AMCOR/PAPERLINX

SUBMISSION ON

THE GASNET AND VENCORP

ACCESS ARRANGEMENTS APPLICATIONS

June 2002

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1. Introduction

AMCOR and PaperlinX welcome the opportunity to present our views on the GasNet and VENCorp Access Arrangements applications. We are aware, and supportive of, the submissions that have been lodged by several key stakeholders expressing their substantial concerns with the inadequate disclosure of information, especially by GasNet, to allow independent and considered assessments to ensure that reference tariffs are fair and reasonable. We assume that the ACCC will address this issue and rectify the inadequacies. AMCOR and PaperlinX will provide further views when additional information is disclosed to the market.

AMCOR and PaperlinX are concerned with GasNet's application, particularly as significant unsubstantiated costs are being claimed, and inappropriate cost allocations are being proposed. The proposed significant increases in tariffs, and the significant changes to their structure, unfairly discriminate against users' interests and must not be allowed by the ACCC.

AMCOR and PaperlinX share many of the views expressed by BHP Billiton and the Energy Users Association of Australia, particularly in relation to GasNet's ambit claims and the proposal to cross-subsidise certain assets. In a number of areas our views are based on analysis undertaken for BHP Billiton.

This submission covers the following areas of concern, which are detailed in subsequent sections:-

- GasNet's Pro-Infrastructure Assertions
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2. GasNet's Pro-Infrastructure Assertions

GasNet selectively quotes from recent publications, including submissions by, and prepared for, pipeline companies, to assert that there is support for:-

> "…GasNet's overall philosophy that in setting terms of access (including pricing) the Commission should adopt a pro-infrastructure approach. In the long run this will lead to benefits to consumers in the form of greater investments and competition in pipelines". (GasNet Australia Access Arrangement - Submission, p.16).

AMCOR and PaperlinX would draw to the ACCC's attention that the issue of access reviews is not **whether** there should be regulation of pipelines, nor is the issue whether regulation hinders **some** investment or not. The real issue (as in this current access review) is **how** to regulate without impeding **efficient and desirable** (rather than duplicate) investment or encouraging **over-investment:** in effect, to allow a fair and reasonable return to capital investment on infrastructure without conferring **monopoly rents** on franchise holders – to reward real and appropriate investment rather than allow an unearned benefit on **notional** investment,licence holdings and monopoly positions.

Indeed, the objectives of the National Third Party Access Code for Natural Gas Pipeline Systems seek to establish a framework that:-

> " (a) facilitates the development and operation of a national market for natural gas; and
> (b) prevents abuse of monopoly power; and
> (c) promotes a competitive market for natural gas in which customers may choose suppliers, including producers, retailers and traders; and
> (d) provides rights of access to natural gas pipelines on conditions that are fair and reasonable for both Service Providers and Users; and
> (e) provides for resolution of disputes."

In other words, there is **no justification at all** for legitimising the extraction of monopoly rents by (transmission) pipeline owners. Nor is there justification for allowing the extraction of monopoly rents by loose access regulation or "taking a pro-infrastructure approach" as is proposed. To incorporate a "pro-infrastructure" stance on transmission pipelines would not only damage investment in upstream and downstream industries, but also in linking infrastructure projects, such as distribution pipelines. The National Gas Code was not intended to create a system of monopolies and rentiers. It was meant to unlock strategic infrastructure and improve the competitiveness and productivity of upstream and downstream industries.

Despite the assertions of pipeline owners that investment will be curtailed unless appropriate (high) returns are granted to pipeline owners to encourage investment in pipelines, a review of all of the recent pipeline investment indicates that the predeterminant for pipeline investment is in providing a linkage between a gas supplier and a gas consumer. If the returns for gas transport are permitted to be too high, this will effectively dis-incentivise consumers from using gas, or directing the investment to other locations, including overseas. It should be remembered that the value of downstream investment far outweighs the value of any pipeline. A review of the history of the PNG gas pipeline is a case in point. The proponents of the pipeline are adamant that investment in the pipeline will not occur with out commitment from downstream gas users and the investment in the downstream activities far outweighs the costs of building the pipeline.

The ACCC must reject GasNet's proposal for it to adopt a pro-infrastructure approach in this access review and to abide by the Gas Code, which inter alia, seeks to facilitate the development of a national market for gas, prevents abuse of monopoly power, promotes a competitive market for gas, and provides access on conditions that are fair and reasonable for pipeline owners and users.

3. Initial Capital Base: Revaluations

GasNet has proposed that because of "a number of errors and omissions in the expression of the Capital Base in 1998" the ACCC should revisit the Initial Capital Base established at the start of the First Access Arrangement Period (1998-2002) and increase the 1 January 1998 value by $35.8 million. The increase in value is to recognise the value of easements and some pipeline regulators (in addition to a few other minor adjustments).

Omission of the value of easements and pipeline regulators is claimed by GasNet to be due to policy decisions taken by EPD (at the time of privatisation). The 'adjusted' Initial Capital Base at 1 January 2002 will, consequently be considerably higher, when additional depreciation allowances and inflation are added. It should be remembered by the ACCC that in setting the initial capital base (at the 1998 review), there was significant debate. EPD (the effective owner of the asset at that time) decided and agreed with ACCC on a specific asset value and it was stated at the time that all of the adjustments were made by the owner as a fair and reasonable assessment of the value of the asset.

