Minister for Energy and Resources

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Mr Andrew Reeves
Australian Energy Regulator
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Dear ~~Mr Reeves~~ Andrew,

VICTORIAN GAS ACCESS ARRANGEMENT REVIEW - VICTORIAN GOVERNMENT SUBMISSION

Thank you for the opportunity to make a submission regarding the Australian Energy Regulator's (AER) consideration of the Victorian Gas Access Arrangements Review. The AER's review marks an important point in the maturation of the national regulatory structure for gas pipelines. Victoria's residential and small-to-medium commercial sectors have unusually high rates of gas penetration for Australia, so getting the investment and pricing decisions right for the gas industry is particularly important for Victoria.

The attached submission represents my views as Minister for Energy and Resources on the draft determination and revised access arrangement proposals submitted by the Victorian gas businesses. If you have any questions regarding this submission, please contact Raif Sarcich, Director - Retail Energy Development in the Department of Primary Industries on (03) 9658 4160 or raif.sarcich@dpi.vic.gov.au.

Yours faithfully,

Michael O'B

HON. MICHAEL O'BRIEN MP
Minister for Energy and Resources

14 / 1 / 2013

Encl.

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SUBMISSION TO THE AUSTRALIAN ENERGY REGULATOR

VICTORIAN GAS ACCESS ARRANGEMENT REVIEW JANUARY 2013 – DECEMBER 2017

REVISED PROPOSAL AND DRAFT DETERMINATION

I welcome the opportunity to make this submission to the Australian Energy Regulator (AER) on its draft determination on the Gas Access Arrangement Review for the Victorian gas distributors for the period 1 January 2013 to 31 December 2017, and the gas distributors' revised proposals.

This submission focuses on the following aspects of the AER's draft determination and the gas distributors' revised proposals:

- The weighted average cost of capital (WACC)
- Capital expenditure
- Operating expenditure
- Incentive mechanisms.

Weighted average cost of capital (WACC)

I support the AER's draft determination on the WACC for the gas distributors' access arrangement.

However, I note that each of the gas distributors has provided additional information to support their claim for an increase in the risk free rate used to determine the cost of equity from 2.98% to 5.00%. They have argued that the AER has incorrectly applied the Capital Asset Pricing Model (CAPM) by combining an estimate of the Market Risk Premium (MRP) based on historic data and a current day estimate of the risk free rate.

Multinet has argued that, in determining the cost of equity, the AER should either[1]:

- Adopt 'spot estimates' of the risk free rate and MRP; or
- Adopt long-term averages of the risk free rate and MRP.

Rule 87 requires that the estimate of the return on equity contributes to the achievement of the allowed rate of return objective and must have regard to the prevailing conditions in the market for equity funds. The allowed rate of return objective is:

> *The rate of return for a service provider is to be commensurate with the efficient financing costs of a benchmark efficient entity with a similar degree of risk as that which applies to the service provider in respect of the provision of reference services.*[2]

This does not constrain the AER to one approach or another, or preclude the AER from combining approaches in attempting to set the overall rate of return at a reasonable and efficient level. In considering the additional information submitted by the gas distributors, the AER should determine the WACC estimate holistically, rather than the outcome of separate consideration of each WACC

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[1] Multinet, *Gas Access Arrangement Review, January 2013 – December 2017, Revised Proposal and Response to Draft Decision,* 9 November 2012, *page* 169

[2] National Gas Rules, rule 87(3)

parameter, to ensure that the allowed rate of return objective and the National Gas Objective are met.

Capital expenditure

The decision on the capital expenditure relies on information that is submitted by the gas distributors on a confidential basis and on bilateral communication between the AER (or its consultants) and the gas distributors. As a result, the comments in this submission are necessarily at a high level rather than on points of detail.

Subject to the comments below, I support the approach taken by the AER in its draft decision to consider the level of historical expenditure and to include a pass through event for low pressure to high pressure mains replacement. I note that the gas distributors' revised proposals are seeking to increase the forecast volume of pipeline replacements and to make amendments to the pass through event.

In making its final decision, the AER should work closely with Energy Safe Victoria to clearly understand:

- the obligation that will be placed on the gas distributors to replace pipelines during the access arrangement period;
- how this obligation compares with the obligation that has been placed on the gas distributors during the current access arrangement period, noting that the gas distributors have replaced a smaller volume of pipeline than forecast; and
- the extent to which there is any certainty that the gas distributors will replace the forecast volume of pipelines.

These matters clearly impact upon the appropriate treatment of capex for pipeline replacement. In the last period, the distributors have undertaken less pipeline replacement than was forecast by the Essential Services Commission. This has manifested itself in cost savings for distributors and improved profitability but also, arguably, poorer performance in terms of gas leakage. There may be safety implications of under-investment in pipeline replacements, which Energy Safe Victoria may have an interest.

While gas distributors have incentives to undertake mains replacement to some extent – for instance to minimise unaccounted-for gas under the Victorian benchmark scheme in the Gas Distribution System Code, these have clearly not incentivised gas distributors to undertake as much pipeline replacement as was forecast to be efficient in the last period.

On the other hand, gas distributors have strong obligations to maintain the safety of their pipelines, which must be backed by efficient levels of capital expenditure.

In weighing up the relevance of incentives and obligations in this area, the AER should carefully consider the balance between an incentive-based economic regulatory regime – which provides an incentive for a gas distributor to improve efficiency – and a cost of service regime (which is the effective outcome of reliance on pass through events to manage changes in costs) which blunts the incentive for a gas distributor to improve efficiency.

