Submission on

ACCC Issues Paper of

Applications for revision lodged by GasNet Australia (Operations) Pty Limited and Victorian Energy Networks Corporation
19 April 2002

May 2002

31 May 2002

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Dear Michael

Applications for Revisions to Gas Transmission Access Arrangements

Please find attached TXU's response to the ACCC Issues Paper dated 19 April 2002 regarding applications for access arrangement revisions lodged by GasNet Australia (Operations) Pty Ltd and Victorian Energy Networks Corporation.

TXU is encouraged by the form of the VENCorp submission and its compliance with the spirit and requirements of the code. However, we have major concerns with the GasNet Submission and have therefore focussed our comments on that submission.

TXU appreciates the 2 week extension for our submission. However, we note that notwithstanding the extension, it remains difficult to provide a definitive response in relation to GasNet's tariff proposals. This is due to the overly-complex nature of GasNet's proposals, and to the lack of appropriate detailed information to enable TXU to form a view as to reasonableness or otherwise.

We also note that in relation to some matters, TXU has sought clarification directly from GasNet. In particular, TXU has sought from GasNet an understanding of the customer impact of its proposed tariff methodology and what, if any, pricing differentials it might create. GasNet has been unable to assist TXU in this regard.

In order to fully understand and to make an informed judgment on GasNet's proposals, TXU believes that GasNet should be required to resubmit the application removing the complexity, improving clarity of information provided and further substantiating proposed changes.

Key areas of concern for TXU based on its current understanding of GasNet's proposals are:

(i) GasNet's access arrangement sets out its reference tariffs without a description of the corresponding reference services it offers. Consequently, TXU understands that it could only pursue VENCorp in the event of a dispute in relation to access. VENCorp in turn would be limited to contractual remedies, if any, against GasNet.

TXU submits that this is inconsistent with the underlying rationale of the access regime, and does not comply with the requirements of the Access Code. Therefore, TXU requests that the Commission require a change to GasNet's access arrangement to include a description of the transportation and capacity services that GasNet provides, and details of the applicable terms and conditions;

(ii) TXU believes that the proposed tariff design is inappropriate for the following reasons:

- It is far too complex and inconsistent with the current and likely future movements in the market (particularly a fully competitive market);
- For contract customers, the proposed price increases will result in significant price shocks. For the majority of domestic customers on standing and deemed contracts, there is no certainty of the retailer's ability to pass on such costs. Therefore, either the retailers will be exposed to losses or there will be significant price shocks to customers;
- It creates perverse incentives for sourcing of gas. For example, under the proposal, a retailer is encouraged to supply gas from Longford to supply a customer in the South West withdrawal zone, rather than from Port Campbell;
- The GasNet tariffs result in significant discrepancies between TXU rural and urban customers. For example, the GasNet price range is $0.28 for TXU urban residential customer versus $1.06/GJ for a TXU rural residential customer. Even if the Commission were satisfied that the higher prices for rural customers were justified based on the cost reflectivity principles of the Code, TXU submits that this is inconsistent with prevailing community expectations and government policies. Therefore, to the extent that GasNet's proposed tariffs exacerbate the differentials for urban and rural customers, they should be adjusted;
- GasNet has provided limited arguments for the basis of its peak pricing methodology. Peak pricing signals on an uncongested system are

unnecessary, and in any case, such signals are better managed through the spot market;

(iii) In light of the above, TXU seeks a complete review of GasNet's tariff methodology to remove the complexity, clarify the information provided and justify and substantiate the proposed changes made. TXU submits that the following changes should be made to GasNet's tariff methodology:

- Removal of MDQ as a basis of charging given the complexities arising from customer churn in a fully competitive market, the mismatch of injection versus customer consumption, and the annual wash-up process;
- Replace MDQ charging with anytime volume charging (if there is concern about peak pricing signals that can be achieved through a peak anytime charge over the winter period);
- Replace the injection tariffs with withdrawal based tariffs, consistent with consumption measurement. At the very least remove all locational injection charging based on matched withdrawals; and
- Aim to aggregate zones to reduce complexity and to reduce rural and urban price differentials (based on postcode methodology);

(iv) TXU believes that, given the significant issues for retailers, with GasNet's proposed tariff methodology, industry and GasNet should try to resolve the matters in a working group environment prior to the release by the Commission of its draft determination;

In relation to GasNet's incentive mechanism, TXU is particularly concerned that the complexity of the structure may create opportunities in any one year for GasNet to recover (earn) more than its revenue requirement. TXU requests that GasNet demonstrate the effectiveness of the revenue control formulae and, in particular, how the correction factor adjusts for differences in actual versus forecast MDQ injection withdrawal assumptions.

(v) Further, the ability for GasNet to pass through the full extent of a prior year loss with the further ability to rebalance individual tariffs by up to 2% is likely to result in retail price shocks and therefore is unacceptable. TXU submits that it would be preferable for the K factor recovery to be subject to a constraint on rebalancing tariffs; and

(vi) More operational market data is available since the Commission's June 2001 decision on GasNet's attempt to roll-in the Southwest Pipeline which should be reconsidered.

TXU reserves the right to lodge further submissions on GasNet's proposed access arrangement as more information becomes available.

If you require any further information please call Bruce Foot on 03 8628 1523 at your convenience.

Yours sincerely

Caryle Demarte
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TXU Detailed Submission

on

ACCC Issues Paper

of

Applications for revision lodged by GasNet Australia (Operations) Pty Limited and Victorian Energy Networks Corporation 19 April 2002

31 May 2002

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1 Broad Issues - GasNet Services, Terms and Conditions for Services

1.1 Summary of TXU position

In the Executive Summary and section 1.5 of its Issues Paper, the Commission asked whether the allocation of responsibilities between GasNet and VENCorp is appropriate to service the Victorian gas market.

TXU submit that the allocation is flawed, in that GasNet includes reference tariffs without providing a corresponding description of the reference services which GasNet provides.

TXU's concerns relate to:

1. Failure of the GasNet proposals to comply with the strict requirements and intention of the Access Code[1]. This is of particular concern where the reference tariffs claimed by GasNet account for 85% of total transmission charges;

2. A failure to recognise the relationship between GasNet and Users, and resulting uncertainty for TXU as a User of the PTS[2] regarding the applicable services, terms and conditions;

3. A lack of adequate regulatory obligations otherwise imposed on GasNet through the MSO Rules and statute; and

4. Potential avoidance by GasNet of valid access disputes relating to the transportation and capacity services provided by GasNet, on which TXU, VENCorp and other Users rely.

Therefore, TXU submit that GasNet should be required by the Commission to include in its access arrangement a description of the services it provides. This may be a clear description, the Service Envelope Agreement (as in force from time to time), or key obligations from that agreement.

1.2 Detailed discussion

TXU considers that GasNet's position is incorrect for the following reasons.

[1] That is, the National Third Party Access Code for Natural Gas Pipeline Systems
[2] GasNet refers to the combined transmission system as the GasNet System (GNS) whereas VENCorp refers to it as the Principal Transmission System (PTS). TXU prefers reference to the PTS, as it is consistent with various industry contracts.

Code requirements – a reference service for each reference tariff

With GasNet's transmission tariffs accounting for 85% of total transmission costs, TXU believes that there should be a clear detailed description of the corresponding services provided. In its revised access arrangement, GasNet goes to considerable lengths to describe the component parts of its transmission tariffs, but only refers to the corresponding Tariffed Transmission Services as "being the availability of the PTS, which is sourced by VENCorp from GasNet through the Service Envelope Agreement". TXU considers that this is inconsistent with:

1. The intention of the Code, and the preference for unbundling services and tariffs wherever practicable;

2. Clause 5.3.1(a) of the MSO Rules, which requires GasNet "to provide to VENCorp gas transportation services and pipeline capacity" through a valid service envelope agreement;

3. The Service Envelope Agreement (though TXU notes that any amendments to this agreement made since it was originally submitted with GasNet's current access arrangement in 1998 have not been made public); and

4. The reasonable requirements of a significant part of the market (section 3.2(a) of the Code). Users not only need to know that the system is available, they also need to understand any relevant technical performance standards or limitations on the transportation and capacity services provided by GasNet.

Relationship between Users and GasNet

As a User of the PTS, it is important for TXU to understand the exact services provided by each of the system owner and operator. At present, based on the current GasNet and VENCorp access arrangements, the relationship and division of responsibilities is clear. In contrast TXU believes that GasNet's proposed revised access arrangement will not be clear.

TXU must deal regularly with GasNet. Through Gas Transportation Deeds and the Service Envelope Agreement, GasNet invoices TXU, and requires TXU to pay for Tariffed Transmission Services directly to GasNet. When TXU seeks a new connection, or additional capacity on the system, it must deal directly with GasNet. Also, consistent with GasNet's current access arrangement, TXU considers that 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 and GasNet

The MSO Rules do not of themselves impose clear obligations on GasNet to ensure that GasNet maintains the system and provides the transportation and capacity services required by TXU and other users. Similarly, GasNet has a wide discretion outside the role of VENCorp under the MSO Rules in relation to extensions and expansions. Therefore, it is not enough for GasNet to assert that the terms and conditions will be the MSO Rules as in force from time to time.