The principles for establishing the Initial Capital Base for each Access Arrangement Period after the first are set out in Section 8.9 of the Code. In essence, it allows for the roll-forward of the inflation-adjusted capital base by adding new facilities investment and subtracting depreciation and redundant capital.

GasNet, however, submits that Section 8.9 of the Code does not mean that it allows only a mechanical roll-forward of the capital base from the start of the immediately preceding Access Arrangement Period, without adjustments to take account of any errors and omissions from the original valuation. GasNet refers to "errors and omissions", but as each of the new amounts claimed by GasNet was discussed and resolved at the time, it is incorrect to claim them decision to as either errors or omissions.

In particular, GasNet complains that the value of easements was incorrectly omitted from the ICB. This overlooks the consideration that, as the assets were to be sold subsequent to the review, EPD (in this case as representative of the Government) decided quite rightly that easements which were never purchased by the Government, or were in public and crown land, should not be permitted to be included in the asset value, as to do so would permit a private entity to, in effect, levy a charge on the community (through the imposition of a return on the capital involved) on land that was actually owned by the community.

It should be noted that Section 8.14 of the Code has, to date, been interpreted as preventing a revaluation of the Capital Base viz "when an Access Arrangement has expired, the Initial Capital Base at the time a new Access Arrangement is approved is the Capital Base applying at the expiry of the previous Access Arrangement adjusted to account for the New Facilities Investment or the Recoverable Portion (whichever is relevant), Depreciation and Redundant Capital (as described in Section 8.9) as if the previous access arrangement has remained in force". We have not seen any clear reason for not accepting that interpretation.

AMCOR and PaperlinX note that the ACCC states in its Issue Paper that it is its "understanding that the Code does not allow for such an adjustment".

AMOCR and PaperlinX consider that the Code does not permit the Initial Capital Base to be changed in the manner proposed by GasNet. Once the initial Capital Base of a Covered Pipeline has been determined and the related Access Arrangement is approved by the Relevant Regulator, the Code is clear that the determination cannot be re-opened. In order to ensure that the initial Capital Base is correctly determined, the Service Provider and interested parties are provided with the opportunity to make submissions and apply for administrative and judicial review, in advance of the final approval of the Access Arrangement or, if the Relevant Regulator drafts and approves its own Access Arrangement, after such approval is made.

Having set the Initial Capital Base, it can only be adjusted (in terms of Section 8.9) by indexation and allowances for New Facilities Investment or Recoverable Portion, Depreciation and Redundant Capital.

Section 3.5 of the Code prescribes that an Access Arrangement must include a Reference Tariff Policy. Clause 5.3.2 of the Access Arrangement currently applicable to the GasNet system provides that the reference tariffs applicable to the system are those described in the Victorian Gas Industry Tariff Order 1998. Clause 5.3.4 of the Access Arrangement provides (in part):

> *"Chapter 9 of the Tariff Order provides a mechanism whereby certain principles in the Tariff Order, and therefore by definition, the Reference Tariff Policy, cannot be changed at the 1 January 2003 review of reference tariffs."*

Moreover, Clause 9.2(a)(3) of the Tariff Order provides that:

> *"(a) In making a price determination in relation to tariffed transmission services for the subsequent access arrangement period, the Regulator is to adopt the following fixed principles:*
>
> *(3) Use the capital base for the TPA at the start of the initial regulatory period, adjusted to take account of inflation since 1 January 1998, depreciation, wholly or partially redundant assets and additions and disposals in the ordinary course of business since 1 January 1998, other than a disposal of:*
>
> *(A) all of the assets and liabilities of TPA;*
>
> *(B) assets interdependent with a transaction pursuant to which all the issued shares in or the assets and business of TPA cease to be held by or on behalf of the State of Victoria or a statutory authority; or*
>
> *(C) assets pursuant to which the assets of TPA are sold and leased back to TPA. "*

Accordingly, it is one of the **fixed principles** of the Reference Tariff Policy incorporated in the current Access Arrangement that the initial Capital Base cannot be changed for the subsequent Access Arrangement period.

AMCOR and PaperlinX understand that the Regulator-General of Victoria considers that the Victorian Tariff Order prevents the regulator from re-visiting the Initial Capital Base. This is an important issue regarding the need for regulatory consistency between the Regulator General of Victoria and the ACCC in the regulation of gas transmission and distribution pipelines.

The Gas Code does not allow for any adjustments (in terms of those sought by GasNet) to the Initial Capital Base at the start of the Second Access Arrangement Period, and the Victorian Tariff Order also prevents a re-visiting of the Initial Capital Base for the Second Access Arrangement Period.

4. Structure Of GasNet's Assets

The ACCC had previously determined, in relation to an application for the South West Pipeline (SWP) to be "rolled into" the Principal Transmission System (PTS), that it:-

> "…is not convinced that GPU GasNet's investment in the South West Pipeline would pass the system – wide benefits test. For this reason in particular, the Commission has now made a final decision under section 2.38 (a)(ii) of the Code that it does not approve the revisions to the PTS arrangement. The Commission also has reservations about the prudence of the investment and is uncertain as to the portion of the investment that would pass the economic feasibility test. In addition, the Commission considers that the proposed tariff structure is inconsistent with the principles of the Code[1]." .

