TXU Response to the ACCC's release of the Draft Greenfields Guideline for Natural Gas transmission Pipelines

1. Introduction

1.1 TXU welcomes the opportunity to comment on the release of the Draft Greenfields Guideline for Natural Gas Transmission Pipelines. The company supports the release of the guideline subject to some major qualifications.

1.2 The ACCC's release of the Guideline seeks to clarify how the ACCC will apply certain aspects of the National Third Party Access Code for Natural Gas Pipelines (the Gas Code) in regulating greenfields natural gas transmission pipelines. The Guideline aims to provide greater certainty & transparency in the process to be applied by the ACCC in regulating greenfields transmission natural gas pipelines under the Gas Code.

1.3. However, the uncertainty associated with the project "take–up" rates in greenfields natural gas transmission pipelines makes these projects marginal compared with mature pipelines. As such, these projects can have difficulties achieving their "ex-ante" required returns. Adding access regulation acts as a deterrent to investment. Greenfields natural gas transmission pipelines have long lead times, incur heavy capital expenses early on & recover their revenues in the later part of the asset's life. TXU's view, and experience, suggests that monopoly pricing behaviour in this environment is unlikely. It is far more likely that service providers will reduce prices to encourage demand rather than engage in monopoly pricing, to achieve ex-ante returns.

1.4 TXU believes that regulation should only act as a surrogate for competition. Where pipeline on pipeline competition is evolving, TXU believes that the market should set the price. Applying access regulation in this case will lead to an inefficient allocation of resources. TXU believes the gas market in Australia is still maturing, and that it is essential this maturing process is facilitated rather than inhibited. The most effective way of achieving this, in TXU's view, is to "allow the market to work". In this environment TXU believes regulators should deliberately take a "back-seat", providing a light-handed framework that encourages the development of a competitive model in the South East Australian gas market. TXU further believes that regulators should deliberately seek to minimise intrusive regulation in such a developing market where investment is so vital.

1.5 The market model being developed in the South Eastern Australian gas market will lead to a more efficient allocation of resources through competitive market outcomes. These benefits will be passed on to consumers in the long run. Regulators' attempts to apply access regulation to transmission pipelines in these developing hubs will only act as a disincentive to investment. The Productivity Commission highlighted its concerns about the significant deficiencies in the national access regime in its recent review of the National Access Regime. In light of this finding, regulators should be cautious about determinations that lead to the application of access regulation, especially where market outcomes will lead to a more efficient allocation of resources. In making a determination to apply to access regulation, TXU reminds all participants in this debate regarding the conclusion drawn by the Productivity Commission review of the National Access Regime on pXII

> " *The present national access regime, operating in tandem with industry access regimes, has important advantages. But it also has significant deficiencies. The paramount concern is the potential for access regulation to deter investment essential infrastructure. To lessen this risk, the commission has proposed that new measures be incorporated into national access regime to facilitate efficient investment."*

1.6 TXU believes the best outcomes for gas consumers in Australia will be delivered not through stringent price regulation for pipelines, but instead through the development of vigorous upstream competition. Key to the development of vigorous upstream competition is the development of inter-basin competition. Australia is fortunate to have access to rich gas basins, but they are geographically dispersed. Therefore, it is essential that Australia has sound investment in gas pipelines, as this will promote the vigorous upstream competition that is required to deliver the best outcomes for the Australian gas consumer. Investment in pipelines will be inhibited if heavy-handed price regulation continues. A light-handed regime will promote an inter-connected pipeline system, forcing gas basins to compete against each other, therefore delivering the best possible outcome to Australia's gas consumers. TXU encourages regulators and policy-makers to focus on the "big picture" of the end outcome to consumers, and define regulatory settings accordingly, rather than focusing on individual components of the supply chain such as the transmission pipeline.

1.7 TXU therefore advocates that greenfield gas transmission pipelines should not be subject to the current regulatory regime, which we believes inhibits pipeline investment. Instead, we advocate a light-handed regime be adopted where the service provider offers access to the pipeline on a non-discriminatory basis according to a set of "open access principles". These principles should encompass such matters as ring-fencing, tradeable capacity and the requirement to post prices. TXU recommends an industry code of practice be developed to capture these principles.

1.8 Whilst TXU's preferred position is that greenfield natural gas transmission pipelines should be subject to the light-handed access model referred to above, TXU acknowledges that the ACCC must regulate these pipelines in accordance with its obligations under the law. As such, if the National Competition Council (NCC) is satisfied that a greenfield natural gas transmission pipeline satisfies the key provisions of section 1.9 of the Code and this recommendation is approved by the relevant Minister, then it will become a 'covered' pipeline under the Gas Code. (Similar principles apply under Part IIIA of the Trade Practices Act). In these circumstances, the ACCC must apply access regulation to a greenfield transmission pipelines.

