21 April 2011

Jemena Limited
ABN 95 052 167 405

321 Ferntree Gully Road
Mount Waverley VIC 3149
Locked Bag 7000
Mount Waverley VIC 3149
T +61 3 8544 9000
F +61 3 8544 9888
www.jemena.com.au

By email: qldsagas@aer.gov.au

Mr Warwick Anderson
General Manager
Australian Energy Regulator
GPO Box 3131
CANBERRA ACT 2601

AER Draft Decisions for the Envestra Ltd access arrangement proposals for the South Australian and Queensland gas networks

Dear Mr Anderson

Jemena appreciates the opportunity to make this submission on the AER's draft decisions for the South Australian and Queensland gas networks owned by Envestra Ltd.

Because both draft decisions deal in a similar way with the issues of most concern to Jemena, we have produced a single submission. Those issues are:

- the network management fee paid by Envestra to the APA Group
- the trigger mechanism required by the AER for Envestra's access arrangement upon commencement of the National Energy Retail Law and/or National Energy Retail Rules in Queensland and South Australia.

Jemena's response to the AER's request for comments is set out in **Attachment 1**.

Jemena directly owns Jemena Gas Networks in NSW (**JGN**), the largest individual gas distribution network in Australia, and Jemena Electricity Networks in Victoria (**JEN**). Jemena partially owns the United Energy Distribution electricity distribution business in Victoria (34%) and the ActewAGL gas and electricity distribution business in the ACT (50%).

Jemena looks forward to the AER's consideration of matters raised in this submission. If you wish to discuss the submission further, I can be contacted on (02) 9270 4512 or email: sandra.gamble@jemena.com.au.

Yours sincerely

Sandra Gamble

Sandra Gamble
General Manager Regulation and Strategy
Jemena Limited

Attachment:
1. Jemena, *Response to AER draft decisions —Envestra Ltd, Access arrangement proposal for the SA gas network* and *Envestra Ltd, Access arrangement proposal for the Qld gas network*, both 18 February 2011

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ATTACHMENT 1

AER Draft Decisions for the Envestra Ltd access arrangement proposals for the South Australian and Queensland gas networks

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1. The network management fee paid by Envestra to the APA Group

1.1 AER reasoning

The AER has applied the same conceptual framework set out in the AER's Victorian electricity distribution decision, plus some additional arguments, to determine if Envestra should be allowed to recover the network management fee (NMF) paid to the APA Group (APA) for its South Australian and Queensland gas networks.

In addition, the AER has linked recovery of an outsourced network management fee to regulatory incentive arrangements.

The AER Queensland draft decision uses the lack of an efficiency carryover mechanism to infer under rule 71 of the NGR that a distributor can be allowed an outsourcing margin, and that the margin would thus be compliant with rule 91.

The South Australian draft decision has disallowed a margin on the grounds that an efficiency benefits sharing scheme (EBSS) operates in SA - similar to that in electricity - whereby Envestra will be allowed to retain outsourcing efficiencies, but for only a limited time. The AER's rationale is that an EBSS requires a service provider to eventually share efficiencies (including from outsourcing) with customers, whereas allowing an outsourcing margin (in combination with an efficiency carryover) permits a service provider and its related party contractor "to withhold from consumers the benefits of the efficiencies derived from their outsourcing agreement for an indefinite period of time".[1]

The AER's underlying logic is that if an asset owner and its outsourced contractor are related, any benefit an asset owner gains from an EBSS (calculated using the contractor's base costs) replicates a competitive market and rewards a service provider for the efficiencies achieved through its contractor's economies of scale and scope. How the service provider and contractor share those rewards is a matter for them.

In contrast, where an EBSS does not apply, a service provider may recover the outsourcing profit margin until the next price review, at which time the AER will examine the issue again.

1.2 Jemena comments

Jemena contends that AER reasoning process outlined above is an inconsistent decision-making approach for assessing whether an outsourcing margin meets the requirements of the National Gas Rules (NGR), in particular rule 91.

The AER's argument has some fundamental flaws. In particular, when the AER currently applies an EBSS in regulatory decisions, it is specifically directed only at opex. However, the AER has either allowed or disallowed a margin for Envestra's networks which effectively applies to both capex and opex The NMF (margin) is a calculated as a percentage of revenue, and is not specific to either capex or opex.

