. It was also suggested that the K-factor may allow GasNet to earn more than its revenue requirement and that it shifts risks from GasNet to retailers. TXU was of the view that the K-factor should be applied separately to the Southwest Pipeline and the rest of the system.

TXU also expressed concern that there is the potential for revenue over-recovery under the proposed tariff arrangements. In particular, TXU suggested that the tariff structure provides GasNet with the opportunity to recover more than its revenue requirement in any year through the working of the price control.

Removal of peak withdrawal charges

Energy Advice notes that revenue collection has moved from peak to annual volumes, which removes most of the effect of daily load factor from tariffs, and impacts negatively on the higher load factor customers. This will diminish the incentive to reduce peak consumption, and lead to inefficient use of the system, and to the need for further investment to meet increased peaks.

They have included a table of tariff impacts on customers of differing load factors which demonstrates that the higher load factor customers will pay higher tariffs.

6.3 GasNet's response

Injection charges and matched rebates

A large part of the critique put forward by TXU deals with the issue of determining the correct transmission tariff to pass through to individual users. TXU notes that this problem would be removed if there were no injection charges. However, GasNet does not see any difference in the problem of allocating injection charges to customers, and the problem of allocating gas supply costs to customers. It is highly likely that the difference between gas costs at each injection point will be greater than the difference between injection charges at each injection point. TXU is likely to have a procedure for allocating gas costs to users, otherwise it would not be able to calculate the profitability of its customer base. To the extent that TXU quotes gas supply costs to customers as an average over all TXU sources, it is equally able to quote transmission charges as an average over all TXU sources.

TXU agrees with GasNet that there is no evidence for congestion on withdrawal pipelines during the next five years. However, TXU advocates the removal of all peak signals by removing injection charges completely. GasNet believes that some peak signals should be retained, and preferably on injection charges where congestion is most likely to occur, if it occurs at all.

Whilst Energy Advice supports the use of peak charges, they have questioned the reasons for a move from 5-peak day to 10-peak day injection charges. GasNet prefers the 10-day method because it reduces the incentive for users to avoid using the transmission system on peak days (by using LNG or alternative fuels), when the transmission pipelines may well be unconstrained. In our view it is undesirable to cause users to use more expensive fuels when there is spare capacity on the pipelines.

There are two additional barriers to the removal of injection charges *per se*, and of the peak day charging method on these pipelines. Firstly, the application of the economic feasibility test on the SWP is dependent on creating an injection charge which isolates revenue from this pipeline to injections into the pipeline. There are doubts as to whether the economic feasibility test could be implemented if the SWP costs were instead allocated to withdrawal zones based on a forecast of the flows along the SWP.

Secondly, GasNet has inherited existing contracts with retailers on the SWP, which presume that the Reference Tariff is an injection charge on the SWP, levied on the peak day flows. This militates against removing the injection charge and the peak day charging method. However, if the affected retailers agree to a contract revision that keeps GasNet whole, then this barrier can be removed.

Cross-system withdrawal tariffs

GasNet agrees that cross system charges increase complexity for retailers. However, retailers are well aware of their own injection strategies, and can calculate the impact of the cross system charges on their own costs. As TXU has demonstrated, a retailer supplying a customer across the system will pay more than a retailer who supplies the same customer from a closer injection point. However, this is a reasonable and cost-reflective outcome, since one retailer uses more of the system than the other.

Matched rebates

GasNet notes TXU's concern in relation to the increased complexity associated with the matched rebates. However, GasNet cannot remove this rebate without exposing itself to bypass. GasNet would only remove the matched rebate if bypass was prohibited or if GasNet was indemnified in some way. However the Code does not permit a pipeline company or the regulator to prohibit bypass. Accordingly, GasNet can see no other option than to offer a cost reflective matched rebate tariff.

Annual wash-up

The annual wash-up process is required because of the retention of peak injection charges. However, the impact of the annual wash-up will be dramatically reduced, because peak charges are reduced from approximately 65% of revenue to approximately 27% of revenue.

In addition, the wash-up can be completed in October rather than in January of the next year, as at present.

Longford versus Port Campbell gas

TXU has stated that there is a perverse incentive to source gas from Longford rather than Port Campbell. Whilst GasNet does not dispute this point, GasNet is constrained by the Code requirements that tariffs be cost reflective.

Average revenue control (K-Factor)

A number of the issues raised by TXU in relation to the operation of the K Factor have already been addressed in the First Response⁴. In response to some of the specific issues raised by TXU, GasNet makes the following comments.