Access disputes

In seeking any extension or expansion of the system, TXU should be able to enforce an access dispute directly against GasNet. Under the model proposed by GasNet, with no express service provided by GasNet, TXU understands that it could only pursue VENCorp. VENCorp in turn would be limited to contractual remedies, if any, against GasNet. TXU submits that this is inconsistent with the underlying rationale of the access regime.

2 Prudent discounts

2.1 Summary of TXU position

In section 1.5.3 of its Issues Paper the Commission has asked:

"What portion of a prudent discount should be recovered from other users?"

TXU supports prudent discounts where they meet the test set out in section 8.43 of the Code. In relation to the proposed GasNet discounts on the Western Network, TXU believes that such discounts should not be offered until the threat of by-pass is actual rather than perceived.

2.2 Detailed discussion

GasNet has proposed prudent discounts for specific connection points at Warrnambool and Koroit based on the threat of by-pass resulting from the proposed construction of a pipeline from Iona to Adelaide. GasNet asserts that the expected economies of scale on the proposed pipeline are likely to result in the pipeline owner being able to offer significant discounts over the current GasNet WTS tariffs.

TXU submits that section 8.43 of the Code enables a prudent discount to be offered if there is a real threat of by-pass.

3 Merging of the GasNet Access Arrangements

3.1 Summary of TXU position

Refer to section 2.1.1 of the Commission's Issues Paper.

Section 2.47 of the Code states that the regulator must not approve revisions to an access arrangement if a provision of the access arrangement as revised would, if applied, deprive any person of a pre-existing contractual right. Providing the pre-conditions described in section 3.2 are met, TXU is satisfied that its pre-existing contractual rights will be preserved, and would support the merging of the Principal Transmission System (PTS) and Western Transmission System (WTS) access arrangements on the basis proposed by GasNet in its revised access arrangement for the PTS.

3.2 Detailed discussion

Currently, TXU has a transportation agreement (the WTS Agreement) with GasNet to transport gas on the WTS under a contract carriage model. The WTS Agreement expires in 2008 but provides for termination prior to that date upon connection of the WTS to the PTS subject to the following conditions:

1. Approval by the Commission of GasNet's and VENCorp's revised access arrangements giving effect to reclassifying the WTS as a market carriage pipeline and pursuant to which the reference tariff and other terms and conditions are no less favourable than the terms and conditions of the WTS Agreement;

2. TXU being granted Authorised MDQ equivalent to the rights under the WTS Agreement;

3. TXU entering into a gas transportation agreement with VENCorp for use of the PTS; and

4. Inclusion of the WTS in the Service Envelope Agreement.

GasNet, VENCorp and TXU have been working to ensure that the WTS can form part of the PTS. TXU is satisfied that its pre-existing contractual rights have been preserved by work completed to date (allocation of AMDQ), and with GasNet's proposed inclusion of the WTS in the PTS. Therefore, provided:

1. The Commission approves GasNet's proposal for merging of the WTS with the PTS in its revised access arrangement for the PTS; and

2. The Service Envelope is amended to VENCorp's satisfaction to ensure that the WTS and associated assets, performing to acceptable standards,

are incorporated in the system operated by VENCorp under the MSO Rules,

TXU will terminate the WTS Agreement.

4 Inclusion of South West Pipeline (SWP)

4.1 Summary of TXU position

Refer to sections 2.1.2 and 2.7 of the Commission's Issues Paper.

In its June 2001 decision, the Commission concluded that the SWP met the s8.16(a) prudent test but that it did not provide the required system wide benefits (s8.16(b)(ii) of the Code) for inclusion in the PTS asset base.

Consequently, GasNet has proposed stand-alone tariffs for the SWP for most withdrawal zones (including Metro). These tariffs are nearly double that of the equivalent Longford injection tariffs. TXU is concerned that the transmission charges for gas transported from Longford and withdrawal in the "South West" zone are less than gas transported from Port Campbell to the South West zone (see section 6 below for more detail).

TXU submits that:

1. The SWP fails the economic feasibility test as specified in section 8.16(b)(i) of the Code on the basis that the anticipated incremental revenue generated by the SWP would not exceed the capital cost of the SWP; and

2. The proposed tariff is to the detriment of users of the PTS on the basis that the tariff is not likely to encourage upstream competition to the current ESSO-BHP Billiton gas supplies. Further, TXU believe that there are more system benefits to be obtained from the SWP than for the Interconnect.

Therefore, TXU proposes that:

1. The Commission reconsider the basis of the SWP being included in GasNet's Capital Base. Options for inclusion in the Capital Base include application for roll-in of the SWP into the PTS Capital Base based on system wide benefits and/or creation of a speculative investment fund; and

2. GasNet recalculate the Port Campbell injection tariffs such that they are competitive with the Longford injection tariffs.

4.2 Detailed discussion

Economic feasibility test

TXU submits that the SWP fails the economic feasibility test as specified in section 8.16(b)(i) of the Code. That is, the anticipated incremental revenue generated by the SWP would not exceed the capital cost of the pipeline given the proposed GasNet tariff.

The 10 day peak injection tariff of $4.0860/GJ proposed by GasNet is based on the following average volumes as specified in the VENCorp Annual Planning Review (APR) 2001:

Year	Average of 10 peak injections TJs/day
2003	182
2004	207
2005	234
2006	248
2007	256

TXU submits that, given the implications of the proposed GasNet tariffs, these figures now significantly overestimate the likely gas flows, and therefore revenue is overstated.

The VENCorp APR forecasts are based on volumes from Longford and Culcairn being capped at around the current contracted amounts, with all extra gas needed to meet forecast demand supplied via the SWP (presumably from storage) and then from LNG if required. TXU believes that actual gas flows are likely to be different given the proposed SWP tariff level given that:

1. The stand-alone 10 peak day tariff of $4.08/GJ will provide a real disincentive for market participants to utilise the SWP (see further below);

2. *(Paragraph removed for confidentiality reasons)*

Therefore, TXU submits that the SWP would not pass the economic feasibility test under s8.16(b)(i) of the Code at the proposed GasNet tariff.

System wide benefits

In 2000, GasNet applied for roll-in of the SWP on the basis of system wide benefits under section 8.16(b)(ii) of the Code. The system wide benefits identified by GasNet[3] were:

1. System security benefits provided in winter 1999;

[3] Section 2.7 of ACCC Issues Paper, Application for Revision by GPU GasNet Pty Ltd Southwest Pipeline, November 2000

2. Ongoing system security benefits; and

3. Upstream competition benefits – GasNet argued that the SWP must act to stimulate further gas exploration in the Otway Basin to provide competition against ESSO-BHP Billiton.

In making a final decision on GasNet's application for inclusion of the SWP in June 2001, the Commission concluded that there was insufficient operational history to provide a sound basis for assessing GasNet's claims and recommended that GasNet submit its amended roll-in proposal at the time of this access arrangement review (March 2002). In particular, the Commission concluded[4]:

> "*… the Commission accepts that the SWP provides some system wide benefits in terms of section 8.16(b)(ii) of the Code. This includes additional system security for the PTS users and enhanced competition. Importantly, it provides an additional source of supply at times of peak demand (including following an incident). However, the Commission considers that the extent of the likely benefits is currently uncertain.*"

Given that there is further operational information available, TXU believe that with the passage of time, the likely benefits are now sufficiently certain to justify the roll-in of the SWP into the PTS and have SWP tariffs set on this basis.

Increased system security

The Commission, in its Final Decision regarding the SWP dated 29 June 2001, stated that the SWP does provide some system security benefits to users of the PTS. However, the Commission questioned the reliability of the quantities of gas available from both storage and toll processed gas. Since the Commission's Final Decision regarding the SWP dated 29 June 2001, TXU submits that increased system security on the PTS has been achieved through:

1. Increased access to storage volumes resulting in increased utilisation of SWP capacity;

2. Increased certainty of the volume of toll processed gas available from Port Campbell; and

3. Fast response capability – operational procedures and efficiencies now allow gas to be flowed within 1 hour of scheduling. TXU understands that this capability provided a real alternative to LNG (VENCorp is currently modelling this capability).

[4] Page 54 of ACCC's Final Decision, Access Arrangement for PTS, Application for Revision by GPU GasNet Pty Ltd, Southwest Pipeline, 29 June 2001

Increased utilisation of SWP capacity

Since June 2001, VENCorp has undertaken scenario based modelling to determine its optimal system security reserve. The modelling work completed by VENCorp incorporated a range of assumptions and other inputs to determine a realistic risk assessment. The work highlighted:

> *"that in the event of an emergency requiring the system to be safely shut down, particularly during the winter period, the ongoing supply from UGS (and the SWP) at the maximum rate up to 250 TJ / day was essential. In contrast, the Interconnect injections (50 TJ/ day) only provide a marginal effect on pressures in Melbourne. Much of the gas supplied via the Interconnect remains as line-pack in the northern part of the State. The Interconnect is more useful for gas rationing over a period of days following such an event.[5]"*

TXU believes there is now further evidence available that proves the existence of substantial system security benefits.