If the obligation on the gas distributors to replace pipelines:

- is stronger than in the current access arrangement period and there is thereby a higher degree of certainty that the pipelines will be replaced than during the current access arrangement period, then the AER can err on the side of forecasting a higher volume of pipeline replacements as part of the allowed revenue and provide the gas distributors with a stronger incentive to improve efficiency;
- is the same as, or weaker than, in the current access arrangement period, then the AER should err on the side of forecasting a lower volume of pipeline replacements as part of the allowed revenue and rely on the pass through mechanism for the gas distributor to recover additional revenue from customers if required. This will ensure that customers only pay for gas pipelines that are replaced.

If a pass through mechanism is used, it should be designed in a way to maximise the incentives for efficiency improvements on the gas distributors, to smooth the impact of any price impacts on customers and, if necessary, to be symmetrical.

To maximise the incentives on the gas distributors, the pass through mechanism could be linked to a benchmark length of pipeline which is forecast to be replaced. The pass-through could be then limited so as to vary the revenues only to the extent that there is variance between the actual and forecast length of pipeline replaced, and be based on agreed unit costs.

The pass through mechanism should be symmetrical – customers should pay more if a longer length of pipelines are replaced and pay less if a shorter length of pipelines are replaced. The case for a symmetrical pass through event is higher when there is a lower degree of certainty that the gas distributor will replace pipelines as forecast and the AER has not erred on the side of forecasting a lower volume of pipelines to be replaced.

In making its final decision, I would urge the AER, after considering each component of capital expenditure, to assess the total level of capital expenditure that is forecast for the purposes of the allowed revenue to ensure that it appropriately balances the needs of the gas distributor and the long term interests of consumers.

Operating expenditure

As with capital expenditure, the decision on the operating expenditure relies on information that is submitted by the gas distributors on a confidential basis and on bilateral communication between the AER (or its consultants) and the gas distributors. As a result, the comments in this submission are necessarily at a high level rather than on points of detail.

I support the AER's approach to assessing the gas distributors' forecast operating expenditure through consideration of the base operating expenditure, step changes and annual cost changes. I note that the gas distributors have revised the expenditure for step changes that is forecast for the next access arrangement period.

The AER will need to assess the forecast step changes in operating expenditure to ensure that they are in the long term interests of consumers. The assessment of step changes in operating expenditure tends to be focused on increases in expenditure and not on decreases in expenditure.

There will be some variation in expenditure from year to year – the AER needs to consider the extent to which small forecast increases in expenditure will be offset by small decreases in expenditure that have not been forecast.

The gas distributors have also included additional expenditure for ESV levies. The amount that is included in the allowed revenue needs to be consistent with the licence fee factor in the price control formula.

In particular, I do not support the following step changes in expenditure that have been forecast:

- Multinet – "cost over-shooting" by Jemena Asset Management (JAM). The key issue is that Multinet should not be rewarded for its previous arrangement with JAM that gave rise to cost over-shooting. With the transfer of the economic regulatory regime to the AER, it was intended that the AER would consider the *actual costs* incurred by parties that provide a large proportion of services to a gas distributor so that the incentive-based economic regulatory regime was not distorted. The AER should consider this matter in the context of a holistic decision on operational expenditure, and ensure that Multinet is not reimbursed in this period for cost overshoots in the previous period.
- Multinet – network development – the Victorian Government's experience with the introduction of smart electricity meters is that the distributors will not take any action unless obligated to do so or where there is a clear benefit for them to do so. There is no obligation for them to use the AMI infrastructure for gas metering nor is there an obligation for them to introduce time of use pricing for small gas customers. Therefore, the AER would need to be convinced that there are compelling efficiency benefits that would result from this expenditure, as well as mechanisms to ensure that customers benefit from this efficiency, to allow it.
- Envestra – incentive payments – under Envestra's scheme, customers are effectively required to pay for others to connect to the gas network so that benefits can accrue to those customers that are connected in 15 years time. Envestra notes that customers will benefit from lower tariffs in the following access arrangement period but provides no comparison to the increase in tariffs that would be paid in this access arrangement period to recover the costs of the program. The Victorian Government has a number of issues with this program including :
    - the equity impacts, with short term cost shifting from connecting customers to existing customers,
    - the length of the payback period (noting this is longer than many similar programs that are funded by the government),
    - whether a prudent monopoly provider should be imposing these costs on its customers, and
    - the prudency of the approach, in particular whether the payments are only being made where there is excess capacity in the gas network.

As with capital expenditure, in making its final decision, I would urge the AER (after considering each component of operating expenditure) to assess the total level of operating expenditure that is forecast for the purposes of the allowed revenue to ensure that it appropriately balances the needs of the gas distributor and the long term interests of consumers.

Incentive arrangements

I support the inclusion by the AER of an incentive arrangement for operating expenditure but not for capital expenditure. While I support, in principle, the inclusion of an incentive arrangement for capital expenditure, I note the concerns raised by AER with incentive arrangements that have previously been applied to capital expenditure.

Following the AEMC's recent review of proposed rule changes, the National Electricity Rules have been revised to require the AER to develop Capital Incentive Guidelines. The AER recently released an Issues Paper (*Better Regulation*) that indicates that an Issues Paper on Expenditure Incentives will be released in March 2013 with a guideline to be finalised on 29 November 2013. The information released to date indicates that the application of incentive arrangements will be considered for electricity networks and gas pipelines.

The inclusion of a capital expenditure incentive arrangement should therefore not be included in an access arrangement until this review is complete.