22 June 2012

Mr Sebastian Roberts
General Manager
2012 Victorian Gas Access Arrangement Review
Australian Energy Regulator

Dear Sebastian

A: Introduction

TRUenergy welcomes the opportunity to comment on the APA GasNet Australia (Operations) Pty. Ltd. (APA GasNet) Access Arrangement (AA) submission for 1 January 2013 to 31 December 2017.

TRUenergy is a major integrated energy company with diverse interests in south-east Australia. We have a significant commercial and retail gas load in Victoria, as well as gas fired generation. The Victorian Transmission System (VTS) is critical to our operations.

APA GasNet is required to submit proposed revisions to the full AA that will apply to the Victorian Transmission System (VTS) by 31 March 2012. The AA represents a key part of the Third Party Access Framework. It governs the terms and conditions under which a shipper of gas is able to transport gas to its end users. The AA is governed by the National Gas Law (NGL) and the National Gas Rules (NGR).

APA GasNet has provided a public submission to support the proposed revisions of this AA for the VTS. As part of our response, we will comment on a range of issues in response to the APA GasNet AA submission.

B: Concerns with the Victorian Transmission System regulatory framework

The Victorian Transmission System is a set of market carriage pipelines enmeshed in a largely contract carriage pipeline system. The regulatory framework currently governing this market carriage system establishes weak signals for new, efficient investment to upgrade capacity and reduce congestion.

As a mechanism to manage any pipeline congestion, Authorised Maximum Daily Quantity (AMDG) credit certificates are currently issued at a premium to peak day injection rates. The value of AMDQ credit certificates provides an important signal for new capacity. However, currently the certificates enable APA GasNet to over-recover on the pipeline with no requirement to invest additional funds (over and above their regulated revenue requirement) in expanding pipeline capacity.

TRUenergy accepts that these issues are beyond the scope of the Australian Energy Regulator but considers that, going forward, the regulatory framework will need to be re-considered by the Australian Energy Market Commission to ensure there are adequate signals for new investment and to develop a mechanism to deliver this investment and provide firm access to participants that directly contribute to the funding of any capacity expansions.

C: Key recommendations: APA GasNet's Access Arrangement

TRUenergy's response to APA GasNet's AA submission for 1 January 2013 to 31 December 2017 is outlined below.

We consider that:

- the proposal to offer a single reference service through the Tariff Transmission Service (TTS) is consistent with the NGR. As we understand it, an AA must specify at least one reference service that is likely to be sought by a significant part of the market. We consider that this proposal satisfies this requirement under the NGR.

- the price control formula (PCF) in Schedule D of the AA should be adjusted to make it compulsory for APA GasNet to include actual volumes from AMDQ every year. This would guarantee that users of the VTS get a rebate for the revenue that is recovered via the volume effect of AMDQ.

- the terms and conditions of payment under the proposed Transmission Payment Deed (TPD) in the AA cause us some concerns. These concerns relate to billing and payments terms, prudential requirements and termination payments.

- the methodology applied to calculate the weighted average cost of capital (WACC) by APA GasNet is appropriate. However, we consider that some adjustments to the risk profile of APA GasNet need to be made (via the WACC parameters) to cater for the lower risk of the business as a result of the additional pass through provisions that have been proposed by APA GasNet. Naturally, were the AER to reject the proposal to include a wider range of pass through provisions in the next AA, then we would not expect such adjustments to the WACC.

- the capital redundancy mechanism applied to the Regulated Asset Base (RAB) is supported on the basis it complies with Rule 85 of the NGR. The capital redundancy mechanism provides for the assets to be removed from the capital base where they cease to contribute in any way to the delivery of the Reference Service. However, should the AER agree to share the demand risk for pipeline services between APA GasNet and users then TRUenergy considers that the WACC should be adjusted downwards to reflect this risk adjustment.

- the proposal to increase the RAB by including any part of any new capital expenditure that satisfies Rule 79 of the NGR is appropriate.

- the incentive mechanism applied by APA GasNet is appropriate. It permits a service provider to retain certain returns from reference tariffs during the fourth AA period that exceed the level of returns expected at the beginning of the fourth AA period. To the extent that the regulated firm achieves its observed performance goals, then it should be allowed to keep some of the benefits associated with its performance in the next regulatory period.

