origin

9 July 2007

Mr Chris Pattas
General Manager
Network Regulation Branch South
Australian Competition and Consumer Commission
GPO Box 520
Melbourne VIC 3001

Dear Mr Pattas

REVISIONS LODGED BY GASNET FOR THE PRINCIPAL TRANSMISSION SYSTEM - ISSUES PAPER

1. General comments

Origin Energy Limited (Origin) welcomes this opportunity to make comments on the Commission's issues paper on GasNet Australia (Operations) Pty Ltd's (GasNet's) revised access arrangement for the Victorian Principal Transmission System (PTS).

Origin has two very high level concerns with GasNet's proposal as well as comments on the specific issues raised in the proposal.

First, GasNet has proposed significant and unprecedented increases in capital expenditure during the third access arrangement period (2008-12, AA3) amounting to a total capital expenditure of some $334 million on a closing 2007 capital base of $542 million (that is, some 64 per cent of the closing value). The majority of this expenditure (approximately 65 per cent) is forecast to occur in the first 2 years of AA3. This growth in expenditure particularly when combined with the proposed roll-in of non-forecast capital expenditure from AA2 is the main driver behind the significant increase in real network tariffs over the AA3 period and occurs in a time of only moderate demand growth. For this reason, we strongly urge the Commission to conduct a full examination of both the amount and timing of the reported second access arrangement period (2003-07, AA2) capital expenditure and the proposed AA3 expenditure in terms of whether such expenditure was and is prudent and feasible.

Second, GasNet is yet again proposing significant changes to the methodologies it uses in the calculation of its revenue requirements and reference tariffs for AA3. These changes include fundamental changes to the revenue control mechanism, the forecast of demand, cost allocation methodology and tariff setting (including a single postage stamp price for Tariff V customer withdrawals and moving from ten day peak injection charge to a seasonal approach).

While Origin can understand some of the reasoning put forward by GasNet motivating these changes, it is concerned that they (again) represent a fundamental shift in the

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pricing of services provided by the PTS, generating uncertainty for retailers and other users of GasNet's system.
The present proposal is similar in scope to the changes in tariff structure put forward by GasNet for the 2003-07 access arrangement for the PTS. For example, the removal of peak charges from withdrawal pipelines in the proposed revisions to the 2003-07 (AA2) access arrangement were rationalised by GasNet claiming that it "...has attempted to draw a balance between administrative simplicity and cost reflective tariffs."[1]

A rationale for the proposed changes in tariff structure is advocated by GasNet for the forthcoming access arrangement period (for Tariff V customers):

> A simple, predictable and stable across-the-board flat rate tariff for Tariff-V customers will reduce administrative costs…

In setting out its approach to Reference Tariffs, Origin would suggest that the Commission should consider the impact upon users of the PTS of continual change in the structure of underlying tariffs, and the costs to (for example) retailers of altering information technology systems and factoring in the uncertainty generated by changes initiated at the beginning of each new access arrangement period. It is contended that continual and fundamental redesign of tariffs at the end of each five year regulatory period is not in the interests of users of the PTS.

More immediately, such fundamental changes make the evaluation of the full impact of GasNet's proposal on our customers for the AA3 period extremely difficult. Furthermore, it is difficult to assess how prudent and feasible the capital expenditure proposals are. This is exacerbated by the significant information asymmetry between system users and GasNet and Origin places great reliance on the Commission itself undertaking a detailed assessment of these changes against the requirements of the National Third Party Access Code for Natural Gas Pipelines (the Code).

We address specific issues raised in GasNet's proposal in turn below.

2. Reference Tariffs

2.1 Changes to the revenue control mechanism

GasNet has proposed substantial changes to the revenue control mechanism ("RCM"), replacing the current average revenue yield control with a modified version that also changes the allocation of risk between GasNet and users of the system.

Origin understands in part the difficulties that the previous formula posed to GasNet as revenue adjustments were driven by changes in the tariff mix rather than changes in the volume. Nevertheless, we consider that part of this problem was in turn related to the complexity of GasNet's previous tariffs and that the proposed simplification of these tariffs (particularly the postage stamp Tariff V, the replacement of the ten peak injection days with winter injection period, the simplification of the cost allocation procedures for withdrawal and injection tariffs) will reduce some of the difficulties associated with the RCM.

