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Dear Ms Kaur

ACCC Draft Decision on GasNet AA

Opex, Benchmarking and Benefit Sharing

Further to our submission of 13 September to the ACCC regarding its Draft Decision on the GasNet application, due to the late release of the last additional information from GasNet on 25 September 2002, the following submission picks up the points we were unable to properly address with our first response to the Draft Decision. In particular we wish to comment on the proposals for opex, benchmarking and benefit sharing.

Due to your decision not to hold a pre-decision conference at which we intended to provide certain more information and to explain our views on aspects of the draft decision, we have to take this opportunity to amplify on some other points made in our earlier submission.

Lack of information from ACCC supporting its decisions

We particularly use this opportunity to comment on not only the right of the ACCC to aggregate the benefits of south west pipeline, but to comment on the fact that neither ACCC nor GasNet has provided calculations on the revenue anticipated from the SWP nor has either party provided calculations of the supposed system wide benefits, other than a simple and now out of date calculation by GasNet in its SWP application, and on which the ACCC throws significant doubt in its Final Decision on SWP.

In relation to this we refer to the recent decision of the WA Supreme Court decision regarding the Offgar/Epic case. Arising from this decision, it is quite clear that the regulator may make "regulatory judgements" but that in doing so the regulator must clearly identify that it has taken each and every one of the various factors affecting the regulatory judgement into account. The decision notes that a fundamental part of the regulatory process is to document each aspect of the factors considered by the regulator and in doing, so the regulator is obliged to give an explicit explanation of its reasons for its view on each aspect. There is no doubt that the draft decision of the ACCC on the GasNet application is deficient in a number of aspects where the ACCC has not clearly defined the reasons underlying its decision. There is no doubt that the draft decision is lacking in the clarity and explanation needed of a regulator.

The EUCV believes that the draft decision needs to address these shortcomings, and interested parties provided with the missing information and explanation so that they have the right to comment with full knowledge. We had hopes that a pre-decision conference would have provided a forum for the ACCC to provide an explanation and supporting information in those areas where it had used "regulatory judgement".

This matter of the lack of clarity and explanation of those aspects requiring "regulatory judgement" of the draft decision was raised with Commissioner John Martin on Friday 4 October 2002.

Due to the lack of explanation by the ACCC in so many areas of its draft decision, EUCV believes that the ACCC should issue a supplement to its draft decision providing the explanation and justifications so clearly absent from the current draft decision. Comments should be sought on this supplement.

We accept that this suggested process will delay the introduction of the new access arrangement, but we are of the view that it is more important to get the basis of the new access arrangement correct, than it is to rush a decision through because the current AA is nearly due to end. In this regard we would highlight that GasNet has been very remiss in not providing adequate information on which the ACCC can make an informed decision.

Benchmarking

Benchmarking is the only way the ACCC can ensure that the costs allowed to be included in the target revenue are even near acceptable. It must be accepted that the regulated business will use every opportunity to maximise the allowed revenue stream, despite any protestations to the contrary. To do so is a sound business principle. The ACCC comments that it has to balance its review between light handed regulation and eliminating monopoly rents. As payers of the monopoly services, EUCV members are of the view that eliminating monopoly rents is a more important criterion for the ACCC, than esoteric concepts such as "service providers

will want to play fair", and they will place the attraction of short term enhanced cash flow ahead of long term benefits to users.

The level of benchmarking provided by GasNet can be considered modest at best. Notwithstanding the concerns on this matter stated in the draft decision, the ACCC would appear to have accepted what GasNet has provided subject to the addition of one additional benchmark.

The ACCC comments that benchmarking of the GasNet operations is difficult because it has significant network characteristics such as a peaky load and little linepack, both of which both influence gas control. The ACCC does not explain why these should increase the opex allowed, nor does it assess the impact of GasNet's compact system. Our investigations indicate that each of these aspects could well reduce the opex.

After a review of benchmarks for distributions businesses, it would appear that opex costs for the Victorian gas distribution businesses do indeed indicate a cost structure different to other transmission businesses. The benchmarks provided to the Victorian ESC as part of its current review shows that $opex per kilometre of mains for distribution is about one third the level of GasNet's requested costs, and this comparison excludes the benefits GasNet has because VENCorp provides the gas control element of the GNS. On this comparative basis the ACCC should expect GasNet's opex to be much lower (rather than higher) than its equivalents in other parts of the country.

