GasNet response to submissions

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1 Introduction

1.1 Background

On 24 August 2004, GasNet lodged with the Commission an application to revise the Access Arrangement under 2.28 of the Code (**Revisions Application**). The revisions contained in the Revisions Application are voluntary and separate from the:

(a) scheduled review of the Access Arrangement, due in 2007; and

(b) annual tariff adjustment, which, for 2005, must commence by 17 November 2004.

On 30 August 2004 the Commission published a notice to interested parties seeking submissions on the Revisions Application by 30 September 2004.

This Response sets out GasNet's response to the issues raised in public submissions lodged with the Commission.

1.2 Public submissions

This Response addresses issues raised in the following public submissions, as received by the Commission by 8 October 2004:

(a) Energy Advice submission dated 28 September 2004 (**Energy Advice Submission**);

(b) Origin submission dated 29 September 2004 (**Origin Submission**);

(c) TXU submission dated 30 September 2004 (**TXU Submission**); and

(d) AGL submission dated 4 October 2004 (**AGL Submission**).

GasNet reserves the right to make further submissions in relation to these or any other public submissions.

1.3 Terminology

For simplicity, this Response adopts the terminology used in the Revisions Application.

2 K Factor Revision

2.1 Summary of GasNet proposal

The purpose of this Revision is to cure an anomaly in the K-factor mechanism that has the potential to artificially ratchet down GasNet's tariffs, leading to an unwarranted deferral of revenue.

A key component of the Price Control Formula is the K-factor, which is designed to modulate the impact of within-system load shifting. For example, if in a year:

(a) the aggregate gas volumes equalled the forecast; but

(b) within that aggregate, some load shifted so that more gas flowed in a high tariff zone than anticipated (and correspondingly less gas flowed in a low tariff zone),

then the K-factor would apply so that the resulting over-recovery (ie above the target average tariff) is returned to Users in the following year in the form of lower tariffs.

A number of discounting mechanisms were included in the Access Arrangement to overcome potential bypass threats. The discounts have caused unintended volatility in GasNet's revenue, with a corresponding increase in the likelihood and extent of K-factor accruals. This effect, coupled with the year-on-year cap on increases in individual tariffs, produces a potential to ratchet down GasNet's tariffs and for significant amounts of revenue to be artificially deferred.

GasNet proposes that the K-factor mechanism be amended so that any over-recovery be repaid by a reduction in tariff over the **balance** of the Access Arrangement Period, rather than in a single tariff reduction in the year following the accrual of the over-recovery. This procedure will avoid substantial deferral of revenues and dampen tariff fluctuations.

2.2 Issues raised in submissions

All submissions commented on the K-factor Revision. AGL and Energy Advice supported this Revision, while TXU and Origin raised a number of concerns.

The balance of this section addresses those concerns.

2.3 Mid-term review

This issue was canvassed in detail in GasNet's Revisions Application and GasNet does not propose to repeat it. However, the following discussion addresses the specific points raised by TXU and Origin.

Risk already addressed

Both TXU and Origin opposed this Revision being implemented as a mid-term review on the basis that this risk had already been addressed in the Access Arrangement. TXU asserted that the price control formulae were "well understood" during the last review, while Origin claimed that the increase in tariff cap from 1% to 2% accommodated this issue.

However, as outlined in the Revisions Application, this Revision is necessary because of two new aspects affecting the application of the price control formulae, namely the new injection sources and the additional matched rebate arrangements. These items have caused unforseen volatility in the price control formulae.

Issue already addressed in WACC

As a related point, TXU asserted that this risk is already provided for in the WACC.

This is not the case. GasNet's WACC was set largely by reference to industry (or economy)-wide factors and contains no allowance for this risk.

Regulatory risk

Finally, TXU thought GasNet should not "deal with the rebalancing constraint" as a mid-term review because it creates unnecessary regulatory risk (presumably for gas retailers such as TXU).

However, a change in tariffs (or the price control formula) does not, of itself, present an unacceptable regulatory risk. In this case, the Revision:

(a) enhances regulatory certainty by addressing anomalies in the price control formula that have the potential to cause significant revenue deferrals; and

(b) there is no material adverse effect on the retailers.

2.4 Varying consumption

Origin criticised this Revision because, it said, marginal differences in consumption volumes do not justify a revision.

With respect, this misconstrues the nature of GasNet's proposed Revision.

Importantly, the Revision is not based on a variation in consumption. GasNet accepts that, as part of the incentive mechanism in its Access Arrangement, GasNet bears the risk (and reward) of consumption fluctuations. However, this Revision relates to the allocation of tariffs across the GNS and the related fluctuations in gas flow locations (ie as opposed to absolute changes in overall volumes).