GasNet acknowledges that the average revenue control shifts some risk to retailers. However, GasNet retains significant risk through the dependency of final revenues on delivered volume.

GasNet revenues are constrained to equal the regulated average price multiplied by the actual annual volume delivered. GasNet will lose revenue if volumes fall below forecast and gain additional revenue if volumes are above forecast. Any cross-system revenues will be returned to the market in the form of lower tariffs in the subsequent year (with interest).

The risk of a transmission charge price shock is relatively small compared to price risks already in the market. Currently retailers pass potentially significant uplift risk through to users. Retailers also face spot market risks, and are likely to pass through the price outcome of the next renegotiation of the Gascor contract price.

Removal of peak withdrawal charges

Energy Advice is concerned that the shift away from peak responsibility tariffs will reduce the incentive for customers to manage their peak demand, leading to higher peak usage, and earlier reinforcement of the system. However, as demonstrated by the VENCORP Annual Planning Review, there is no significant reinforcement of the system required in the near future, with the exception of the SWP, and the Western System. The Western System is near capacity, but the existence of the parallel Port Campbell to Adelaide pipeline from 2004 will ensure that constraints are not likely to occur on the GasNet pipeline. The Southwest Pipeline will be subject to a peak injection charge.

The increase in tariffs for higher load factor customers is an unavoidable consequence of removing peak charges. However, the customers who have lower than average load factors will be beneficiaries of this change.

⁴ See section 6.3 of First Response.

7 Pass Through

7.1 Summary of GasNet's proposal

GasNet proposes to include in its revised Access Arrangement a set of pass through rules which would permit GasNet to apply to the Commission to pass through within-period cost changes relating to:

- (a) change in taxes events;
- (b) regulatory events; and
- (c) insurance events.

The key features of GasNet's proposal is that these events are all beyond GasNet's control and any pass through is subject to approval by the Commission.

7.2 Issues raised in submissions

TXU questioned whether a pass through for increased regulatory requirements and increased insurance premiums is consistent with the incentive mechanism proposed by GasNet in its Access Arrangement or the intention of the Code.

7.3 GasNet's response

The issues raised by TXU have been addressed by GasNet in the First Response.⁵

8 Prudent Discounts

8.1 Summary of GasNet's proposal

GasNet is proposing to introduce prudent discounts for the Latrobe, Wodonga, and Western Zones, and the Dandenong Bypass.

8.2 Issues raised in submissions

Prudent discounts on WTS

TXU stated that prudent discounts on the WTS should only be offered if the threat of bypass is actual rather than perceived.

Funding prudent discounts

Energy Advice suggested that there was a good case for GasNet to fund the cost of discounted tariffs.

⁵ See section 8 of the First Response.

8.3 GasNet's response

Prudent discounts on WTS

GasNet is only proposing to offer a prudent discount in the Western Zone if the Port Campbell to Adelaide pipeline is built.

Funding Prudent Discounts

Energy Advice asserts that GasNet should be required to fund the cost of prudent discounts. However, no clear argument is advanced as to why GasNet should bear this cost. Under section 8.43 of the Code, GasNet may only introduce a prudent discount if the Reference Tariff without the prudent discount (and therefore without the bypass customers) would be higher than the Reference Tariff with the prudent discount.

9 Asset lives

9.1 Summary of GasNet's proposal

The economic lives for the majority of the system assets are consistent with the estimates made for the First Access Arrangement Period. However, the SWP is accorded a longer life, reflecting the recent construction date and the anticipated long-term value of a connection between the metropolitan area and WUGS.⁶ Also, the economic life of the Longford pipeline has been reduced slightly consistent with recent forecasts of the effect of the growth of interstate exports on the depletion of Bass Strait reserves.

9.2 Issues raised in submissions

Life of Longford pipeline

TXU questioned the reduction in the life of the Longford pipeline. In particular, TXU points to a seismic survey currently being conducted by Esso/BHP Billiton and suggest that this is evidence of a reasonable degree of confidence that new fields will be discovered.

Life of SWP

TXU questioned why the economic life of the SWP has been reduced below the technical life of 60 years.