The ACCC accepts the comment of GasNet that the peaky load of the GNS will lead to higher comparative opex costs. We are at a loss to understand this. The GNS is designed to handle the peak of Victoria's gas demand. We can accept that the capital requirement of a system may increase to reflect a lower load factor (average demand in relation to peak demand) but we can see there is little correlation between opex and load factor, and GasNet (and ACCC) fails to explain why there should be any correlation.

Gas management (ie managing linepack, LNG, sourcing from different suppliers) is a duty carried out by VENCorp, and so is not a factor in GasNet's opex.

A key provision of the Gas Code is the need to avoid the circularity of benchmarking by comparing only against a few (local) benchmarks. The ACCC (and the Code) both acknowledge the desirability of international benchmarking as part of assessing reasonable opex levels. However, beyond the broad statement of its desirability the ACCC does nothing to require GasNet to provide any international benchmark comparisons. The ACCC fails to explain why international benchmarking is not required in GasNet's case.

The ACCC comments that it does not wish to attempt "micro-management" of GasNet. At the same time it does not provide any in-depth analysis to demonstrate

that GasNet has shown it is subject to rigorous "competition by comparison". The ACCC must explain why it does not require this feature of its review.

The ACCC appears to accept the GasNet assertion that the activities of VENCorp only saves GasNet $660,000 pa. The GasNet statement is accepted by the ACCC without any corroboration of VENCorp, or indeed from anyone else – it certainly is not challenged by the ACCC, not does the ACCC attempt its own cost review to support or deny it. However, the implications of the acceptance or otherwise of this amount has a profound impact on all of the benchmarking comparisons supposedly used by the ACCC to support the opex claimed by GasNet. By its failure to do this the ACCC has again not recognised the very explicit outcome of the Offgar/Epic decision of the WA Supreme Court, that the regulator must clearly give its reasons (and document them) behind any use of the regulator's judgement. The decision by the ACCC to accept unchallenged the assertion by GasNet that the costs it saves by the involvement of VENCorp, constitutes only 4% of VENCorp's costs, must require more than a one line statement of dismissal.

Benchmarking is the one acceptable method by which the ACCC can assess the legitimacy of the opex claims by GasNet. The ACCC itself identifies that the benchmarking undertaken is inconclusive (Draft Decision page 187). In light of this, the draft decision, and the failure by GasNet to provide more information, makes the ACCC's acceptance (Draft Decision page 85) of the reasonableness of the claimed increase over past levels of opex, totally unacceptable.

New opex allowance

Past opex is the starting point for assessment of reasonable future opex. GasNet has saved an average of $4M pa, a saving of nearly 25% against the allowances made in the current AA. GasNet is seeking an increase above the allowances granted in the current AA, and identifies certain unsustainable savings made in the current AA which cannot be carried forward. The ACCC has queried some of the opex increases sought but appears to accept the basic level of opex requested by GasNet. The benchmarking supplied by GasNet to verify the new opex claimed is noted by the ACCC as inconclusive.

GasNet was required by the ACCC to provide greater detail of its past opex, specifically for years 2001 and 2002, in the draft decision (page 85). This was to provide an itemised breakdown of the costs. GasNet has not provided this information and therefore interested parties are unable to comment on the detail of current opex with respect to past opex.

The ACCC states that the increase in costs between 2001 (noted as $13.9M) and the forecast amount of $18.4M is "… not unreasonable". There is no quantification of any of the reasons behind the supposed increases and this runs counter to the requirement of the Offgar/Epic decision for the regulator to fully explain the reasons for its exercise of "regulatory judgement". As well as the qualitative assessment

made by the ACCC, there is a need for quantitative analysis to support the contention.

However, EUCV has noted that there are very large opex savings from the allowed levels for the current AA, which GasNet says are unsustainable and in the draft decision the ACCC notes that it accepts this statement from GasNet of them being unsustainable. GasNet notes that these savings were the result of deferral of pigging and staff replacements and other reasons such as warmer weather reducing demand and less business marketing. They opine that the new opex increase of nearly one third is due the existence of increases in staffing and pigging. However, neither GasNet nor the ACCC provide any costing of the GasNet assertions of unsustainability of GasNet's past opex.