2.5 Customer impact

Origin contended that customers (ie end Users) would either be neutral or negative towards this Revision.

Domestic and small industrial/commercial customers receive a bundled gas service, and the tariffs for this have been set until the end of 2007[1], which coincides with the expiry of the current transmission and distribution access arrangements. As a result these customers are unlikely to be affected in the short term whether or not this Revision is made. However, in the longer term:

(a) the current mechanism could result in an under-recovery to be recouped in the next access arrangement period (and therefore introducing a greater risk of tariff shock); while

[1] Media Release, 23 December 2003, Victorian Minister for Energy, Industry and Resources.

(b) in contrast, this Revision should have the effect of bringing forward some of that recoupment, resulting in a lower risk of tariff shock.

As the retailers are not disadvantaged by the Revision (the approved retail tariffs reflect the CPI+2% "ceiling" in the transmission tariffs and the Revision retains that ceiling), GasNet considers that the Revision is in the interests of small industrial/commercial customers who are, in any case, not subject to direct pass through of transmission tariffs.

In relation to larger customers, GasNet does not accept that these customers will always prefer a lower short term price in exchange for a higher long term price. In GasNet's experience, larger customers, who make investment decisions over a longer time frame, generally prefer greater stability and certainty in prices.

Similarly, TXU suggested that the Revision is contrary to the short term interests of customers. For the reasons canvassed above, GasNet does not accept this. And even if the Revision was contrary to the short term interests of customers, this is outweighed by:

(a) the longer term interests of customers in avoiding tariff shocks; and

(b) GasNet's legitimate interests in minimising any significant deferral of revenue.

2.6 Efficient tariffs

TXU asserted that the Revision is contrary to Section 8.1 of the Code, which requires tariffs to have an efficient level and structure, in that the tariff following a year of over-recovery will not be efficient.

However, TXU appears to have misconstrued Section 8.1(e) of the Code.

To meet the requirements of the Code, the forecast tariff should be efficient in level and structure over the regulatory period, rather than over each tariff year. Where tariffs are levelled over the regulatory period as is accepted practice, then it is impossible for tariffs for individual years to be purely cost reflective. To insist on cost reflective tariffs on a year-by-year basis, as TXU's proposal implies, would amount to rate of return regulation.

By revising the K-factor to provide a smoother price path, GasNet is not departing from a tariff that is efficient in level and structure over the Access Arrangement Period, as required by Section 8.1(e) of the Code. Accordingly, GasNet does not accept that this Revision introduces unacceptable inefficiencies. If anything, it achieves a greater level of long term efficiency by keeping tariffs closer to the underlying costs.

3 Refill Tariff Revision

3.1 Summary of GasNet's proposal

GasNet currently applies a lower tariff to withdrawals into storage facilities. This tariff is deliberately lower than other tariffs on the GNS to encourage storage.

GasNet has become aware that it is now possible for Users who have access to the WUGS storage facility at Iona to export gas from the GNS to the SEA Gas Pipeline, via the WUGS facility, and receive the benefit of the cheaper withdrawal tariff. This opportunity is not available to Users who export through the nearby SEA Gas delivery point.

This use of the cheaper withdrawal tariff for exports was never intended. GasNet proposes to retain the storage incentives while preventing export "leakage" by:

(a) removing the cheaper withdrawal tariff; and

(b) instead operating a rebate system so that stored gas attracts the lower tariff when it is re-injected into the GNS.

3.2 Issues raised in submissions

All submissions commented on the Refill Tariff Revision. AGL supported this Revision, while TXU and Origin raised a number of concerns.

Energy Advice supported the revision in principle but requested that GasNet ensure that transfers of ownership of gas be recognised and the rebate be paid accordingly.

The balance of this section addresses those concerns.

3.3 Other costs of shipping gas

Both Origin and TXU claimed that other costs associated with shipping gas must be included in the delivered gas price. For example:

(a) Origin specifically noted costs such as the commercial rates for injection, storage, withdrawal, losses, compression and use of the lateral pipelines; and

(b) TXU argued that gas shipped to South Australia via WUGS and the SEA Gas 18 inch arterial could be more expensive than gas shipped directly through the SEA Gas 14 inch arterial.

This argument is flawed in two respects.

First, GasNet's Revision is designed to cure an anomaly which, when viewed from "within" the GNS, has the potential to discriminate between retailers and undermine the cost-reflective pricing methodology. This also produces the potential to distort competition in South Australia but GasNet has not modelled this impact and does not rely on this as a major factor.