- the inclusion of a wider range of pass through events under which the service provider seeks to vary one or more of the reference tariffs as a result of a cost pass through is inappropriate. We have proposed an alternative methodology to deal with pass through provisions that we consider to be more consistent with the National Gas Objective (NGO).

- the expansion policy proposed for the next AA period is appropriate. However, TRUenergy considers any extension provided by APA GasNet (or any other provider who can meet the technical requirements for connection) should either be rolled in (and AMDQcc assigned), or should remain outside the Victorian Transmission System and be operated by the owner as they see fit (but again, meeting the requirements for connection). This reflects the arrangement for EGP and for the Western Transmission System. In particular, it should not be possible for the AER to reject a roll in application and still require that pipeline extension be part of the market carriage system.

- the inclusion of a specific cost pass through as a fixed principle in the fourth access arrangement is appropriate. The cost pass through would apply where its financial impact was not included in the reference tariffs that apply in the fourth access arrangement because the timing of the event did not allow the service provider to deal with it. In these circumstances, the service provider should be allowed to recover the costs associated with the cost pass through in the fifth AA period.

D: Pipeline services

TRUenergy submits the following detailed comments on the pipeline services offered in the AA.

1. Reference Service

TRUenergy is satisfied the APA GasNet proposal to offer a single reference service is consistent with the NGR. As we understand it, an AA must include at least one reference tariff for at least one service that is likely to be sought by a significant part of the market. By offering the Tariff Transmission Service under the AA, APA GasNet satisfies this requirement under the NGR.

2. Authorised Maximum Daily Quantity Credit Certificates (AMDQ)

APA GasNet issue available AMDQ credit certificates (AMDQcc) to the market through a specified auction process for the south west pipeline (SWP). The revenue that it earns by issuing AMDQcc is currently not regulated by the AER.

The AER recently sought changes to the NGR through a rule change it lodged with the AEMC. This Rule change would give the AER power to regulate the revenue that APA GasNet earns from issuing AMDQcc. More specifically, the AER sought changes to the NGR that would provide it with the discretion to determine whether a service sought by a significant part of the market would be deemed to be a “reference service”. If the Rule change is successful, the AER will have the discretion to argue that AMDQcc was sought by a significant part of the market and regulate it as a reference service.

APA GasNet does not consider AMDQ to be a reference service. Instead, it believes that is more akin to a financial instrument than a pipeline service. In addition, it considers that the revenue that it recovers from providing this service is insignificant. In fact, in 2010 APA GasNet retained $2.5M (over-recovery) in AMDQcc revenue above its regulated revenue of $120M.

The AEMC rejected the changes to the NGR proposed by the AER in its draft decision on this issue. If successful, the Rule change will allow the AER to regulate revenue earned from AMDQcc by clawing back any over-recovery and rebating it to exiting users of the SWP. In its consultation paper, the AEMC estimated that there were two potential sources of over-recovery associated with AMDQcc.

This included:

- The price effect which occurs when the price paid for AMDQcc is above the reference tariff, and is the difference between these two prices; and
- The volume effect of AMDQ when APA GasNet is able to earn additional revenue for providing reference services on unused AMDQ contracted capacity.

Following the investigations undertaken by the AEMC during this Rule change proposal, it determined that APA GasNet was rebating users for the volume effect of AMDQ under the current AA. The volume effect represents the majority of the AMDQ generated revenue. In fact, APA GasNet told the AEMC that 80% of AMDQcc total revenue was generated via the volume effect of AMDQcc revenue. APA GasNet rebated users of the VTS for revenue earned through the volume effect of AMDQcc in the price control model. The remaining 20% of revenue was generated through the price effect. The AEMC decided that this smaller amount should be retained by APA GasNet giving it an incentive for investment in the Victorian DTS.

We make the following points regarding the AEMC’s observations:

- APA GasNet indicated that it would continue to update its price control model to rebate the revenue earned via the volume effect of AMDQcc in the next AA review. However, the AER claims that APA GasNet is not required to do this. In fact, the AER claim that this rebating is only undertaken by APA GasNet on a "voluntary basis".