In that determination the ACCC also stated that:-

> " It is concerned that GPU GasNet's proposal to fund the majority of its investment in the South West Pipeline through increased Longford charges is inconsistent with cost – reflectivity principles and would be likely to distort investment decisions.[2]" .

It is noted that GasNet's current application provides no support for the "rolling in" of all the GasNet assets into one effective tariff arrangement and has proposed that SWP and WTS should have standalone tariffs.

AMCOR and PaperlinX have no objection to having the three separate elements (PTS, SWP and WTS) being part of one access arrangement, providing cross subsidisation of uneconomic elements within the GasNet system are prevented. This means that the allocation of costs and the recovery of revenue from the discrete elements of SWP and WTS (and PTS) need to be clearly assessed and ring-fenced to ensure there is no cross-subsidisation. All costs (including capex, opex, G&A, benefit sharing and K-factor adjustments) need to be allocated to each element fairly and transparently

GasNet must institute a mechanism to allocate accurately all costs and revenue from each of PTS, SWP and WTS to eliminate cross subsidisation. Strong ringfencing is required..

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[1] Access Arrangement for the Principal Transmission System, Application for Revision by GPU GasNet Pty Ltd, South West Pipeline 29 June 2001 – ACCC Final Decision, p. ix
[2] ibid, p viii

5. South West Pipeline: Tariff Structure

As noted in the previous section AMCOR and PaperlinX have no objection to GasNet's proposal to allow SWP its own "standalone" tariff provided it is based on the risk profile appropriate to the asset, as well as based on efficient costs.

With the decision for Minerva Gas to flow to Adelaide via the recently committed SEAGas Pipeline combined with a review of the Saturn report it would appear that there is little likelihood of significant gas flows from the Otway Basin during the course of this new regulatory period.

The development of the Minerva field has taken more than 5 years to bring into production. It would be surprising, therefore, if the developers of the Geographe and Thylacine fields could bring them into production during the course of the next access arrangement period. This would support the view that SWP is unlikely to deliver "new" gas into the Victorian market in the near term.

Accordingly, our view is that SWP will be a greatly under-utilised resource in the regulatory period under review and the tariff structure would need to reflect this situation.

We note also that GasNet is proposing to allocate "incremental costs" to SWP (schedule 5.7.4). We strongly consider this proposal as inappropriate as it would provide an element of cross-subsidisation from the rest of the GasNet assets. This is contrary to the cost-reflective principles of the Code, which the ACCC had previously paid particular regard to in its earlier decision on SWP roll-in. SWP was built as an "entrepreneurial" pipeline and it would be completely contrary to the Code for cross subsidisation of SWP to be approved.

To meet the cost reflectivity principles of the Code, AMCOR and PaperlinX consider that the SWP tariff structure should ensure that all costs associated with SWP should be fairly and appropriately allocated including opex, capex, depreciation, benefit sharing and K-factor carryover. The tariff should recognise that gas flows will be bi-directional and injection and withdrawal tariffs should apply at both ends of SWP, not at one as proposed by GasNet.

In particular, if GasNet decides to have a low start tariff, then the total losses incurred must be fully identified and carried forward only to future SWP tariffs

The tariff structure needs to recognise SWP will be a greatly under-used in the regulatory period under review, and therefore tariffs must fully recover actual costs and not allow

cross-subsidisation from other parts of the GasNet system must not be allowed.

6. Depreciation

The implication of the Saturn report of the "Remaining economic life of GasNet's transmission assets" is of grave concern. In summary, the report has been used to demonstrate that the Longford GasNet assets should be depreciated faster and the South West Pipeline (SWP) assets slower than might otherwise be expected. More rapid depreciation adds costs onto Longford related assets and reduces the relative costs of SWP assets.

The Saturn report assumes the drawdown rates from each gas basin serving South Eastern Australia, which are then used to support its conclusions of the basin lives of Gippsland, Cooper, Otway and Bass. Table 4 of the Saturn report lists a total annual average drawdown for these 4 basins of 942pj/a from 2002 to 2020. However, using ABARE projections, the total average drawdown form these basins is about 650pj/a, some 30% below that shown in the Saturn report. Using this simple approach, the actual reserves of the 4 basins would give a life of Saturn's assessed actual gas reserves of nearly 40 years, or a depletion rate beyond 2040, rather than 2024.

Strangely, the Saturn report ignores undiscovered Gippsland reserves in its economic evaluation, although elsewhere, the report acknowledges that actual reserves could be as high as 12,000pj – i.e. there is an additional 4,000pj of undiscovered reserves.

As a reality check on the outworkings of the Saturn report, the following should be considered:-

- There are clearly expectations of higher reserves in the Gippsland Basin which have led to significant investments being made over the past two or three years, viz the Eastern Gas Pipeline from Longford to Sydney has been completed, and the Bass Pipeline from Longford to Tasmania is under construction.
- ExxonMobil and BHP Billiton have dedicated substantial funds for further explorations in the Gippsland Basin.
- The current capacity of the Eastern Gas Pipeline is not 110pj as noted in the Saturn report, but 65 pj/a[3].

There is, therefore, considerable doubt about the conclusions of the Saturn report on gas reserves and the implications drawn regarding Longford assets. When considering the demands for Gippsland gas from NSW and Tasmania, and allowing for the current capacity of the existing Longford and GasNet

[3]See Duke website which reports a current capacity of 65pj a year

assets, there real are doubts that Gippsland Basin reserves can be depleted before 2025.