Even worse than the ACCC's easy acceptance of the assertions of unsustainability, is that the ACCC appears to accept the carry forward of a significant amount of pigging work from the current AA into the new AA. GasNet advises that some of the unsustainable savings were caused by the deferral of some pigging activity (and therefore this work could not have been done). GasNet explains that some of the increase in opex it needs in the new AA is to carry out this deferred pigging work. If GasNet is paid again in the new AA for this deferred work, this must amount to GasNet being paid twice for carrying out the same work. The ACCC appears to be condoning this double payment for the same work.

We would also note that other savings GasNet made in the current period relate to deferral of certain staff appointments, with an increase in the new AA due to addition of junior staff. GasNet does not provide any costing of these staff, but members of EUCV are large employers of people covering a wide range of responsibility levels. Based on their experience of staff costs, GasNet would appear to have either very highly paid staff, or to have had major staff shortages. A view of the GasNet published cost structure does not support the former assumption, nor does the performance of GasNet over the past 5 years support the second assumption. If GasNet could "survive" at this opex level without any reduction of its operating performance for four years, then this is tantamount to an identification of good benchmark performance, and there is no justification for the replacement of the staff so obviously not needed.

GasNet adds that reduction of sales due to warmer weather reduced its opex. The ACCC does not ask how, but accepts that, because GasNet says this is the case, it must be correct. As consumers of gas we cannot see that there is any basis on which reduced sales could have such a big impact on opex costs, other than perhaps less gas being needed for gas pumping reasons. GasNet does not quantify the opex benefit arising from less gas sales, and the ACCC has not required them to do so.

GasNet advises that it reduced its industrial gas marketing and as a result needs to increase it for the next period. At best the saving from marketing could only be of the order of some $100k for the years that it reduced its marketing.

In the analysis above, EUCV is not able to identify savings valued at anything like $4M pa unless they are a carry forward of previously approved and paid for activities such as pigging. The impact of weather warming which may have reduced opex is covered by the K-factor adjustment. The other costs GasNet claims are unsustainable do not total anywhere near the amount GasNet wishes to see as "unsustainable" and so retain as unearned profits.

Benefit sharing

The ACCC has proposed that future sustainable savings can remain with GasNet for a period of five years. Thereafter, the full saving is to revert to users. EUCV accepts this proposal as it endorses the concept of incentivising suppliers to provide users with long term benefits. However, the ACCC proposal fails by the very requirement that GasNet has to declare that a saving has been made. By declaring a saving as "unsustainable" GasNet avoids having to share anything with users. This is what is happening with the current review of the new AA proposed by GasNet.

GasNet has agreed that it was able to under-run the allowances made in the current regulatory period, but adds that these savings are unsustainable. It mentions in particular the deferral of activities such as pigging and staff appointments to support its contentions. However, GasNet does not quantify the value of these deferrals, other than to say that its forecast opex for 2002 will be higher than in previous years. GasNet has not provided even actual opex for the first half of 2002 to support its forecast and so there can be some doubts as to whether GasNet will indeed incur the full forecast costs.

In the current AA, GasNet has been granted a certain amount of revenue to manage the GNS. By "deferring" expenditure in the current AA, GasNet has made a windfall of some $20M over the period. Consumers have already paid GasNet for this opex as part of the tariffs. GasNet now proposes that at least some of the work paid for but not carried out in the current AA should be carried out in the new AA and paid for again. We note the ACCC desire not to "micro-manage" GasNet's activities, but the ACCC is required to ensure that GasNet should not be paid for the same work twice.

We are clearly of the view that GasNet has been able to sensibly reduce its operating costs from the levels paid for in the current AA, and there is a saving available to be shared with users.

We also note that the ACCC intends to allow GasNet to recover some of its losses incurred in the current AA by virtue of the K-factor adjustment, and add these to the revenue stream permitted for the new AA. Of the reasons for the opex savings GasNet has noted, there are some which are already included in the K-factor carry forward, such as those related to the loss of sales due to warmer weather. In this way GasNet is permitted to levy a lump sum premium on future users of the GNS

due to its poor past volume forecasting, but at the same time claim a benefit for itself by not declaring that it achieved savings as a result.