- We suggest the AER change the price control formula so that the updates to actual volumes from AMDQcc are undertaken on a compulsory basis to ensure that users of the DTS get a rebate from the volume effect of adjusting the price control model. To date, we have not been able to clearly determine whether there is a compulsory requirement for APA GasNet to update the actual volumes for AMDQcc in its price control formula. At first glance, it appears that APA GasNet is required to do this.[1] But, we are not clear whether the requirement on APA GasNet to provide a best estimate of "volumes" actually includes volumes from AMDQcc. In our view, this is not clear. Therefore, we would appreciate more clarity on this issue.

3. Transmission Payment Deed

The service provider provides a single pipeline service under this AA being the reference service. The reference service comprises the tariffed transmission service. The terms and conditions on which the service provider will supply the reference service, in respect of entering into agreements with shippers for the payment of reference services tariffs, terms and conditions reflect the principles in Schedule F. Schedule F includes the Transmission Payment Deed (TPD) terms and conditions which apply to gas shippers.

We offer the following comments on part F of the TPD.

Part "F" – Transmission Payment Deed Terms

F2 – Billing and Payment

TRUenergy prefers to retain the wording in the current Transmission Entitlement Deed (TED) that relates to the treatment of disputed amounts. We believe that wording in the current TED more clearly describes the obligations of Shipper when the invoiced amount is disputed (in part, or in whole) and the consequential financial costs following resolution of the disputed amount.

However, if the AER retains the facility as proposed in F2, we suggest that greater clarity is required regarding the interest chargeable in the instances where the disputed amount is found to be payable by, or re-payable to, the Shipper. To this end we propose that after "together with interest on that amount" the following should be added "at the Commonwealth Bank corporate overdraft reference rate plus two percentage points".

F4 Prudential requirements

TRUenergy suggests that the prudential facility in the current TED should be adopted (i.e. Clause 4). The advantage of Clause 4 in the existing TED is that it clearly describes the shipper's corporate investment rating to avoid credit support. This qualification is less clear in the proposed F4 as it relies on the "reasonable" view of the Service Provider.

F8 Termination

TRUenergy believes that F8 should overtly indicate that failure to pay a disputed amount is not a material default. We suggest at the end of F8 insert: "Failure to pay an amount which is included in an invoice under F2 but which is disputed by the Shipper does not constitute a default for the purpose of this clause F8".

[1] GasNet Australia Access Arrangement – Schedule 4 – 4.1 (H) Price Control Formula
"All calculations and figures used in this schedule 4 for determination of any price control formula component at any particular time must be the best estimate of that component at the relevant time using reported or actual (as the case may be) values where available and the best estimates of forecast values where required. For the purposes of this paragraph (c) , the price control formula components include revenues, **volumes**, CPI, EDDs, Pass through Amounts etc.)

E: Determination of Total Revenue

TRUenergy's detailed positions on the major components that make up the total building block revenue are provided in this section below.

1. <u>The Weighted Average Cost of Capital (WACC)</u>

TRUenergy supports the methodology applied by APA GasNet to estimate the weighted average cost of capital (WACC) to apply to the VTS in the next AA.

APA GasNet adopts a methodology that is similar to the approach that has been taken in other regulatory proceedings. However, we consider that some adjustments to the risk profile of APA GasNet need to be made (via the WACC parameters) to cater for the lower risk profile of the business should the AER permit the additional pass through provisions that have been proposed by GasNet.

2. <u>The Regulated Asset Base (RAB)</u>

TRUenergy supports the capital redundancy mechanism adopted by APA GasNet which is consistent with Rule 85 of the NGR.

APA GasNet proposed a mechanism that provides for the sharing of costs associated with a decline in demand for pipeline services between APA GasNet and users, consistent with Rule 85 (3) of the NGR. APA GasNet considers that such a sharing mechanism reduces the uncertainty of including a capital redundancy mechanism in the AA by reducing the risk faced by the service provider where volumes decline unexpectedly.

We support a capital redundancy mechanism provides for the assets to be removed from the capital base where they cease to contribute in any way to the delivery of the Reference Service. However, should the AER agree to share the demand risk for pipeline services between APA GasNet and users then TRUenergy considers that the WACC should be adjusted downwards to reflect this risk adjustment.