It is assessed that the actual reserves of the 4 gas basins would give a life of nearly 40 years, or a depletion rate beyond 2040, rather than 2024. The proposal for Longford assets to be depreciated faster relative to SWP assets must be rejected.

7. Depreciation Allowances: GasNet System And SWP

The GasNet assets have been divided into four separate elements by Saturn, with economic lives given for each – Longford-Dandenong (23 years), the South West Pipeline and WUGS (52 years), the WTS (30 years) and the rest of the system (32 years)[4].

These figures are based on the GHD report on technical life, backed up by the Saturn report indicating that economic conditions may cause a shortening of useful life. Technical depreciation rates used in the GHD report indicate a standard 60 year operating life for the GasNet pipeline assets, but in the SAIPAR assessment of the Envestra assets in South Australia, it was noted that "protected" pipelines are expected to have a life expectancy of twice that of unprotected pipelines[5]. that the GasNet prospectus states most of GasNet's assets are "protected" by both cathodic protection and impervious coating. Thus there is doubt as to the technical life allocated to the GasNet assets.

AMCOR and PaperlinX are of the view that, using the proper conclusions from the Saturn report, there is no reason to more rapidly discount the life of the Longford assets, and that there is an argument that the technical and economic life should be extended. We also wish to be assured that the capex expended on Longford-Melbourne assets has been incorporated in the asset life.

A **notable** omission from the GasNet submission is life extension of the assets due to capex injection. It must be remembered that maintenance and refurbishing capex is designed to extend the life of an asset and therefore in the calculation of depreciation, this assessment must be carried out.

However, what the Saturn report actually does highlight is that the economic life of the SWP would appear to be limited, based on the current and future plans for Minerva gas to flow to South Australia and the total gas reserves in the Otway basin. Based on gas reserves and forecast demand, there is little need for Otway basin gas for sale in the Victorian system before about 2035, as, on most forecasts of supply and demand, Gippsland basin gas supply will be more than adequate until then for the Victorian and Tasmanian markets, and even part of the NSW market.

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[4] Summary table page 40 Remaining economic life of GasNet's transmission assets by Saturn Corporate Resources 18 February 2002

[5] (SAIPAR Final Decision table 5.5.7.1)

Even on the most conservative of analyses, there is little doubt as to the ability of Gippsland basin to provide for the Victorian and Tasmanian markets and a part of the NSW market for the next 30-40 years. Thus Otway basin gas will have only a minor impact on the Victorian supply and this is seen by the decision for Otway gas to flow to Adelaide, With this in mind, SWP can only have a short and minor life as an asset to deliver gas from Otway basin into the Victorian demand.

The wider implications of this state of affairs need to be assessed. SWP is an over-sized resource, basically connecting the Melbourne demand to the Western Underground Storage facility (WUGS). From the information provided SWP has for much of the time it has been receiving gas for storage and only occasionally providing some gas into the system on a few peak usage days each year. Therefore at best SWP will provide a marginal benefit, and that its sizing (and cost) makes it relatively uneconomic for providing injection on peak days.

Saturn states that the economic life for the SWP is measured as 50+ years, because:-

a. It will remain an integral part of the system for “stabilising system flows” when Gippsland basin is depleted assuming when Gippsland basin is depleted WUGS will still be the major underground storage in Victoria and that it is appropriately located for this purpose when new gas comes into the State.
b. The Otway basin is unlikely to be significantly accessed until 2013 to 2025 period, overlooking the fact that already gas flows from Minerva are planned from 2004, to Adelaide.

The current plans for Otway basin would appear to be for it to be predominantly a source of gas for South Australia with minimal injection into the Victorian system. There have also been plans mooted for WUGS to be used as an intermediate step in the transfer of Victorian gas into the SA system, for power generation, and neither of these options would appear to have been given credence by Saturn in its analysis.

Thus, there is insufficient analysis and data provided to determine that SWP will in fact be any more than what it is currently, and available data would appear to contradict the recommendation made by Saturn for SWP to have an economic life of 50+ years.

The claimed economic life for SWP is significantly over-stated and ACCC should review the assumptions made for the technical life of the GasNet assets.

8. “Flattening” Injection And Withdrawal Tariffs

GasNet submits that because it is subject to the unique market carriage model of gas transport, it requires significant flexibility in its tariff structure. However, through use of the K-factor adjustment system, it is permitted to vary its tariffs (and even carry forward into the next access arrangement) losses it may incur through setting incorrect tariffs. Thus, GasNet can reset its tariffs to allow it to recover the regulated allowable revenue. But despite the statement that the market carriage model makes it difficult for GasNet to ensure it gets its forecast revenue, it is quite apparent that GasNet does not suffer a detriment in this regard. Therefore, there is no reason for GasNet not to follow the cost reflectivity requirements of the Code

In the introduction to the reference tariff principles section of the Gas Code, it states that:-

> ***Allocation of the Total Revenue***
>
> *The Reference Tariff Principles set out broad principles for determining the portion of the Total Revenue that a Reference Tariff should be designed to recover from sales of the Reference Service, and the portion of revenue that should be recovered from each User of that Reference Service. These principles essentially require that the Charge paid by any User of a Reference Service be cost reflective, although substantial flexibility is provided.*

In its explanation for reducing its emphasis from a cost reflective basis, GasNet[6] alleges that under the current system users cannot respond to pricing signals (and even that some signals would apply when no signals are needed), that charges under the present system are unpredictable, and the duplication of tariff and congestion signals places an excessive cost burden on peak flows. GasNet implies that these problems derive from the market carriage model.

