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8 March 2004

Gas Access Regime Inquiry  
Productivity Commission  
LB2 Collins Street East  
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Dear Sirs

## **REVIEW OF THE GAS ACCESS REGIME**

AGL is pleased to make a submission on the Productivity Commission's Draft Report on the Review of the Gas Access Regime.

AGL welcomes the findings and many of the recommendations in the Draft Report as providing a solid starting point for improvements to the Regime.

In the introductory chapters of the Draft Report, the Commission presents an informed assessment of the Australian Gas Industry and the Regime. In particular, the Commission's analysis of the effectiveness of the Regime achieves a commendable balance in emphasising the benefits that have been delivered to existing customers while detailing opportunities where even greater benefits could be achieved in the future.

AGL's submission in response to the Commission's Issues Paper acknowledged the benefits that have arisen from energy market reforms through the past decade, including the introduction of the Regime. We sought to present a strong view, however, that the access regime was flawed, and went on to detail numerous aspects of the Regime where changes were needed to deliver longer term benefits to the Australian economy.

The Commission has recognised many of the economic arguments presented by the industry in framing its draft recommendations. We endorse many of the draft recommendations.



This submission focuses largely on further developing the draft recommendations to resolve outstanding issues and provide a view on implementation.

- Objectives and Objects Clause

AGL strongly agrees with the Commission's finding that there is a need to clarify the objectives of the Regime. We support the proposed objects clause but believe that the Commission's intent could be better achieved by providing further definition or guidance as to the interpretation of key terms (such as economic efficiency and economically efficient investment). We agree that consequent changes are needed within the body of the Gas Code. However, some proposed changes, such as the removal of section 2.24(a) would result in unintended and detrimental outcomes in the longer term.

- Coverage Issues

AGL welcomes the Commission's findings that the Regime should only apply where it would improve economic efficiency significantly, and that this requires the threshold for coverage to be higher than at present. Nevertheless, we are concerned that the two-tier arrangement proposed will prove complex and potentially confusing to administer. We suggest that, at the very least, the coverage terminology (ie both "substantial" and "material" increases in competition and "significant" improvement in economic efficiency) be more fully defined to realise the Commission's intentions.

In addition, we are concerned that the introduction of a new price monitoring tier of coverage into the Code could potentially be seen as the Commission's major response to deficiencies it has identified with the existing access arrangement tier; and by implication, that little change is needed to the existing Code provisions dealing with access arrangements. If so, then potentially a large portion of the nation's gas infrastructure will still be subject to many of the deficiencies of cost-based price regulation identified by the Commission and receive minimal benefit from this review.

- Access Arrangements

AGL notes with some concern that a number of findings in relation to the existing regime are not matched with corresponding recommendations for change. We consider that improving access arrangement based regulation is a critical component of the present review and reform process. AGL agrees that the pricing principles proposed by the Commission are appropriate, given the desirability of consistency with those now endorsed by Governments for the National Access Regime in Part IIIA of the Trade Practices Act. We believe, however, that further changes are needed within Section 8 of the Code to allow for less intrusive regulatory pricing models than the building block approach. Further, we believe that where it is necessary to establish a rate of return on capital, guidance is needed to overcome the substantial difficulties identified by the Commission with the existing process.

One of the concerns expressed by AGL in its submission in response to the Commission's Issues Paper was the focus of regulators on forensic examination of the 'efficient' costs of service providers. Suggestions that regulators should be given additional powers in order



to obtain information between access arrangement reviews only serve to heighten such concerns. The priority should be to develop the regulatory regime so that it creates genuine incentives for service providers to search for efficient management, operating and financing practices – rather than (as at present) imposing even greater administrative burdens on both the service provider and regulator.

The Commission has correctly found that the current regime imposes uncertainties, risks and costs on service providers, with inadequate focus on longer term outcomes. AGL has offered a number of proposals to improve the access arrangement provisions in the Code, which would help to reduce the focus on unachievable accuracy in the regulatory assessment of parameters such as efficient costs and *ex ante* rates of return.

We emphasise that such improvements to the heavy-handed tier of regulation are just as important as the proposal for a new light-handed tier.

- Lighter Handed Regulation

AGL welcomes the acknowledgment that there can be substantial costs under the existing regime. We support the introduction of a truly light-handed price monitoring regime, but repeat our call that this should not detract from the need to also improve existing access arrangement regulation.

Equally we believe it is important that the price monitoring tier remains truly light-handed, that it not be hampered by complex information disclosure and other administrative requirements nor subject to uncertainties over its application.

- Investment and Access Arrangements

The Commission has correctly identified many of the deficiencies of the Code (and of the ACCC's Draft Greenfield Guidelines) in respect of new investment. AGL endorses the Commission's draft findings in this area with some qualifications, in that the findings do not go far enough to explore alternative means of reducing uncertainties created by the current provisions of the Code.

- Ring Fencing and Associate Contracts

AGL welcomes the Draft Recommendation that Associate Contracts for Reference Services should not require regulatory approval. We believe that further relaxation of the requirement would be appropriate, so that regulatory approval is only required if and where the same terms and conditions for access are not available to all users whether associates or not.

AGL agrees with the Commission's findings that the ring-fencing requirements in the Code are warranted. We note further that those requirements necessarily constrain a service provider to impose corresponding obligations on any contractor – including an associate asset manager. An explicit additional requirement in the Code to cover the latter is unnecessary.

The Commission introduces a discussion of contracted asset management functions in its



Draft Report. This is a significant matter for AGL, with its wholly owned subsidiary Agility being the pre-eminent specialist provider of asset management services. We note, however, a strengthening trend towards the separation of asset ownership and asset management functions across the gas industry as it is in many other industries, both regulated and unregulated.

AGL believes that it is a clear misinterpretation of the intent of the Code to seek to apply the Associate Contract provisions to asset management contracts. We firmly believe that the Code gives regulators adequate powers to access relevant information held by an associate asset manager – or indeed by any asset manager whether an associate or not.

Further powers to allow the regulator explicitly to examine the costs of an asset manager would be both unnecessary and an unfortunate constraint on the potential of such businesses to emerge as fully competitive operators.

- Administrative and Appeal Processes

AGL strongly supports the Commission’s findings on the importance of rights of appeal as a necessary balance to the potential impact on asset owners of the discretionary powers held by regulatory bodies and Ministers. We consider this to be an essential component of the overall reform programme.

We endorse the draft recommendation to remove current limitations on the grounds of appeal. The proposal to provide for backdating of tariff charges is both unnecessary and would be extraordinarily complex to administer.

AGL does not support the Commission’s proposal to impose a 21-day deadline on a Ministerial decision following the NCC’s recommendation on coverage. It is an important feature of the current regime that the coverage decision rests with a Minister and not an administrative body. That being the case, the Minister must have adequate time to give the decision due consideration.

The Commission’s proposals for changes to the appeal process in respect of access arrangements raise a number of issues. AGL notes that if the further final decision is to be removed, there would remain the practical necessity for provision for the regulator to confirm whether the access arrangement submitted by the service provider following the final decision did substantially reflect that decision. We accept that it is appropriate to remove the opportunity for the service provider to seek to engage in further substantive debate with the regulator about the merits of the final decision. We note further that it would be appropriate for the regulator to be able to approve an access arrangement which deviates from the final decision by virtue of a material change in circumstances.

AGL further accepts that if a service provider appeals against a regulator’s decision to draft its own access arrangement, it should not have unfettered freedom to introduce new material in the appeal. There should, however, be scope for the Tribunal to decide that new material be allowed if it believes that to be appropriate.



- Institutional Arrangements

Subsequent to the Commission's Draft Report, the Ministerial Council on Energy has confirmed the creation of the Australian Energy Regulator and the Australian Energy Market Commission on 1 July 2004. The MCE has also recommended that these bodies take responsibility for gas transmission in 2005. AGL encourages the Commission to frame its recommendations in such a way that they are compatible with the MCE timetable and that the implementation of its recommendations be coordinated with the evolution of the AER and AEMC. We further request the Commission to address transitional issues in moving from the current arrangements to those to apply beyond 2005.

AGL would be pleased to clarify or expand any of the comments made in the attached submission.

Yours sincerely

Robert Wiles  
General Manager  
Regulation and Policy





**The Australian Gas Light Company**

ABN 95 052 167 405

Submission on the Draft Report of the Productivity Commission:  
Review of the Gas Access Regime

March 2004

# The Australian Gas Light Company

## Submission on the Productivity Commission's Draft Report: Review of the Gas Access Regime

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## 1. Objectives and objects clause

### 1.1 Need for an overarching objective

In its September 2003 submission, AGL indicated that the lack of clear and appropriate objectives was one of the flaws in the current Gas Access Regime. AGL welcomes the acknowledgment of the Productivity Commission (“**Commission**”) that the objectives are not well specified and that there are too many objectives, some potentially in conflict, with insufficient guidance to regulators on how to weight the trade offs. AGL also welcomes the acknowledgment that “*the consequential explicit capacity of the regulator to apply virtually unlimited discretion carries with it its own disadvantages, such as reduced transparency and increased uncertainty*”<sup>1</sup>.

#### **Draft Findings 5.1 and 5.2**

AGL strongly agrees with the Commission’s Draft Finding 5.1 that there is a need to better specify the objectives of the Gas Access Regime in the enabling documentation.

AGL agrees with Draft Finding 5.2 that the insertion of an overarching objects clause in the Gas Access Regime legislation would enhance the effectiveness of the Regime (with the proviso that this overarching clause is appropriate).

### 1.2 Proposed objects clause

AGL welcomes the Commission’s acknowledgment of the importance of a long-term focus<sup>2</sup>. AGL considers a long-term focus is critical and agrees with the Commission that while:

*“Reductions in access prices benefit current users and may stimulate the demand for and use of pipeline services.....returns to pipeline owners are reduced, which may deter investment and thereby adversely affect future users The objective should seek a balance between these short term and longer term considerations.”*<sup>3</sup>

In broad terms AGL supports the Commission’s Draft Recommendation 5.1 that:

*The following overarching objects clause should be inserted into the Gas Access Regime:*

*To promote the economically efficient use of, and investment in, the services of transmission pipelines and distribution networks, thereby promoting competition in upstream and downstream markets.*

AGL supports the Commission’s emphasis on efficiency and efficient investment, and seeks to ensure that the Commission’s intention is properly understood and not open to misinterpretation or dispute at a later point.

Since the clause is intended to be the key reference point for regulators and other decision makers, and is intended to replace the current range of diverse and in some cases conflicting

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<sup>1</sup> Draft Report – pages 140 - 141

<sup>2</sup> Draft Report – pages 144 – 5

<sup>3</sup> Draft Report – page 144

objectives in the Gas Access Regime, it is important that there be a clear and common understanding of concepts such as:

- “economically efficient use of” and “economically efficient investment in” the services specified in the clause;
- what might be involved in “promoting” these outcomes; and
- interpretation of the (presumed) causal link between efficient pipeline or network use and investment and “the promotion of effective upstream and downstream competition”.