3. <u>Service provider to increase the Regulated Asset Base (RAB) for any part of the capital expenditure that satisfies Rule 79.</u>

TRUenergy supports the proposal by APA GasNet to increase the capital base for any part of any new capital expenditure that satisfies Rule 79.

Rule 79 of the NGR ensures that any capital expenditure "rolled into" the RAB is incurred by a prudent service provider acting efficiently. Therefore, we consider that this rule is appropriate.

4. <u>Proposed capital expenditure</u>

TRUenergy supports capital expenditure that satisfies Rule 79 of the NGR.

Importantly, we support the proposed Gas to Culcairn Project. The project has been proposed by APA GasNet as a result of the many requests to increase the injection capacity of the south west pipeline, as well as the capacity of the system for withdrawals at Culcairn. The forecast cost of the project has been estimated at $158.1 million.

To meet the incremental flows on the system, APA GasNet has proposed to undertake the following augmentation works within the VTS in 2013-2014:

- Installation of a Taurus 60 5.5 MW compressor station at Stonehaven on the South West Pipeline (SWP)
- Lay 104.1km of 450mm pipeline looping the Wollert to Barnawartha pipeline comprising:
    - Wollert to Wandong (27.8 KM)
    - Line valve 12 to inlet Euroa Compressor Station (30.0 KM) and

- Outlet Euroa Compressor Station to Line valve 17 Benalla (46.3 KM)

APA GasNet can increase the capital base for any part of any new capital expenditure that satisfies Rule 79 of the NGR. As part of its submission, APA GasNet has justified the project under Rule 79 (2) (a) of the NGR arguing the overall economic value of the project is positive, when the benefits of shippers are included in the analysis. APA GasNet has argued that the details of the benefits submitted to the AER to justify these benefits are confidential, and have been provided in a confidential business case provided for this project.

TRUenergy has submitted data to APA GasNet relating to these economic benefits as a gas shipper on the VTS. We would welcome the opportunity to discuss the details of these benefits as we consider this investment is critical for gas consumers and should satisfy Rule 79 (2). We hope that our input helps the AER get a better understanding of the economic benefits that this proposed capital project will provide to shippers on the VTS.

5. **The incentive mechanism**

TRUenergy supports an incentive mechanism that permits a service provider to retain certain returns from the reference tariffs during the fourth access arrangement period that exceed the level of returns expected at the beginning of the fourth access arrangement period.

We believe that the primary purpose of CPI-X incentive regulation is to motivate the regulated firm to undertake actions that further regulatory goals. Because the regulator often has limited knowledge of the opportunities available to the firm, the regulator cannot often dictate ideal actions and expect the firm to follow orders. Instead, the regulator must induce the firm to behave in a desirable fashion by specifying financial rewards and penalties that will be imposed according to the firm’s observed performance. To the extent that the regulated firm achieves its observed performance goals, then it should be allowed to keep some of the benefits associated with its performance in the next regulatory period.

F: Reference Tariffs

TRUenergy’s detailed positions on the major issues associated with the proposed reference tariffs in this AA proposal are provided below.

1. **Reference tariffs can be adjusted to allow for the following pass through events**

TRUenergy does not support the inclusion of a wider range of pass through events under which the service provider will seek to vary one or more of the reference tariffs as a result of a cost pass through.

APA GasNet has proposed that reference tariffs can be adjusted to allow for a wider range of cost pass through events. The cost pass through events include:

- A carbon cost event
- An insurance cap event
- An insurance credit risk event
- A natural disaster event
- A regulatory change event
- A service standard event
- A tax change event
- A terrorism event

A materiality threshold of 1% applies (to the smoothed forecast revenue) before a cost pass through can be implemented.

We suggest that any change to the AA that automatically allows APA GasNet to pass through these costs could erode the incentive regime on capital expenditure. In the long run, if the AA is changed to automatically allow more pass through events – then this could undermine the incentive properties of the regulatory arrangements.

In short, the inclusion of these pass through events will result in more frequent adjustments to tariffs during the AA period.