It should be noted that these same issues apply equally to the contract carriage model of gas transmission and to electricity transmission and that the issues are addressed without affecting the basic cost reflective approach of allocating costs to maximum usage of the system. Structures which apply in the gas contract carriage system and in the electricity pricing system (which exhibits many features of the gas market carriage model) can equally apply to the gas market carriage system.

There is no reason given by GasNet that demonstrates that the only way to solve the concerns of consumers and send market signals in the gas market is to “flatten” the tariff structure. To remove strong signals is counter-intuitive and so reducing the signals to users to modify their behaviour will not achieve the aims of the Code nor get consumers to pay for what they actually use.

We note the comment that[7]

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[6] GasNet submission schedule 5.8

[7] Consultation Paper on Proposed Tariff Design for the Victorian Gas Transmission System, prepared by NERA GasNet submission annexure 10 page 12

> *Finally, the current approach is based on the assumption that peak days occur during the winter period. The growth of summer gas-fired electricity generation might eventually introduce a summer peak, which could make the current winter peak approach inappropriate*.

Reviewing the forecast data there is nothing which indicates that gas peak demand will change from winter and therefore we consider that the assumptions underlying the current tariff structure have not changed. We do note that the new proposal will move from allocating cost based on a one in twenty year peak demand to a lesser proportion of a one in two year peak demand. GasNet conveniently fails to state the major impact this lessening of incidence has on the cost allocation away from true cost reflectivity. Without GasNet providing the data for the 1:20 year peak demand compared to the 1:2 year peak demand, we are unable to calculate the true extent this "flattening" approach will have.

GasNet states that its changes will make the forecasting of transmission costs by users easier, completely overlooking that consumers will still incur the volatility inherent in the variable injection costs, congestion cost uplift and curtailment risk.

GasNet states[8] that transmission costs only amount to 5-10% of the total delivered gas cost. To flatten the tariff will reduce signals when increased signals are needed to get changes in consumer behaviour from a small element of the gas price. We believe that it is more appropriate to use tariff pricing which sends strong signals to modify usage behaviour and this is one of the key tenets of the Gas Code. We oppose minimizing the cost reflective signals as proposed by GasNet.

GasNet has not provided any legitimate reason for its desire to reduce market signals to consumers. The proposed "flattening" of the tariff structure is not cost reflective and GasNet has not provided necessary data which demonstrates the extent by which it proposes to flatten the tariffs .

9. The Anytime withdrawal tariff

The current GasNet approach to institute cost reflectivity from the impact each user imposes on the gas system, by requiring each user to pay for use of the system in accordance with the average of the usage of the five peak days, is seen to be cumbersome. This mechanism, whilst it does recognise cost reflectivity, requires an ex-post event reconciliation. This mechanism is seen

[8] GasNet submission schedule 5.3(a)

by consumers as ineffective, cannot send appropriate pricing signals and does not allow knowledge of costs incurred until well after the event. It is universally seen by users as inappropriate.

Equally, the proposed anytime withdrawal tariff does not send appropriate pricing signals, and discriminates against users who have high load factors. The proposal, while it does not require “post event” adjustment still does not meet the Code requirements for cost reflectivity, and also does not give certainty of costs to consumers.

The contract carriage model for gas transport accommodates for this cost reflectivity and certainty by allowing users to set an agreed MDQ with penalties for over-run. Electricity transport systems (effectively follow the market carriage approach), use a mechanism similar to the gas contract carriage approach, of setting a maximum usage which is paid for and instituting a penalty for over-run. The maximum usage set point can be adjusted to reflect recent history of usage – in the electricity example this is usually set at the highest demand used in the previous twelve months.

AMCOR and PaperlinX do not accept that the move to an anytime withdrawal tariff is cost reflective, nor does it send the appropriate pricing signals to modify consumer behaviour. The perceived need for the approach is not a result of the application of the market carriage model, as electricity systems (which use the market carriage model as well) use a more cost reflective structure than that proposed. What is of major concern to us is that the new structure will favour those users (such as peak electricity generators) who wish to use the system for short periods of time and may cause constraints in the system which will in turn impose further but unknown costs on high load factor users

The proposed anytime withdrawal tariff is not appropriate. ACCC should require GasNet to develop a withdrawal tariff which meets both the needs of users for certainty, and meets the Code requirements for cost reflectivity.

10. Allocation Of Costs On A “Postage Stamp” Basis

GasNet proposes[9] to allocate the shared cost elements on a “postage stamp” basis, but does not specifically state what this means. Interpolating it would appear that GasNet proposes to allocate much of the shared costs on an “annual volume” basis. This is at best a very coarse allocational basis and not reflective of the usage made of the network. All users should pay for usage in proportion to their usage **of the network**, rather than the volume of gas consumed. Whilst using annual volume as the basis for allocation appears to be a simplistic solution to a complex issue, such an approach clearly discriminates against customers with flat loads to the benefit of customers

[9] GasNet submission Table 9-7 page 110

with high and peaky demands which require greater use of the system in proportion to the total amount of gas used.