Interpretational issues which might arise include:

- (i) the notions of “economically efficient use of” and “economically efficient investment in” are able to be interpreted in ways which are consistent with many diverse outcomes. Further legislative guidance may be required to assist decision-makers in applying these concepts. This issue is also relevant to the coverage criteria where the concept that coverage is “likely to improve economic efficiency significantly” is recommended by the Commission as a new criterion; and
- (ii) the objects clause might possibly be seen as giving primacy to the promotion of competition over the promotion of efficient investment – ie a focus on the outcomes of an access arrangement. If so, this may direct regulators to go beyond the notions of efficient pipeline or network use and investment to give effect to “the promotion of effective upstream and downstream competition”. Clarification is needed as how the Commission sees the various elements of the clause being applied in practice.

AGL also notes that an objects clause focused on efficiency is not, by itself, an adequate guide to regulators, a point well recognised by the Commission:

*As general statement of principle, an objects clause, of itself, does not provide regulators with all of the guidance necessary---on how best to improve the efficiency of resource use (Part IIIA Report, p 136)*

The Commission agreed with the view expressed by NECG that the Part IIIA regime should itself be tightened to avoid relying solely on an objects clause. The numerous changes proposed by the Commission for the Gas Access Regime illustrate that it is aware that an objects clause must be reinforced by the specific provisions of the regime. Nevertheless, AGL suggests that the objects clause itself needs to be tested for adequacy since the Commission states that the clause is to be the guiding principle for crucial criteria such as coverage and access pricing<sup>4</sup>.

***Draft Recommendation 5.1***

AGL supports the Commission’s Draft Recommendation 5.1 and suggests that the key concepts contained in the proposed objects clause should be clearly defined or that some guidance should be given by the Commission so that there will be a clear and common understanding for decision makers and participants.

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<sup>4</sup> Draft Report – page 147

Consistent with the Federal Government's response to the Part IIIA inquiry, AGL also recommends that the regulator be required to have regard to the objects clause in carrying out its functions under the Gas Access Regime.

### **1.3 Consequential Revisions**

The Commission has noted that the insertion of an overarching objects clause requires an assessment of the appropriateness of retaining the documentation for the Gas Access Regime's other references to objectives. Draft Recommendation 5.2 is to delete the objectives in the preamble to the existing legislation and the related objectives in the introduction to the Gas Code.

AGL agrees the insertion of an appropriate overarching objects clause means that the objectives in the introduction to the Gas Code are no longer required.

#### ***Draft Recommendation 5.2***

On the basis that an appropriate overarching objects clause is inserted, AGL supports Draft Recommendation 5.2.

### **1.4 Guidance for access arrangements**

The Draft Report notes that section 2.24 of the Gas Code lists seven factors that a regulator must take into account when assessing a proposed access arrangement<sup>5</sup>. AGL agrees with the Commission that as these factors provide further guidance to regulators as to what needs to be considered in approving an access arrangement, they need to be assessed for their continuing relevance, particularly in the light of Draft Recommendation 5.1.<sup>6</sup>

In Draft Finding 5.3, the Commission finds that sections 2.24(b) and (c) should be retained as providing guidance for regulators as factors to be taken into account when assessing access arrangements. In respect of section 2.24(b), AGL agrees with the Commission that it is important that the provision of access to third parties does not impinge on the property rights of service providers and foundation contract users and that impinging on these rights could have adverse implications for future investment in pipelines<sup>7</sup>.

AGL also agrees that it is important to include the safety requirement as a factor to be considered in access arrangements.

#### ***Draft Finding 5.3***

AGL agrees with the Commission's finding that sections 2.24(b) and (c) should be retained.

In Draft Recommendation 5.3, the Commission recommends that a number of elements of section 2.24 of the Gas Code should be deleted:

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<sup>5</sup> Draft Report – page 149

<sup>6</sup> Draft Report – page 149

<sup>7</sup> Draft Report – pages 149 - 150

*The following elements of s.2.24 of the Gas Code should be deleted:*

- (a) *the Service Provider's legitimate business interests and investment in 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 (whether or not in Australia)*
- (f) *the interests of Users and Prospective Users*
- (g) *any other matters that the Relevant Regulator considers are relevant.*

The removal of many of the section 2.24 factors will mean that the regulator's main guidance will be the overarching objects clause (together with the revised pricing principles). As a result, this will place substantial weight on the objects clause as a protector of a service provider's legitimate interests. Service providers are entitled to assurance that their interests would be no less protected under the implementation of the Commission's recommendations than under the current regime.

The Commission states that the overarching objects clause encapsulates the possible tension between the interests of service providers and users and seeks to resolve it in an efficiency context<sup>8</sup>. The Commission also states that the guidance for access arrangements, discussed in Chapter 7, particularly in relation to reference tariffs, would seem to cover these issues.

While the overarching objects clause may address efficiency issues, the reason for section 2.24(a) was to protect the property rights of service providers under an access regime. The introduction of the Gas Access Regime resulted in a significant erosion of service provider's property rights. Service providers *lost* property rights to the future use of their assets with the introduction of the Gas Code, whereas users (existing and prospective) *gained* from mandated access rights without any qualification on the exercise of those rights except for the other provisions of clause 2.24. Section 2.24(a) establishes a boundary to the extent of loss of rights of service providers. If section 2.24(a) were removed, users would still have their mandated rights of access, whereas specific protection for the rights of service providers will disappear.

It must be asked whether the recommended objects clause could provide a similar level of protection as that provided by section 2.24(a).

For example, in the extreme, economic efficiency could be interpreted as operating a pipeline under *short run marginal cost*. AGL notes that the Commission has recognised this danger in its discussion of the Code's section 8.1 pricing principles (chapter 7) and has recommended insertion of a new principle [8.1(a)(i)] that mandates the recovery of long run efficient costs. However, AGL also notes that both the Commonwealth Government's interim and final responses to the Commission's recommendation for a similar clause to be inserted in the national access regime have proposed that the reference to "long run" costs be *deleted*. A similar change to the Commission's recommendation for the Gas Access Regime would eliminate the safeguard intended by the Commission and put the interests of service providers at major risk.

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<sup>8</sup> Draft Report – page 152

Yet another interpretation of the objects clause could direct regulators to focus exclusively on the promotion of economically efficient *future* investment, to the neglect of the service provider's legitimate interests in *sunk* investment.

AGL's understanding is that clause 2.24(a) has a stand-alone function of *preserving* the legitimate interests of service providers which is not in any way linked to "balancing" the interests of users referred to in clause 2.24(f). The Commission is correct in drawing attention to the difficulties faced by regulators in balancing diverse interests, but it does not follow that both 2.24 (a) and (f) should be deleted.

For these reasons, AGL considers that section 2.24(a) should be retained.

There is a further dimension to s. 2.24(a) apart from its use as regulatory guidance in assessing access arrangements. It reappears in section 6.15(a), providing guidance for arbitrators in access disputes under the Gas Code (and in fact is one of the requirements for an "effective" access regime specified under clause 6(4) of the Competition Principles Agreement). AGL notes that, when arbitrating a dispute, the arbitrator is obliged by section 6.15 to apply the provisions of the access arrangement concerned. In the circumstances specified under section 6.13, the arbitrator must require the service provider to supply a prospective user at the appropriate Reference Tariff. If, in approving an access arrangement, the regulator failed to take account of the service provider's legitimate interests due to the omission of section 2.24(a), then it would seem difficult, if not impossible, for an arbitrator to confidently meet the obligations imposed under section 6.15(a). There appears to be a serious loss of balance in removing section 2.24(a) from assessment of an access arrangement but retaining it (appropriately) in 6.15(a).

Accordingly, AGL considers that both sections 2.24(a) and 6.15 (a) should be retained

***Draft Recommendation 5.3***

AGL agrees with the draft recommendation that sub-sections (d), (e), (f) and (g) should be deleted.

However, AGL considers that section 2.24 (a) should be retained in its present form as should section 6.15(a). At present, it is far from clear that the recommended objects clause will offer the same level of protection to a service provider's legitimate business interests that is currently provided in the regime.

## 2. Coverage Issues

AGL welcomes the Commission's finding that there is a need to amend the coverage test. AGL considers that the issues raised in Chapter 6 are among the most complex in the Draft Report. Consequently, there are concerns that, while the Commission is attempting to improve the regime, its recommendations could generate much additional operational complexity but result in only minor improvements to the overall regime.

In broad terms, AGL agrees with the Commission's Draft Finding 6.1 that

*it is important that the coverage process and criteria are designed so intervention occurs only in those circumstances in which it is likely to generate a significant improvement in economic efficiency.*

AGL therefore considers it vital that there is a common understanding among regime participants of the concept of "a significant improvement in economic efficiency".

AGL welcomes the Commission's findings that:

- it is important the Gas Access Regime applies only where the benefits of regulation are likely to outweigh the costs;
- the coverage test for the Gas Access Regime, given the regime's heavy handed characteristics (reliance on price regulation) sets too low a threshold for regulation; and
- the threshold should be set higher to ensure the benefits of regulation significantly outweigh the costs for all regulated pipelines<sup>9</sup>.

AGL agrees with the Commission's Draft Finding 6.2 that:

*the coverage criteria need changing to ensure that the Gas Access Regime is applied to pipelines only when likely to improve economic efficiency significantly.*

### **Draft Finding 6.2**

AGL agrees with Draft Finding 6.2, but notes that it is vital that there is a common understanding of the concept of "a significant improvement in economic efficiency".

### **2.1 Transmission pipelines and distribution networks**

AGL agrees with the Commission's Draft Finding 6.3 that different coverage criteria for transmission pipelines and distribution networks are not warranted since the framework proposed by the Commission is capable of dealing with the different market circumstances of both facilities.

### **Draft Finding 6.3**

AGL agrees that the same coverage criteria should apply to both transmission pipelines and networks. Nevertheless, AGL refers to its earlier submission to this review which recommended that several provisions of the Code – mainly of a technical administrative nature – should apply only in a transmission context.

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<sup>9</sup> Draft Report – page 173

## **2.2 Modifying the coverage criteria**

AGL strongly agrees with the Commission’s finding that the coverage test’s threshold for regulation should be higher<sup>10</sup>.