Second, each "exit point" from the GNS will necessarily attract a range of costs in terms of transport beyond the GNS. For example, it appears from the TXU Submission that, in order for gas to be shipped via Minerva, additional compression is required. Ultimately, these costs are not relevant to an analysis of the GNS price control formulae.

3.4 Retention of funds

Origin expressed concern that GasNet's proposal to retain $0.09 per GJ for gas leaving the GNS until it is returned from WUGS will incur additional working capital costs on Users. Users often store hundreds of terajoules of gas for several months before withdrawing it. Under the proposed arrangement, Origin contends that GasNet would have the benefit of these funds while the gas is in storage.

However, the working capital effect of the proposed full tariff/rebate method of charging is negligible. The total benefit to GasNet of 10PJ (full capacity) being stored for six months is approximately $25,000.

3.5 Existing contractual commitments

TXU appears to have argued that:

(a) TXU "did not intentionally seek access" to the WUGS arterial purely to take advantage of a lower tariff;

(b) TXU has entered into contractual commitments on the WUGS arterial and in downstream supply contracts on the basis of the existing tariffs and these would be adversely affected by the Revision; and

(c) TXU would support the Revision at the next regulatory review (ie for the next Access Arrangement Period).

The extrapolation is (presumably) that GasNet should not be permitted to revise the refill tariffs now.

The Code provides no specific guidance on this issue but, the general provisions of the Code are relevant.

First, the Code specifically contemplates mid-term reviews and therefore these must always be considered a possibility. Also, unlike some other aspects of the Access Arrangement (for example, the efficiency carry-over) the refill tariff does not rely on a consistent application to be effective.

Second, while TXU has raised some concerns about the effect on its contractual position, GasNet does not have sufficient evidence to ascertain whether TXU would be disadvantaged by the Revision.

Third, even if TXU would be disadvantaged, GasNet considers that the benefit to other Users in preventing discriminatory pricing outweigh any disadvantage of an individual User.

3.6 Security of supply

TXU argues that security of supply in Victoria and South Australia is enhanced by retaining the lower refill tariff.

This submission misconstrues the purpose behind the refill tariff. GasNet does not provide the refill tariff because WUGS provides security of supply to Victoria (although it does have this effect). Rather, the refill tariff was created because:

(a) it helps ensure that use of the storage facility is economic; and

(b) as the annual use of the facility varies considerably, providing a cost recovery only tariff for this service allows GasNet to remove the highly uncertain volumes (and therefore revenue) from its price control formula thus decreasing the level of uncertainty in the annual tariff rate changes.

Also, even if Victorian system security were the basis of the refill tariff, it is inappropriate to argue that this would require Users of the GNS to subsidise South Australian security of supply.

3.7 Rebate proposal

Origin also claimed that the rebate system proposed by GasNet is neither cost reflective nor provides any additional services to Users.

This appears to misunderstand the rationale for the refill tariffs.

The refill tariffs are designed to be cost recovery tariffs only, on the understanding that GasNet will earn its return when the gas is later reinjected back into the GNS. As such, these tariffs are not part of the GasNet price control calculation and do not attract overhead recovery. They were specifically designed and labelled as refill not export tariffs.

3.8 Transfers of ownership of gas

Energy Advice agreed with GasNet's proposal to remove the upfront discounted tariff for withdrawals into storage and replace it with a rebate payable on re-injection into the GNS.

However, Energy Advice was concerned that the rebate be attributed to the appropriate directional flow. Where the User withdraws gas into WUGS and then sells the stored gas, it will not receive the rebate for the gas it has stored since the rebate is only payable in re-injection. Nor would the purchaser of the stored gas receive the rebate, since the rebate only attaches on re-injection of gas where that gas has been recorded and attributed by GasNet as stored by the purchaser.

Energy Advice was concerned that this would:

(a) decrease the incentive to use storage; and

(b) provide GasNet with a windfall.

GasNet proposes to deal with changes of ownership in the same way as it presently deals with gas assigned for the purposes of Matched Withdrawals under Schedule 1.5(d)(v) and (vi) of the Access Arrangement. That is, if gas is withdrawn from the GNS into WUGS and then, whilst in WUGS, sold to another User, the vendor and purchaser of the stored gas agree to sell the right to the rebate. This must be evidenced by confirmation from both parties to GasNet 18 business days after the month in which the gas was sold.

3.9 GasNet over-recovery

AGL expressed a concern that the Revision could result in Users who do not re-inject gas (i.e., exporting the gas) paying more and therefore lead to an over-recovery for GasNet.

