TXU submission to Gas-Net Australia Access Arrangement – Application to revise 24 August 2004

I. Executive Summary

TXU's does not support GasNet Australia's (GasNet) proposal to revise its access arrangements mid review to

- Amend the 'K' factor mechanism so that any over recovery be repaid by a reduction in tariff over the balance of the AA period
- Retain the special tariff class for storage refill but to modify the WUGS refill tariff so that the benefit of the special tariff will only accrue to those users who inject gas back into the GNS at the same point in time.
- Amend its demand forecasts and adopt revised forecasts for the period of 2004 to 2007 on the basis of the data released by Vencorp for 2004 to 2008 in the Vencorp 2003 review.

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Let me outline the reasons why

<u>K FACTOR</u>

- Sect. 2.24 (f) of the Gas Code requires the ACCC to consider the interests of users when assessing the proposed access arrangement. The change to the mechanics of the "K" factor through the variation to the access arrangement will lead to a reduction in the total "K" being passed through after a tariff year (T+1), [1] which represents a short term detriment to users' interests.

- Sect. 8.1 (e) of the Gas Code requires a reference tariff be designed with a view of achieving efficiency in the level and structure of that reference tariff. If the "K" factor changes so that when over –recovery leads to a "K" factor carry over amount, the full amount of which is deferred to be recovered over 3 years, then the tariff following the year of over recovery will not be efficient. As such, it appears inconsistent with sect. 8.1 (e) of the Gas Code.

- Sect 2.24 (g) requires the ACCC to consider any other matter the regulator considers relevant in assessing a proposed access arrangement. GasNet have argued that as the result of 18 months of prudent discounts has lead to unanticipated volatility in GasNet's average price, coupled with the asymmetric price path, this has deferred significant amounts of GasNet's revenue.

[1] Regulatory year "T" is the regulatory year in respect of which a tariff has been applied. T+1 (in the context of this paper) is simply the year following regulatory year (T).

TXU submits that the ACCC should give due consideration to the following in assessing the access arrangement

(a) The average price control formulae was well understood during the last review period. The risks associated with this formula and its implication would have been factored into GasNet's cost of capital. Any change of the price control formulae mid review would change the GasNet's risk profile and have implications for its WACC.

(b) TXU opposes re-opening the price control formula mid review given its implications on the risk profile of GasNet & the sensitivity around the implication of re-opening the WACC.

- Sect 2.24 (g) requires the ACCC to consider any other matter the regulator considers relevant in assessing a proposed access arrangement. GasNet has requested changes to the operation of the "K" factor mid review, because prudent discounts and the asymmetric price path presently lead to a deferral of GasNet's revenue. TXU submit that if the price control formula leads to this outcome

(a) GasNet should consider dealing with the rebalancing constraint formula that causes this revenue problem. Varying its access arrangement mid review by implementing a smoothing mechanism creates unnecessary regulatory risk.

(b) It should deal with the rebalancing constraint directly at the end of the regulatory period.

<u>REFILL TARIFF</u>

- Sect. 2.24 (e) of the Gas Code requires the ACCC to consider the public interest, including the public interest in having competition in markets. TXU believes that the mid term review of the refill tariff causes excessive regulatory risk for the shippers using that tariff. Many downstream supply contracts, especially in SA, have been negotiated on the basis of using the existing refill tariff and any change mid review would cause excessive regulatory risk as increased costs could not be passed through in a competitively neutral way.. This would impact on TXU's ability to compete in downstream markets.

TXU would support a review of this tariff at the next regulatory review, as long as it was not conducted mid review.

The ACCC should give due consideration to these issues (as TXU considers they are relevant) when assessing the proposed access arrangement.