Specifically, the Iona reservoir and the actions of market participants ensure that there is a significant quantity of gas available all year round for supply to the Victorian market. TXU is currently the major user of the Underground Gas Storage (UGS) facility. Notwithstanding other market participants' actions, TXU's planned use of storage would result in the following minimum quantities being available:

Month end	***Quantity PJ***	***MDQ***
Jan	*6*	*260*
Feb	*7*	*260*
Mar	*8*	*260*
Apr	*9*	*260*
May	*10*	*260*
Jun	*8*	*260*
Jul	*6*	*260*
Aug	*4*	*260*
Sep	*3*	*200*
Oct	*3*	*200*
Nov	*4*	*260*
Dec	*5*	*260*

(Paragraph removed for confidentiality reasons)

TXU faces a heavy penalty if it does not store enough gas to meet these needs, and therefore it is probable that TXU will store more gas than it actually requires. This buffer gas is likely to vary from 0.5PJ to 4PJ. For example, at the end of winter 2001 (October) UGS's inventory of storage gas was 6.7PJ which included 3PJ of cushion gas. Obviously, other market participants may also have stored gas.

[5] ibid

Given that storage refill occurs after the winter period, the total quantity of gas available from storage is likely to exceed the minimum amounts shown in the table above. The average quantity available is likely to be between 6 and 7 PJ whilst the minimum available will usually be 4PJ or 5PJ. Therefore, the SWP is likely to have deliverability of about 260TJ all year round.

Toll Processed Volumes

(Paragraph removed for confidentiality reasons)

The Otway Basin also contains several discovered but undeveloped gas reserves as well as significant undiscovered reserves that may be developed during the 2003-7 period. These include:

1. Minerva/La Bella - approximately 450PJ;

2. Thylacine - approximately 600PJ; and

3. Geographe – approximately 450PJ.

If the SWP tariffs are set comparative to Longford tariffs, TXU would expect that some or all of these fields will be developed and be available for the Victorian market.

Upstream Competition

In its submission to the COAG Energy Market Review, the National Retailers Forum[6] concluded that inter-basin competition was primarily driven by upstream and transportation costs, rather than market design:

> *"Inter-basin competition is economically possible in all major markets. However, based on the above it is clear that:*
>
> *1. inter-basin competition may limit the number of competitors to just two, eg in Melbourne;*
>
> *2. intra-basin competition, such as is possible with the development of the Kipper or other fields in the Gippsland Basin, is also critical;*
>
> *3. pipeline costs have a major impact on the upstream competition."*

GasNet anticipates transportation of sufficient volumes of gas to support the proposed Port Campbell injection tariff. It quotes Santos supplies and gas from Thylacine and Geographe.

[6] Part B, Gas Wholesale Market Reform Issues, 19 April 2002, page 24.

However, TXU submit that the proposed SWP 10 peak day injection tariff of $4.08/GJ will:

1. Significantly affect the likelihood of new gas developments in the Otway Basin;

2. Discourage market participants from contracting new gas supplies in the Otway Basin;

3. Discourage market participants from contracting raw gas in the Port Campbell region.

GasNet's proposed SWP tariff disadvantages the cost of delivered gas to Melbourne from the Otway Basin compared to new gas from the Gippsland Basin. For example, the GasNet delivery of gas to the Metro zone from Iona adds about 11c/GJ more to the transportation cost than gas delivered from Longford (assuming a 50% residential load factor).

In its 2000 submission for roll-in of the SWP, GasNet quoted differentials of $0.08 to $0.13/GJ resulting from a stand-alone SWP tariff compared with Longford. In its final decision on the SWP proposed roll-in, the Commission stated:

"The Commission notes that, while such a differential appears substantial compared with existing tariffs on the PTS, it is questionable whether it would, in practice, have a substantial impact on usage. While the differential would add to the high cost of using the WUGS facility, it would be expected to represent a comparatively small portion of prices of approximately $2.70/GJ and the prospect of substantially higher transmission prices (at least for peak deliverability gas), the price differential would be expected to have only a marginal impact on average for existing and prospective Otway Basin producers."

TXU believes that such differentials can "make or break" a project and that one cannot underestimate the impact on the outcome of a project.

TXU is extremely concerned with the lack of competition that exists in the upstream gas industry. In order to understand the importance of the competition benefits the SWP provides, it is necessary to place in context the current status of the upstream gas market. Below is an extract from TXU's submission to the COAG Energy Markets Review Issues Paper 2002.

"TXU submits this (natural gas upstream competition) is the most critical issue facing Australian stationary energy markets. A negotiating environment of dependent small buyers facing monopolistic suppliers developed through historical accident. One or two players hold control on the few (yet largely unexploited) basins of economic reserves adjacent to Australian population.

…We believe the present behaviour of the suppliers, in particular the refusal to offer terms outside or beyond the timeframe of existing contractual arrangements, is evidential of classic oligopolistic economic withholding. Unlike electricity supply, threat of new entry is negligible in gas supply, as economic basins that can challenge the incumbents in terms of cost, volume and proximity do not exist or face major impediments.

Compare the history of reform with that of electricity, where the vertically integrated monopoly was broken into many upstream and downstream parts. Generators were only given control of only very local fuel or hydro resources, and the many retailers can purchase from a range of incumbent or new entrant producers. In gas, a separate monopoly supply and monopoly retail function coexisted, with a negotiating tension that whilst not necessarily competitive or efficient, was nevertheless reasonably fair. We have since broken up the retailing function into many parts but have not altered the upstream.

Gas retailers have limited sources of supply, which impacts upon their ability to provide innovative, competitive tariff options. Gas producers have limited incentive to offer competitive prices to retailers or innovative solutions to retailers or generators and have significant market power when faced with disaggregated buyers.

The gas market has exhibited extraordinary price stability, which is ironically a prime indicator of the entrenched market power of producers. We must not allow this stability to create a false sense of public contentment in gas prices. If left alone, there is a strong probability of a major price shock when existing contracts terminate, which will provoke a public backlash. The backlash will come after, not before, the window of opportunity closes to address the cause of the price shock.

Suppliers often speak of favourable international price comparisons, but this must be considered against:

- *The east Australian context of large basins, exploitable at low cost.*
- *Its relatively high cost compared to its competitor, coal, that is similarly abundant but whose ownership is diversified.*
- *The fact that east Australian gas basins were discovered as an accident of oil exploration and the incremental capital cost of gas development has already been over recovered.*
- *Customers are faced with a single non-negotiable tariff per gigajoule, and suppliers fail to offer better terms to new customers requesting off-peak supply, despite negligible costs of production.*
- *These prices are set by pre-existing long-term contracts, and it is extremely difficult to obtain any gas price beyond their termination.*

The termination of long-term contracts will occur in big steps; in 2004 in South Australia, 2006 in NSW and 2009 in Victoria. TXU fears price shocks at those dates. Governments will also need to allow retailers to pass this

shock to the vocal consumer, or face a Californian style crisis in the retailing of gas.

The price shock is not limited to gas. It may not be obvious due to its small market share by volume, but the cost of gas has a large effect on the price of retail electricity. During intermediate electricity demand periods (the majority of time), spot market price is set by a range of gas, hydro and coal generation competing for volume in a price-band effectively capped by the fuel cost of gas-fired generation. The spot price then in turn is reflected in forward and retail prices.

With the roll off of gas contracts late this decade, without regulatory intervention a price increase of 50% or more in wholesale gas cost is conceivable. This would then reflect in a rise of perhaps 20% in the wholesale price of electricity. Such a future implies a very large wealth transfer from customers of both gas and electricity in favour of gas producers and non-gas-fired electricity generators, and another rapid expansion of coal-fired generation. Note that the early stages of the Californian electricity crisis were driven by a gas price shock, despite being only a small input cost to that power system."

While the cost of transmission is only one of the issues affecting competition in the upstream gas industry, its impact upon producers' decisions should not be underestimated. This is especially the case where possible new sources of gas supply are green-field sites and are competing with brown-field sites. As stated in TXU's COAG submission, the Bass Strait fields were developed for the recovery of oil and capital costs have already been recovered many times over. The marginal cost of new gas exploration in the Gippsland Basin is low as it is able to leverage off the existing gathering lines and production facilities at Longford. This compares with the cost of developing green-field discoveries in the offshore Otway Basin.

A transmission tariff which discriminates against a relatively unexplored basin may have significant anti-competitive consequences.

The competition benefits that the SWP provides are similar to those contributed by the electricity interconnects between the states and the National Electricity Market. There is no separate transmission charge for electricity interconnects. Users incur a slightly higher anytime transmission tariff to cover the cost of interconnectors but gain the benefit of interstate generators able to supply local markets in times of high demand or local generator problems. Users are protected from higher commodity prices that may occur in a market where they would otherwise be reliant on a small number generators. The SWP provides similar benefits.

TXU submits that the SWP provides competition benefits to all users of the PTS, including base load supply and peak day supply. There are several large fields from which gas is likely to be produced during the next four years.