[1] GasNet (2002a), *Response to Submissions on ACCC Issues Paper*, page 10
http://www.aer.gov.au/content/item.phtml?itemId=679407&nodeId=ac127eba2b8a8b45293136cc4ac29e94&fn=GasNets%20response%20to%20submissions%20(12%20June%202002).pdf

Moreover, the proposed changes provide GasNet with all the benefits of any growth in demand above the VENCorp medium 2006 forecast. In particular, Origin is concerned that consumers may be deprived of the opportunity to benefit from any increased demand for Gas Powered Generation ("GPG") while at the same time, bearing the costs of greater demand through the capex proposal. We note here that VENCorp's medium forecast for GPG is relatively conservative and has already been overtaken by significant amounts in the last three out of four years (including 2007) notwithstanding that Laverton North power station has not been in full commission during this period.

Therefore, while GasNet claims that the risks are symmetrical, Origin would urge the Commission to either maintain the current RCM, or at a minimum seek a further review of the 2006 VENCorp forecast, and the sensitivity of GasNet's total revenue to variations from this forecast.

2.2 Changes to the cost allocation methodology

Again, Origin understands some of the drivers to simplify the cost allocation methodology, in particular, by simplifying Tariff D withdrawals and injection tariffs to be based on the length of pipeline and throughput volumes rather than specific cost allocation. However, we ask that the Commission carefully evaluate the proposal in the context of the requirements of that clause 8.1 of the Code (see below) and, in particular, any impact on the efficiency of investment decisions in the absence of specific pipeline cost allocation.

2.3 Expansion of Culcairn withdrawals over 17TJ per day

GasNet has proposed that it have discretion over whether the expansion at Culcairn for withdrawals above 17 TJ/day should be covered.

Origin sees no compelling reason to put aside coverage for expansion beyond 17 TJ/day. We consider that this may set a precedent for other withdrawal zones and believes this issue is more appropriately handled within the existing regulatory framework. Moreover it creates further uncertainty and complexity for users which GasNet has in other areas of their proposal, been endeavouring to reduce.

As a secondary point in this context, Origin highlights the unique importance of these interconnects in the broader context of south-eastern gas supply security. As part of the effective management of supply security events, it is essential that users of the system have a clear understanding of the full costs of alternative supply sources.

2.4 Changes to Tariff V

GasNet's proposal to apply a single postage stamp tariff to Tariff V customers is likely to reduce complexity for retailers in the pricing of small gas customers throughout Victoria. However in doing so, GasNet has explicitly recognised that those customers served by augmentations that are not fully recovered will be effectively cross subsidised by other tariff customers located in Victoria. Origin would ask if this policy will result in Tariff V customers served by future transmission extensions benefiting from future postage stamp tariff approaches.

For example, the incremental Murray Valley transmission tariffs were designed to recover the specific costs of that pipeline over more than 20 years as this pipeline has no system-wide benefit offsets. As we understand it, these costs will now be rolled into the general

rates. Would similar "socialisation" of costs apply to Tariff V customers on any new augmentation to the PTS pipeline? Would this type of benefit be equally available to Tariff V customers on non-PTS systems?
GasNet suggest:

> …that the benefits of a simple tariff structure to retail competition (and resulting efficiency gains) outweigh the relatively small economic efficiency benefits of a complex zonal tariff structure for Tariff-V customers…[2]

Origin agrees that practically, this argument is persuasive; however we note that at the margin (in spite of the "cost of gas being a relatively small proportion of the total household budget"[3]) the increase in cost for Tariff V withdrawals will be significant on a relative basis. For example, withdrawal tariffs in Gippsland zones may double for some of Origin's Tariff V customers through the application of postage stamp pricing. GasNet also state that "most retailers amalgamate the PTS transmission tariff zones for the purpose of marketing gas, in order to save administrative costs."[4] While this may be the case, each retailer will make such a judgement depending on their own commercial objectives and systems, and such amalgamation may take place to a greater or lesser extent. Therefore, the discretion retailers may apply in simplifying transmission tariffs will vary and of itself should not be considered justification for change.

Nonetheless, Origin does not oppose the approach put forward by GasNet (subject to the questions of principle raised in the first paragraph in this section), but questions the consistency of postage stamp pricing with the type of pricing signals that might be desirable if there is an intention to reflect the cost of augmentations and extensions to the PTS.

GasNet itself said in response to submissions on the Commissions issues paper released in relation to the second access arrangement period that it:

> …believes it is not appropriate to send a price signal unless there is a reasonable prospect of congestion over the near to medium term. There is no economic benefit if customers reduce their peak usage when spare capacity is available in the withdrawal pipelines.[5]

Given the conditions identified by GasNet warranting extensive augmentation of its existing assets (discussed in section 2.13 of the issues paper), Origin would ask the Commission if the reasoning that led to significant changes in Reference Tariffs at the beginning of AA2 could have alleviated the need for the current substantial restructure in tariffs proposed for AA3.