AGL notes the Commission’s Draft Finding 6.4 that:

*the test ‘would be likely to have the effect of increasing competition in a market to a substantial degree’ would set a higher threshold than ‘promotes competition’*

Draft Recommendation 6.1 is that:

*The first criterion for assessing coverage with the current approach to regulation (access arrangements with a reference tariff) (that is, s.1.9(a) of the Gas Code) should be amended such that the National Competition Council would need to be satisfied:*

*that access (or increased access) to Services provided by means of the Pipeline would be likely to have the effect of increasing competition to a substantial degree in at least one market (whether or not in Australia), other than the market for the Services provided by means of the Pipeline.*

AGL agrees with the Commission that the term “substantial” should be defined<sup>11</sup>.

### **Draft Recommendation 6.1**

AGL supports Draft Recommendation 6.1 on the basis that the term ‘substantial’ is appropriately defined. AGL considers that it is imperative that this term be defined satisfactorily to remove any potential ambiguity in the interpretation of 1.9 (a) and to make it clear that the threshold has been raised.

AGL also suggests that coverage should only apply where there is likely to be a substantial increase in competition by reason of the intervention of coverage.

## **2.3 Guidance in assessing the ‘promotion of competition’ test**

AGL agrees with the Commission that there would be benefits from providing guidance to the regulator for assessing the competition issues under criterion (a) and welcomes the Commission’s Draft Recommendation 6.2 that the Gas Access Regime should be amended to give guidance on matters to consider in assessing the “promotion of competition” test in coverage decisions<sup>12</sup>.

### **Draft Recommendation 6.2**

AGL agrees with the Commission’s Draft Recommendation 6.2.

AGL agrees with the factors the Commission has proposed and, in addition, suggests that the list could be expanded to include consideration of the dynamic characteristics of the market.

<sup>10</sup> Draft report – page 175

<sup>11</sup> Draft Report – page 177

<sup>12</sup> Draft Report – page 179

The Commission found that since criterion (b) is a screen for natural monopoly and consistent with the CPA and Part IIIA, it should be retained with no change<sup>13</sup>.

Draft Finding 6.5 is that:

*the ‘uneconomic to develop another pipeline’ criterion (s.1.9 (b)) should be retained in the coverage criteria.*

**Draft Finding 6.5**

AGL agrees that this test should be retained.

However, given that the relevant Minister raised concerns about the ‘point to point’ competition approach in the Moomba-Sydney pipeline revocation decision, there may be a need for guidance in assessing this criterion. Such guidance might say, for example, that the term “another pipeline” does not mean a pipeline following exactly the same route.

Draft Recommendation 6.5 is that

*section 1.9(c) (access provided without undue risk to health or safety) should be removed from the coverage criteria of the Gas Code.*

Draft Finding 6.6 is that

*the ‘not be contrary to the public interest test’ should be retained in the coverage criteria of the Gas Code.*

**Draft Recommendation 6.5 and Draft Finding 6.6**

AGL agrees with the Commission’s draft recommendation to remove criterion 1.9(c) and with the draft finding in relation to section 1.9(d)

The Commission has indicated that it considers there is a case for adding a new criterion that explicitly addresses economic efficiency, to ensure that the benefits of regulation significantly exceed the costs<sup>14</sup>. This suggestion is picked up in Draft Recommendation 6.4:

*The coverage criteria in s.1.9 of the Gas Code should include a new test — namely, that coverage of the pipeline is likely to improve economic efficiency significantly.*

In broad terms, AGL agrees with and supports this draft recommendation. However, AGL makes the following observations:

- (i) the notion of “economic efficiency” is capable of being interpreted in ways which are consistent with many diverse outcomes; and
- (ii) for efficiency to be a practical guide in the application of the Code, there needs to be a common understanding of the concept of “a significant improvement in economic efficiency” and how it should be applied in assessments for coverage.

The Commission notes that in its Part IIIA Review, participants expressed little concern about employing the term “efficiency” and cited the Law Council’s endorsement of the term<sup>15</sup>. AGL comments that:

<sup>13</sup> Draft Report – page 180

<sup>14</sup> Draft Report – page 185

<sup>15</sup> Draft Report – page 184

- the concept of “a significant improvement in economic efficiency” is being given a more pivotal role in the Commission’s recommendations for the Gas Access Regime than was considered for the national access regime. The coverage criteria will incorporate both a competition test *and* an efficiency test; and
- the Law Council observed that “the measurement of efficiency enhancements is likely to be a more complex task than the assessment of a promotion of competition” and (in recognition of this complexity) suggested an alternative approach (for declaration of coverage) which did not require affirmative proof of economic efficiency<sup>16</sup>.

The burden of interpreting and applying the concept of “a significant improvement in economic efficiency” will fall on the NCC and Ministers, and AGL suggests that the NCC and Ministers could be provided with guidance in this area. As noted by the Commission, the NCC and Ministers already assesses net impacts on efficiency, so the additional guidance may not need to be extensive.

#### ***Draft Recommendation 6.4***

AGL supports the Commission’s intentions behind the new test, but points to the need for a common understanding of the concept of “*a significant improvement in economic efficiency*” and how it will be applied in coverage assessments. The NCC and Ministers could be furnished with guidance in this regard.

## **2.4 Form of Regulation**

The Commission observes that a decision on the form of regulation needs to weigh up the benefits and costs of different forms of regulation, and that the coverage decision currently involves an assessment of the benefits and costs of the current form of regulation. The Commission considers that there would be benefits in undertaking these two tasks at the same time<sup>17</sup>.

If there is to be a two tier option, AGL agrees with Draft Finding 6.7 that:

*the decision on the form of regulation should occur at the same time as the coverage decision.*

AGL supports the proposed introduction of a price monitoring option into the Gas Access Regime, although we remain doubtful whether the additional complexity of a two-tier coverage test is appropriate in the circumstances.

A major concern with the price monitoring option, however, is that it may be regarded as the Commission’s key response to the problems it has identified with the current regime. In fact, much more needs to be done to alleviate the difficulties and uncertainties faced by those pipelines still subject to the heavier handed regulation.

The introduction of the monitoring option does not solve the problems for those under the “heavier handed” regime. Nor do the recommendations made by the Commission in its Draft Report go far enough to resolve the issues in the “heavier headed” option. (This is addressed in more detail in Chapter 3 of this submission.)

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<sup>16</sup> Draft Report – page 184

<sup>17</sup> Draft Report – page 186

**Draft Finding 6.7**

AGL endorses the intent behind the Commission's proposed monitoring regime, but notes that very significant interpretation and operational issues need to be resolved to achieve that intent. Moreover, AGL is concerned to ensure that the Commission remains focussed on improving the existing heavier handed option.

**2.5 'Likely to increase competition' test**

AGL notes that the Commission considers that the extent to which access (or increased access) would be likely to have the effect of increasing competition in a market is one of the criteria that should dictate the form of regulation<sup>18</sup>.

AGL notes the Commission has proposed two thresholds for criterion (a):

- a high threshold for applying access arrangements with reference tariffs, given the inherent costs; and
- a lower threshold for applying the monitoring regime, (which has less costs).<sup>19</sup>

The Commission suggests the lower threshold would be where it was "likely to have the effect of increasing competition to a material degree in at least one market..."

Draft Finding 6.8 is that

*the test 'would be likely to have the effect of increasing competition in a market to a material degree' would set a higher threshold than 'promotes competition', but would set a lower threshold than 'would be likely to have the effect of increasing competition in a market to a substantial degree'.*

The Commission's intention is to have a two-tier coverage test. AGL raised concerns with the proposal for a two-tier test in its earlier submission.<sup>20</sup> AGL still has concerns with the workability of the Commission's draft recommendations. There are concerns with how the two tests would be applied in practice and the probability that the boundaries of the two tiers are not sufficiently differentiated. AGL considers that a two-tier regime will generate complexities and considers the Commission's draft recommendation has not developed a framework for the predictable application of the regime.

Draft Recommendation 6.5 incorporates the monitoring regime:

*Section 1.9(a) of the Gas Code (the first of the coverage criteria) should be amended such that access (or increased access) to Services provided by means of the Pipeline would be likely to have the effect of increasing competition to a material degree in at least one market (whether or not in Australia), other than the market for the Services provided by means of the Pipeline.*

<sup>18</sup> Draft Report – page 187

<sup>19</sup> Draft Report – page 187

<sup>20</sup> AGL September 2003 Submission – page 26

**Draft Recommendation 6.5**

We are concerned at the potential complexity and confusion involved in the distinction between ‘material’ and ‘substantial’ increases in competition and suggest that at the very least, the terms should be defined in such a way as to give clear guidance to the NCC and Ministers as to their intended application.

## **2.6 Operationalising the recommendations**

Section 6.5 set out the Commission’s proposed framework for coverage decisions by the NCC and Ministers, incorporating the Commission’s recommendations for revised coverage criteria and tests. The framework hinges on a requirement to consider the *benefits* of coverage (defined as a significant improvement in economic efficiency from allowing access) against the *costs* of coverage (that is, the cost of regulation *particularly through its effect on the efficient provision of pipelines*). The significant mechanisms to achieve this requirement are:

- Narrowing coverage criterion 1.9 (a) and inserting the new economic efficiency criterion;
- Creation of a new monitoring regime for covered pipelines.

Draft Recommendation 6.6 sets the new framework:

*The Gas Access Regime should be modified such that the National Competition Council, in making a recommendation that a pipeline should be covered, should also recommend the form of regulation to apply to the pipeline.*

*The monitoring regime should be applied if one of the following applies:*

- *if access (or increased access) would be likely to have the effect of increasing competition to a material, but not a substantial, degree (and if the other tests are met); and*
- *if access (or increased access) would be likely to have the effect of increasing competition to a substantial degree, but applying the monitoring regime (with its lower costs) would improve economic efficiency more than would an access arrangement with reference tariffs (and if the other tests are met).*

*The current regulatory approach (access arrangements with reference tariffs should be applied if access (or increased access) would be likely to have the effect of increasing competition to a substantial degree, and if such regulation would improve economic efficiency more than would the monitoring regime (and if the other tests are met).*

**Draft Recommendation 6.6**

The new framework is complex and untried. AGL considers that rather than providing certainty, it could generate greater uncertainty.

However, if the concept is taken forward, it is critical that the terms “material” and “substantial” are appropriately defined. AGL notes the Federal Government’s response to Part IIIA on 19 February 2004, and points out that this emphasises the uncertainty around the meanings of the terms and the need for appropriate definition.

Other concepts requiring clarification include ‘economic efficiency’ and ‘economically efficient investment’ and the extent to which ‘improving economic efficiency’ and ‘increasing competition’ can be used as different criteria.

AGL is not clear how Draft Recommendations 6.1 and 6.6 fit together and welcomes clarification from the Commission.