Exploration in the offshore Otway Basin has accelerated since the SWP was built, with Thylacine and Geographe being discovered in 2001. Competitive SWP transmission tariffs compared with Longford will further encourage development of these and other gas fields to increase upstream competition in the Victorian market.

5 Regulation of LNG Facility

5.1 Summary of TXU position

Refer to section 2.7 of the Commission's Issues Paper.

TXU believes that, depending on the outcome of the commercial negotiation between GasNet and VENCorp targeted for June 2002, the Commission should consider including GasNet's provision of LNG storage capacity for system security gas as a reference service in GasNet's access arrangement.

5.2 Detailed discussion

The LNG storage facility (and GasNet as the LNG storage provider) is subject to the MSOR, specifically section 4.2. These rules set out rights and obligations of VENCorp, the LNG Storage Provider and market participants to maintain sufficient LNG stock to ensure the security of the PTS and to satisfy VENCorp's operating requirements.

VENCorp has contracted with GasNet to provide up to 3,000 tonnes of gas from the LNG storage facility for $1.4m per year with this amount capped by the Tariff Order until 31 December 2002. VENCorp has a contract with GasNet for these services to May at a higher price. Thereafter, VENCorp state the charges will be determined following commercial negotiations with GasNet (refer VENCorp submission letter of 28 March 2002). There is no regulatory guidance in the MSOR or Code for VENCorp to arrange a follow-on contract beyond 2004.

During 2001 VENCorp completed an extensive review, involving all Victorian gas industry Participants and the Office of Gas Safety, of the level of storage required for system security purposes. The review confirmed that 3,000 tonnes of LNG remains necessary for safety/security given current system configuration and demand profile.

At this time, the Office of Gas Safety considers that the integrity of the PTS is dependent on VENCorp having access to 3,000 tonnes of system security LNG. GasNet has the only storage facility capable of meeting this demand.

GasNet's revised access arrangement simply lists the LNG storage capacity as an injection point (see clause 1.3). In the absence of continuing regulation, the price for the 3,000 tonnes storage capacity that is essential for system security will be left to the current commercial negotiations occurring between VENCorp

and GasNet (and between other Market Participants and GasNet). TXU is concerned about VENCorp's negotiation position given the monopoly provision of the LNG storage facility by GasNet.

Therefore, TXU believes that depending the outcome of the commercial negotiations targeted for June 2002, it may be necessary for the Commission to consider the inclusion of the provision of LNG storage for system security purposes by GasNet as a reference service in its access arrangement. The inclusion would be on the basis that it is a service (as a "Service" within the meaning of the Code, i.e. a service ancillary to services provided by means of a covered pipeline) that is likely to be sought by a significant part of the market, at least until an alternative means of providing system security is developed or becomes available.

6 Reference tariff methodology

6.1 Summary of TXU position

In relation to the reference tariff methodology and level of reference tariffs, in sections 2.2.1 and 2.7 of the its Issues Paper, the Commission has asked:

"How would these proposals affect the relative risk of GasNet and users of the PTS?

Are the proposed changes likely to enhance the efficiency and effectiveness of the tariff structure? Do the proposed tariffs meet the objectives of the Code?"

TXU submits that the GasNet tariff methodology does not meet the following requirements of the Code:

1. Section 3.2(a) – "The Access Arrangement must include a description of one or more Services that the Service Provider will make available to Users or Prospective Users, including:

    a. One or more Services that are likely to be sought by a significant part of the market;"

2. Section 8.1(d) – "not distorting investment decisions in Pipelines transportation systems or in upstream and downstream industries;"

3. Section 8.1(e) – "efficiency in the level and structure of the Reference Tariff."

In relation to Services, TXU has set out in section 1 its concerns with GasNet's failure to describe its Services. Further, TXU submits that a significant part of the market does not agree with GasNet's overly complex tariff methodology. The complexity arises from:

1. Multiple (five) injection point tariffs;

2. Injection tariffs being based on 10 day peak withdrawals matching the location of gas injected to the location of withdrawal;

3. The annual wash-up of injection charges increasing from 5 to 10 days in the context of a fully competitive market;

4. The introduction of cross system withdrawal tariffs;

5. Zonal withdrawal tariffs (compared with the current peak and anytime tariffs – although noting that the movement from peak and anytime withdrawal tariffs to tariff D and V volume tariffs does create simplicity and removes the need for an annual wash-up);

6. Basing the zones on Custody Transfer Meters rather than the current post codes will create system and process changes and efficiency complications; and

7. Creation of 3 extra withdrawal zones.

TXU also submits that GasNet's tariff methodology is likely to distort investment decisions in upstream and downstream industries, as it does not take account of recent and likely future developments in the market, particularly:

1. The introduction of full retail competition and the impact that this has on retailer risk profile arising from customer churn;

2. The increasing need for retailers to unbundle charges, including transmission charges, on customer bills;

3. The need to encourage upstream competition and the likelihood of alternative sources of supply in the future.

GasNet has acknowledged that the tariff methodology is more complex for retailers and may act as a barrier to customer churn in a fully competitive market. In particular, the proposed injection tariff methodology is likely to inhibit retail competition given the complexity of matching injection and withdrawal zones, and will require more effort on behalf of retailers to match supply of gas with the customer location. This will reduce the flexibility of retailer operations in the market. It should also be recognised that in proposing the tariff methodology, GasNet has made its proposal on the basis of investment decisions in the PTS and has not considered the upstream and downstream industries.

Lastly, TXU believes that the section 8.1(e) efficiency Code principle is not achieved by GasNet's proposal given:

1. The vast majority of the load will not be responsive to the price signals that underpin GasNet's tariff methodology;

2. Costs of implementing the GasNet proposal are likely to significantly outweigh and benefits;

3. The proposed injection tariff methodology is likely to inhibit retail competition.

The resulting tariffs:

1. Create perverse incentives for sourcing of gas and in some cases may act to inhibit upstream competition;

2. The resulting matched injection tariffs (i.e. injection, cross system withdrawal) are inconsistent with the intent of a market carriage model which was developed to avoid the need to have rights to capacity and to match the flow of gas from the point of injection to the point of consumption. The GasNet methodology does not require the need for capacity rights: however, the required matching of injection to withdrawal zones appears to be inconsistent with market carriage;

3. Create significant discrepancies between rural and urban customers, with GasNet withdrawal price range of $0.28/GJ for a TXU urban residential customer compared with $1.062/GJ for a TXU rural residential customer (across the state the range is $0.05/GJ to $2.56/GJ); and

4. May have the potential to create opportunities in any one year for GasNet to recover (earn) more than its revenue requirement. This arises from the injection tariffs being based on 10 day peak withdrawals and the combination of:

    i. Likely development of upstream competition;

    ii. Customer churn in the full competitive market; and

    iii. Assumptions underpinning the initial tariff calculations compared with actual outcomes of (a) and (b) above.

    TXU has been unable to confirm whether there is an opportunity for GasNet to earn greater than its revenue requirement given the lack of information provided by GasNet on its demand assumptions and

calculations supporting its Average Transmission Tariff set out in schedule 4 of its access arrangement.

TXU submits that the GasNet tariff methodology is inappropriate given the current and likely market developments. The tariff methodology is likely to inhibit upstream and downstream competition, does not reflect the service sought by TXU and potentially creates the opportunity for windfall gains to GasNet. TXU submits that GasNet's tariff methodology is not efficient and does not meet the objectives of the Code.

In light of the above, TXU seeks a complete review of GasNet's tariff methodology to remove the complexity, clarify the information provided and justify and substantiate the proposed changes made. At the very least, TXU submits that the following changes should be made to GasNet's tariff methodology:

1. Removal of MDQ as a basis of charging given the complexities arising from customer churn in a fully competitive market, the mismatch of injection versus customer consumption, and the annual wash-up process;

2. Removal of injection tariffs. At the very least remove all locational injection charging based on matched withdrawals;

3. Maintaining the existing postcode zone allocation methodology;

4. Replace MDQ charging with anytime volume charging (if there is concern about peak pricing signals that can be achieved through a peak anytime charge over the winter period);

5. Replace the injection tariffs with withdrawal based tariffs, consistent with consumption measurement. At the very least remove all locational injection charging based on matched withdrawals; and

6. Aim to aggregate zones to reduce complexity and to reduce rural and urban price differentials.

TXU believes that the tariff structure for distribution pricing achieves the right balance between being easily understood, economically efficient and operational easier to manage.

6.2 Detailed discussion

6.2.1 Market development

Firstly, in assessing GasNet's proposed tariff methodology, TXU believes that it is important to consider changes in the market since the lodgement of the initial

access arrangement, and the likely future market developments. In particular TXU submits that the following should be considered:

1. At time of lodgement of the current GasNet access arrangement (1997):

    a. The Victorian market was fully franchised with progressive introduction of full retail competition (FRC) planned. At that time, very little consideration had been given to the impact of FRC on customer behaviour and what that meant to the market;

    b. The PTS was based on injection at Longford, with limited capacity through the interconnect. This in turn created limited upstream opportunities;

    c. The SWP and interconnect expansion had not occurred and the SWP was not planned until the latter part of the access arrangement period;

2. Now and beyond:

    a. FRC is expected to be implemented by 1 October 2002 (currently all customers greater than 5TJ are contestable);

    b. There are multiple injection points into the PTS - Culcairn, Port Campbell, Pakenham and Dandenong; and

    c. There is the potential for more injection points in the foreseeable future e.g. South Australia.