Thus, those costs not related to asset usage should be cost reflective to a more appropriate base such as maximum MDQ or number of transactions required (for General and Administrative), diameter-length of pipeline (for working capital), and K-factor redistribution towards those assets not returning the anticipated share of expected revenue.

Allocation of shared costs should be cost reflective and not on a "postage stamp" basis.

11. Passing Risks To Users

Throughout the GasNet submission it refers to its need for a high return due to the risk profile it is exposed to as part of its normal business.

However, of concern is the statement[10]

> *"In addition, the higher return better reflects the risks resulting from GasNet's unique characteristics, such as:*
> *(i) the pay-as-you-go market carriage system, which prevents GasNet from securing long term haulage contracts; and*
> *(ii) the price cap regime, which exposes GasNet to volume risks and which will result in an estimated aggregate revenue shortfall of $19.3 million in the First Access Arrangement Period."*

The second risk referred to by GasNet is not a risk at all. GasNet is permitted a revenue cap for use of its assets during the regulatory period under review. It is the setting of the reference tariffs by GasNet which determines the method and extent of revenue recovery. Under the K-factor adjustment arrangement GasNet can vary tariffs within an agreed range to recognize any under and over run experienced by the application of the tariffs set by GasNet.

Thus, the so called exposure experienced by GasNet is really only a matter of cash flow timing, and not a risk as to whether GasNet will in fact ever recover its approved revenue stream. The very fact that GasNet is seeking the under recovery of revenue from the current period to be carried over to the new period, highlights that GasNet has little exposure to the volume forecasts. This view has been tacitly agreed to by the ACCC[11]. Further, GasNet has nominated this feature as a fixed principle for the new period, continuing its ability to get consumers to take the risk for GasNet poor tariff setting.

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[10] GasNet Australia Access Arrangement – Submission 27 March 2002, page 45
[11] ACCC Issues Paper 19 April 2002, executive summary

Whilst it is not an issue for the current review, we are concerned that ACCC should recognize that if unnecessarily high tariffs are permitted for the new regulatory period there is a real possibility of a negative K-factor carry over into the subsequent period. It should be accepted that K-factor adjustments can be both positive and negative.

It must therefore be accepted under the GasNet proposals, that volume forecasts are a risk faced by users and not by GasNet, and therefore the return allowed on GasNet assets should reflect this fact.

However, it should be also noted that some users have already paid for their share of use of the GasNet assets, and that the allocation of the K-factor carry over needs careful attention. Whilst GasNet has identified that in aggregate it has a under run of revenue arising from the tariffs previously set, the stated K-factor underrun is a net figure. It is quite likely that certain elements of the GasNet system actually returned more than was estimated for the current period and therefore care should be taken to ensure that these users are not penalized by the broad brush application of a net amount of K-factor adjustment requirements.

Thus GasNet should analyse the revenue streams from the various elements of its network, to identify how each element performed to its targeted regulated revenue, and the K-factor adjustment should be applied to each element in proportion to its actual performance.

A similar approach should be followed for the allocation of any performance (efficiency) benefits which GasNet may return to users.

GasNet should be required to provide analysis of the revenue streams from the various elements of its network so as to identify how each element performed to its target approved revenue, and the K-factor adjustment should be applied to each element in relation to its actual performance in returning its target.

12. Efficiency Gains: Benefits Sharing

Assessments of the GasNet application shows that it will take all the benefits from efficiency gains made whilst all losses (based on the structure of the revenue cap and the K-factor) from GasNet activities (except prudent investments) are passed onto users, partly in the current regulatory period, with the balance in the following regulatory period.

AMCOR and PaperlinX accept that GasNet should be provided with incentives for out-performance, but only a proportion of efficiency gains should be retained. Likewise, losses from its activities should be shared between GasNet and users. The approach taken by the Essential Services Commission is supported.

Efficiency benefits and losses should be shared between GasNet and users, but only to the extent to reflect the risk each party takes.

13. Pass Through Of Asymmetric Costs And Risks

GasNet has identified a number of risks it faces as part of its activities as a gas transporter and proposes that these risks should be provided for by way of additional regulated revenues.

However, in the absence of details about these risks – we note the relevant report on these risks by Trowbridge is embargoed – the ACCC should seek to decline such claims. Users are expected to fund these risks, but are prevented to have access to the information!

> ***The ACCC should decline GasNet's claims for pass-through of asymmetric costs and risks.***

14. Capital Raising Costs

GasNet proposes that costs associated with its capital structure should be funded by users. However, decisions as to how GasNet wishes to structure its capital and the costs associated is a matter for GasNet alone. There is no reason why users should be expected to cover these costs!

> ***The ACCC should decline GasNet's claims for costs associated with its capital structure to be funded by users.***

15. Opex And Marketing Costs

Both GasNet and VENCorp have provided for allowance for opex for managing the gas system. GasNet states that its proposed costs are in the lower range of "reasonable" when compared to other Australian transmission systems, and VENCorp states that there is no comparative data for doing what it does.