## **2.7 Process for pipelines moving between types of regulation**

The Commission notes that, currently, there are no restrictions on when applications for either coverage or revocation of coverage of a pipeline can be made under the existing Gas Access Regime. There are no mandatory periods for coverage, and there are no restrictions on who can apply for coverage. However, the Commission notes this approach might not be suitable for a monitoring regime and the Commission proposes a number of rules for different coverage situations<sup>21</sup>.

### **2.7.1 Non covered pipelines**

Draft Finding 6.9 is that

*there might be merit in limiting coverage applications for uncovered pipelines to access seekers that demonstrate they have undertaken ‘best endeavours’ in commercial negotiations that failed.*

#### **Draft Finding 6.9**

AGL agrees that regulators should not be able seek coverage for a non-covered pipeline. Applications for coverage should be made only by genuine access seekers.

### **2.7.2 Pipelines covered with monitoring regime**

Draft Recommendation 6.7 is that

*when the monitoring option is applied, it should be for a minimum period, say five years. During this period, no one would be able to apply for coverage with price regulation (an access arrangement with reference tariffs).*

The Commission’s views on what would happen after five years are discussed on page 196 and further spelt out in section 8.5 of the Draft Report. At that time:

- the regulator [who has administered the monitoring regime] could apply to the NCC to change the coverage decision from monitoring to one involving an access arrangement; and
- it would not be appropriate to prescribe rules on what would trigger a regulator’s application to the NCC for heavier handed regulation. Rather, the NCC should assess such applications in the light of new evidence from at least five years of monitoring data.

The Commission further considers that there should be no restrictions on revocation applications for a price-monitored pipeline.

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<sup>21</sup>Draft Report – page 195

***Draft Recommendation 6.7***

If price monitoring is adopted, then AGL accepts that there should be a role for the regulator in an application for heavier handed regulation by providing factual material to the decision-maker.

In relation to revocation, AGL considers that there should be no restrictions on when applications can be made or who can apply.

AGL also agrees with a minimum period that precludes an application for regulation.

AGL's interpretation of the five-year monitoring period proposed by the Commission is that, after five years, there would be no automatic re-assessment of the status of the covered pipeline; price monitoring would simply continue unless an application to change this was made.

If price monitoring is to be adopted, then AGL seeks clarification that price monitoring would continue after the five-year period expired, until a successful application was made for heavier handed regulation.

### 2.7.3 Pipelines covered under an access arrangement

The Commission considers that there should be no restrictions on applications for either revocation or a move to a monitoring regime. This issue is addressed in the Draft Report's figure 6.2 that indicates the various options for applications for either coverage or revocation. The Commission seeks comment on this framework.

***Applications for coverage/revocation under heavier handed regime***

In relation to pipelines covered under an access arrangement with reference tariffs, AGL agrees with the Commission that there should be no restrictions on either when applications can be made or who can apply.

## 2.8 Forum Shopping

To prevent the possibility of double regulation, the Commission has reiterated its recommendation from the National Access Regime review that a Part IIIA undertaking should not be accepted where coverage under the Gas Code has yet to be resolved.

Draft recommendation 6.8 is therefore:

*The Gas Access Regime should be amended to provide that where a service provider potentially covered by the Gas Code lodges a part IIIA undertaking, this should trigger an assessment (currently by the National Competition Council) to determine whether the pipeline meets the requirements for coverage under the Gas Code. The Australian Competition and Consumer Commission's assessment of the part IIIA undertaking should be held over, pending the outcome of the coverage assessment.*

***Draft Recommendation 6.8***

AGL agrees with this recommendation.

### **3. Content of Access Arrangements – access arrangement regulation**

Chapter 7 of the Draft Report examines issues relevant to the content of access arrangements as they are currently specified under the reference tariff approach of the Gas Access Regime. AGL considers that improving access arrangement regulation is one of the most critical issues. While AGL welcomes many of the Commission's observations, findings and recommendations, AGL is concerned that the Commission's recommendations do not go far enough in addressing the issues the Commission has identified.

Nevertheless, AGL welcomes several of the Commission's key observations on access arrangements, including:

- Even if a regulator held the same information held by a regulated business, it is unlikely that the regulator would be able to determine the most efficient prices/revenues. Businesses typically have to make decisions under uncertainty and so regulation of those businesses also involves uncertainty<sup>22</sup>;
- A drawback of cost-based price regulation is that it makes pricing inflexible and precludes more efficient pricing methodologies. In addition, cost reductions are passed through to customers when a regulator next resets prices and this provides businesses with little incentive to improve their efficiency (although a profit sharing arrangement can address this problem to some extent<sup>23</sup>; and
- The Commission notes that the Gas Access Regime's "building block" approach is in practice a form of cost-based price regulation, with limited pricing flexibility<sup>24</sup>.

#### **3.1 Pricing principles**

AGL's September 2003 submission pointed out that there were a number of significant issues with the pricing principles, and that the key issue was a lack of clear specification of pricing objectives<sup>25</sup>. AGL recommended that appropriate pricing principles be introduced.

AGL noted that the current section 8.1 pricing principles were confusing and provided too much regulatory discretion to the regulator and that regulators were not provided with clear guidance. As a result, regulators were left to determine whether pricing should be about achieving the lowest possible price or some alternative outcome. The result was a range of uncertainties for asset owners, particularly in relation to the treatment of efficiency gains and issues surrounding the recovery of efficient costs. AGL endorsed the adoption of pricing principles similar to those recommended in the Commission's Part IIIA review (with some modification).

AGL is pleased that the Commission has acknowledged that the building block approach has inhibited commercial negotiations<sup>26</sup>.

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<sup>22</sup> Draft Report - page 200

<sup>23</sup> Draft Report - page 201

<sup>24</sup> Draft Report – page 206

<sup>25</sup> AGL September 2003 Submission – page 12

AGL welcomes the comments made by the Commission that, in general, the arguments made about requiring principles in the National Access Regime apply also to the Gas Access Regime and that “pricing principles are needed to provide guidance on how the broad objectives of the regime should be applied in setting reference tariffs, provide greater certainty for regulated businesses and access seekers, and reduce the scope for regulatory risk and error (arising from regulatory discretion).<sup>27</sup>”

AGL also welcomes the Commission’s acknowledgment that access prices should promote the efficient use of, and investment in, pipelines and networks<sup>28</sup>. AGL strongly agrees with the Commission on this point.

### 3.1.1 The Part IIIA pricing principles

At page 209 of the Draft Report, it is noted that participants in this current inquiry endorsed many of the recommended pricing principles for the national regime, such as:

- recovery of (at least) the long-run efficient costs of providing access; and
- prices should be set to include a rate of return commensurate with the regulatory and commercial risks involved.

The Federal Government’s interim and final responses to the Part IIIA review modified the Commission’s recommendations, including removal of the reference to ‘long run’ costs. The Commission sets out the Government’s reasoning at (in relation to the interim response) page 210. In relation to the removal of the reference to long run costs, AGL agrees with the Commission’s argument that removal of this reference exposes service providers under the Gas Access Regime to the imposition of short-run marginal cost pricing, which would create uncertainty regarding potential to recoup investments and thus reduce investment incentives.

After reviewing the Government’s response and submissions of participants, the Commission arrived at Draft Recommendation 7.1:

*Section 8.1 of the Gas Code should be replaced with the following:*

*The relevant regulator must have regard to the following principles when approving a reference tariff or reference tariff policy:*

*(a) that reference tariffs should:*

- (i) be set so as to generate expected revenue across a service provider’s regulated services that is at least sufficient to meet the efficient long-run costs of providing access to those services*
- (ii) include a return on investment commensurate with the regulatory and commercial risks involved*
- (iii) generate revenue from each service that at least covers the directly attributable or incremental costs of providing the service.*

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<sup>26</sup> Draft Report – page 202

<sup>27</sup> Draft Report – page 204

<sup>28</sup> Draft Report – page 205

*(b) that reference tariff structures should:*

*(i) allow multi-part pricing and price discrimination when it aids efficiency*

*(ii) not allow a vertically integrated service provider to set terms and conditions that disadvantage competitors of its associated businesses in upstream or downstream markets, except to the extent that the cost of providing access to these competitors is higher.*

*(c) that reference tariffs should be set so as to provide incentives to reduce costs or otherwise improve productivity.*

AGL notes that:

- principle (a)(i) may still allow a relatively narrow regulatory focus on “efficient cost recovery” to the detriment of other more dynamic aspects of service provision, and thus reduce the ultimate benefits to consumers; and
- the treatment of efficiency gains is not dealt with in the proposed pricing principles, except for the very general reference to incentives in (c).

These issues are dealt with in more detail below.

#### ***Draft Recommendation 7.1***

AGL considers that improving access arrangement regulation is the most critical task facing the Commission. While AGL generally agrees with the Commission’s expression of pricing principles, AGL considers that additional pricing principles are required, that access providers should be able to choose the pricing methodology they prefer and that an earnings sharing model is appropriate.

### 3.1.2 Efficient cost recovery

AGL noted in its September 2003 submission that:

*“The current regulatory model, especially the provision that only ‘efficient costs’ shall be recoverable, presumes that efficient costs are capable of accurate estimation by the regulator<sup>29</sup>”*

This concern is echoed in the Commission’s observation quoted above that “even if a regulator held the same information held by a regulated business, it is unlikely that the regulator would be able to determine its most efficient prices and revenues”.

As a result of the inherent deficiencies of the cost of service approach (also noted by the Commission), AGL suggested that regulated entities themselves should be left to optimise their operating costs<sup>30</sup>. AGL suggested a model whereby, if forward prices were to be fixed

<sup>29</sup> AGL September 2003 Submission - page 16

<sup>30</sup> AGL September 2003 Submission - page 16

by regulation, they should be set on the basis of actual costs and actual volume sales at the time of price fixing, not on the basis of forecasts [of efficient costs]<sup>31</sup>.

In AGL's view, the greatest incentives to optimise costs and provide benefits that can be equitably shared with consumers would come from much reduced regulatory intrusion via a minute ex-ante examination of costs. This would seem to be consistent with the Commission's intention to have pricing principles which "reduce the scope for regulatory risk and error (arising from regulatory discretion)"<sup>32</sup>.

AGL acknowledges the Commission's view that (it) "is not convinced that regulators can avoid a detailed examination of each service provider's costs while they continue to be required to approve reference tariffs"<sup>33</sup>. However, AGL understands this comment to be contrasting the cost-based approach to regulation with alternative (less developed) forms such as benchmarking. The issue is not whether costs require examination in some form, but whether the intrusive and excessive focus on pinpointing 'efficient costs' – an acknowledged impossibility – is in fact inhibiting the most efficient outcomes.

#### ***Efficient cost recovery***

AGL repeats the comments made in its September 2003 submission that the current access pricing methodologies are too intrusive and that regulated entities should be able to choose the access pricing approach they prefer.