However, it is wrong to characterise these revenues (if any) as an "over-recovery". If these revenues arise, then they should be regarded as export volumes and treated the same as other export volumes (for example, volumes withdrawn through the Iona withdrawal point). This is precisely what GasNet's proposed Revision achieves.

Some background to the export and refill tariffs may assist.

(a) At the time of the Access Arrangement review in 2001/02 there was an expectation that there would not be significant exports from the GNS to South Australia.

(b) There were two competing proposals to construct pipelines from Port Campbell to Adelaide (which were then merged into one proposal - the SEAGas pipeline).

(c) In terms of gas flows, these proposed pipelines planned to take production from the Minerva project at Port Campbell for export to South Australia without ever entering the GNS. Minerva was to be operational at the same time as the Port Campbell-Adelaide pipeline so that there would be no need for supply from the GNS into the Pt Campbell-Adelaide pipeline. There was an expectation that there would probably be a low level of injection of Minerva gas into the GNS for sale in Victoria.

(d) These expectations were factored into the demand forecast underlying GasNet's tariffs, which therefore did not include any exports from the GNS to South Australia.

(e) Since then, the SEAGas pipeline has been completed.

(f) However, the Minerva project is still not operational. Moreover, there have been significant production problems at Moomba, the alternative supply source for gas demand in South Australia. As a result, there have been significant unforeseen exports from the GNS to South Australia.

As these exports represent extra volumes not included in the forecast on which the tariff was based they would, if not classified as refill volumes, result in increased revenue for GasNet. However, this should not be characterised as an over recovery. In particular:

(a) GasNet's forecasts, which were published and reviewed during the Access Arrangement review process in 20002 specifically stated that:

(i) no exports were forecast; and

(ii) refill volumes were excluded from the forecast; and

(b) GasNet is allowed to earn its average tariff over all of its withdrawal volumes (with the exception of refill volumes). When these overall volumes exceed the forecast, GasNet will earn more than its target revenue and, likewise, less than its target revenue if volumes are below forecast. This is part of its incentive mechanism.

4 Weather Pattern Revision

4.1 Summary of GasNet's proposal

Weather forecasts are a critical element of GasNet's price path methodology. A forecast that is artificially cold results in forecasts of higher gas consumption and, therefore, a price cap that is too low to recover required revenue, and vice versa.

During the Access Arrangement approval process in 2002, GasNet became aware of a possible warming shift in the weather in Victoria. However, as there was insufficient evidence to substantiate the shift at the time, GasNet proposed that the issue be revisited in 2004, when further evidence might be available. The ACCC observed that it would be open to GasNet to seek a mid-term revision if further information became available.

Since 2002, there has been further research done into the weather in Victoria which substantiates GasNet's concern of a warming shift. Consistent with the ACCC's observations in its 2002 decisions, GasNet now proposes to revise the forecasts in its Access Arrangement to reflect the impact of warmer weather. All other things being equal, this will marginally increase the average tariffs payable by GasNet customers. However, if the existing tariffs remain, GasNet revenues will be reduced (on average) below the approved revenue requirement because the existing tariffs are based on a volume forecast which is higher than is expected to occur. Put another way, the current forecast artificially depresses the tariffs and the proposed change does no more than return the tariffs to a level that is likely to earn GasNet its approved revenue requirement.

4.2 Issues raised in submissions

All submissions commented on the Weather Pattern Revision. AGL and Energy Advice supported this Revision, while TXU and Origin raised a number of concerns.

Those concerns, which are addressed in the balance of this section, fall into two broad categories:

(a) that there is insufficient evidence to support GasNet's Revisions; and

(b) even if there is enough evidence, it is inappropriate to make the Revision.

For the reasons set out below, GasNet does not consider these concerns operate to deny the Revisions.

4.3 Sufficiency of evidence

Step change

Origin Energy argued that the 2003 VENCorp Report (on which GasNet relies to support its Revision) does not support GasNet's claim that there has been a "step change" in the weather. Two points are worth noting.

First, the question of whether there has been a "step change" is largely one of semantics rather than substance. Ultimately, GasNet is not arguing that VENCorp has declared a step change in the weather.

Second, and more importantly, GasNet is seeking to revise its demand forecasts to match the revised forecasts in the 2003 VENCorp Report. Origin Energy does not dispute these forecasts. Whether these revised demands amount to a "step" change is immaterial. The issue is with the content of the revised forecasts, not their characterisation.

2005 revision

Origin Energy claimed that GasNet should wait until 2005 to change its demand forecasts, to coincide with a review VENCorp has proposed of the 2003 VENCorp Report.