6.2.2 Multiple injection point tariffs are not appropriate

GasNet is proposing to match the location of gas injected to the location of the withdrawal, and apply a charge based on that distance. The injection tariff assumes that gas flows from the closest injection point to withdrawal point. GasNet will calculate tariffs for each shipper based on actual injections and withdrawals based on up to 4 withdrawal zones.

The International Energy Association in its OECD publication "Natural Gas Transportation – Organisation and Regulation", page 132, questions the appropriateness of this methodology for a transmission system with characteristics similar to that of the PTS:

"When a pipeline is part of a grid with a number of input and off-take points, gas from one input site does not necessarily travel the shortest route to a contractual off-take point if the total system is integrated and optimised. It is then much more difficult to calculate the exact cost of transporting gas. Some studies indicate that the total cost of a network is not solely peak related but

depends on a variety of factors, including the geographical distribution of input and off-take points. Generally, the economics of a grid are much more complex than those of a single pipeline. In bundled regimes, there has been no need to analyse them fully. Yet as access to grids expands and competition in retail gas markets develops, such analysis will be increasingly important."

TXU has the following concerns with the proposed methodology:

1. It is very difficult for retailers to provide unbundled transmission charges to customers given:

    a. Customer consumption is measured at the withdrawal point, not the injection point. It is therefore impossible to truly measure the injected gas allocated to any given customer on any injection day (i.e. user pays principle);

    b. The proportion of gas injected from multiple injection points must be known to determine the transmission costs. It would be extremely difficult, if not impossible, to determine accurately the allocation of injected gas sources for any individual customer. In order to pass through costs to customers, retailers will need to make estimates of the gas injected. This places an unnecessary financial risk on retailers in a fully competitive market;

    c. Further, the source of gas is likely to vary over the life of a contestable customer. Without a uniform injection Reference Tariff, the process of passing through changing injection source costs is further complicated, both in justification to a customer and in reflecting the correct charge.

Obviously the effect of GasNet's proposal is to place higher risks on retailers in their pricing strategies and/or result in customers receiving significant price fluctuations.

TXU notes that the UK system defines gas that can be injected at an entry point and withdrawn at an exit point. A national balancing point (NBP) was created and transportation tariffs set between each entry point and exit point. The tariffs reflect peak volume demanded rather than capacity actually used. This enables retailers and traders notionally to trade gas at the NBP. This concept supports the development of efficient financial spot markets and other financial markets. The value of the exit and entry charges is based on long run marginal cost.

6.2.3 Cross System withdrawal tariffs

TXU submits that the introduction of cross system withdrawal tariffs is not warranted given that:

1. The very nature of the tariffs will increase costs for gas injected outside an Injection Zone and hence inhibit competitive downstream and upstream market development;

2. The current injection tariffs are based on the point of withdrawal, users are charged more the further away they are from the injection point. The cross system withdrawal tariff adds further unnecessary charges for distance;

3. GasNet has not provided any justification for their inclusion; and

4. They introduce another level of unnecessary complexity.

6.2.4 A Maximum Daily Quantity (MDQ) injection charge is inappropriate

TXU believes that a MDQ injection charge is inappropriate given that:

1. As mentioned above, injected gas is not measured on a customer basis;

2. Historical evidence shows that peak injection days and quantities do not necessarily match the peak withdrawal days of any zone;

3. Any intended price signalling is not passed onto customers to minimise consumption on the peak days. This is due to the maximum injections being determined retrospectively and unknown in advance;

4. An MDQ cannot be measured for a typical tariff V customer, even at the withdrawal point, given meter readings occur every second month.

Therefore, the ability for retailers to accurately pass through transmission charges for the mass market customers in the fully contestable market, is likely to be problematic.

TXU is concerned that GasNet is proposing to recover considerably more MDQ injection charge revenue. The injection revenue effectively doubles at the predominant Longford source, through changing the basis from 5 to 10 MDQ allocation days. This will place greater emphasis on the above mentioned risks associated with the injection MDQ.

6.2.5 Annual wash-up

The retrospective MDQ injection charge requires an annual wash-up process. TXU believes that the current wash-up of GasNet's peak injection and withdrawal charges has not worked with limited contestability. The current wash-up process is uncoordinated, time consuming and costly to manage. No process exists for an equitable and fair wash-up between retailers.

The wash-up process will become extremely complicated in a fully competitive market. Greater risk is likely through customer churn, as the cost may not be recovered from the customer switching. In addition, different gas injection point patterns by retailers confuse the process.

GasNet has eliminated the current 5-day withdrawal charge, eliminating the current wash-up withdrawal process. TXU supports this move.

However, the proposed 10-day MDQ injection charge will only further complicate the current wash-up process that does not work. Such an inefficient process should be avoided in the tariff methodology proposed.

6.2.6 Zonal withdrawal charges

The GasNet zonal withdrawal tariffs add to the complexities of pricing in a fully competitive market. In addition, GasNet's proposed zonal withdrawal charges may result in price shock to some customers within specific zones. For example, the Calder and Carisbrook withdrawal charges triple compared with the current uniform withdrawal charge.

Standardising the withdrawal charges would move significantly towards standardising the retail tariffs between rural and urban customers and encouraging competition.

6.2.7 Tariff methodology

In relation to peak charging, VENCorp's Annual Planning Review for the next five years indicates that there is unlikely to be any major congestion on the PTS. GasNet's proposed flat withdrawal charge for each class of customer is consistent with this.

Given the uncongested PTS, TXU submit that GasNet's proposed peak pricing methodology is not necessarily appropriate. TXU understands that the Commission has accepted that cost reflective pricing is not an appropriate methodology for recovery of sunk costs in uncongested systems (refer NECA review of electricity transmission pricing).

6.2.8 Potential inefficiencies

The tariff methodology has the real potential to discourage efficient use of the system and/or result in potential windfall gains to GasNet. This arises from:

1. Transportation of Longford gas withdrawn in the South West zone being cheaper that the transport of gas injected at Port Campbell; and

2. Potential windfall gains arising from the injection tariffs being based on 10 day peak withdrawals and the combination of:

    a. Likely development of upstream competition and the resulting change in the mix of gas injected;

    b. Customer churn in the full competitive market; and

    c. Assumptions underpinning the initial tariff calculations compared with actual outcomes of (a) and (b) above.

Longford versus Port Campbell gas withdrawn in the South West zone

GasNet's proposed tariff methodology does not necessarily encourage sourcing gas from the nearest injection point. For example, it is cheaper to transport injected gas from Longford on a MDQ day into the South West zone (at $2.3152/GJ) than from Port Campbell (at $2.9426/GJ) on a MDQ day.

Obviously this has the perverse incentive of encouraging gas for consumption in the South West zone to be sourced from Longford rather than Port Campbell. In fact, given the level of the Port Campbell injection tariffs, the only time that transportation from the Port Campbell injection point is cheaper than the Longford injection point is when gas is withdrawn in the Western zone.

It should also be noted that relative to injection at Culcairn and withdrawal in the metro zone, Port Campbell tariffs are very high (some 350% higher).

Potential revenue requirement over-recovery

TXU is particularly concerned that the complexity of the structure provides GasNet with the opportunity to recover (earn) more than its revenue requirement in any one year through the out workings of its proposed price control (see section 13 for more detail). TXU's concern arises from differences between forecast and demand assumptions of the injection charges by withdrawal zones.

The GasNet methodology proposes that injections are matched against the nearest zone, which in itself is fine. The key issue is the basis of GasNet's

injection and matched withdrawal assumptions, which GasNet has not provided, and whether they are best estimates arrived at on a reasonable basis (section 8.2(f) of the Code). TXU submits that, in the case of the tariff methodology proposed for injection tariffs, this is unlikely.

The GasNet methodology requires accurate forecast of the matching of injection with withdrawal points which is dependent upon the source of supply of gas (and in turn the level of upstream competition) and on who supplies the customers. In a fully competitive market with expected customer churn TXU believes that any such forecasts are highly subjective and likely to be materially different from assumptions made at the outset of the access arrangement period.

If the entire GasNet injection and withdrawal dynamics are compared to the dynamics of individual users, the charges resulting may differ. It is not clear whether GasNet's calculated revenues are based on individual retailer expectations or on the net system. In basing them on the net system, there may be an over charging of usage on certain pipelines due to specific retailer gas buying patterns.

This can be demonstrated by a simple example:

Scenario 1

There are only two retailers, retailer A and retailer B in the state, supplying only two customers in the state as follows:

1) In the South West withdrawal zone, Customer 1 consumes 100GJ on an MDQ injection day; and

2) In LaTrobe withdrawal zone, the Customer 2 consumes 100GJ on an MDQ injection day.