### 3.1.3 Treatment of efficiencies

The Commission notes that "incentives to reduce costs or otherwise improve productivity are appropriate, given that without these incentives potential efficiency gains might not be exploited"<sup>34</sup>. This statement may be correct, but it does little to address the difficulties of implementing incentive regulation under the current regime, particularly the regulatory treatment of efficiencies.

AGL's September 2003 submission made the following points:

- the current regime does not provide real incentive regulation;
- prices are based on regulator forecasts of 'efficient' costs;
- this leaves investors uncertain as to whether prices will allow recovery of costs for an efficient operator;
- regulators are in effect awarding 100 per cent of what they consider achievable efficiencies to consumers; and
- if regulators overestimate potential efficiencies, they will have transferred to consumers efficiency gains which did not arise<sup>35</sup>.

<sup>31</sup> AGL September 2003 Submission - page 16

<sup>32</sup> Draft Report – page 204

<sup>33</sup> Draft Report - page 214

<sup>34</sup> Draft Report - page 213

<sup>35</sup> AGL September 2003 Submission – page 14

AGL submitted that true incentive regulation required:

- that only realised efficiencies be shared; and
- upfront certainty as to how such efficiencies will be shared.

AGL recommended that the Gas Access Regime provide clear guidance on the treatment of efficiency gains<sup>36</sup>.

AGL is disappointed that the Draft Report has not directly picked up the concerns of service providers on the issue of equitably sharing “real” efficiency gains and suggests that the Commission consider this matter further.

AGL proposed an earnings sharing model which began with today’s average price for a service provider and progressed along a price path to a target at the end of the next regulatory period<sup>37</sup>. The difference between today’s price and the target would represent efficiency gains in the last regulatory period, which would thus be transferred progressively to consumers. This model has the obvious benefits of focusing on real, as opposed to theoretical, efficiency outcomes, and gives service providers an ongoing incentive to discover new operating economies.

#### ***Treatment of efficiencies***

AGL remains convinced that an earnings sharing model would be appropriate. AGL repeats its call for an earnings sharing model. This will give managers of regulated businesses the appropriate signals to search for additional efficiency gains.

#### **3.1.4 Target revenue Methodologies**

The Commission notes the many technical issues involved in implementing target revenue methodologies and observes that

*“As a result, it is possible to generate a range of values for the revenue target, even using a single methodology. In other words, the most efficient target revenue cannot be known with certainty”<sup>38</sup>.*

The Commission also cites the fundamental concerns that service providers have with regulators’ interpretations of the Code in relation to efficient costs and prices, and the possibility of using various benchmarking approaches as alternatives to cost-based regulation.

The Commission also records its previously expressed view that “the setting of access prices cannot be fully decoupled from a business’s costs” since benchmarks may incorporate significant measurement errors<sup>39</sup>.

<sup>36</sup> AGL September 2003 Submission – page 15

<sup>37</sup> AGL September 2003 Submission - page 15

<sup>38</sup> Draft Report - page 215

<sup>39</sup> Draft Report - page 220

Draft Finding 7.1 sees little merit in further research on benchmarking, but seeks further comment from participants on the matter.

***Draft Finding 7.1***

Broadly, AGL sees greater value in focusing on clearer guidance for regulators in applying the components of the cost-based model to the determination of target revenue, rather than focusing on refinements to benchmarking approaches. AGL considers that benchmarking has some limited usefulness but not as a primary methodology of access regulation. This accords with the Commission's view that it is difficult to decouple access prices from costs. AGL's September submission recommended that the pricing principles should make clear that:

- Where the cost of capital is relevant, the parameters of the regulatory WACC should be determined by a panel of experts. Industry and the regulator should then apply the parameters which have been determined by a panel of experts;
- where the cost of capital is relevant, the risk component should be fixed for the life of the asset;
- capital investment deemed prudent at the time of investment should not be stranded;
- Where forward prices are fixed by regulation, they shall be set on the basis of actual costs and volume sales at the time of price fixing, not on the basis of forecasts; and
- Investors shall share in all realised improvements in efficiency, not only in the improvements that exceed regulator benchmarks.

AGL repeats its call for the adoption of these additional principles.

### 3.1.5 *Ex ante* Regulatory Rate of Return

The Commission notes that the target revenue approach requires a regulator to set an *ex ante* rate of return on capital. The Commission cites several problems with this requirement:

- The debt costs of a service provider are relatively straightforward but the return required by equity investors is not;
- implementing the WACC/CAPM approach is not a precise science;
- meeting the Gas Code's requirements does not lead to a single indisputable [cost of capital] number for a reference tariff;
- there is no widely agreed estimate for the market risk premium; and
- there are difficulties in estimating equity beta in the Australian context<sup>40</sup>.

AGL welcomes the Commission's acknowledgment of these regulatory problems, but notes that the Commission has not proposed a mechanism to resolve them, simply observing in Draft Finding 7.2 that:

*There is disagreement among technical experts about how regulatory rates of return (WACC) in Australia compare to those in other countries. This illustrates the inevitable imprecision and subjectivity that occurs when regulators are required to approve reference tariffs.*

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<sup>40</sup> Draft Report - pages 233-234

AGL appreciates that the Commission's proposed new pricing principle to *include a return on investment commensurate with the regulatory and commercial risks involved* may be an improvement on the present clause 8.30 of the Code but substantial problems with the regulatory application of WACC remain.

In its September 2003 submission, AGL highlighted two major uncertainties with regulated rates of return<sup>41</sup>:

- uncertainty regarding the initial regulatory rate of return for new infrastructure and uncertainty as to whether the rate for successful investments will be reduced; and
- uncertainty as to whether the regulator will, in future price determinations, reduce the risk component of the rate of return for successful investments from the figure set initially.

AGL must allocate its investment funds in an efficient manner (ie to meet minimum expected returns) and the discretionary power of regulators to select a wide range of parameters for WACC which put downward pressure on rates of return additional to "pure" market movements creates additional uncertainty for potential investment. The first instance cited above refers to problems in "second guessing" what assumptions a regulator will use to set WACC at a regulatory review. The second instance refers to *ex post* regulatory adjustments to WACC incorporating a risk component substantially lower than that prevailing when a successful investment was first appraised and committed. Both instances highlight the need to obtain firmer commitments from regulators as to their future specifications of WACC parameters.

***Draft Finding 7.2***

AGL welcomes the Commission's finding and suggests that the principles AGL referred to under its recommendation in respect of Draft Finding 7.1 should be adopted as a solution to this issue.

### **3.2 Other Reference Tariff Matters**

Section 7.6 of the Draft Report comments on competitive tendering.

***Draft Recommendation 7.2***

AGL agrees with Draft Recommendation 7.2 that *the Gas Code's competitive tendering provisions should be simplified to make them more flexible and less costly.*

### **3.3 Detailed Information Requirements**

Section 7.7 of the Draft Report reviews the information gathering powers of regulators and the views of market participants as to the adequacy of those powers. In general, service providers believed that the powers were more than adequate, while some participants – notably OffGAR - wanted the powers extended.

The Commission's assessment was that under the building block approach, there seems to be limited scope to reduce the information requirements for service providers, given that regulators need a significant level of information to fulfil their obligations<sup>42</sup>. In addition:

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<sup>41</sup> September 2003 Submission - page 35

*The Commission is seeking further information on the specific nature of the non-financial information that service providers could maintain and provide that is essential for regulators in understanding the derivation of elements of a proposed access arrangement and for forming an opinion as to its compliance with the Gas Code.*

However, the Commission also recognised that information requirements are not costless, and that the onus should be on regulators to minimise the costs of information requirements where possible.

AGL considers that the current Code gives regulators adequate information collection powers. AGL does not consider there is any deficiency in the current arrangements.

***Draft Finding 7.3***

AGL agrees with Draft Finding 7.3 which is that *regulators are currently seeking to have their powers extended so they can obtain information between access arrangement reviews. This extension has the potential to add unnecessarily to service providers' compliance costs.*

AGL considers that the current information collection provisions are adequate. AGL sees no need whatsoever for the collection and submission of regulatory information between reviews.

Draft Recommendation 7.3 is that

*the Gas Code should be amended to ensure that regulators' requirements for establishing and maintaining information are standardised across jurisdictions and are as close to existing gas industry accounting or record keeping practices as possible.*

While AGL welcomes the Commission's intent, AGL considers that this recommendation may in fact result in more intrusion and more complexity as it may require regulated businesses to change their current business practices to meet new requirements and result in increased costs.

***Draft Recommendation 7.3***

AGL has some concerns about the implementation of Draft Recommendation 7.3

### **3.4 Non-Price Issues**

AGL welcomes the Commission's acknowledgment that the Gas Access Regime requires regulators to make decisions where there is no single indisputable answer and AGL agrees that regulators are placed in the difficult position of being expected to act as omniscient central planners<sup>43</sup>. AGL also welcomes the Commission's acknowledgment of other problems.

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<sup>42</sup> Draft Report – page 245

<sup>43</sup> Draft Report –page 252

Draft Finding 7.5 is that

*there is high potential for regulatory error when approving reference tariffs. The Gas Access Regime requires regulators to make decisions about future market circumstances that are uncertain. This has led regulators to use many debatable assumptions. There is a consequential tendency for regulators to seek additional information from service providers and further studies by consultants. This is unlikely to reduce uncertainty significantly.*

AGL agrees with this conclusion, and the Commission’s observations on problems with the current regime including:

- high regulatory risk — service providers cannot be certain about the regulatory parameters and mechanisms that will be applied to their pipeline, despite the many pages of the Gas Code and the Gas Pipelines Access Law; and
- detailed information requirements which are costly and intrusive<sup>44</sup>.

The Commission has made a number of recommendations on improving the cost-effectiveness of the current regulatory approach, including new pricing principles.

***Draft Finding 7.5***

AGL appreciates moves to overcome deficiencies of the current regime proposed by the Commission. Nevertheless – as indicated in this section of AGL’s submission – there are many uncertainties and problems left unresolved by the Commission’s recommendations. There is still likely to be a focus on unachievable accuracy in the regulatory assessment of efficient costs and rates of return, and the ‘incentive’ feature of shared efficiency gains can still be minimal for service providers under regulatory determinations.

AGL repeats its calls for:

- an earnings sharing model;
- regulated entities to be able to chose the pricing methodology they prefer; and
- additional pricing principles to be added in line with its recommendation (contained in the box headed “Draft Finding 7.1” above);

Draft Finding 7.6 observes that the current regulatory approach of having access arrangements with reference tariffs is costly and there is a sound basis for an alternative less costly approach.