- Sect 2.24 (g) requires the ACCC to consider any other matter the regulator considers relevant in assessing a proposed access arrangement. GasNet argues that since the SeaGas Pipeline became operational it has been possible for users with access to WUGS to withdraw gas from the GNS into WUGS and then export gas via the SeaGas Pipeline to South Australia, in effect by passing the more expensive standard delivery point on the GNS. TXU submit that

i. Whilst TXU transport gas via the route described above, it does so because they have negotiated access to the SeaGas arterial (SeaGas 18 inch Lateral Pipeline). When TXU did this, it had no idea what the reference tariffs on the GasNet pipeline would be. Hence, TXU did not intentionally seek access to this arterial to purely take advantage of a lower tariff.

ii. TXU rebuts GasNet's assertion that access via the SeaGas 18 inch Lateral Pipeline has the potential to distort competition for gas in South Australia. In fact, whilst transporting gas via this route provides access to the refill tariff, there are costs incurred by the storage service holders associated with storage services. Thus, transporting gas via this route is actually at least as expensive as other alternatives.

iii. TXU have paid for access to the SeaGas 18 inch arterial and wish to utilise it. . Other parties have paid for firm access to the SeaGas 14 inch lateral. Thus, if TXU is to compete in SA, it will need to continue to ship gas via the existing route, given the current commercial arrangements.

iv. TXU believe that there is presently no gas been shipped directly from Longford to the SeaGas 14 inch Lateral Pipeline (incurring the more expensive tariff) because there is no compression available on the route at this point in time.. As such, it is physically impossible to ship firm gas via this route, which explains why no gas is flowing.

- Sect 2.24 (g) requires the ACCC to consider any other matter the regulator considers relevant in assessing a proposed access arrangement. GasNet argues that there has been an abuse of the transmission refill tariff on the basis that that since the SeaGas Pipeline became operational it has been possible for users with access to WUGS to withdraw gas from the GNS into WUGS and then export gas via the SeaGas Pipeline to South Australia, in effect by passing the more expensive standard delivery point on the GNS.

TXU submit that

i. we agree with GasNet that the refill tariff should still apply in recognition of the security of supply it affords Victoria because some part of the gas exported to WUGS goes back into the GNS.

ii. that the remaining gas exported from the GNS through WUGS to South Australia via SEAGAS supports the security of supply to South Australia. For example, gas transported via this route in early 2004 helped to enhance the security of supply to South Australia during the Moomba crisis. Therefore, the refill tariff should logically also apply for these volumes.

WEATHER PATTERN REVISION

- Sect 2.24 (g) requires the ACCC to consider any other matter the regulator considers relevant in assessing a proposed access arrangement. TXU submits that the ACCC should give due consideration to the regulatory risks associated with re-opening demand forecasts mid review in assessing the proposed access arrangement. TXU does not support re-opening GasNet's tariffs mid review to change its demand forecast to account for warming shift in the weather because

    - it could not be certain that reduced demand is purely a function of the weather
    - TXU supports Vencorp's demand forecasts for 2002 –2004.. Total system demand on the MIBB Int. 79(b) (measures total gas withdrawals) points to higher throughput in calendar 2003-2004 compared to calendar 2002. Hence, whilst Gasnet have argued that the weather has warmed up in the last 5 years prior to the 2002 Final decsion, this trend is certainly not supported by 2003-2004 MIBB data. Hence, TXU warns against the dangers of re-opening clauses mid review.
    - the regulation would be asymmetric if allowable.

The ACCC should give due consideration to these issues (as TXU considers they are relevant) when assessing the proposed access arrangement.

RE-OPENING OF THE ACCESS ARRANGEMENTS

- Sect 9.2 of the Tariff Order sets out a number of fixed principles to apply for the duration of this access arrangement. These include the need to utilise incentive based regulation adopting a CPI-X approach and not rate of return regulation. TXU believes that if the ACCC re-open the access arrangements to change the operation of the "K" factor, abolish the refill tariff & re-open the demand forecasts, it risks implementing rate of return regulation. That is, it will create a precedent that will encourage frequently costly and contentious regulatory hearings or re-openings.