[1] AER Draft Decision: *Envestra Ltd, Access arrangement proposal for the SA gas network, 1 July 2011 – 30 June 2016*, February 2011, p. 140.

Another inconsistency is that the AER's argument should apply equally to related and unrelated contractors. While a margin paid to an unrelated contractor might easily pass the first leg of the AER's 'two step test' (the presumption threshold) depending on the circumstances, the AER's reliance on the existence of an EBSS to determine if efficiencies are being shared appropriately with customers simply clouds the underlying issues that the AER should be examining under the rules.

The AER's logic provides no long term certainty to regulated businesses. While the AER has indicated that it will re-examine the NMF for Envestra's Queensland network at the next review, the AER has provided no certainty either way as to how it will treat this margin in the longer term. Consequently, there is no firm base upon which a business like Envestra can make decisions about future related party outsourcing.

Overall, Jemena considers that the AER's Victorian decisions on an outsourcing margin for regulated businesses, together with the Envestra gas decisions, offer businesses very little flexibility in constructing efficient outsourcing arrangements including a margin that the AER would accept as being consistent with the expenditure that would be incurred by a service provider acting in the manner prescribed in rule 91(1).

1.3 NERA analysis of AER reasoning

In Jemena's view, Envestra has responded with a well-argued revised access arrangement information submission for both its South Australian and Queensland draft decisions to counter the AER's uncritical application of the Victorian electricity distribution framework to its networks. In particular, Envestra has submitted a report from NERA which carefully examines this framework as applied in the South Australian draft decision.[2]

Without repeating the NERA analysis in detail, Jemena finds the following NERA views to be particularly compelling:

Appropriate benchmark

The price payable by a service provider under an outsourcing arrangement can be taken to be consistent with the expenditure that would be incurred by a service provider acting in the manner prescribed in rule 91(1), if at the time the service provider negotiated the contract terms it agreed to pay a price that it reasonably expected to be less than or equal to the risk-adjusted cost of providing the service in house (after taking into consideration any incremental co-ordination costs).

It is this test that provides the appropriate benchmark against which to assess outsourcing arrangements.[3]

What a regulator should examine

Any concern about the potential for the price struck within an outsourcing contract to be 'artificially inflated' should not be addressed by excluding the entire margin on a per se basis. Rather, if a regulator were concerned about the potential for this to have occurred, then a detailed examination of the contract price and other terms and conditions should be undertaken having regard to the test outlined above.

AER's assessment framework

[2] NERA Economic Consulting: *Assessment of Outsourcing Arrangements - A report prepared for Envestra*, 22 March 2011.

[3] NERA, op. cit., p. 6.

This framework, at its most elementary, comprises a two stage inquiry process: the 'presumption threshold' and an economic rationale.

Where a regulated service provider is found to have had no incentive to agree to non arms length terms, the contract will be deemed to pass the presumption threshold and any further analysis of the contract will be undertaken having regard to the criteria specified in stage 2A of the framework.

In those cases where a regulated service provider is found to have had an incentive to agree to non-arm's length terms, the contract may still pass the AER's presumption threshold if it was subject to a "competitive open tender process in a competitive market". In the absence of such a tender, the contract will be deemed to fail the presumption threshold and any further analysis of the contract will be undertaken having regard to the criteria specified in stage 2B of the framework.

In its current form, stage 2B of the AER's framework does not specify the test against which outsourcing arrangements that fail the presumption threshold should be assessed. This is a fundamental shortcoming of the current framework and could be addressed if the AER were to adopt the "appropriate benchmark" test [described above][4].

Ability to access the same level of efficiency

For the reasons set out in its report, NERA does not agree with the AER's presumption that in cases where a contract is deemed to fail the 'presumption threshold' it can necessarily be assumed that the regulated service provider will be able to access the same level of efficiency as its contractor (or by implication incur the same level of costs as its contractor).[5]

NERA therefore disagrees with the more fundamental assumption implicit in stage 2B of the AER's framework, which is that a contract that fails the presumption threshold can never be viewed as being more efficient than the regulated service provider undertaking the services itself.