***Draft Finding 7.6***

While AGL agrees with this finding, the number of existing service providers who will be able to transfer to this new approach (ie lighter handed regulation as discussed in chapter 8) and whether it will in practice be as light handed as intended are still unknown quantities. Therefore, a focus on improving the existing regime as much as possible is clearly critical.

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<sup>44</sup> Draft Report - page 253

## 4. Lighter handed regulation

Given the costliness of the existing Gas Access Regime, the Commission recommended (in Chapter 6) amending the coverage test to apply a lighter handed form of regulation to some covered pipelines. AGL welcomes the acknowledgment that there can be substantial costs under the current approach of prescribing reference tariffs and other matters in Access Arrangements<sup>45</sup>.

The Commission notes that in general, lighter handed regulation places greater emphasis on encouraging commercial negotiations between parties rather than prescribing the terms of transactions or imposing constraints on financial variables<sup>46</sup>.

As well as reducing costs for all participants, the Commission notes other benefits of lighter handed regulation such as reducing the scope for regulatory error, reducing regulatory risk and encouraging innovation by service providers<sup>47</sup>.

AGL agrees that these are worthwhile objectives; therefore, it is vital to ensure that the lighter handed regime can fulfil these aims, and is not, either by regulatory error or design fault, allowed to regress to heavier handed regulation. However, as previously noted, AGL is disappointed that the Commission has not made more comprehensive recommendations to address the deficiencies of access arrangement regulation.

### 4.1 Proposed approach

The Commission notes that lighter handed regulation does not mean “no regulation” (page 261); hence, the recommended coverage test in chapter 6 requires the NCC and Ministers to assess the market power held by service providers, as measured by the scope for access regulation to increase competition.

AGL reiterates the thrust of its concerns in relation to chapter 6, but if price monitoring is to be proceeded with, the definitional framework for appraising a ‘material’ versus ‘substantial’ increase in competition must be sound, there must be a common understanding of what ‘a significant improvement in economic efficiency’ would entail and appropriate guidance should be furnished to the NCC in order to apply the coverage tests.

Draft Recommendation 8.1 is that:

*The Gas Access Regime should be amended to provide for a lighter handed form of regulation whereby the application of the alternative regulation involving an access arrangement with reference tariffs would only occur in the more extreme circumstances. The lighter handed alternative should be a monitoring regime. It is important that the monitoring regime not develop into an intrusive and costly form of regulation.*

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<sup>45</sup> Draft Report – page 255

<sup>46</sup> Draft Report - page 258

<sup>47</sup> Draft Report - page 259

**Draft Recommendation 8.1**

Subject to AGL's earlier comments about price monitoring, AGL supports the recommendation

The Commission then notes that while it is desirable that pipelines be run at arms length from associated businesses in upstream and downstream markets, the issue is whether this can be done without the highly prescriptive requirements of the Gas Code<sup>48</sup>. As a result:

*The Commission invites inquiry participants to comment on how ring fencing and associate contract requirements could be implemented under the proposed monitoring regime that does not involve the prescription of reference tariffs<sup>49</sup>.*

**Ring fencing and associate contracts – price monitoring**

While AGL believes that ring fencing arrangements would be appropriate, AGL does not consider that it is necessary to have associate contract requirements approved under the proposed price monitoring regime. Rather, notification would be sufficient.

The Commission model for a monitoring regime is given in Draft Recommendation 8.2:

*The monitoring form of regulation to be implemented under the Gas Access Regime should have the following features:*

- *a third party access policy formulated by the service provider;*
- *separation of pipeline operations from associated businesses in upstream and downstream markets;*
- *public disclosure of information by the service provider (which would be well short of the 'access arrangement information' currently required under the Gas Code); and*
- *scope for the service provider to adopt, at its discretion, additional pro-competitive features, such as a code of conduct.*

**Draft Recommendation 8.2**

Subject to AGL's earlier comments regarding complexity and workability, AGL supports the concept of price monitoring.

However, AGL reiterates that its "workability" depends both on satisfactory resolution of the coverage issues identified by AGL in relation to chapter 6 and on the NCC, Ministers and jurisdictional regulators acting in accordance with the intended aim of the monitoring regime.

In this regard, AGL welcomes the Commission's recognition that those making coverage decisions might "err on the side of caution" and the statement that "the proposed coverage criteria should be applied rigorously so the extent of coverage would be no greater (and probably less) than what would occur under the current access regime"<sup>50</sup>.

<sup>48</sup> Draft Report - page 262

<sup>49</sup> Draft Report – page 263

<sup>50</sup> Draft Report – page 263

## 4.2 Information disclosure

The Commission recognises correctly that the current reporting requirements of the Gas Code would be quite inappropriate for a monitoring regime<sup>51</sup>. The Commission suggests the reporting requirements should:

- specify only data that are essential to ascertaining whether a service provider has misused its market power; and
- rely as far as possible on data and accounting practices that already exist.

*The Commission invites inquiry participants to provide their views on what data items should be reported under the proposed monitoring regime, the level of disaggregation that should be involved and how data should be presented.*

AGL agrees that data collection should have a focus on market outcomes (not detailed inputs as with the existing regime) and should aim to minimise costs. A focus on a few significant issues should help avoid the worst features of the intrusive information requirements of the current regime. AGL endorses the Commission's warning on the scope for 'regulatory creep' in setting information requirements<sup>52</sup> and the view that information requirements should not be amended without agreement between the service provider and regulator. AGL endorses the Commission's concept that there should be a set of "information guidelines" from which particular information requirements are derived<sup>53</sup>.

Draft Recommendation 8.3 is:

*In making a coverage decision to apply the monitoring regime, the National Competition Council should specify what information the service provider is required to disclose to the relevant regulator. Implementation of the information disclosure requirements would involve:*

- *the regulator focusing more on trend performance, including in relation to profitability;*
- *the regulator particularly monitoring cases where access negotiations have been unsuccessful; and*
- *reporting and monitoring after the event, without any need for prior endorsement by the regulator.*

### **Draft Recommendation 8.3**

AGL notes that the NCC's role is not to make coverage decisions, but rather recommendations to the relevant Minister. AGL has concerns with Draft Recommendation 8.3. In particular, AGL does not consider it appropriate that the NCC or the relevant Minister should specify the price monitoring information. Rather, this should be set out in Code.

Draft Finding 8.1 is:

*Information disclosure under the monitoring regime would be assisted by disclosure guidelines. The National Competition Council (rather than a regulator) would need to*

<sup>51</sup> Draft Report - page 268

<sup>52</sup> Draft Report - page 271

<sup>53</sup> Draft Report - page 271

*develop and update such guidelines. Ideally, this would involve a consultative process that is open and transparent with interested parties.*

AGL agrees that regulators should not be responsible for setting and updating information requirement guidelines<sup>54</sup>. However, it has some concern with the Commission's proposal that the NCC could specify and update such guidelines, given that the NCC is not required to, or is experienced in, carrying out this function under its present charter. AGL considers that these guidelines should be developed by the Government under a transparent consultative process. Alternatively, the Commission itself could provide some guidelines in its final report.

AGL notes that information disclosure guidelines should have specific provisions for the protection of the confidential information held by the service provider (which may well be information relating to third parties), particularly if monitoring information is to be published.

Draft Recommendation 8.4 is:

*The relevant regulator should collate and publish annually the information disclosed by a pipeline under the monitoring regime. Any commentary made by the regulator should be of a factual nature only.*

**Draft Recommendation 8.4**

AGL notes this recommendation. However, it could be asked why it is necessary for the information to be published, and what value the regulator's comments would add. If the basic purpose of the information is for the regulator to assess whether market power is being used, the publication of data will add little to that process.

The Commission proposes that a number of compliance measures should be part of the monitoring regime. These are given in Draft Finding 8.2:

*To ensure the data disclosed by service providers under the monitoring regime are accurate, it would be appropriate to:*

- *require chief executive officers (CEOs) to sign a declaration stating that the data are true; and*
- *allow regulators to seek financial penalties through the courts if companies refuse to provide the required monitoring data.*

**Draft Finding 8.2**

AGL has no objection to compliance measures as such, but notes that this is a finding not a recommendation. It may be that the Commission does not see this as a basic element of a monitoring regime. AGL notes that if there are financial penalties, it is critical that the information that is required is not too onerous and should not be able to be changed without the agreement of the service provider.

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<sup>54</sup> Draft Report - page 271

## 5. Investment and Access Arrangements

AGL generally supports the Commission's findings and recommendations in Chapter 9.

AGL notes that the level of greenfield investment will be determined by investors' assessments of projects taking account of all relevant factors including the regulatory context. At the end of the day, given a particular set of circumstances and regulatory arrangements, there will always be projects that are marginal. The current review provides an opportunity to address those aspects of the current regulatory regime that add unnecessary uncertainty and have the potential to result in the deferral or abandonment of socially desirable projects that would otherwise be viable.

### ***Draft Finding 9.1***

AGL agrees with the Commission's conclusion in Draft Finding 9.1 that the solutions proposed in the ACCC's Draft Greenfield Guidelines do not "substantially alter the potential for the Gas Access Regime to discourage investment"<sup>55</sup>; that is, they cannot meet industry's concerns.

In addition to the problems identified by the Commission in respect of the Draft Greenfield Guidelines, AGL has an overriding concern that the realisation and retention (by the service provider) of a share of the "blue sky" from a successful greenfield project is essentially incompatible with the current structure of the Code which is directed towards allowing only efficient costs. For this reason, the Draft Greenfield Guidelines cannot provide an appropriate solution.

It is arguable that the defining characteristics of a true greenfield project, such as the Central West Pipeline, are that:

1. the principal purpose of the pipeline is to bring natural gas to a region that does not already have gas.
2. penetration of existing energy markets in the region served by the pipeline will not be sufficient to assure its viability – such a project relies for its viability on expectations of regional development and consequent growth in the region's energy market which the project itself will make possible.

If the anticipated development and growth do not materialise, the project will never achieve an acceptable return. This highlights another failing of the ACCC's Draft Guideline proposal which the Commission alludes to in its Draft Report. That is, solutions which purport to offer symmetric truncation are likely to remain asymmetric in practice – returns will be truncated when a project is successful, but nothing can be done to improve the outcome when a project is inherently unsuccessful.

### ***Draft Finding 9.8***

AGL supports the Commission's Draft Finding that the right of a service provider to seek revisions to an access arrangement is no remedy for the distorting effects of asymmetric truncation.

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<sup>55</sup> Draft Report - page 279

One of the consequences of the market growth profile for a greenfield project is that economic losses are not only likely but expected during the initial years of the project's life as the market for services is developed. If the project is to be viable on both an ex ante and an ex post basis, it must be permissible to carry those losses forward to be recovered if/when circumstances permit. The Commission observes that "[there may] be conflict between the principle of efficient pricing and the use of depreciation to recover past 'losses' from users<sup>56</sup>." If Code changes designed to facilitate investment are to be effective, it is of fundamental importance that any such conflict be resolved. The ACCC's Draft Greenfield Guidelines do not achieve this.