Furthermore, Origin notes that clause 8.1 of the National Third Party Access Code for Natural Gas Pipelines states (the Code) that:

> 8.1 A Reference Tariff and Reference Tariff Policy should be designed with a view to achieving the following objectives:
>
> (b) replicating the outcome of a competitive market;
> (d) not distorting investment decisions in Pipeline transportation systems or in upstream and downstream industries;
> (e) efficiency in the level and structure of the Reference Tariff…

[2] GasNet (2007), *GasNet Access Arrangement Submission*, page 99.
[3] Ibid.
[4] Ibid.
[5] GasNet (2002a), op. cit., page 11.

Origin would ask if the Commission considers whether GasNet's proposal to adopt a postage stamp price for Tariff V customers meets the specific Code criteria described above. Our example of how the postage stamp pricing approach might impact on decisions around a new "Murray Valley" type extension should be considered in this context.

2.5 Tariff path

In its submission to the Commission's 2002 issues paper, Origin Energy noted that GasNet's then proposal of a 38 per cent increase in revenue (for the start of AA2) between 2002 and 2003 was designed to limit the impact of price shock in the transition to AA3.[6] The issues paper sets out an increase in 2008 of 30 per cent in real average tariffs for the PTS. Origin would question whether the objectives of the tariff path established for AA2 met the requirement to minimise price shock now likely for the beginning of AA3.

If the 30 per cent increase in real average tariffs in 2008 is found to be justifiable by the Commission, Origin would like to see a clear explanation as to why the previous forecasts and proposed treatment of the revenue path were so inadequate, so that price shocks in the future can be avoided.

3. Forecast capital expenditure

GasNet have signalled significant increases in capital expenditure for the forthcoming access arrangement period (2008-12). The $334.1 million investment identified includes a substantial proportion of augmentation capital expenditure ($245.9 million), the bulk of such augmentation projects comprising this total having already being approved by the Victorian Energy Network's Corporation (VENCorp) as the system planning authority.

Notwithstanding the approval by VENCorp, Origin would ask the Commission to seek further validation of the proposed capital expenditure. This is particularly so given that the $334.1M is based on augmentation and refurbishments/upgrades only and there appear to be no changes in either annual or peak demand growth that would warrant (per se) an effective five-fold increase in capital expenditure from AA2 to AA3 (i.e. from $67.6M to $334.1M).

We are also concerned with the pattern of capital expenditure and the decision processes and planning that have led to such a significant increase and concentration of expenditure during AA3. Origin would ask the Commission to consider why these significant projects were not anticipated earlier, such that any increase in reference tariffs required to fund new capital expenditure could have been optimised to avoid the increases contemplated for AA3.

In 2002, interested stakeholders expressed concern that the restructuring of tariffs (moving from peak to annual volumes) may accelerate the need for "reinforcement" of the GasNet system, for example:

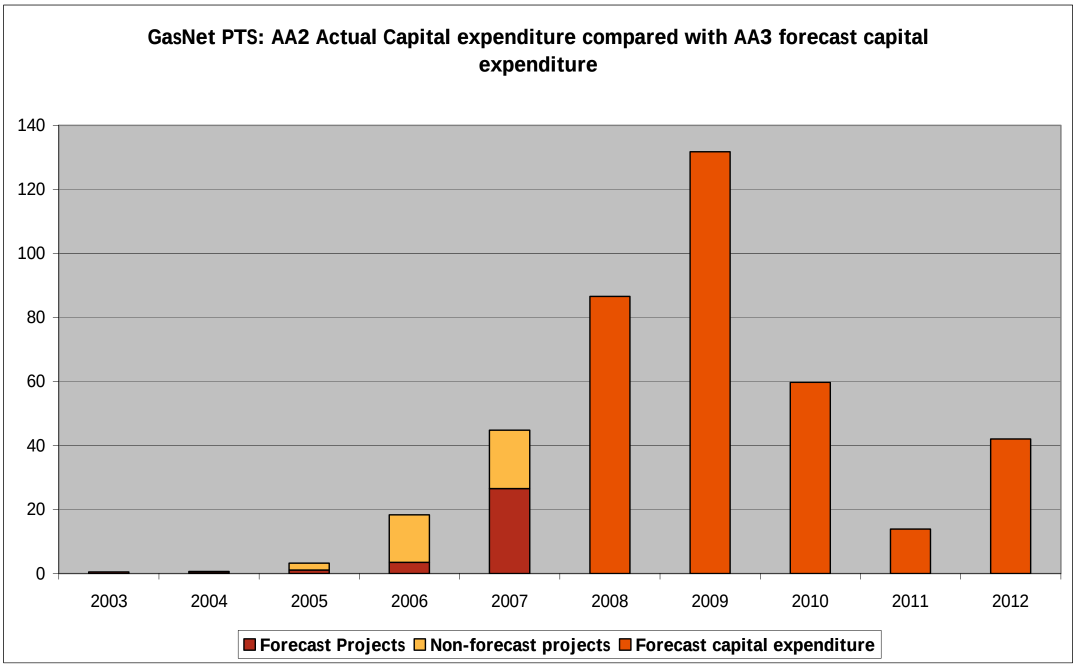
> Energy Advice is concerned that the shift away from peak responsibility tariffs will reduce the incentive for customers to manage their peak demand, leading to higher peak usage, and earlier reinforcement of the system. However, as demonstrated by the VENCorp