9.3 GasNet's response

Life of Longford pipeline

The reason a longer economic life was attributed to the Longford pipeline in the 1998 submission is documented in the Saturn Resources Report of June 1997 attached to the GHD Valuation Report on the TPA Assets. Table 1.1 in that report quotes the proved and probable reserves (as at December 1994) in the Gippsland basin of 9272 PJ. Based on these reserves, the report notes that

⁶ Each pipeline in the GNS has a distinct lifetime, but the majority are included together in the Rest of System group and assigned an economic life equal to the weighted average of the individual pipeline lifetimes.

the Gippsland basin could be depleted by 2020. However the table also shows a higher reserve estimate of 16929 PJ, which is used to determine the economic life. This figure is attributed to the opinion of “a range of knowledgeable industry and agency personnel” who were consulted by the Victorian Government Gas Industry Reform Unit for other purposes. These advisors were un-named and their assertions were unsupported. GasNet believes that while these estimates may be suitable for general government energy policy, they are not suitable for determining the level of financial risk appropriate to a regulated pipeline company.

In relation to the 3-D seismic program currently being conducted by Esso/BHP Billiton, GasNet considers that the Commission should not be persuaded by optimistic appraisals from interested parties or by evidence of exploration activity. The economic life of pipeline infrastructure should be based on reliable, scientifically established statistics, not on risky exploration activity.

The relevant issue in determining the economic life of a pipeline is the level of confidence that additional reserves exist. GasNet pipelines are regulated long-lived assets and therefore a reasonable degree of confidence is required in establishing the economic life. Exploration activity, such as the seismic program being planned by Esso/BHP Billiton, is generally regarded as a high risk venture. Gas producers receive a number of compensations for the high level of financial risk they undertake. For example, gas production is not regulated, there is approval of joint marketing efforts, and there are monopoly rights to hold and exploit gas tenements. These rights are conferred despite the considerable market power of the gas producers, and are only justified by the high risks of exploration activity. It is entirely inappropriate for the GasNet regulated pipelines to face the same level of financial risks as a gas exploration company. GasNet believes that new gas discoveries are not certain and that GasNet’s financial health should not be tied to such uncertain events.

Life of SWP

The reduction in the economic life of the SWP to 55 years is designed to allow for market and other risks. In any event, since GasNet proposes to defer depreciation of this pipeline, the reduction in the life does not impact on the calculation of the tariff.

10 Capital Base

10.1 Summary of GasNet’s proposal

For the purpose of calculating the Capital Base for the commencement of the Second Access Arrangement Period, GasNet proposes to include certain assets (including easements) which were included in the original GHD valuation but were excluded from the Capital Base determined by the Commission.

10.2 Issues raised in submissions

Excluded assets

TXU rejected GasNet's proposal to include easements and "forgotten assets" in the rolled forward Capital Base on the basis of the Code and GasNet's current Fixed Principles.

Government funded assets

TXU questioned whether assets funded by the government payments have been accounted for in the asset base (eg payments referred to in the Auditor General Report, Victoria, 1998-99 and payments under the SWP Trust).

10.3 GasNet's response

Inclusion of forgotten assets

GasNet's response to these issues has been dealt with in the First Response.

Government funded assets

GasNet confirms that the payments referred to by TXU have been accounted for in the asset base.

11 Capital Expenditure

11.1 Summary of GasNet's proposal

The actual capital expenditure incurred by GasNet in the First Access Arrangement Period was \$199.6 million. A portion of this capital expenditure (\$40.4 million) relating to the Interconnect Assets, has already been incorporated into the Capital Base. GasNet proposes to include in its Capital Base an additional \$102.0 million (as spent) of the remaining capital expenditure. The GasNet Submission provides a detailed justification for the inclusion of these projects in the Capital Base.

GasNet has forecast recoverable capital expenditure of \$87.0 million (nominal) for the Second Access Arrangement Period. The main items of capital expenditure are the partial looping of the pipeline between the Brooklyn compressor station and Lara, the Gooding compressor station refurbishment and the Lurgi pipeline refurbishment.

11.2 Issues raised in submissions

Justification for forecast capital expenditure

TXU requested an independent assessment of the prudent value of the proposed capital expenditure. TXU also requested clarification on the capital expenditure relating to GasNet's operating and maintenance program and forecast system demand.

Gooding Compressor Station and Brooklyn Loop

Energy Advice argued that the costs of the Gooding Compressor station refurbishment and Brooklyn Loop should be allocated to the winter peak component of the tariff.

11.3 GasNet's response

Justification for forecast capital expenditure

In relation to forecast capital expenditure, the Code requires a justification of all planned investments. GasNet has provided a detailed description of each of the major projects it proposes to undertake and a justification as to why the expenditure must be incurred.