## **5.1 Binding Rulings**

In Draft Recommendation 9.1, the Commission recommends the introduction of binding rulings on coverage. From the way in which the draft recommendation is framed, it appears that the process to obtain such a ruling is intended to be the same as the process for dealing with coverage matters generally. In context (c.f. figure 9.1) it appears also that the process, and hence a binding ruling, would be available to any "new pipeline".

If the process envisaged by Draft Recommendation 9.1 is to be the same as that for dealing with coverage generally, AGL is concerned at the length of time and resources, and to a lesser extent the cost, that would be involved in obtaining a decision. There are also issues of confidentiality. One option might be to establish a "gate" criterion to distinguish between true greenfield pipelines (which should have a prima facie entitlement to a 15 year coverage holiday) and other new pipelines. It appears to AGL that there would be a need to distinguish true greenfield pipelines from other new pipeline in any event, in order to establish entitlement to the proposed truncation premium (assuming one is implemented as a result of Draft Findings 9.5 and 9.6).

### ***Draft Recommendation 9.1***

AGL considers that it will be necessary to define the term "greenfield pipeline".

As to the form that the binding decision could take, AGL makes the following observations:

#### **5.1.1 The 15 year regulation free period:**

AGL and others have noted in previous submissions that, from an ex ante perspective, a marginal greenfield project is unlikely to become NPV positive within a 15-year period or even longer. Of course, in cases where the project is successful, the service provider may enjoy some "blue sky" within a 15-year regulation free period.

AGL's principal concern is with the treatment of the asset once the 15-year period has expired. This treatment will affect the way in which a project is evaluated today. Assuming that a pipeline becomes covered under the more onerous access arrangement and reference tariff regime at some time during its life, the key issues at that time are:

- (a) The criteria for the coverage decision;
- (b) The basis for determining the asset value to be carried into the coverage regime. In particular:

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<sup>56</sup> Draft Report - page 303

- the assurances that can be given that any “blue sky” attained during the period of uncoverage and/or monitoring is not clawed back;
  - the treatment of any economic losses carried forward from the period of uncoverage and/or monitoring;
  - the implications for record-keeping requirements during the period of uncoverage;
- (c) The determination of WACC both when the pipeline is covered and for the period of uncoverage (to the extent that WACC is relevant in determining whether the pipeline should become covered and/or subject to the access arrangement and reference tariff regime). In particular:
- whether the truncation premium will apply;
  - the basis on which the risk components of WACC will be determined. (ie on the basis of the ex ante assessment of risk for the project or on the forward looking view of risk at the time.)

### ***NPV Sharing Mechanism***

In past submissions, including its September 2003 submission to the Commission, AGL has proposed a NPV sharing mechanism modelled on the Petroleum Resources Rent Tax. AGL is aware that the Commission has considered that proposal and decided in favour of the alternative options set out in the Draft Report. In this submission, AGL notes simply that the NPV sharing mechanism would deal satisfactorily and automatically with the points raised in (a) and (b) above.

#### **5.1.2 The monitoring regime as an alternative to a 15 year regulation free period:**

The Commission has suggested in the Draft Report that having the monitoring regime available as an alternative to the more onerous access arrangement and reference tariff regime is likely to reduce the need for regulation free periods<sup>57</sup>. In AGL’s view, having a greenfield project under the monitoring regime would do little to resolve uncertainty because, as proposed in the Draft Report, it would be open to the regulator to seek a transfer to coverage under the more onerous access arrangement and reference tariff regime at any time after the initial 5 year period of assurance has expired.

The circumstances under which a regulator could make such an application and the criteria that will apply in making the decision to impose the more onerous regime are presently unclear. For example, it would be of concern to AGL if the regulator could initiate such action simply because annual accounting returns appeared high on an historic cost basis, which would be the case when/if a project is established and the service provider is seeking to recover capitalised losses. Of course, if coverage were imposed at the more onerous level, the issues discussed above in connection with the 15-year regulation free period also come into play.

## **5.2 Truncation Premium**

The Commission favours a truncation premium as a means of addressing truncation risk. AGL agrees that such a premium would be of some benefit although it must be recognised

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<sup>57</sup> Draft Report - page 312

that, as with any truncation/risk sharing mechanism, the result will be a curtailment of the potential value of high-side scenarios, thus reducing the ex ante expected return and ex post actual return if the project is successful compared with the regulation-free alternative.

Assuming that the premium and the manner in which it will apply is known at the time an investment decision is made, it can and will be taken into account in making that decision. Of course if the premium is not known at that time then a significant, avoidable, uncertainty will remain. Investors must also have confidence that regulators will not discount the “bare” WACC or other factors within their discretion to detract from the benefit of the premium.

The truncation premium proposal would appear to require some development and refinement. Apart from the issue of quantification, it is not clear which classes of investment would be entitled to the premium. AGL assumes the Commission does not intend the premium to be available to all “new pipelines”. For example, it is arguable that a pipeline constructed to serve an established gas market is not subject to the same level of truncation risk as one that is built to bring gas to a new undeveloped market. As discussed above, the establishment of a definition for the class of pipeline that would be entitled to the truncation premium could also be of value as a means of streamlining the process for binding coverage decisions.

***Draft Finding 9.6***

AGL agrees that a truncation premium would be of some benefit, however, notes that the truncation premium proposal would appear to require some development and refinement.

**5.3 Other matters relevant to new investment decisions:**

**5.3.1 Unnecessary uncertainty:**

In its submission in response to the Commission’s Issues Paper, AGL referred to seven sources of uncertainty in the context of Pricing Principles<sup>58</sup>. Several of those uncertainties are of direct relevance to investment decisions and are discussed again here:

- (i) Uncertainty regarding the initial regulatory rate of return for new infrastructure.

There is no practical reason why those elements of rate of return that are independent of the investment itself should not be posted in some way. At present an investor must second-guess the regulator. It is also important that any truncation premium that may be introduced as a result of the Commission’s inquiry, be known at the time an investment decision is made.

- (ii) Uncertainty as to whether the regulator will, in future price determinations, reduce the risk component of the rate of return for successful investments from the figure set initially.

An investment decision is made on the basis of an ex ante assessment of risk and ex post assessments of project outcome and performance are made on the same basis. It is inappropriate for the regulator to reassess the risk component of return downwards in the event that an investment proves to be successful.

<sup>58</sup> AGL September 2003 Submission – page 13

- (iii) Uncertainty as to whether benefits from taxation investment incentives will be removed through regulatory price determinations after the investment has been made.

In AGL's view it is unnecessary for these uncertainties to exist. Their removal would increase the certainty with which investment decision could be made without detracting from the effectiveness of the regulatory process.

***Other matters relevant to new investment decisions***

AGL's view is that it is possible to remove elements of uncertainty:

- there is no practical reason why those elements of rate of return that are independent of the investment itself should not be posted in some way;
- Regulators should not be able to reassess the risk component of return downwards in the event that an investment proves to be successful; and
- Benefits from taxation investment incentives should not be able to be removed through regulatory price determinations after the investment has been made.

**5.3.2 Exclusive Franchises:**

In its submission in response to the Commission's Issues Paper, AGL also identified retail/supply arrangements as an important factor in determining the viability and success of greenfield pipelines<sup>59</sup>. In particular, AGL recommended that consideration be given to allowing exclusive retail franchises for a reasonable period in association with greenfield developments. The Commission's Draft Report does not address this point.

***Exclusive franchises***

AGL remains of the view that consideration should be given to allowing exclusive retail franchises for a reasonable period in association with greenfield developments.

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<sup>59</sup> AGL September 2003 Submission – page 21

## 6. Asset Management Contracts

At pages 321 and 322 of the Draft Report, the Commission discusses the developing trend for asset owners to contract out Asset Management functions, noting that in some cases the counter-party is an associate of the asset owner. The Commission seeks participants' views on several matters that arise in this context.

In its response to the Commission's Issues Paper, AGL described how infrastructure industries are embarking on a process of restructuring that has the potential to deliver additional efficiency gains which, on one view, could be as great as those delivered already by the separation of contestable activities (retailing and supply) from the natural monopoly activities of transmission and distribution.<sup>60</sup>

It is AGL's view that any move to have the costs of asset management businesses (whether wholly owned or associates of a service provider) open to regulatory review at this critical stage in the evolution of this "second wave" of restructuring, has the potential to remove the incentive for businesses to pursue those arrangements. If that occurs then the potential efficiencies will never be realised.

Comments made in AGL's response to the Issues Paper were made in the context of the treatment of efficiencies. Those comments are expanded in the sections which follow.

### 6.1 *Regulatory intervention is likely to remove the incentive for businesses to pursue efficient arrangements*

Efficiency can be increased through arrangements that allow parties or services to share resources and costs where the joint cost is less than the sum of costs that would result if the parties acted separately. Businesses can be relied upon to pursue these opportunities if they have an incentive to do so.

Infrastructure industries in Australia are on the verge of a process of further restructuring which is expected to lead to greater contracting out of asset management and operation services which are presently, and for the most part, provided in-house. This will lead to greater competition in the provision of those services, and compared with the alternative of independent stand-alone businesses or services, has the potential to produce significant economic efficiencies through sharing of resources and economies of scope and scale. McKinsey's have expressed a view that "the impact of this second wave of disaggregation will be at least as great as that of the first wave."<sup>61</sup>