In counterpoint, by declaring that $20M of identified savings in opex from the current period are “unsustainable” and by not requiring GasNet to either cost the savings gained (and so impact the opex allowance for the new AA) or to give a lump sum benefit to GNS, the ACCC is permitting GasNet to levy users an unreasonable level of opex for the new AA and retain cash that GasNet was provided but never spent.

If the ACCC is not sufficiently diligent to ensure that savings are properly identified and then passed onto users, EUCV cannot endorse the ACCC proposal for benefit sharing. This is because the benefit sharing approach proposed by the ACCC fails to bring forward real savings GasNet has made, allows GasNet to be paid for the same work twice, and at the same time, gives GasNet a lump sum benefit arising from its own poor forecasting.

Aggregation of benefits of SWP

We have a real concern that the under recovery of SWP by GasNet is to be funded by all users of PTS. This is not only inequitable but contrary to the Gas Code. Attachment A to this submission analyses the Gas Code and all publicly available information purporting to provide costing of any system wide benefits.

This analysis demonstrates that the ACCC has erred on two counts with respect to the application for roll-in of the SWP.

Firstly, the ACCC is not permitted to aggregate benefits of an augmentation of a gas transmission system. Our analysis would indicate that the ACCC has overstated its powers with regard to this issue. Even so, the ACCC has not provided any explanation in support of its conclusion in the draft decision. The Offgar/Epic decision quite clearly anticipates that a regulator must provide not only its conclusions about an issue, but is to provide a full explanation as to why it reached this specific conclusion, and the reasons why it has denied those aspects which militate against the conclusion reached. The ACCC has ignored this essential requirement of regulatory decision making.

Secondly, even if it were so permitted to aggregate benefits, there has been no quantification by GasNet or ACCC to demonstrate that a system wide benefit is actually there, and if there is any benefit, whether it is of sufficient magnitude to balance the unstated revenue GasNet alleges it will get from the SWP tariffs. Again, the ACCC has purported to have reached a regulatory judgement on an issue without apparently calculating any putative benefits, or if they have, failing to share the reasons (both qualitative and quantitative) behind the conclusion reached as part of the regulatory decision.

Conclusions

1. The ACCC must make its GasNet decision clearer, and provide detailed qualitative and quantitative data supporting its “regulatory judgements” as required by the WA Supreme Court decision on Offgar/Epic.
2. The ACCC should issue a supplement to its draft decision providing the explanation and justifications absent from the current draft decision. Comments should be sought on this supplement.
3. The ACCC has failed to require GasNet to provide benchmarking which gives a true comparison of the GasNet activities and which eliminates the circular issue of comparing only amongst the same small group. By failing to either “micro-manage” GasNet or to rigorously enforce benchmarking as a surrogate for competition, the ACCC is permitting GasNet to levy a monopoly rent on users.
4. There is no quantified support for the contention that GasNet past opex savings are “unsustainable”. Included in the new opex is work already paid for under the current AA, and an initial review of the other areas noted as “unsustainable savings” indicates that these savings have a value at best of only a few hundred thousand dollars, rather than the $millions implied by GasNet.
5. EUCV supports the concept of benefit sharing but unless the ACCC diligently applies itself to identifying savings and then rigorously applies them to future decisions, we can see no point in debating the merits of the various ways of granting a share of savings to GasNet.
6. The ACCC is not permitted to aggregate benefits of the SWP in order to permit the rolling in of the SWP into the PTS. The “regulatory judgement” exercised by the ACCC with regard to the roll-in of SWP has no quantifiable assessments to support it.

We thank you for the opportunity to make these additional comments with regard to the draft decision on the GasNet application, and we remain available for any discussion on these issues. We would be pleased to meet with you and more fully explain the points made in this letter.

Yours sincerely

David Headberry
Secretary to EUCV

Attachment A

We have investigated the issue of the SWP roll-in and believe that the ACCC has not considered the ability to aggregate benefits in the context in which the Code was drafted.