The only capital expenditure related to system demand is the Brooklyn Loop. All other capital expenditure is required to maintain the existing services and therefore is not required to pass the economic feasibility test.

Gooding Compressor Station and Brooklyn Loop

The cost of the Brooklyn Loop is allocated to the peak injection charge at Port Campbell. The cost of the Gooding compressor station refurbishment is added to the total cost of all compressors which is then allocated to each compressor station. Since the Gooding Compressor station is the largest station, the greatest share of refurbishment costs goes to the Longford pipeline, which is charged on the basis of peak flows.

12 Operating costs

12.1 Summary of GasNet's Proposals

Over the Second Access Arrangement Period, GasNet's operating costs will remain relatively flat. However, there are some variations from year to year, particularly in relation to pipeline maintenance costs. GasNet has also included an allowance of \$0.4 million to expand its general marketing activities.

12.2 Issues raised in submissions

Litigation expenses

Energy Advice argued that it was not appropriate for GasNet to pass through litigation expenses.

Historical costs

TXU requested information on historical costs and an explanation for the differences between forecast and historical costs. TXU also queried the amortised capital raising costs.

12.3 GasNet's response

Litigation expenses

Litigation expenses represent a normal and reasonable operating cost of any regulated utility business. In particular, they represent an efficient means of managing the costs relating to the underlying claims to which the litigation relates.

Historical costs

Section 8.3 of GasNet's Submission provides a comparison of historical operating costs and forecast operating costs. It also provides an explanation of the differences between forecast and historical operating costs.

GasNet's justification for the inclusion of amortised capital raising costs is dealt with in detail in section 8.8 of GasNet's Submission. The amortised capital raising costs are the transactional costs for raising equity and debt. These costs are not included in the debt and equity betas which are used to calculate the cost of capital under the CAPM. It is now generally accepted that such transactional costs should be included in the cashflows as specific line items.

13 Key Performance Indicators and Benchmarking

13.1 Summary of GasNet's proposal

GasNet adopted the following methods to demonstrate that its forecast operating costs are prudent:

- (a) Firstly, GasNet's forecast operating costs have been compared against a range of statistics collected from published data of other Australian pipeline companies; and
- (b) Secondly, GasNet commissioned a benchmarking report from international consulting firm Cap Gemini which compares GasNet's operating costs with a wide range of Australian and overseas companies.

13.2 Issues raised in submissions

KPIs

TXU stated that "GasNet has excluded many items including compressor costs, maintenance capital expenditure, and made adjustments to its forecast costs for 2003". It was suggested that GasNet should be able to derive benchmarks with compressor fuel included in order to provide a basis for determining whether its forecast compressor costs are reasonable.

TXU was also critical of the exclusion of maintenance capital expenditure and questioned whether GasNet has excluded such expenditure from the companies benchmarked.

TXU also questioned what allowance had been made for gas control to account for VENCORP's functions. Some concern was also expressed as to why incremental insurance costs were excluded.

Energy Advice suggested that a comparison of \$/TJ/km with other pipeline tariffs shows GasNet's tariffs are very high, particularly for high load factors.

Benchmarking

TXU questioned the way in which costs were defined in the Cap Gemini Benchmarking Report to enable intercompany comparisons.

TXU also requested that a copy of the Benchmarking Report be provided.

13.3 GasNet's response

KPIs

GasNet obtained the KPI data for Australian companies from the draft and final decisions of the Commission for each company. All of this information is in the public domain. GasNet has taken the approved operating costs for the year 2003, made adjustments for differences in CPI assumptions, and compared these costs to GasNet's forecast of costs for 2003.

GasNet has not, as suggested by TXU, excluded compressor maintenance costs from its KPIs. However, it has excluded compressor fuel costs because other Australian companies have a range of inconsistent methods to fund the cost of compressor fuel (for example, some companies require the shipper to provide the fuel used in operations). GasNet is not aware of any published statistics which would enable it to benchmark compressor fuel usage. Even if such statistics existed they would be of little relevance, since the use of compressor fuel depends on many other factors which cannot be controlled-for in any inter-company comparison.

Maintenance capital expenditure was not included in the review of operating expenses and was excluded from the companies benchmarked. As indicated in GasNet's submission, GasNet considers that, although maintenance capital expenditure and operating expenditure are to some extent interchangeable, the level of capital expenditure is asset specific, and that where maintenance capital expenditure is required, the projects can be identified and justified on a case by case basis.