We would support the inclusion of a wider range of pass through provisions only in limited circumstances. We suggest that:

- the trigger for the pass through would need to be <u>material</u>
- the pass through event would need to be <u>limited and clearly defined</u>
- the pass through provisions would be used <u>sparingly</u>.

We are concerned that any change to the AA that would automatically allow APA GasNet to pass through any additional costs for a wider range of events would just erode the incentive properties of the regime on capital expenditure. There is a risk that if the AER continues to prescribe more pass through provisions in the AA that the incentive arrangements will be undermined and the regime will inherit some of the problems associated with rate of return regulation. So, further relaxing the pass through provisions may lead to:

- more frequent, contentious re-openings through these pass through provisions
- consumers rather than the regulated firm bearing much of the business risk
- limited incentive for exceptional performance.

Therefore, we consider that the cost pass through provisions that apply to the AA should be tightened further. To this extent we would suggest the AER consider the following criteria for a pass through regime. This would include:

- the event is not already provided for:
    - through the operational expenditure allowance (e.g. the insurance or self insurance components)
    - through the WACC
    - through any other mechanism or allowance

- the event is foreseeable – in that the nature or type of event can be clearly identified

- the event is uncontrollable – in that a prudent service provider through its actions could not have reasonably prevented the event from occurring or substantially mitigated the cost impact of the event

- the event cannot be self insured because a self insurance premium cannot be calculated or the potential loss to the relevant DNSP is catastrophic

- the party who is in the best position to manage the risk is bearing the risk

- the passing through of the costs associated with the event would not undermine the incentive arrangements within the regulatory regime.

Any reduction in risk faced by APA GasNet (through additional pass through provisions) should be accompanied by a corresponding reduction in the risk adjusted WACC.

G: Extensions & expansions

1. <u>Extensions</u>

As stated above, TRUenergy is concerned that there are insufficient price signals for augmentation of the Victorian Transmission System.

Essentially AMDQcc do not provide sufficient compensation for new investment as it is required/economic. This is most easily resolved in the case of extensions and is within the scope of the NGR.

TRUenergy considers any extension provided by APA GasNet (or any other provider who can meet the technical requirements for connection) should either be rolled in (and AMDQcc assigned), or should remain outside the Victorian Transmission System and be operated by the owner as they see fit (but again, meeting the requirements for connection). This reflects the arrangement for EGP and for the Western Transmission System. In particular, it should not be possible for the AER to reject a roll in application and still require that pipeline extension be part of the market carriage system.

2. **Expansions**

TRUenergy supports the revised expansion policy that has been submitted by APA GasNet for the AA.

Where a service provider expands the capacity of a pipeline, then this AA will apply to the incremental services provided by the expansion unless the service provider proposes, and the AER agrees, that it does not apply to the incremental services provided by the expansion.

An application to expand the pipeline can be coupled with an advanced determination on whether the proposed expansion will meet the new capital expenditure criteria under rule 79 of the NGR so that it is covered by this AA. We consider that this proposal is logical and we support it.

Where a service provider applies to successfully include an expansion so that it forms part of the AA, then it will vary tariffs in accordance with Schedule D of the AA. We consider this policy to be fair and reasonable.

H: Fixed principles

TRUenergy supports the following fixed principle in the AA on the basis that it is fair and reasonable.

Where a cost pass through event occurs in the fourth access arrangement and the financial effect is not included in the reference tariffs that apply in the fourth access arrangement because the timing of the event did not allow the service provider to deal with it, then the service provider may include the costs associated with the cost pass through in the fifth AA period.

I: Conclusion

TRUenergy looks forward to working with the AER on APA GasNet's AA proposal for the VTS.

We consider that our submission has raised some substantive issues for the AER to consider before making its Draft determination. We believe that our suggestions in this paper are consistent with the NGO and NGR. Therefore, we urge the AER to consider them.

In order to deal with the issues that we have raised in a rigorous and transparent manner, we expect that there will be an opportunity to consult further with the AER on the range of issues that we have raised in this submission. In this regard, we would welcome further dialogue with the AER on any of the issues that we have raised in this submission.

For any enquiries regarding this submission, please feel free to contact Mr. Con Noutso - Regulatory Manager at TRUenergy on Tel: 03 8628 1240.

Yours sincerely

Signed for email

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