GasNet has provided three categories only for describing nearly 80% of its requested opex allowance, divided nearly equally between "maintenance" and "general and administrative". GasNet has provided limited comparative data demonstrating these amounts are reasonable and efficient, and no international benchmarks. In order for international benchmarking GasNet should ensure that the amounts in each category are appropriately aggregated for direct comparability, and use a sensible benchmarking divisor eg G&A costs are probably more related to numbers of customers served than GJ of gas transported, therefore requiring a number of different benchmarking divisors to be assessed rather than the single benchmark divisor offered in the application.

Further, opex costs should also be related to the benefit the consumer gets from the investment in these activities. In particular, GasNet includes an allowance for marketing of gas. It does not, however, provide substantiation of the need for this activity by GasNet (as distinct from other entities interested in the maintenance or growth of gas usage). Further, GasNet does not include what outcomes (or measurable) are expected from this marketing activity so that future reviews can assess the efficacy of the activity or the funds used.

However what both GasNet and VENCorp fail to state is that in aggregate, the GasNet and VENCorp costs can be compared to other gas transmission systems, and when this is done, the aggregate of the charges levied on users takes the Victorian system opex costs well beyond the "reasonable" range.

GasNet should be required to provide information and analysis to support its claims for Opex and marketing costs. Benchmarking data should be presented to demonstrate that total costs are reasonable and efficient.

16. CAPEX

GasNet has provided qualitative analysis supporting its proposed capex for the new access arrangement. There is, however, no quantitative analysis provided to support the contemplated augmentation and enhancement of the network. At the very basic level, what GasNet needs to provide is the probable return for the capex injected, although for the level of capex suggested a more detailed financial assessment is clearly needed.

Users will be expected to fund GasNet to improve the operation of the system. However, GasNet has not provided a cost/benefit analysis of investment of human or financial resources achieved from the current access arrangements. GasNet needs to provide likely or expected outcomes from the future proposed investment of human and financial resources

GasNet should be required to provide information and analysis to support augmentation of its network.

17. GST Spike in 2000

In the actual valuation approach used by GasNet, it has applied the full CPI adjustment as a carry forward mechanism. As the period over which the CPI adjustment is made included for the introduction of the New Taxation Regime – (i.e. the introduction of the GST), to include for the GST impact on the CPI as part of the calculation is incorrect.

GasNet should recalculate the CPI adjustment of the Capital Base Roll forward, excluding the impact of GST on the CPI.

18. WACC

The issue of setting the WACC WACC probably is given more attention than any other aspect of the access arrangement.

AMCOR and PaperlinX have assessed the GasNet proposals and offer the following comments regarding the setting of WACC:

a) Whilst there is much attention given to addressing the individual parameters in the CAPM approach to identifying what might be an appropriate WACC, there is almost no attention given to assessing whether the outcome is in keeping with the market overall. We believe that the WACC set must recognize what is being achieved in the competitive market place, and the risk profile faced by those enterprises in that competitive environment. To blithely compute a WACC using the CAPM and not compare it to returns in the competitive market place consigns regulation to a purely mechanical exercise (devoid of the exercise of regulatory judgement) and which therefore does not place a monopoly enterprise under the strictures of "competition by comparison".

b) In specific terms of the CAPM elements we believe that:-
    - the ACCC approach to the risk free rate (5 year bonds) is correct as it matches the forward looking period of the access arrangement and reflects the expected risk profile of the period under review;
    - the gearing of 60% allowance is seen as conservative and does not reflect the actual gearing possible; and
    - whilst the allowances for the debt calculation of CAPM is slightly on the high side, the equity calculation would appear to give grossly inflated returns.

c) Unfortunately the financial advice used by regulators in Australia about what is needed for input to the CAPM is mainly provided by the regulated businesses. There is little independent advice used to substantiate (or refute) the claims made by the applicants and their financial advisers. Advice on WACC comparisons from NERA, Sims, Davis and others would appear to be overlooked or disregarded.

d) The return which a monopoly gets should reflect its risk profile. GasNet has placed the risks of volume, asymmetric, pass through and others onto consumers. Its "competitive counter-part" does not have this luxury and therefore has a higher risk profile, warranting a higher return. Those monopolies accepting these risks should have a higher return.

e) The Australian regulatory world is small and has been in operation for a limited time. There is much to be learned from regulators in overseas jurisdictions. Despite the claims of regulated enterprises in Australia, they get their funding from the same sources as their equivalent counter-parts overseas. Australia is recognized as a safe financial location (its triple AAA rating stands testament to this fact) so its enterprises are seen as much the same as their overseas equivalents. Bearing this in mind regulatory decisions overseas give a good guide to what might be appropriate for monopoly WACC in this country.

f) WACC should be set at the **minimum level** to allow the regulated monopoly to gain funding for its activities, not at an inflated amount seen as being needed to perhaps fund new investment.

g) It is quite apparent that the WACC set for the current period was set at a level which encouraged purchasers of the assets to pay considerably over the value of the assets. There are those that observe the trend of the US purchasers now wishing to sell assets in this country are doing so because of the poor returns and regulatory intervention. Nothing is further from the truth – those companies who are vacating the Australian market are doing so from **all offshore investments** and returning to the US, as their US shareholders are requiring company management to concentrate on “home” activities.

h) We fail to see why a high WACC is needed on existing assets to encourage new investment, and there is no evidence that a higher WACC will encourage further investment in infrastructure assets. The ready investment currently observed would indicate the current levels are adequate and in fact probably too high.