[6] Origin Energy (2002), *Review of Victorian Natural Gas Transmission Access Arrangements – Response to ACCC issues paper*, page 8.

Annual Planning Review, there is no significant reinforcement of the system required in the near future, with the exception of the SWP, and the Western System.[7]

Despite the relatively slow growth in gas demand, there is significant proposed capital expenditure, committed, as GasNet has stated, in order to maintain system security.

The figure below illustrates the distribution of actual and forecast capital expenditure reported by GasNet over AA2 and AA3, reinforcing the concern held over the pattern of expenditure proposed.



The total capital expenditure over AA2 and AA3 is $401.66 million, with more than 50 per cent of this expenditure (forecast) to occur in 2008 and 2009 (the first to years of AA3), with only 16.8 per cent of the total being spent during AA2.

Origin would question if this pattern of expenditure could have been allocated in a manner that would have reduced the concentration of capital expenditure in the first two years of AA3.

We also have serious reservations with the absolute level of capital expenditure; there is a concern that with such a substantial increase in capital expenditure proposed for AA3 (five times the amount invested in AA2) that GasNet may not be able to manage (due to external and internal factors) such a large array of projects over the expenditure period, which may result in an over-recovery of revenue. Origin would ask the Commission to assess carefully if the number of capital projects are viable (particularly given the many competing demands for infrastructure development over the next few years and associated demand for skills and materials) and whether these projects could be

[7] GasNet (2002b), *Response (No 2) to Submissions on ACCC Issues Paper*, 17 July 2002, page 14 http://www.aer.gov.au/content/item.phtml?itemId=679407&nodeId=92806366fcee6cfd296d606c244d0823&fn=GasNets%20response%20to%20submissions%20(17%20July%202002).pdf

prioritised down to a more manageable level. Origin would not like to see a situation where either:

- Useful, but not essential, projects proceed in an era of very high costs so increasing the project costs and revenue requirements; or
- Approved projects do not proceed (or are significantly delayed) because of resource competition while GasNet receives the benefit of additional revenue from early on in AA3 period.

Origin notes here that the Queensland Competition Authority, when faced with a similar dilemma with respect to proposed large increases in capital expenditure by ENERGEX, sought independent advice on whether all the projects were "justifiable and deliverable" by ENERGEX.[8] Such an approach might be useful for the Commission to consider given the extent of the proposed capital expenditure increases.

Origin notes under the refurbishment and upgrades section that multiple compressor units are being replaced with a lesser number of dry seal units. We would ask if this may impact on system security due a reduction in diversity. For instance, when units are being maintained under programmed maintenance there is a risk that failure of other units may occur.

4. Actual capital expenditure in AA2

The Commission has asked on page 22 of its issues paper -

> *…whether:*
> - *GasNet's actual capital expenditure in AA2 is reasonable and prudent; [and]*
> - *The allocation of $8.84m of the $10 million corporate restructuring costs to the regulated business is appropriate.*

Origin supports the Commission's proposed investigation into the prudency of the AA2 investment particularly in the light of the following:

- GasNet did not spend some $15.56 million of the original forecast projects and where it did proceed, a number of these projects were delayed; and
- GasNet spent some $35.42 million on non-forecast projects in the same period.

Origin also notes that the pattern in which such expenditure was made resulted in significant investment in the final two years of AA2 rather than smoothed through the whole period. Together these factors indicate that previous attempts to forecast the capital requirements of GasNet have had limited success despite the relative geographic simplicity of the PTS, the access to VENCorp's planning and forecasting skills and the relatively stable growth pattern in demand.

We therefore encourage the Commission as part of their review of the AA2 and AA3 expenditures to consider whether improvements can be made, and/or incentives put in place, to improve the accuracy of these forecasts of capital expenditure in the AA3.