The resulting GasNet charges (on a single peak injection day, tariff D, looking at injection, cross system and withdrawal) are:

Scenario 1	**GasNet Charges**
Retailer A supplies Longford gas to Customer 1	$257
Retailer B supplied Iona/Port Campbell gas to Customer 2	$427
Total GasNet charges	**$685**

Scenario 2

There is only one retailer.

The resulting GasNet charges (on a single peak injection day, tariff D, looking at injection, cross system and withdrawal) are:

Scenario 2	**GasNet Charges**
Retailer supplies Port Campbell gas to Customer 1	$60
Retailer supplies Longford gas to Customer 2	$306
Total GasNet charges	**$366**

In the scenario 1, both retailers are transporting gas theoretically across the PTS from opposing points. Whereas in scenario 2 the combined retailer need only pay for the transportation of gas from the nearest injection point (which is likely to reflect the position in a non-competitive market). However, in both scenarios GasNet has provided exactly the same service.

The end result is that in a fully competitive market where customer churn is expected, it is possible that under GasNet's proposed injection methodology GasNet could receive a significant premium for its services to that initially planned even though the services are identical. Further, the increase in revenue does not result from GasNet encouraging growth in demand. A similar position is also likely to occur if there is a change in the source of gas compared with the initial assumptions underpinning tariffs.

6.2.9 *Economic efficiency*

In its submission accompanying its access arrangement, GasNet states in section 9.4.1 that "there is no assumed relationship between injections and withdrawals, except in certain zones where matched rebates are offered. This corresponds to the Market Carriage structure, where Users can inject and withdraw as they please, with any differences taken to be purchases (or sales) on the spot market." This is clearly not the case for the injection tariffs being matched to withdrawal zones.

GasNet has provided little justification for its proposed matched injection and withdrawals.

A load that locates close to an injection point will be able to reduce transmission charges. In the face it this may support economic efficiency since it may reduce requirements for investment in transmission capacity and reduce the costs associated with congestion. However, the methodology creates artificial incentives for retailers to match injections and loads for no economic efficiency benefit.

The GasNet proposal for locational transmission pricing signals, which in itself is complex, has not been considered as to how it would fit with possible future reforms of the gas market. Such reforms are likely to provide a more economically coherent and robust system for locational signalling. In particular, TXU has the following comments on economic efficiency issues:

1. There is no evidence that most loads, other than a very small number of large loads would be motivated to change their locational decisions based on these signals. Therefore, a complex system is being imposed on all loads for no economic efficiency benefits. The economic efficiency benefits could be achieved with a simpler approach that focused only on very large loads that might respond to these pricing signals;

2. The economic efficiency and signalling questions associated with transmission tariffs ought to be a considered on a holistic basis together with the structure of the Gas spot market. VENCorp completed a review in March 2001 on the option of introducing hourly locational pricing. The main benefit of introducing hourly locational pricing would be for the spot and forward market prices to manage congestion. The review was subject to extensive consultation with industry participants. It was concluded that congestion occurred too infrequently to justify the costs of shifting to locational hourly pricing, at this time but the option should be considered in the future. The market does provide locational pricing signals through the spot market, uplift payments and ancillary charges. The GasNet proposal overlaps to a considerable extent with the concept of hourly and locational pricing;

3. Further, GasNet has not taken into account the potential complexities that are likely to be created in the event that there is a decision in the future to shift to hourly and locational pricing, or some other form.

7 Pass through

7.1 Summary of TXU position

Refer to section 2.2.1 of the Commission's Issues Paper.

In relation to GasNet's proposed "pass through" mechanism whereby tariffs could be increased to reflect higher costs incurred during a regulatory period (resulting from tax increases, increased regulatory requirements and increased insurance premiums), TXU submits that:

1. Pass through for tax increases seem reasonable; and

2. However, pass thorough for increased regulatory requirements (which is widely defined) and increased insurance premiums is not consistent

with the incentive mechanism proposed by GasNet in its access arrangement nor the intention of the Code.

Further, to the extent that the Commission allows such a mechanism for any or all of the elements proposed by GasNet, TXU submits that at the very least:

1. Appropriate consultation be undertaken by GasNet with affected Users;

2. GasNet only be allowed to pass through the net cumulative impact.

7.2 Detailed discussion

GasNet has proposed a pass through mechanism whereby tariffs could be increased to reflect higher costs incurred during a regulatory period (resulting from tax increases, increased regulatory requirements and increased insurance premiums) without assessment under the review process set out in section 2 of the Code. The mechanism does not require the pass through of decreases in these costs.

The GasNet proposal is for the Commission to have 20 days to decide whether a pass through event has occurred, and failure to do so is deemed acceptance. TXU is concerned that such a mechanism may occur in a non-transparent manner and potentially result in cost shifting to users.

If the Commission does agree with the proposal, TXU believes that:

1. The Commission should give consideration to the impact of the risk allocation in making its decision on GasNet's non-capital costs and rate of return;

2. Such a mechanism is inconsistent with the operation of incentive based regulation (as intended by the Code); and

3. At the very least the Commission should ensure that the appropriate level of consultation with affected Users occurs prior to approval by the Commission.

In light of the above, TXU submits that the Commission should review GasNet's proposal for consistency with:

1. The Code;

2. Other positions put forward by GasNet on its non-capital costs and rate of return; and

3. Best regulatory practice (including consideration of the net cumulative impact before an adjustment is made) of consulting with affected Users prior to regulatory approval.

8 Economic life of PTS

8.1 Summary of TXU position

In section 2.2.1 of the its Issues Paper, the Commission has asked, "What impact do the recent discoveries of new sources of gas supply have on the economic life of the GNS?"

TXU is concerned with the proposed reduction to the life of the Longford to Dandenong pipeline and the reduction in the SWP life to 2052 (compared with industry technical life of up to 60 years). Estimation of reserves is inherently difficult and requires a great deal of judgement and suffers from an asymmetry of information (between producers and buyers). TXU believes that there are valid reasons as to why the pipeline life should remain as it is and submit that the Commission seek independent advice on the economic life of the PTS to critique the terms of reference for the review and the methodology applied by Saturn Resources.

8.2 Detailed discussion

GasNet is proposing to decrease the estimated life of the Longford pipeline from 2030 to 2023, increase the SWP to 2052 (GasNet proposed 34 years in its 2000 roll-in application), and leave the remainder of the system unchanged (2033).

GasNet commissioned Saturn to review its economic life of its assets. In relation to the Longford pipeline, Saturn concluded that the economic life expiry date is 2024[7] based on a 50% probability[8] of Gippsland gas reserves being depleted in 2013 to 2025. Based on this, GasNet has proposed a reduction in the economic life from the Longford pipeline from 2030 to 2023. TXU believes that this is a conservative position to adopt and would like to know what has changed from when the 2030 limit was put in place, some five years ago, compared with now.

In completing its analysis, Saturn relied on proved, probable and likely commercial reserves. Saturn did state that "actual reserves in south east Australian basins may be well above the official reserve estimates[9]." TXU

[7] Remaining Economic life of GasNet's Transmission Assets, prepared by Saturn Resources, page 13
[8] ibid, page 34
[9] ibid, paragraph 13, page 3

offers the following comments which it believes are relevant in assessing the useful remaining life of the Longford to Dandenong pipeline:

1. Esso/BHPB have just embarked on the biggest 3D seismic survey ever conducted over the existing Bass Strait oil and gas fields area at a cost of some $57 million. Obviously, Esso/BHPB would not embark on such a costly program without a reasonable degree of confidence that they will discover one or more new fields;

2. TXU believes that it is fair to expect that the earliest a new discovery in the Bass Strait could come on line by 2006 (but it is more likely to be 2009) with a life expectancy of 20 to 30 years;

3. This optimism on the part of Esso/BHP supports the fact of the long-term utilisation of the Longford to Dandenong pipeline and suggests that the line may well be required beyond 2030; and

4. There have been discussions in the past about the potential benefits of using existing Bass Strait gas fields for storage purposes in the future. While the offshore cost structures would normally work against using these fields for storage it should be noted that Esso has an interest in several very distant gas prone areas which could benefit from storage operations 'close' to the end user. If Esso were to bring gas into south-eastern Australia and use its own storage in the Bass Strait then the Longford to Dandenong pipeline would have a useful life more in line with the SWP.

The ultimate outcome of these issues is difficult the predict with reasonable accuracy, suffice to say there is enough optimism to suggest that the Longford to Dandenong pipeline estimated life should remain at 2030 at this point in time. Future reviews will no doubt address this issue as more information comes to hand.

Further, in relation to the SWP TXU notes that Gutteridge Haskins and Davey[10] in valuing GasNet's initial Capital Base stated that the expected technical life of new high pressure pipelines was up to 60 years. Saturn Resources used 60 years as the basis for the technical life of the pipelines. GasNet has proposed an economic life of 53 years compared with Saturn Resources estimate of 55[11] years.

TXU believes that there are valid reasons as to why the Longford economic pipeline life should remain as it is and the SWP economic pipeline life to be equal to the technical life of 60 years. Therefore, TXU submit that the Commission seek independent advice on the economic life of the PTS.