II. The K Factor

2.1 GasNet has proposed to revise its access arrangements to change the way in which the "K" factor is applied. The change to the access arrangements has been sought on the basis that it will lead to a smoothing of tariffs over the regulatory term.

TXU does not support GasNet's proposal to vary its access arrangement mid review and change the mechanics of the 'K" factor.

Let me outline some reasons why;

2.2 TXU believes that a change to the way in which the price control formula is applied to GasNet mid review creates un-necessary uncertainty and regulatory risk. The price control formula makes up an important part of the regulatory compact between GasNet and the ACCC after much consultation with stakeholders. If GasNet have concerns around how the "K" factor is applied and its impact on tariffs, then detailed consultation with all key stakeholders will first be required. TXU believes that the debate around changing the mechanics of how the "K" factor and its application should be conducted at the end of the review period.

The ACCC is required at law to consider the Sect. 2.24 of the Gas Code in considering the variation to GasNet's access arrangement to change the mechanics of the "K" factor when assessing the proposed access arrangement.

In assessing a proposed access arrangement, the regulator must take the following into account:

(f) the interests of users and prospective users

Where changes to mechanics of the "K" factor lead to a deferral of revenue (Year T+1) causing short term increase in tariffs mid review, the short term impact on users through higher tariffs should be taken into account before the ACCC approve this.

2.3 Whilst TXU acknowledges that sect. 2.28 of the Gas Code allows a service provider to revise its access arrangement mid review, sect.2.24 of the Gas Code clearly states that the regulator may only approve a proposed access arrangement if it is satisfied that the access arrangement contains the elements of and satisfies the principles set out in sects 3.1 to 3.20 of the Gas Code. [2] Sect. 3.4 of the Gas Code requires the ACCC to determine whether the access arrangement complies with the reference tariff principles described in sect. 8. [3]

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[2] Sect 2.24 of the Gas Code states
" The relevant Regulator may approve a proposed access arrangement only if it is satisfied the proposed access arrangement contains the elements and satisfies the principles set out in sections 3.1 to 3.20. The Relevant Regulator must not refuse to approve a proposed access arrangement solely for the reason that the proposed access arrangement does not address a matter that sections 3.1 to 3.20 do not require an access arrangement to address. In assessing a proposed access arrangement, the relevant regulator must take the following into account

(a) the Service Provider's legitimate business interests and investment in the covered pipeline
(b) firm and binding contractual obligations of the service provider or other persons (or both) already using the covered pipeline
(c) the operational and technical requirements necessary for the safe and reliable operation of the covered pipeline
(d) the economically efficient operation of the covered pipeline
(e) the public interest, including the public interest in having competition in markets
(f) the interests of users and prospective users
(g) any other matters that the relevant regulator considers are relevant

TXU submit the variation to GasNet’s access arrangement potentially breaches sect. 8.1 (e) of the Gas Code. Sect 8.1 states

> “ A reference tariff or reference tariff policy should be designed with a view of achieving the following objectives:”
>
> (f) efficiency in the level and structure of the reference tariff

If the mechanics of the “K” factor alter so that when over –recovery leads to a “K” factor carry over amount, and the full amount is deferred to be recovered over 3 years, then the tariff following the year of over recovery will not be efficient.

2.4 Sect 2.24 (g) requires the ACCC to consider any other matter the regulator considers relevant in assessing a proposed access arrangement. GasNet has requested changes to the operation of the “K” factor mid review, because prudent discounts and the asymmetric price path presently lead to a deferral of GasNet’s revenue. TXU submit that if the price control formula leads to this outcome

> (a) GasNet should consider dealing directly with the rebalancing constraint formula that causes this revenue problem. Varying its access arrangement mid review by implementing a smoothing mechanism creates unnecessary regulatory risk
>
> (b) It should deal with the rebalancing constraint at the end of the five-year period.

2.5 The “K” factor arrangements have been set for 5 years following extensive consultation. Users invest on the basis of an environment that is expected to remain fixed within these regulatory periods. Any disruption to that adds un-certainty for users and harms the competitive environment.