The ability to aggregate benefits is not permitted

After excluding the roll-in of SWP into the PTS under the current access arrangement due to the fact that the current access arrangement prevents the aggregation of benefits, the ACCC now advises in its draft decision that they consider that the roll-in of the SWP into the PTS is permitted in aggregate by the part recovery of revenue from the SWP tariff, and in part (the balance) from the system wide benefit. The draft decision comments that this approach is permitted to the ACCC by the fact that at a regulatory reset their assessment of the New Facilities Investment is purely based on the Gas Code, and not by the extensions policy included in the Access Arrangement, which will only apply between regulatory resets. Thus their decision to permit the SWP roll-in is being made under the rules of the Gas Code.

In regard to this issue the Gas Code states:-

> 8.16 The amount by which the Capital Base may be increased is the amount of the actual capital cost incurred (***New Facilities Investment***) provided that:
> (a) that amount does not exceed the amount that would be invested by a prudent Service Provider acting efficiently, in accordance with accepted good industry practice, and to achieve the lowest sustainable cost of delivering Services; and
> (b) one of the following conditions is satisfied:
>
> > (i) the Anticipated Incremental Revenue generated by the New Facility exceeds the New Facilities Investment; or
> > (ii) the Service Provider and/or Users satisfy the Relevant Regulator that the New Facility has system-wide benefits that, in the Relevant Regulator's opinion, justify the approval of a higher Reference Tariff for all Users; or
> > (iii) the New Facility is necessary to maintain the safety, integrity or Contracted Capacity of Services.
>
> 8.17 For the purposes of administering section 8.16(a), the Relevant Regulator must consider:
> (a) whether the New Facility exhibits economies of scale or scope and the increments in which Capacity can be added; and
> (b) whether the lowest sustainable cost of delivering Services over a reasonable time frame may require the installation of a New Facility with Capacity sufficient to meet forecast sales of Services over that time frame.
>
> 8.18 A Reference Tariff Policy may, at the discretion of the Service Provider, state that the Service Provider will undertake New Facilities Investment that does not satisfy the requirements of section 8.16. If the Service Provider incurs such New Facilities Investment, the Capital Base may be increased by that part of the New Facilities Investment which does satisfy section 8.16 (the ***Recoverable Portion***).

Review of the Gas Code requirements reveals a number of issues when considered in the context of the PTS.

Effectively section 8.16(a) combined with section 8.17(b) requires the investment to be the lowest cost option available. The ACCC observes advice that augmentation of the Longford to Pakenham (L-P) section of the PTS could achieve the same benefit as the SWP[1], but that this would not provided a link to Otway and WUGS. While the ACCC notes that the link to Otway brings system benefits as does the connection to WUGS, it entirely overlooks that there is competition from the Gippsland basin itself to Esso/BHP which will not be served if L-P is not augmented. Equally, the broad assumption that access to WUGS is a system wide benefit is not a sustainable argument because there is no demonstrable benefit of WUGS that could not be satisfied by L-P augmentation. It must be remembered that L-P system has served Victoria for forty years without disruption. Thus, augmentation of the L-P section of PTS will deliver similar benefits to those noted by the ACCC as applying to SWP, and apparently at a lower cost.

The ACCC avers that the Gas Code permits aggregation of benefits to satisfy the feasibility of new facilities. This is not the case. Section 18(b) requires that the investment, in addition to being the lowest cost option (ie. complying with section 8.16(a)) it must satisfy **one** of the other tests (which implicitly are: sufficient revenue, **or** system wide benefit, **or** system safety). The use of the term "**one**"[2] in clause 8.16(b) does not imply part of one and part of second. The wording is quite explicit – the terminology allows only one of the three tests to be applied. The ACCC is incorrect to assume that an aggregation of benefits is permitted. The very definite use of the term "**or**"[3] between each of the options (i), (ii) and (iii) in section 8.18(b), clearly denotes mutual exclusion between the alternatives, and the clear requirement of "**one"** of the options in section (b) to be complied with does not permit aggregation. If aggregation of benefits was anticipated then the wording would have been different along the lines of "one or more, in part or in full".