1.9 TXU is aware the ACCC has no alternative but to apply access regulation under the law if the pipeline satisfies the 'coverage' tests under sect. 1.9 of the Code (See 1.6 above). Under this scenario, TXU believes the ACCC's release of the greenfields guideline provides greater clarity on how it will apply access regulation to greenfield natural gas transmission pipelines under the Gas Code.

2 Key Issues

2.1 The ACCC Draft Greenfields Guideline for Natural Gas Transmission Pipelines is a comprehensive document that explains how the ACCC will regulate key areas of the Gas Code as they apply to greenfield natural gas transmission pipelines. This part of the submission will comment on the key issues covered by the guideline.

2.2 **Guidelines treatment of risk in the regulatory framework***:*

TXU supports the Guideline's treatment of risk in the regulatory framework & emphasises both the systematic and non-systematic risk of a project is appropriately captured in its treatment of risk. The ACCC provides compensation for systematic risk through the market risk premium & the beta factors which form part of the Capital Asset Pricing Model (CAPM). Non-systematic risks (Project specific) are also captured & factored into the project cash flows rather than the cost of capital (WACC).

2.3 Whilst TXU re-iterates the significance to investor confidence in capturing both the systematic & non systematic risk in greenfield gas transmission pipelines, TXU believes that the ACCC should consider the Productivity Commission's recommendation to capture the additional risk associated of investing in greenfield projects by adding a premium to the WACC. This could be reflected in a higher Beta in the project's WACC. TXU submits that this option should be considered carefully by the ACCC before finalising the guideline. The recommendation is also consistent with the ACCC's consultants Prof. Kevin Davis & John Handley who argued that whilst the systematic risks of both mature and greenfield transmission pipelines should not differ, cash-flows for greenfields have a longer maturity than cash-flows in established pipelines. Whilst this systematic risk might be reduced via the Code's treatment of foundation contracts, the academics argued that the net effect of all this was to allow the higher end of the beta to apply in WACC calculations in greenfield gas transmission pipelines.

2.4 Guidelines Treatment of the Initial Capital Base (ICB):

TXU supports the ACCC's regulatory treatment of the Initial Capital Base (ICB) for the following reasons:

2.5 TXU supports the ACCC's position to support service providers manage their financial risk by including the costs incurred for Hedging & SWAP arrangements in the ICB. Where these arrangements were attributable to construction costs then such costs could be capitalised and reflected in the ICB. Funding for greenfield transmission natural gas pipelines are raised in the world's capital markets. Projects that procure materials from overseas will require multi-option currency facilities with appropriate hedging & SWAP facilities attached. These arrangements form part of a prudent commercial operator's financing facilities. TXU supports the ACCC's position to acknowledge these related construction related costs and its position to allow these costs to be capitalised and reflected in the ICB.

2.6 TXU supports the ACCC's position to include construction cost over-runs in the ICB. For greenfield pipelines subject to access regulation, the Gas Code provides scope for including a prospective greenfields pipeline from construction cost risk. Any cost over-runs will be included in the ICB as a component of the "actual capital cost."

However, the Guidelines states it is not the intention of the regulatory regime to compensate a service provider for risks that can be addressed through established commercial practice, such as the management of construction risk via contractual or other arrangements. Whilst TXU agrees with this, the commercial practices used by service providers to manage these risks comes at a commercial cost. For example, project financing techniques allocate risk to the party most capable of undertaking that risk. Construction risk may take the form of a turn-key project that a construction company maybe willing to undertake. However, a prudent service provider will require an insurance bond to underwrite the construction company's credit risk. TXU would expect these costs associated with the construction of a pipeline to be included in the ICB.

2.7 Guideline Treatment of Demand Forecasts

The ACCC has acknowledged the complexities that service providers have associated with delivering demand growth forecasts. This includes the complexities of determining a best estimate of forecast demand & the potential volume risk in greenfield pipeline where "take-up" has not been secured by foundation contracts.

2.8 Industry participants are concerned the current application of an incentive mechanism that limits blue-sky profits by rewarding service providers for outperforming benchmarks but has a reduced capability to share the downside in a black-sky scenario. As such the draft greenfield guideline attempts to apply an incentive mechanism that caters for volume risks in greenfield natural gas transmission pipelines.

2.9 The incentive mechanism applied by the ACCC in the greenfield Guideline has two key characteristics in that

(a) It imposes an incentive mechanism that allows for the sharing of returns with customers, but ensures that under all scenarios, the service provider achieves "ex-ante" returns after efficiency gains have been allocated to customers.
(b) It addresses the problem of under-recovery relative to demand forecasts via the capitalisation of financial losses. This allows a service provider to recover its "ex-ante" return in a "black-sky" scenario. Whilst this does not have an immediate effect on the project's profitability (or cash-flow) the project will recover its "ex-ante" return by inflating the regulated asset base (RAB).