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[3] Sect. 8.1 of the Gas Code states
“ A Reference tariff and reference Tariff Policy should be designed with a view to achieving the following objectives:

(a) Providing the service provider with the opportunity to earn a stream of revenue that recovers the efficient cost of delivering the reference service over the expected life of the assets used in delivering that service.
(b) Replicating the outcome of a competitive market
(c) Ensuring the safe and reliable operation of the Pipeline.
(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; and
(f) Providing an incentive to the Service Provider to reduce costs and to develop the market for Reference and other Services.

III. The Refill Tariff

3.1 Gas Net argues that since the the SeaGas Pipeline became operational it has been possible for users with access to WUGS to withdraw gas from the GNS into WUGS and then export gas via the SeaGas Pipeline to South Australia, in effect by passing the more expensive standard delivery point on the GNS. However, TXU points out that when it negotiated access to the SeaGas arterial (SeaGas 18 inch Lateral pipeline) it had no idea what the reference tariff that it would be charged by GasNet to deliver gas to it from Longford. Thus, it did not negotiate access on the SeaGas arterial on the basis that it would receive a discounted tariff. Hence, it cannot be accused of abusing of the Transmission Refill tariff. It merely paid the access tariff applicable to shipping gas to WUGS.

3.2 TXU has undertaken the commercial decision to pay for access to the SeaGas 18 inch Lateral arterial and wish to use it. Other parties have paid for firm access to the SeaGas 14 inch arterial. Hence, if TXU wishes to continue to ship gas from Victoria to South Australia and compete downstream, it will continue to deliver gas via the same route, given it has negotiated access through the SeaGas 18 inch arterial.

3.3 TXU believes that GasNet’s assertion that shipping through WUGS to South Australia and receiving the refill tariff will distort competition down stream is misleading. When transporting gas through this route storage costs must be included to arrive at the delivered cost of gas in South Australia. . Thus, gas delivered to South Australia via WUGS and the SEAGas 18 inch arterial will be more expensive then the gas shipped directly through the SeaGas 14 inch arterial.

3.4 TXU believes that there is presently no gas flowing directly from Longford to the SeaGas 14 inch arterial, because there is no compression available on this route at this point in time. As such, even if TXU negotiated access via this route, it would physically be unable to ship firm gas.

3.5 TXU submit that the refill tariff should still apply because some part of the gas exported to WUGS goes back into Victoria ensuring security of supply. However, gas is transported via SeaGas to South Australia, which supports the security of supply to South Australia. Thus, gas transported from WUGS to SeaGas into South Australia re-enforces security of supply for that state. Hence, upon the same logic, the refill tariff should apply.

3.6 TXU has entered downstream commercial supply contracts based on the expectation the current tariffs will continue through 2007.

IV. Weather Pattern Revision

TXU does not support re-opening GasNet's tariffs mid review to change its demand forecast to account for warming shift in the weather.

Let me outline 3 reasons why:

4.1. GasNet argues the weather has progressively become warmer in the past few years. It will produce documented evidence to support this position. As GasNet has over-stated its demand forecasts, it will need to revise them (downwards) and to adjust tariffs accordingly to recover their required revenue during the regulatory term.

TXU believes it is much too complex to clearly ascertain whether the reduced demand (relative to demand forecasts) has been driven by weather warming. Whilst TXU accept that under-performance relative to forecasts maybe in part be due to warmer weather, it is very difficult to clearly prove in an environment with many different variables impacting demand, that warmer weather has had a significant impacted on demand. It could be that a combination of other variables has significantly impacted demand.

4.2 If the ACCC accepts the argument that the weather has progressively become warmer and significantly impacted demand, TXU requests clear evidence that this and not other factors has significantly impacted demand.