The WACC of 7% proposed by ORG and ACCC in the Draft Determination on TPA in 1998, was seen by the Victorian Government as too low to get an adequate sale price for the assets. ACCC finally approved a WACC of 7.75% and the resulting sale price for TPA significantly exceeded expectations. We believe that the WACC of 7.0% proposed in the Draft Determination was closer to being correct and was probably still too high bearing in mind the risk profile for the enterprise

19. Responsibilities

There appears to be some confusion as to who is the service provider of the Victorian transmission pipeline system. It would appear that at a practical level VENCorp is the service provider and that GasNet (the owner) has no responsibility to users of the system. This issue needs to be clarified.

If VENCorp is indeed the service provider, as would appear to be the case, this presents users with a major difficulty. In the event that anything goes wrong with the transmission of gas through the network, users have only recourse to VENCorp. However, under the legislation governing VENCorp, VENCorp is not required to take any responsibility or liability for its actions. This basically precludes any user from gaining recompense for failure to supply gas, regardless of the cause. In the event that GasNet causes users costs for which GasNet would normally be liable, users are then in the unenviable position of relying on VENCorp to seek restitution on their behalf, bearing in mind that VENCorp has no incentive to maximize the restitution sought by users.

Therefore there needs to be a mechanism within the access arrangement that permits users to bypass VENCorp and seek restitution from GasNet who not only does not have legislative protection, but also has assets from which restitution can be funded.

The Access Arrangement must contain a mechanism to enable users to seek restitution from GasNet for any failure to supply gas.

20. Conclusion And Recommendations

AMCOR and PaperlinX are concerned at the substantial increases in tariffs embodied in the GasNet Access Arrangements application. The application is extremely disappointing, as every attempt has been made to substantially raise capital and non-capital costs (with little substantiation or inadequate justification), or to allocate costs to cross-subsidise certain assets that are heavily under-utilised, such as the South West Pipeline.

AMCOR and PaperlinX are also disappointed with the level of information disclosures and the apparent disregard for the need to enable independent evaluation by users of the range of costs claimed by GasNet.

Accordingly, AMCOR and PaperlinX recommend the following:-

- *The ACCC must reject GasNet's proposal for it to adopt a pro-infrastructure approach in this access review and to abide by the Gas Code, which inter alia, seeks to facilitate the development of a national market for gas, prevents abuse of monopoly power, promotes a competitive market for gas, and provides access on conditions that are fair and reasonable for pipeline owners and users.*
- *The Gas Code does not allow for any adjustments (in terms of those sought by GasNet) to the Initial Capital Base at the start of the Second Access Arrangement Period, and the*

Victorian Tariff Order also prevents a re-visiting of the Initial Capital Base for the Second Access Arrangement Period.

- *GasNet must institute a mechanism to allocate accurately all costs and revenue from each of PTS, SWP and WTS to eliminate cross subsidisation. Strong ringfencing is required.*
- *The tariff structure needs to recognise SWP will be a greatly under-used in the regulatory period under review, and therefore tariffs must fully recover actual costs and not allow cross-subsidisation from other parts of the GasNet system must not be allowed.*
- *It is assessed that the actual reserves of the 4 gas basins would give a life of nearly 40 years, or a depletion rate beyond 2040, rather than 2024. The proposal for Longford assets to be depreciated faster relative to SWP assets must be rejected.*
- *The claimed economic life for SWP is significantly over-stated and ACCC should review the assumptions made for the technical life of the GasNet assets.*
- *GasNet has not provided any legitimate reason for its desire to reduce market signals to consumers. The proposed "flattening" of the tariff structure is not cost reflective and GasNet has not provided necessary data which demonstrates the extent by which it proposes to flatten the tariffs.*
- *The proposed anytime withdrawal tariff is not appropriate. ACCC should require GasNet to develop a withdrawal tariff which meets both the needs of users for certainty, and meets the Code requirements for cost reflectivity.*
- *Allocation of shared costs should be cost reflective and not on a "postage stamp" basis.*
- *GasNet should be required to provide analysis of the revenue streams from the various elements of its network so as to identify how each element performed to its target approved revenue, and the K-factor adjustment should be applied to each element in relation to its actual performance in returning its target.*
- *Efficiency benefits and losses should be shared between GasNet and users, but only to the extent to reflect the risk each party takes.*
- *The ACCC should decline GasNet's claims for pass-through of asymmetric costs and risks.*
- *The ACCC should decline GasNet's claims for costs associated with its capital structure to be funded by users.*
- *GasNet should be required to provide information and analysis to support its claims for Opex and marketing costs. Benchmarking data should be presented to demonstrate that total costs are reasonable and efficient.*
- *GasNet should be required to provide information and analysis to support augmentation of its network.*

- *GasNet should recalculate the CPI adjustment of the Capital Base Roll forward, excluding the impact of GST on the CPI.*
- *The WACC of 7% proposed by ORG and ACCC in the Draft Determination on TPA in 1998, was seen by the Victorian Government as too low to get an adequate sale price for the assets. ACCC finally approved a WACC of 7.75% and the resulting sale price for TPA significantly exceeded expectations. We believe that the WACC of 7.0% proposed in the Draft Determination was closer to being correct and was probably still too high bearing in mind the risk profile for the enterprise*
- *The Access Arrangement must contain a mechanism to enable users to seek restitution from GasNet for any failure to supply gas.*