However, the review proposed by VENCorp in 2005 will not be a complete re-examination of the conclusions raised in the 2003 VENCorp Review. Rather, it will assess the suitability of the new standards for 2006 to 2008 and be the first of a general commitment to review the weather standard every 2 to 3 years.

And, contrary to Origin's implication, the 2003 VENCorp Review was undertaken with full industry consultation. Further reviews are not likely to involve any greater level of industry consultation.

Link between weather and demand

TXU argued it is impossible, at this stage, to ascertain whether the reduced demand (relative to demand forecasts) has been driven by warmer weather. TXU suggested that a combination of other variables has affected demand and referred to recent VENCorp market data to support its claim that demand has not fallen.

However, a brief analysis confirms GasNet's arguments.

First, the data on which TXU relied (VENCorp's market information bulletin board) reports aggregate total system demand. These need to be broken down into two separate categories:

(a) volumes for space heating, which are driven by weather; and

(b) other volumes such as withdrawals to refill, demand for electricity generation and exports.

Second, while GasNet agrees that it is difficult to discern a strong trend in the "other" volumes, the report on which TXU relied has other shortcomings which make it unreliable for interpreting gas demand trends. These include that it reports gross withdrawals rather than netting back flows through CTMs and only net flows at injection points which also act as withdrawal points.

Third, VENCorp confirmed in the 2003 Annual Planning Review (APR) that the relationship between weather and demand has not changed, i.e., demand changes per Effective Degree Day. The 2003 VENCorp APR also concluded that the portion of demand linked to weather (chiefly space heating) compared with other uses in Industry and electricity generation is lower than in earlier forecasts.

Mid-term revision

Origin Energy claimed that GasNet relies on a statement by the Commission that was out of context. In particular, Origin Energy claimed that the Commission's acceptance of the possibility of a mid-term review related to a review of 10 peak days rather than demand forecasts.

However, looking at the context of the Commission's comments, there is no controversy. The Commission was considering the appropriate treatment of demand forecasts and, as demand relates to both annual totals and peak periods, the Commission focused on the 10 peak days, being the days from which peak demand tariffs are derived. In this context, demand forecasts includes both annual volume and 10 peak days.

In addition, Origin incorrectly claimed that the Commission did not accept the continuation of the identified warming trend in GasNet's forecast. The Commission did accept the continuation of the trend raised by GasNet in the March 2002 Submission and incorporated this into the Access Arrangement and VENCorp's access arrangement.

Retrospectivity

Origin claimed that by making adjustments to the K-factor for 2004, the revised forecasts will be retrospectively changing tariffs for 2004.

However, as GasNet is retaining the cap on the K-factor mechanism, the interests of Users are protected by ensuring tariff certainty. Under the present Access Arrangement, although Users cannot predict the price path from year to year (given the uncertainties in the calculation of the K-factor), Users are assured that any individual tariff component will not increase by more than the tariff cap in the formula CPI - X + 2%. This tariff cap will be preserved for each tariff component.

Accordingly, if any 2004 revenues are recovered through operation of the K-factor, this is in effect no different to the situation that would have prevailed prior to amending the volume forecasts.

Consistency

Origin argued that changing the weather basis of GasNet's forecasts would introduce inconsistency between GasNet and VENCorp decisions and decisions made by the ESC.

While consistency between regulatory decisions is desirable:

(a) Origin Energy has identified no real detriment to Users if decisions are based on different forecasts;

(b) it is appropriate to make this change now, given GasNet indicated in 2002 it would seek to revise its Access Arrangement when more information became available; and

(c) as the material from the 2003 VENCorp Review is more conclusive than that relied on by GasNet in 2002, the Access Arrangement should reflect the best available information.

Rate of return regulation and asymmetry

TXU argued that if the Commission re-opened the Access Arrangement as requested by GasNet, then it ran the risk of implementing rate of return regulation, (or, to use the language of the Code, "cost of service regulation"). TXU was also concerned that, by seeking the revisions, GasNet would be able to adjust its revenues to align with costs, thus introducing an element of asymmetry into the Access Arrangement.

GasNet contends that the changes it is seeking patently do not lead to a cost of service approach. GasNet is seeking to correct certain anomalies in the Access Arrangement.

It is incorrect to argue that that GasNet is aligning costs with revenue. Even if the revisions are made, GasNet will still be subject to all of the incentives related to matters which it can control in order to improve on the returns presently available to it. That is, GasNet will remain subject to the risks of lower throughput or higher costs.

Furthermore, GasNet believes that it is better to address these problems now rather than allow them to remain and for their effects to balloon in the time to the end of the regulatory period. To do so would result in a tariff path that is to the benefit of neither GasNet nor its customers.