2.10 TXU supports an incentive mechanism that shares profits with customers on a fair & reasonable basis, & ensures the project recovers its "ex-ante" return under a black-sky scenario. However, TXU believes sharing efficiency gains with customers in greenfield natural gas transmission pipelines should be kept to a minimum to ensure the incentive to invest is not eroded. Excessive sharing of blue-sky profits will deter investment in these projects.

2.11 TXU supports the greenfields guideline treatment of a project that experiences a "black-sky" scenario. The guideline allows a project under-recovering in relation to its forecasts to capitalise its losses in order to achieve its "ex-ante" returns. The Guideline does not recommend price increases in the short term to recover revenues in the case where a project is under-recovering as this would have the effect of dampening demand and TXU supports this.

2.12 Guideline allows for longer access arrangement periods

TXU welcomes the draft greenfields guideline that allows projects longer access arrangements periods. TXU believes that this will have the following effect

(a) The pipeline has the potential to earn and retain profits for a longer period, allowing it to earn profits above the benchmark level set by the ACCC.
(b) Locking in a project's cost of capital over a longer period of time will add to investor certainty. Access arrangements reviewed every 5 years that lead to price changes for reference services add to a project's uncertainty. Given this impediment is partially removed for the term of the extended access arrangement, then this should encourage investor confidence in these projects.

2.13 Service Provider's right to seek a review at any time of an access arrangement in the event that circumstances materially change.
TXU supports the ACCC's position to allow for appropriate review mechanisms to be triggered if forecasts diverge significantly from actual outcomes. However, TXU believes the Guideline should

(a) Clearly define the term "material change". This could include some examples of events that would constitute a material change.
(b) Keep an open mind on the proposals put forward by the service provider to rectify the material change. This could mean accepting a strategy by the service provider to increase &/or decrease tariffs to resolve financial problems a project may have, for it to achieve its required "ex-ante" returns.

2.14 Guideline allows for flexible depreciation schemes
The ACCC has typically applied straight- line depreciation applied to the economic life of an asset to depreciate a pipeline over its life. However, provided that the principles in the Gas Code are followed, a service provider may adopt an alternative approach.

2.15 The ACCC quote the depreciation methodology applied in the South Western Pipeline (SWP) Final Decision that uses economic depreciation as part of the service providers NPV/price path approach to determine total revenue.

2.16 The ACCC approved the SWP's depreciation approach in recognition of the beneficial effect it would have by allowing the service provider to recoup under-recoveries in the early part of a project's life. In summary:

(a) TXU supports the use of depreciation profiles that allow the service provider to recoup under-recoveries accrued in the early period of a project's life, especially given the high probability that losses will be incurred in a greenfields project's early life.
(b) TXU supports the guidelines flexible approach in accepting depreciation profiles that will suit greenfield projects & reduce asset stranding risk.

2.17 Guideline's use of fixed principles
Fixed principles establish certain aspects of regulatory certainty over an access arrangement period. They can give investors long term regulatory certainty over how their investment will be treated over a long period. A service provider seeking certain conditions to form part of its access arrangement sustained across access arrangement periods can do so.

2.18 The ACCC's flexibility on what it will allow to be included as part of an access arrangement's fixed principles will determine how beneficial the use of fixed principles will be to service providers. The ACCC's approach to this may determine whether an investment goes ahead.

2.19 TXU expects the ACCC will have a flexible approach in determining the fixed principles that it will allow a service provider to include as part of its access arrangement. TXU believes the ACCC should have a more lenient approach to what it will allow a service provider to include in a greenfield natural gas transmission project as part of the fixed principles that form part of its access arrangement. The ACCC approach to these conditions that form part of the fixed principles of an access arrangement could ultimately determine whether the project proceeds. For example, the retention of a higher cost of capital over a longer period & an aggressive depreciation profile that allows a service provider to recoup its revenues in a project's early life might be crucial to its cash flow.

3 Conclusion

3.1 TXU believes greenfield natural gas transmission pipelines should not be regulated and the risks associated with the "take-up" of demand makes these projects marginal. Access regulation adds another layer of complexity to these marginal projects acting as a deterrent to investment.

3.2 TXU believes that regulation should only act as a surrogate for competition. Where pipeline on pipeline competition exists, the market should set price. Applying access regulation in this case will lead to an inefficient allocation of resources.

3.3 Whilst TXU's preferred position is that greenfield natural gas transmission pipelines should be subject only to light-handed open access model described above, TXU acknowledges that the ACCC must regulate these pipelines in accordance with its obligations under the law. As such, the ACCC must regulate greenfield Natural Gas Transmission Pipelines if the NCC and the relevant Minister is satisfied the pipeline passes the 'coverage" tests in section 1.9 of the Gas Code.

3.4 Given the complexities of regulating a greenfield natural gas transmission pipeline under the Gas Code, TXU supports the release of the Draft Greenfields Guideline for Natural Gas Transmission Pipelines. The Guideline does provide greater clarity about the how the Gas Code will be applied by the ACCC to these projects.