4.3 Whilst GasNet have argued that the weather has warmed up in the last 5 years, this trend is certainly not supported by 2003-2004 MIBB data. Total system demand on the MIBB Int. 79(b) (measures total gas withdrawals) points to higher throughput in calendar 2003-2004 compared to calendar 2002. Hence, there is a possibility that the weather will remain cooler in the remaining years of GasNet's access arrangement. Hence, there is a possibility that a clear trend does not exist. As such, TXU warns against allowing access arrangements to be readily re-opened on demand variations. Hence,

- (i) TXU supports Vencorp's demand forecast as accepted by the ACCC in the 2002 access arrangement review.
- (ii) GasNet's right to review the weather impact on demand at the 2007 review.

4.4 TXU believes that if the ACCC allow a mid term revision of GasNet's access arrangement then it risks implementing asymmetric regulation. That is, if GasNet are convinced that the weather warming in the last five years has considerable eroded the demand for gas transmission services, then how will it deal with colder weather that leads to a significant increase in demand leading to over recovery relative to its demand forecasts? Would the ACCC request a variation to GasNet access arrangements given it has over recovered and is it able to? Is it more likely GasNet remain silent on the issue and simply make a 'windfall gain?'

4.5 If the ACCC allow GasNet to re-open its demand forecasts on the basis of warmer weather, then has this regulatory allowance been factored into its cost of capital when the access arrangements were recently reviewed? All of these complex issues should be addressed before the ACCC creates the precedent of allowing the re-opening of GasNet's access arrangements on the basis that its demand forecasts were incorrect. TXU submit that this can only be achieved properly at the next five year review date.

V. The combined effects of three key revisions to GasNet access arrangement

5.0 Sect 9.2 of the Tariff Order sets out a number of fixed principles to apply for the duration of this access arrangement. These include the need to utilise incentive based regulation adopting a CPI-X approach and not rate of return regulation. TXU believes that if the ACCC re-open the access arrangements to change the operation of the "K" factor, abolish the refill tariff & re-open the demand forecasts, it risks implementing rate of return regulation

5.1 TXU notes that the ACCC is considering three key revisions to GasNet's access arrangements during this regulatory term. The mid term adjustments to the access arrangements will bring revenues back in line with costs. For example,

(ii) K factor adjustment for over-recovery will smooth revenues by reducing the one off tariff adjustment in year (T + 1) and give it back over the next three years. GasNet gain the time value of money on the deferred "K" factor not given back in year (T +1)

(iii) Refill tariff adjustment will give GasNet increased revenues by abolishing the discount tariff.

(iv) Demand forecast adjustments mid review will lead to increase tariffs.

TXU notes that all three adjustments will lead to increased revenues via adjustments during the regulatory term. Revenues are being adjusted to align with changes in costs.

5.2 TXU notes that in the GasNet access arrangement – Final Decision the tariff order established a number of fixed principles for the next access arrangement period. The first principle noted was the requirement to use a CPI-X approach and not rate of return regulation. Whilst GasNet had proposed to modify its price path with an expanded pass through mechanism, the ACCC remained satisfied that the basis of regulation had not been altered enough that it could be described as rate of return. [4]

[4] Final Decision GasNet access arrangement: 2002 p.239
" As noted above, the Tariff Order established a number of fixed principles for this next access arrangement period. Fixed principles can only be changed with the agreement of the service provider. However, as GasNet has not proposed to alter any of the fixed principles, the prosed revised access arrangement must also comply with these principles.

The first principle of relevance noted above is the requirement to use a CPI-X approach and not a rate of return approach. While GasNet has proposed to modify its price path mechanism further with the introduction of an expanded pass through mechanism, the basis of regulation for GasNet remains CPI-X. The approach has not been altered to the extent that it could be accurately described as rate of return."