[8] See: http://www.qca.org.au/files/E-EnergexCAPEX_cost_pass_through_Final_Decision.pdf

Origin would question if this distribution of capital expenditure is desirable in the context of the form of regulation applying to GasNet's assets.

In addition, Origin does not consider the capitalisation of $8.84m of corporate restructuring costs appropriate to include with capital expenditure associated with the regulated parts of GasNet's business.

Costs associated with GasNet's acquisition have little to do with the services sought by users of the PTS. The capitalisation of corporate costs to customers served by GasNet's regulated assets is therefore inappropriate and in Origin's view, contrary to the principles of clause 8.1 of the Code. For example, in the context of a competitive business, recovery of corporate restructuring costs from its customer base would result in higher prices and the potential loss of customers. No such risk is faced by GasNet.

However, the purchase of GasNet does raise many questions which Origin expects the Commission will investigate including the impact on cost of capital and on any cost savings that might be expected from merger with a national company. To what extent should these benefits be shared with users of the PTS system?

5. Inclusion of interest during construction for AA2 and AA3

Origin notes with some concern the proposal by GasNet to capitalise the cost of interest during construction ("IDC") for each asset constructed during AA2 and forecast AA3. Based on the numbers provided by GasNet, capitalisation of interest amounts to around $6.8 million in AA2 and a further $9.5 million in AA3, a total increase in "asset value" of some $16.1 million.

Our concern is twofold. In the first place, this approach does not reward efficiency or penalise inefficiency and leaves the Commission in the invidious position of assessing whether the proposed "benchmark performance standards" (eg expenditure on pipelines treated over 22 months) is reasonable for an efficiently operating business. Second, to the extent that the IDC becomes part of this decision, it can be expected to flow onto other decisions by the Commission on regulated assets. Origin requests that the Commission seriously consider these potential flow-on effects

6. Weighted Average Cost of Capital (WACC)

GasNet has proposed a post-tax WACC of 9.01 per cent for AA3, higher than in AA2 (8.93 per cent) despite the AA3 real vanilla WACC being lower than in AA2 (5.74 per cent versus 6.62 per cent). GasNet's rationale for this appears to be their belief that there is a downward bias in the nominal and index-linked CGS yields.

Origin's general principle is that the Commission should continue with its existing approach which is now well understood by the industry and can be consistently applied across different asset based businesses. The Commission should only vary from this if there are strong and compelling reasons and we do not believe that GasNet has established such a case in this proposal.

7. Prudent discounts

Origin notes that GasNet intends to remove its current prudent discount at Pakenham; however, we do not consider market conditions have changed substantially to justify this removal. Particularly with the delay in Yolla coming on stream, the accumulated discounted benefits of the discount to date would not exceed our costs of by passing the transmission system directly from Pakenham into the Victorian distribution network. We will be seeking more detailed discussions on this matter with GasNet shortly.

8. Non capital costs

Origin generally supports GasNet's contention that the industry faces rising costs, and in fact this is the basis of our request to the Commission to review the feasibility of the capital expenditure programme in an era of shortages in skills and materials.

Nevertheless, the claim that productivity gains have been exhausted (at least in terms of units of output per person), should be further investigated particularly in the light of potential operating and overhead cost synergies arising from the purchase of GasNet. The extent to which such synergies should be shared between the new owners and consumers is of course a separate matter of public policy.

Further, Origin notes in section 2.18 of the issues paper that GasNet provided the Commission with certain performance indicators, including "opex per km" and that the Commission noted that GasNet fell "within the middle of the range" (page 35). Given the relatively small geographic size and quality of the PTS itself (for instance, gas losses on the PTS are very low) it would seem reasonable to expect GasNet to sit near the top of the "opex per km" measure.

9. Summary

While Origin is unable to provide evidence on the appropriateness of elements of GasNet's proposal, it would wish to raise matters in principle that it believes warrant the attention of the Commission. In brief, Origin would ask that the Commission further examine:

- The uncertainty generated when regulated service providers substantially redesign their tariff approach at the commencement of each new regulatory period.
- The appropriate balance between economic efficiency and administrative simplicity based on Code principles (noting that retailers built additional administrative complexity into their systems as a result of GasNet's proposals for AA2 in this regard).
- The significant and seemingly unanticipated increase in capital expenditure proposed for AA3, including whether such expenditure is both justifiable and feasible in the relatively short time period.
- The potential for unit cost savings, including overheads, following the acquisition of GasNet.
- The substantiation of the removal of prudent discounts at Pakenham and the impact of this on overall tariff levels.

Origin would be pleased to discuss any matters raised in this submission in more detail with the Commission.

Yours sincerely

[SIGNED]

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