[10] Transmission Pipelines Australia Access Arrangement 30/11/98 p2
[11] Remaining Economic life of GasNet's Transmission Assets, prepared by Saturn Resources, page 39

9 Capital Base

9.1 Summary of TXU position

In section 2.3.1 of its Issues Paper, the Commission has asked, "Is GasNet's proposed roll forward of the capital base consistent with the requirements of the Code? In particular, does the Code allow for the capital base to be reopened?"

TXU submit that GasNet's proposed re-opening of its Capital Base is inconsistent with the Code and GasNet's current Fixed Principles. Section 8.47 of the Code implies that both the Commission's and GasNet's consent is required to change GasNet's current Fixed Principles.

Further, GasNet's inclusion of a value for easements is inconsistent with the Victorian Government policy at the time of privatisation of attributing no value to easements and would result in a windfall gain to GasNet at the expense of consumers.

Therefore, TXU believes that the Commission should not approve GasNet's proposed changes to its initial Capital Base.

9.2 Detailed discussion

Section 8.14 (which in turn refers to section 8.9) of the Code describes the principles to be applied in adjusting the value of Capital Base over time. The Capital Base at the commencement of each access arrangement period after the first (for Cost of Service methodology) is the Capital Base at the start of the previous access arrangement period adjusted to account for New Facilities Investment (or the Recoverable Portion), Depreciation or Redundant Capital as if the previous access arrangement had remained in force. The adjusted Capital Base proposed by GasNet increases the starting Capital Base for the first access arrangement period by an additional $35.8m for excluded assets and incorrect expression.

TXU does not consider that the adjustment sought for excluded assets and incorrect expression falls within any of the categories allowed for under the Code. Therefore, the proposed adjustment cannot be included in the Capital Base.

TXU also notes that:

1. GasNet's current access arrangement[12] contains a Fixed Principle in relation to GasNet's Capital Base forming part of the revised access arrangement. The Fixed Principle is consistent with the Code requirements and reflects previous Government policy preventing

[12] Refer section 9.2(a)(3) of the Victorian Gas Tariff Order

adjustments to the initial Capital Base in the subsequent regulatory period other than for inflation, depreciation, wholly or partially redundant assets, additions and disposals in the ordinary course of business since 1 January 1998. At the time the initial Capital Base was determined, the Victorian Government attributed a nil value to easements. Section 8.47 of the Code states that "The Reference Tariff Policy may provide that certain principles are fixed for a specified period and not subject to change when a Service Provider submits reviews to an Access Arrangement without the agreement of the Service Provider." This implies both the Commission's and GasNet's consent is required to a change to GasNet's current Fixed Principles;

2. GasNet should not be provided with a windfall gain by allowing the inclusion of the proposed adjustment to the Capital Base. GasNet acquired the Victorian transmission business on the basis of the initial Capital Base, which as stated above reflected Government policy to attribute no value to easements; and

3. Downstream businesses have made investment and/or proposed pricing arrangement based on the initial access arrangement.

10 Capital expenditure

10.1 Summary of TXU position

In section 2.3.1 of its Issues Paper, the Commission has asked, "Is the forecast capital expenditure prudent and is it consistent with the other assumptions in the access arrangement?"

GasNet has not provided enough information for TXU to form a view on the reasonableness or otherwise of GasNet's forecast capital expenditure. TXU believes that the Commission should seek:

1. Clarity from GasNet on how such expenditure relates to GasNet's operating and maintenance program (and costs) and forecast system demand;

2. Seek input from VENCorp as to the consistency of the supporting rationale with VENCorp's Annual Planning Review; and

3. An independent engineer's evaluation of the prudent value of proposed capital expenditure (if it has not already done so).

11 Revenue Elements

11.1 Summary of TXU position

In section 2.5.1 of its Issues Paper, the Commission has asked, "Are these costs consistent with those which would be incurred by a prudent operator?"

TXU has attempted to form a high level view on the reasonableness or otherwise of GasNet's forecast costs. However, not only has GasNet provided no historical information, its forecast information is disclosed in such a way as to make it very difficult for users to reconcile back to the previous access arrangement information or any current publicly available financial information.

TXU believes that in order for GasNet to meet the Attachment A and sections 2.6 and 2.7 Code requirements the following information must be provided:

1. Statement of historical operating costs and capital expenditure, to provide a baseline, and a comparison going forward with proposed costs and expenditure at an appropriate detailed basis in order to form a view on the reasonableness or otherwise of the forecasts;

2. Differences should be clearly explained and substantiated.

11.2 Detailed discussion

TXU is very concerned at the level of increase in tariffs over the access arrangement period. The increase results from a combination of the following:

1. Increase in rate of return from 7.75% real pre-tax to 8.22%;

2. Forecast capital expenditure of some $85m over the period;

3. The proposed $35m increase in the Capital Base;

4. Increased depreciation resulting from increases to the asset base and shortening of the economic life of the Longford to Dandenong pipeline; and

5. Increase in operating costs.

In relation to operating costs, GasNet has provided no historical information in its access arrangement information. Further, its forecast information is disclosed in such a way as to make it very difficult for users to reconcile back to the previous access arrangement information or any current publicly available financial information.

TXU has attempted to form a high level view on the reasonableness or otherwise of GasNet's forecast operating costs by reviewing its initial access arrangement information, GasNet prospectus dated 2001, and the access arrangement information lodged March 2002.

Unfortunately, TXU has not been able to obtain historical information to provide meaningful comparisons with GasNet's forecasts operating and non-capital costs. However, in relation to GasNet's forecasts operating and non-capital costs, TXU has the following comments:

1. GasNet is forecasting operating costs to increase greater than the rate of inflation over the access arrangement period;

2. In relation to the non-capital costs:

    a. TXU assumes that the Commission will confirm the level of the K factor;

    b. Refer section 14 for TXU's comments on the determination of any benefit sharing allowance; and

    c. TXU is surprised at the inclusion of an annual $2.5 million allowance for "its prudent amortised capital raising costs[13]."

12 Level of reference tariffs

12.1 Summary of TXU position

In section 2.7 of its Issues Paper, the Commission has asked:

"Is the cost allocation approach appropriate (60% peak, 40% annual demand)?

Is a 38 per cent increase in 2003 and then a real decrease of 4.5 per cent in each subsequent year of the AA period an appropriate average revenue path?"

TXU submits that GasNet's proposed tariff path is unacceptable. Therefore, TXU requests that in its deliberations the Commission aim to minimise any potential price shock impact of GasNet's tariffs to end use customers. In particular, TXU requests that the Commission consider making it a pre-condition of approving the GasNet access arrangement on the basis that the Reference Tariffs reflect a smooth transitional from the current level in 2002 to the level required by 2007 to provide GasNet with equivalent net present value of required revenue.

[13] Section 3.5 of GasNet Access Arrangement Information, draft 27 March 2002

12.2 Detailed discussion

TXU is surprised at the tariff path proposed by GasNet.

GasNet 2003 forecast target revenue is very high comparative to other years as a result of a significant level of non-capital costs (particularly the K factor carryover and benefit sharing allowance). Therefore, GasNet has aimed to smooth the impact of the 2003 forecast revenue over the whole period by levelising its target revenues over the access arrangement period. However, given the significant increase in all other costs over the access arrangement period that make up its target revenue, an unacceptable initial price has been proposed by GasNet. This option would be feasible if all other costs were relatively flat compared with the assumptions underpinning the current tariffs; however, this is clearly not the case.

GasNet should be ambivalent to the price path chosen given that GasNet will forecast to recoup the equivalent net present value of its target revenue whatever tariff path is used.

Therefore, in setting its tariffs GasNet should take into account the potential impact on end use customers and aim to minimise price shocks.

13 Operation of "K" factor

13.1 Summary of TXU position

In section 2.7 of its Issues Paper, the Commission has asked:

"Is the operation of the K factor consistent with the aim that the costs of the SWP be fully recovered from users of the SWP?

Is this limitation to the annual rebalancing of tariffs from those currently proposed appropriate?"

TXU submits that:

1. The ability for GasNet to pass through the full extent of a prior year loss in conjuction with an ability to rebalance individual tariffs is likely to result in retail price shocks and therefore is unacceptable. . TXU submit that the K factor recovery must be subject to an appropriate rebalancing constraint on tariffs;

2. It is concerned that GasNet's proposed price control formula provides GasNet with an opportunity to earn more than its revenue requirement for reasons outside its control;

3. It is concerned that the proposed price control formula shifts risks from GasNet to retailers. GasNet has not provided enough information for TXU to determine whether this is the case or not. If there is proven to be a shift in risk allocation, the Commission should consider the shift in assessing the appropriate return on assets for GasNet and/or the level of GasNet's operating costs; and

4. GasNet's price control formula is inconsistent with its tariff methodology and at the very least GasNet should either seek roll-in of the SWP (refer section 4) or propose a price control formula which separates the SWP tariffs from the rest of the PTS tariffs.

TXU requests that the Commission confirm that GasNet's proposed price control formula, in light of GasNet's tariff methodology, meets the section 8.1(f) Code requirement to provide "an incentive to the Service Provider to reduce costs and to develop the market for Reference and other Services." Further, TXU requests that the Commission consider the retail price shock implications of GasNet's incentive mechanism in its deliberations.