In our submission of 13 September 2002 we stated:-

> "Under the Gas Code there are three alternatives for assessing whether an extension can be permitted to be rolled in to the asset base. Our examination of the Gas Code's applicable clauses (sections 8.16 to 8.18) would indicate that each of the tests is separate and there is no clear definition that aggregation of benefits was contemplated or in fact is permitted. As both the current Access Arrangement and the Victorian Gas Code were written to be complementary (they were drafted by the same legal firm at the same time) and further as the Victorian Gas Code was modelled on the on an early draft of the National Gas Code we believe that there is a clear connection running between each of these three documents with regard to this issue. Therefore, if the current access arrangement precludes aggregation of benefits, then it follows that the other two documents probably have the same construction.

[1] ACCC Draft Decision, GasNet Australia access arrangement revisions for the PTS, 14 August 2002, page 45

[2] The Concise Oxford Dictionary Ed 7 denotes the use of "one" (when used as a noun as in this case) as a unit, unity or a single thing or person or example

[3] The Concise Oxford Dictionary Ed 7 denotes the use of "or" as a conjunction introducing the second of two alternatives.

> We strongly believe that the ACCC has erred in assuming that it is permitted to aggregate benefits when permits the aggregation of the benefits of the south West Pipeline."

When there is doubt, as applies in this case, it assists to interpret the Code in context with associated documents developed at the same time by the same authors. As the ACCC noted in its final decision on the SWP roll in, the documents associated with the Victorian Gas Access Code clearly prevent the aggregation, and there is no reason to accept that the National Gas Access Code as legislated is at odds with these other documents.

The ACCC has no alternative but to assess the roll-in of the SWP on either the efficiency test **or** the system wide benefit test, but not on an aggregate of the two. The wording of the Gas Code is quite clear in that the ACCC is not permitted to aggregate benefits in assessing whether the capital for an extension can be rolled-into the RAB.

The costing of benefits

Section 8.18(b)(ii) of the Gas Code allows either or both of the service provider and users to provide sufficient argument to satisfy the regulator that the proposed investment provides a system wide benefit. No user has applied for the SWP to be rolled-in under the system wide benefit test and GasNet has not provided any quantification of benefits of rolling in the SWP in its current application.

Review of the ACCC Final Decision on SWP on 29 June 2001, provides no additional information to support a quantification of the conclusion in this draft decision by the ACCC. Therefore, the ACCC must only have considered the information provided by GasNet in its previous application for SWP roll in, and in its Final Decision of 29 June 2001 on the SWP roll-in, the ACCC itself casts considerable doubt as to the acceptability of the GasNet calculations provided. As this information applied at the time of that application (ie it does not recognise any changes to the GasNet system or introductions of new gas supplies since that time), we are at a loss to understand how the ACCC has now reached the conclusion that the current system wide benefit is sufficient to cover the expected under-run of the revenue flow from the tariff on SWP. The ACCC advises that it has used "regulatory judgment" to reach its conclusion. It was stated that the access to new gas and the provision of the facility that the WUGS provides was sufficient to support the decision.

However, transparent regulation requires provision of more than the use of the words "regulatory judgment". It is not sufficient for the regulator to advise that it has reached a conclusion, it must demonstrate how it reached that conclusion. Failure to state the "how" element of the review, exposes the regulator to accusations of non compliance with transparent regulation as now explicitly required by the Offgar/Epic decision.

In particular, the ACCC has failed to assess whether the same system wide benefit could have been provided in alternative ways, and at what cost. It has failed to take into consideration that the currently proven gas from Otway has been almost entirely contracted for South Australian use, and therefore the supposed benefit of access to new gas is definitely compromised. In view of the lack of quantification of the supposed benefits, EUCV is firmly of the view that the ACCC has over-estimated the system wide benefit of SWP and is loading unnecessary costs onto all consumers.

Section 8.18 clearly envisages that an investment may not meet the requirements of the Gas Code for an extension to be rolled-in, and clearly permits a part only of the investment to be rolled in. Such a part roll-in must require a clear quantification of any benefits to assess the proportion of any roll in permitted.

There has been no evaluation or quantification of the impacts of the current circumstances surrounding gas use in Victoria to support the roll in of the SWP as applying at the time of this reset.

In conclusion, the ACCC is not permitted to aggregate benefits under the Gas Code, and even if it were so permitted, it must carryout a quantification of the benefits to prove they exist. The Gas Code implies that such quantification must be carried out by the inclusion of Section 8.18 which permits the “recoverable portion” to be rolled in.