VI. TXU model of incentive regulation

6.0 TXU submits that the ACCC will have difficulties in reconciling the right to vary an access arrangement mid review (sect.2.28 of the Gas Code) with the requirement to implement incentive based regulation under the sect. 9.2 of the Tariff Order. The more a service provider seeks to re-open its access arrangement mid term, especially to alter critical issues that will impact the building block revenue and tariffs (K factor, demand forecasts) the more it risks breaching sect. 9.2 of the Tariff Order and implementing rate of return regulation. The question that the ACCC need to address

> i. Is at what point does it refuse to re-open the access arrangements, on the basis that it breaches sect. 9.2 of the Tariff Order.
>
> ii. How to reconcile sect.2.28 of the Gas Code (which allows service providers to vary their access arrangements mid term) and the requirement to implement CPI-X incentive regulation and not rate of return regulation.

6.1 TXU provides guidance to the ACCC on how it will achieve this. It believes that it has achieved a model of incentive regulation that complies with sect.9.2 of the Tariff Order (fixed principle to impose CPI-X incentive regulation) and maintains the service provider the right to re-open its access arrangement during a regulatory period.

6.2 TXU has relied on the economic literature on incentive regulation by David E. Sappington, who has published widely on the topic of incentive regulation in designing this regulatory model.. [5] He deals with the issue of re-opening clauses, which he describes as rate of return tools, whilst trying to balance the need to maintain an incentive based regulatory scheme. In summary,, he supports re-opening provisions subject to them being undertaken very infrequently. [6]

6.3 TXU supports the Sappington model of incentive regulation that makes use of re-opening clauses sparingly. It supports re-opening access arrangements subject to some important conditions**:**

- The event that triggered the re-opening would need to have a material impact.
- The re-opening provision should be **limited**.

6.4 By excluding corrections for most or all factors, the regulatory process can be streamlined, and the regulated firm can be forced to become accustomed to the harsh realities of the marketplace. However, whilst this may be true, TXU supports including corrections for some limited factors, so that the firm does not suffer or gain because of events that are beyond its control.

6.5 The characteristics of an event that should allow GasNet to re-open its access arrangement include

[5] David E.M.Sappington is the Lanzillotti-McKethan Eminenet Scholar in the Department of Economics at the University of Florida. He has published widely on the topic of incentive regulation. He has lectured at the Public Utility Research Center, World Bank – International Training Program on Utility regulation and Strategy.

[6] David E Sappington – Lecture on Incentive Regulation – Session 18: "Methods of Incentive Regulation: Designing a Price Cap System" – Ninth International Training Program on Utility Regulation & Strategy.

- The event is truly beyond its control. That is, it is beyond the control of management and its financial impact is beyond the management's control.
- The event has a pronounced magnitude that will help to prevent excessive regulatory hearings.

6.6 TXU supports the use of a re-opening provision with clearly defined events. Some examples of these re-opening allowances include

- Taxes imposed by the government that fall disproportionately on the regulated firm.
- Investment mandates imposed by the regulator
- Pronounced change in input prices for crucial factors of production.

6.7 Adjustments for a limited set of factors can capture some of the beneficial elements of rate of return regulatory regimes without introducing too many of its disadvantages. However, the range of possible factors that allow re-opening of access arrangements should be extremely limited, to prevent excessive regulatory hearings.

6.8 TXU warns against including corrections for of a broad range of factors in the regulatory process because it might introduce some of the negative factors associated with rate of return regimes. If the ACCC interprets sect. 2.28 as allowing a service provider to implement a broad range of factors that will allow re-openings to the price control then this might lead to

- Frequently costly and contentious regulatory hearings or re-openings.
- Consumers, rather than the regulated firm bearing much of the market risk.
- A regime that provides limited incentive for performance in the market place.

6.9 TXU believes that if the ACCC accept the 3 key revisions sort by GasNet to its access arrangements, then it becomes difficult for it to comply with sect 9.2 of the Tariff Order and apply incentive regulation. If it chooses to implement a regulatory regime that opens up the gateway to a flurry of frequent revisions on key issues like changes to tariffs, "K" factor and demand forecasts that have an impact on building block revenue, then it runs the risk of implementing rate of return regulation.

Yours Sincerely

Con Noutso
Senior Regulatory Economist