13.2 Detailed discussion

TXU has attempted to understand the relationship between GasNet's proposed tariff methodology and its proposed price control formula. However, given the complexity of GasNet's tariff methodology and lack of information provided by GasNet on its demand assumptions and calculations supporting its Average Transmission Tariff (ATT) set out in schedule 4 of its access arrangement, TXU has been unable to ascertain what incentives or otherwise GasNet's proposal has on its behaviour and ability to earn revenue above that forecast outside its control.

Having said that, TXU believes that the average price control formula proposed by GasNet potentially passes the risk of differences between changes in demand assumptions (which underpin the initial tariff calculations) and actual demand to users. Or put another way, TXU is concerned that the price control formula does not recognise the likely shift in the retailers load characteristics as the competitive market develops over the access arrangement period.

Further, the GasNet proposal has the potential to provide price shocks to end use consumers through price control formula and the additional ability to rebalance individual tariffs. TXU submits that the K factor recovery should be linked to an appropriate constraint on rebalancing tariffs.

TXU submits that such risk transfer is inappropriate, particularly given the complexity of the tariff methodology proposed by GasNet. As stated in section 6, TXU has concerns with the proposed peak injection by withdrawal tariffs and

GasNet has not provided enough information to enable TXU to fully understand the implications of the GasNet proposal.

Further, TXU is surprised that GasNet has not sought roll-in of the SWP but through its proposed price control formula it effectively treats the SWP as a rolled-in asset. TXU believes that the price control formula should be consistent with GasNet's tariff methodology and either seek roll-in of the SWP (refer section 4) or propose a price control formula which separates the SWP tariffs from the rest of the PTS tariffs.

14 Performance and incentives

14.1 Summary of TXU position

In relation to the calculation of efficiency gains to be carried forward, in section 2.8 of its Issues Paper the Commission has asked:

"Is it reasonable to calculate efficiencies solely on the basis of forecast operating costs, and for GasNet to retain a share of gains but not losses?

Would GasNet's proposal provide appropriate incentives and a fair sharing of efficiencies? How does GasNet's proposal compare with the ESC approach?"

TXU submits that:

1. GasNet's proposal to calculate efficiencies against forecast expenditure may result in GasNet not passing on actual efficiency gains to users;

2. Further, given GasNet's proposal to use the benchmark based on forecast costs adjusted for additional workload, users are likely to pay for GasNet inefficiencies and/or GasNet is likely to get compensated for efficiencies that do not exist;

3. TXU recommends that the approach adopted by the commission and the ESC be consistent.

15 KPIs

15.1 Summary of TXU position

In section 2.8 of its Issues Paper, the Commission has asked, "Are the KPIs provided and the benchmarks chosen the most appropriate ones, and has GasNet correctly interpreted the results?"

TXU notes that not enough detail has been provided by GasNet to form a view as to whether GasNet has correctly interpreted the results nor does TXU have any confidence that GasNet has correctly calculated the KPIs.

TXU is concerned as to whether the KPIs provided are meaningful and requests that under sections 2.6 and 2.7 of the Code:

1. GasNet provide further detail on the basis of its calculations for the Australian benchmarks provided; and

2. Make publicly available annexure 9 of its submission, 2001 Comparative Performance Benchmarking for Natural Gas Pipeline Industry prepared by Cap Gemini.

15.2 Detailed discussion

Based on the information provided, TXU believes that the KPIs provided may be misleading.

In terms of calculating the benchmarks, GasNet has excluded many items including compressor costs, maintenance capital expenditure, and made adjustments to its forecast costs for 2003 "to provide for a fairer inter-company comparison[14]." Reasons have been provided by GasNet for the exclusions and adjustments. TXU is not convinced of the validity of the reasons given. For example:

1. TXU believes that in fact GasNet does monitor very carefully VENCorp's operation of its compressors, relying on the provisions of the Service Envelope Agreement to ensure that they are safely and efficiently operated by VENCorp. TXU does recognise that the cost of compressor fuel is treated differently by other pipelines. However, TXU believe that in addition to determining benchmarks without compressor fuel, GasNet should be able to derive benchmarks with compressor fuel in order to provide a basis for determining whether its forecast compressor costs are reasonable;

2. TXU does not agree with the exclusion of maintenance capital expenditure, and questions whether GasNet has excluded such expenditure from the companies benchmarked;

3. In terms of adjustments to GasNet's forecast costs, TXU would like to know the basis for and what allowance has been made for gas control to account for VENCorp's functions. Further, TXU would like to understand further the reasoning for excluding the incremental insurance costs.

In relation to the international benchmarking analysis completed by Cap Gemini, GasNet states that "these costs were defined specifically to enable intercompany comparisons and are not defined in the same way as the overall

[14] Section 6.1 of GasNet Access Arrangement Information, draft 27 March 2002

activity costs referred to above[15]." GasNet provides no further details on how the costs were defined.

TXU requests that the Commission seek clarity on the above. In addition, TXU requests that Annexure 9 of GasNet's submission, 2001 Comparative Performance Benchmarking for Natural Gas Pipeline Industry prepared by Cap Gemini be made publicly available under sections 2.6 and 2.7 of the Code.

16 Extensions and expansions

16.1 Summary of TXU position

Refer to section 2.9 of the Commission's Issues Paper. GasNet's Extensions and Expansions Policy states that an extension or expansion to the PTS is covered by the access arrangement unless GasNet provides written notice to the Commission, before the extension comes into service, that the extension will not be covered by the access arrangement.

TXU believes that all **expansions** must be covered by GasNet's access arrangement for the PTS. To have a situation whereby an expansion is not covered by GasNet's access arrangement may lead to operational issues. In particular, if capacity was upgraded it would be very difficult to distinguish the difference between that part of the facility or pipeline that is providing the original capacity and that which is providing the expanded capacity.

TXU believe that the GasNet's proposed access arrangement does intend for expansions to be automatically covered. However, to provide clarity TXU submits that GasNet's Extensions and Expansions Policy should make explicit provision for any expansion of the PTS to be automatically covered by GasNet's access arrangement (through the Service Envelope Agreement and MSO Rules).

17 Information

17.1 Summary of TXU position

In section 2.10 of its Issues Paper, the Commission has asked:

"Is all Attachment A information provided?

Are users and prospective users able to understand the derivation of the elements in the proposed revised access arrangement and form an opinion as to the compliance of the access arrangement with the provisions of the Code?

Has GasNet satisfied the access arrangement information requirements of the Code?"

[15] GasNet Access Arrangement Information, draft 27 March 2002, page 36

TXU believes that GasNet has not satisfied the requirements of sections 2.6 and 2.7 of the Code. In addition, what information has been provided is difficult to read and fully understand given the short time available to assess. Therefore, TXU believes that the Commission needs to request GasNet to resubmit its access arrangement under section 2.9(b) of the Code.

17.2 Detailed discussion

TXU has requested[16] that the Commission seek the following additional information from GasNet:

1. Justification for the apparent re-opening of the asset base (i.e. inclusion of extra $35.8m claimed shortfall – refer Issues Paper, section 2.3.1).

2. Statement of historical operating costs and capital expenditure, to provide a baseline, and a comparison going forward with proposed costs and expenditure. Differences should be clearly explained and substantiated.

3. Clarify the explanation that underpins the proposed capital expenditure in the subsequent regulatory period, and whether there should be an independent engineer's evaluation of the prudent value of proposed capital expenditure.

4. Justification for change in the expected lifetime allocated to assets. Specifically, making public Annexure 6.

5. Comparison and demonstration of the impact the proposed tariff changes have on end-use customer charges.

6. Extent that assets funded by government payments have been accounted for in the asset base (eg. payments referred to in Auditor General Report, Victoria, 1998-99 – section 6.67 and GasNet Prospectus 2001, Southwest Pipeline Trust, page 53).

Further information requests from GasNet:

1. Demonstrate the effectiveness of the revenue control formulae and in particular how the correction factor adjusts for differences in actual versus forecast MDQ injection withdrawal assumptions (see section 13);

2. Demand by zone and service category to enable reconstruction of the tariffs:

[16] Letter from Ms Caryle Demarte, General Manager, Government and Regulatory Affairs, TXU to Mr Michael Walsh, project Manager, Regulatory Affairs – Gas, ACCC, dated 3 May 2002.

a. For withdrawal tariffs volume over each zone by reference service;

b. For injection tariffs total 10 day peak MDQ matched to withdrawal zones;

3. Demonstrate the validity of the tariff derivation and provide details on cost allocation by each reference service and zone;

4. Demonstrate how the forecast capital expenditure relates to GasNet's operating and maintenance program and VENCorp's APR (see section 10);

5. Demonstrate whether or not GasNet's proposed price control formula and tariff rebalancing mechanism results in a shift of the current retailer risk profile relating to GasNet charges (see section 13);

6. Provide details and rationale of adjustments made to GasNet's benchmarking analysis. This may be achieved by making publicly available annexure 9 of its submission.