In NERA's opinion, these are genuine deficiencies with the AER's framework and could, depending on the circumstances, result in:

- a regulated service provider failing to recover the efficient costs incurred under its outsourcing contract where the contract genuinely constitutes a prudent and efficient outcome
- a regulated service provider having a perverse incentive to bring the services back in-house or to enter into another outsourcing arrangement
- a regulated service provider having an incentive not to outsource even though to do so may genuinely constitute a more prudent and efficient outcome.

2. 'Trigger event' for the NECF

2.1 AER requirements

In both the SA and Queensland draft determinations, the AER required insertion of a 'trigger clause' in Envestra's access arrangements, potentially to be activated upon implementation of the National Energy Customer Framework (NECF).

The AER's reasoning is:

[4] NERA, op. cit., p. 19.
[5] NERA, op. cit., p. 30.

> "The AER notes that the retail energy and gas connections frameworks are expected to be introduced during the access arrangement period. These frameworks may impact on the terms and conditions of access for users and potential users, such as the credit support provisions proposed under the National Energy Customer Framework (NECF). In these circumstances, the AER considers that a trigger event should be included to enable the AER to review the approved terms and conditions of access for consistency with the arrangements proposed under these new frameworks."[6]

The AER's required amendment is included in amendment 13.43 in the SA draft decision as follows:

> 2) Include the following new clause 9.3:
>
> The AER may require Envestra to revise its Access Arrangement for inconsistencies between the proposed terms and conditions and the NGL or NGR.
>
> The revisions submission date stated in clause 9.1 of the access arrangement proposal will advance on the occurrence of a trigger event described below. For the purposes of this clause, a 'trigger event' occurs if:
>
> (a) there is an amendment to the NGL or the NGR, or the National Energy Retail Law or National Energy Retail Rules commence operation in Queensland[7]; or
>
> (a) the STTM does not operate as anticipated and the Access Arrangement does not effectively accommodate the STTM; and
>
> (b) the AER provides Envestra with a notice stating that the circumstances described in (a) or (b) are significant. An amendment or the commencement in Queensland of the National Energy Retail Law or National Energy Retail Rules is significant if it affects reference tariffs. The new review submission date will be the date 6 months from the date of the notice provided by the AER under this clause.

2.2 Jemena comments

Rather than adding certainty to access arrangements, Jemena finds the AER's draft decisions on the NECF trigger event for Envestra to be confusing and contradictory.

The draft decision states that the trigger event is designed to allow the AER to review the impact of the NECF on the terms and conditions of access (credit support is cited as an example).

Additionally, the draft decision has also tied the trigger event (the NECF) to a change in reference tariffs - an event is "significant" if it affects reference tariffs, and hence a new review submissions date can be required by the AER.

If the trigger event (the NECF) occurs and the AER notifies Envestra to revise its Access Arrangement, the AER's proposed clause 9.3 states that "the revisions submission date stated in clause 9.1 of the access arrangement proposal will advance". Jemena considers this to mean that, under NGR rule 52 and Envestra's proposed access arrangement, a full review

[6] AER Draft Decision: *Envestra Ltd, Access arrangement proposal for the SA gas network, 1 July 2011 – 30 June 2016*, February 2011, p. 250. NOTE: The SA and Queensland decisions are identical in respect of the trigger event, so only the SA draft decision is referenced in this section.

[7] This reference to Queensland must be an error, given that it is the SA decision.

of the access arrangement will be required within 6 months of the date in which the AER provided notice to Envestra. In other words, the review will not be restricted to examining particular elements of the access arrangement relating to the NECF.

While it appears from the explanation in the draft decision that the AER has only contemplated a partial review of the access arrangement which is confined to "inconsistencies between the proposed terms and conditions and the NGL or NGR", the draft decision amendment 13.43, as written, implies otherwise. Jemena is unaware of any provisions of the NGR which would permit the AER to initiate a partial review of an access arrangement.

As a result of the uncertainties and inconsistencies in the Envestra draft decisions, Jemena recommends that the AER in its final decisions:

- states definitively that the appropriate cost pass through mechanisms in the Envestra access arrangements will be the sole avenues for recouping Envestra's legitimate NECF expenditures in the 2011-2016 access arrangement period

- confirms that the AER will not bring forward a full review of the Envestra access arrangements in response to an amendment to the NGL or the NGR, or commencement of the National Energy Retail Law or National Energy Retail Rules.