GasNet has made an allowance of \$0.6 million to cover incremental costs of providing a gas control function comparable to that provided by other companies under the contract carriage system (and taking into account the fact that GasNet already has the assets required to provide a control room function).

GasNet has deducted \$1.1 million from GasNet forecast costs to allow for the fact that the comparable costs from other Australian companies (as approved by the Commission) do not contain the extraordinary increases in insurance premiums since last year. The \$1.1 million represents the extraordinary increase in insurance costs. The base insurance costs were included in GasNet's forecasts and in the companies benchmarked.

In issues raised by Energy Advice on the benchmarking of GasNet's tariffs, GasNet submits that it is not appropriate to compare GasNet with EAPL and EGP on the basis of \$/TJ/km.

Both EAPL and EGP are large diameter, long-distance pipelines predominantly designed to carry gas from supply source to major demand centre. The GasNet system contains a broad network of narrow, low volume distribution pipelines to country centres. In addition, the GasNet system can be characterised as a hub network being supplied from multiple sources. Given the economies of scale inherent in gas transmission, GasNet pipelines will tend to show a higher unit rate per km than large capacity pipelines.

A fairer comparison would be with the GasNet Longford injection charge, which covers the costs of transmission from Longford to Pakenham, and the Port Campbell injection charge, which covers transmission from Iona to Lara. The comparable statistics are shown below⁷. The GasNet injection charges exclude the overhead costs (\$0.08/GJ), but this does not significantly affect the comparison.

Load Factor	Longford	SW Pipeline	EAPL	EGP July 2003
	\$/TJ/km	\$/TJ/km	\$/TJ/km	\$/TJ/km
90%	0.484	0.814	0.560	0.870
75%	0.581	0.977	0.670	1.040
60%	0.727	1.221	0.820	1.300

Benchmarking report

With respect to how costs were defined by Cap Gemini in their study, these definitions were developed by Cap Gemini from their wide benchmarking experience, and they are integral to their proprietary database of comparison companies.

As indicated in the First Response, GasNet has agreed to remove the confidentiality restriction on the Benchmarking Report.

14 Extensions and Expansions Policy

14.1 Summary of GasNet's proposal

Clause 5.1 of the revised Access Arrangement provides that any extension to, or expansion of, the GNS will be covered by the Access Arrangement unless GasNet gives notice to the ACCC stating that the extension will not form part of the Access Arrangement. GasNet proposes to remove the restriction contained in its current Access Arrangement which requires all pipeline extensions less than 10 km in length or less than \$5 million in cost to be covered.

⁷ Assumes flows on 10 peak injection days at 100% of customer MDQ.

14.2 Issues raised in submissions

Coverage of expansions

TXU expressed the view that all expansions should be covered by GasNet's Access Arrangement.

Coverage of laterals

Energy Advice expressed the view that it was not appropriate for laterals to be automatically covered. They have clearly articulated the many practical difficulties with a policy of covering small laterals.

14.3 GasNet's response

Coverage of expansions

It appears that TXU has misunderstood the extensions and expansions provisions in the revised Access Arrangement. Clause 5.1(a) clearly states that any extension or expansion of the GNS will be covered by the Access Arrangement. Clause 5.1(c) allows GasNet to exclude an *extension* from the Access Arrangement. It does not allow expansions to be excluded from the Access Arrangement. Therefore, all expansions will be covered by the Access Arrangement.

Coverage of laterals

The view expressed by Energy Advice is consistent with GasNet's proposed Extension/Expansion Policy.

15 Information requirements

15.1 Summary of GasNet's proposal

The Code requires that a proposed access arrangement be accompanied by Access Arrangement Information. Section 2.6 of the Code specifies that the 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.

Under section 2.7 of the Code, the Access Arrangement Information may include any relevant information but must include at least the categories of information described in Attachment A.

GasNet lodged its draft GasNet AA Information in relation to the GNS with the Commission on 27 March 2002.

15.2 Issues raised in submissions

TXU has requested further information on demand by zone and service category to enable reconstruction of the tariffs. TXU also requested that GasNet demonstrate the validity of the tariff derivation and provide detail on cost allocation by each reference service and zone.

15.3 GasNet's response

As a general comment, GasNet considers that the Code does not require it to provide sufficient data to enable replication of the tariffs.⁸

GasNet has already provided detailed information on cost allocation (see sections 5.3 of the AA Information and schedule 5 of GasNet's Submission).

Information in relation to forecast annual volumes by zone is set out in Table 4-4 of the AA Information.

⁸ See section 17.3 of First Response.