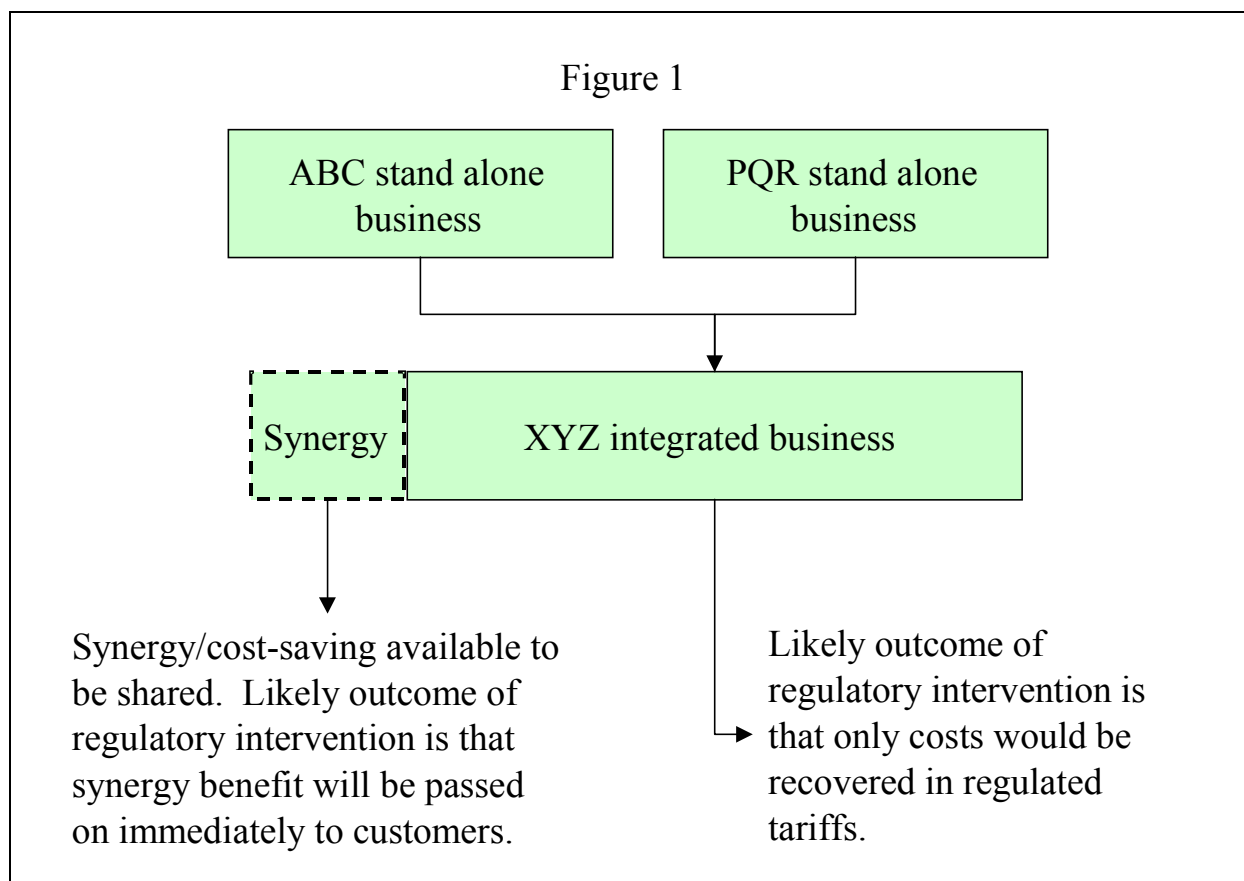
However, if the restructuring is to proceed then the investors in those businesses must be able to foresee some reward, in terms of a share of the efficiencies created, for the costs and risks they will be incurring. At least in the short to medium term, many shared service providers are likely to be associates of regulated businesses because it is regulated businesses

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<sup>60</sup> AGL September 2003 submission, p 14

<sup>61</sup> Birch D, and Burnett-Kant, E., "Unbundling the Unbundled", The McKinsey Quarterly, 2001 Number 4. Note that the "first wave" referred to by McKinsey's is the separation of production/generation and supply/retailing from the monopoly elements of transmission and distribution, which is largely complete in Australia.

themselves that have the knowledge and skills to manage and service infrastructure assets. The risk of extending the regulatory process to associated businesses, and particularly given the current regulatory approach to sharing of efficiency gains, is that the businesses would be denied any share of the synergy benefits that may be generated. The benefits would instead be passed directly to customers. That is, the costs to be allocated and recovered in network tariffs are actual/efficient costs, net of any synergy benefits that may be derivable by virtue of the scale and scope of the business. This is illustrated in figure 1 below:



The type of regulatory intervention suggested by the Commission’s Information Request on page 321 of the Draft Report is likely to have adverse consequences for the development of at least three forms of arrangement involving associated entities:

- Arrangements where parties associated to the Service Provider operate in non contestable markets e.g. a Service Provider and an associated electricity network operator – a multi-utility;
- Arrangements where a Service Provider obtains services from associated parties e.g a gas network owner obtains network management, operation and maintenance services from an associated party contractor; or a corporate services group provides services entity wide to the Service Provider and other businesses within the entity; and
- Arrangements where a Service Provider is associated with parties that operate in contestable markets e.g. a Service Provider and an associated retailer.

In each case there is potential for efficiency/synergy benefits to be generated and investors will pursue those opportunities if there is an incentive to do so, that is, if the investor has the opportunity to retain a share of any synergy benefits that are generated.

The risk from regulatory intervention is that no recognition would be given to the significant costs and risks associated with forming new businesses such as multi-utilities and contracting operations. Neither would recognition be given to the time and effort required to “extract” the synergy benefits after a new arrangement has been established. Similar issues arise for a stand alone non-contestable business contemplating an expansion of its operations into a contestable market through a related party. Investors will not incur these costs unless there is an incentive to do so. That incentive is the prospect, for the investor, of being able to retain at least some of the synergy benefits created by the business.

The effect of regulatory intervention, at least given current regulatory philosophies and approaches to benefit sharing, will be to confiscate synergy benefits thereby removing any incentive for investors to undertake these forms of restructuring. The restructuring will not proceed, and the potential efficiencies will not be realised.

## **6.2 Do fixed regulatory periods help?**

It might be argued that fixed length regulatory periods and price glide paths provide the opportunity for an investor to retain benefits created during the period and that this is adequate incentive to pursue the efficiencies. This overlooks two related matters:

- It takes significant time and effort, in addition to the up-front costs, to reorganise a business or establish a new one and to actually realise the potential synergies. The process of establishing a new structure and then “extracting” the synergy benefits will invariably take longer than the three to five years which has become the norm for regulatory periods in Australia.
- Uncertainty. The current regulatory regime provides no certainty as to how efficiency gains will be treated within periods let alone between periods. Experience to date with the implementation of incentive regulation in Australia is that price paths are routinely set on the basis of anticipated efficiency gains rather than to transfer efficiency gains actually realised. Regulators have complete discretion as to whether and, if so, how, efficiency gains realised in one period will be recognised in any subsequent period(s).

Three forms of arrangement (including asset management contracting) have been described which involve businesses operating in non-contestable markets and their related parties. Each of these has the potential to produce economic efficiencies through sharing of resources and economies of scope and scale.

In AGL’s view, any move to subject these arrangements to regulatory oversight has the potential to remove any incentive for businesses to incur the costs and risks that would be required to produce those efficiencies.

If that is the case, then the efficiencies will never be realised. This significant potential cost must be taken into account in considering any proposal to extend regulatory powers.

### **6.3 *Current code is adequate***

The current Code provides the regulator with the ability to obtain information and compare costs at the level of the asset owner (subject to the inherent imprecision of comparative data). There is no need for any further power.

Further, the Gas Access Regime is concerned with third party access to infrastructure, not the management or review of the method chosen by the asset owner to manage their asset. It is not necessary for the regulator to have the power to approve asset management contracts in establishing tariffs payable by third parties, although it may be appropriate for the regulator to be provided with a copy of the agreement.

## 7. Ringfencing

### 7.1 Associate Contracts

The Commission's Draft Report deals with Associate Contracts at Chapter 10.

#### ***Draft Findings 10.1 and 10.2***

AGL welcomes the Draft Finding that *“The requirement under section 7.1 of the Gas Code that a service provider seek authorisation for the supply of a standard transportation service at the reference tariff imposes costs on the service provider, with little apparent benefit<sup>62</sup>.”* AGL agrees with this finding.

AGL notes Draft Finding 10.1 of the Commission that *“The ring fencing and associate contract provisions of the Gas Code are warranted and are important for an effective regulatory regime. They do not appear to have involved inappropriate costs”*.

AGL disagrees with this finding in respect of the need for approval of associate contracts.

In its submission to the Productivity Commission in September 2003, AGL recommended that Associate Contract provisions should be amended so that regulatory approval is not required:

- For associate contracts for Reference Services;
- Where an associate retailer requests a Negotiated Service to a customer site and the service provider informs the customer of the offer made to the retailer and advises the customer that the customer can accept the offer directly or through any retailer.

AGL recommended that, in such cases, the provision should only require notification to the regulator.

AGL welcomes the draft recommendation that *“Section 7.1 of the Gas Code should be amended such that a service provider entering an associate contract for the supply of services at the reference tariff must notify the regulator, but is not required to seek authorisation.”*

However, AGL considers that the recommendation should be expanded to include negotiated services (where the service provider informs the customer of the offer made to the retailer and advises the customer that the customer can accept the offer directly or through any retailer).

AGL notes that in the Draft Report, the Commission gave consideration to removing the regulatory oversight of associate contracts and relying on transparency of affiliate transactions and non-discriminatory pricing<sup>63</sup>. The Commission indicated that it considered there might be limitations. The Draft Report discussed confidentiality issues, the concern that transparency of affiliate transactions alone would be insufficient incentive for a service provider not to favour its affiliates and indicated that while non discriminatory pricing might

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<sup>62</sup> Draft Finding 10.2

<sup>63</sup> Draft Report – page 319

solve this issue, it might also be inefficient and may not give access seekers flexibility in terms and conditions.

AGL agrees with the Commission that it is not appropriate to prescribe that the service provider is required to offer external parties the same terms and conditions offered to associates. If service providers seek to offer different terms and conditions, then regulatory approval is appropriate. However, AGL considers that the Code should be sufficiently flexible so that if service providers wish to offer external parties the same terms and conditions offered to associates, they can do so, without needing to seek regulatory approval of the contract. In such circumstances, notification to the regulator should be sufficient.

This is what the second limb of the proposal set out in AGL's submission of September 2003 seeks to achieve.

As set out in the September submission, AGL's proposal seeks to eliminate the waste of both time and resources associated with the obligation to seek approval of negotiated services, in circumstances where the service provider informs the customer of the offer made to the retailer and advises the customer that the customer can accept the offer directly or through any retailer. AGL recommends that in such circumstances, notification to the regulator would be sufficient.

AGL continues to be of the view that this would result in pro-competitive outcomes and avoid possible delays in the connection of customers to a supply of gas.

This approach means there is no potential for anti-competitive outcomes as the ultimate beneficiary of competition is in control of the process.

#### ***Draft Recommendation 10.1***

AGL welcomes Draft Recommendation 10.1

However, AGL maintains its recommendation that the Associate Contract provisions should be amended so that regulatory approval is not required:

- For associate contracts for Reference Services;
- Where an associate retailer requests a Negotiated Service to a customer site and the service provider informs the customer of the offer made to the retailer and advises the customer that the customer can accept the offer directly or through any retailer.

AGL also considers that it would be appropriate to make it explicit that the Associate Contract provisions only apply to agreements for transportation services.

## **7.2 Asset Management Contracts**

Asset owners are well aware of the importance of observing ringfencing requirements. Any asset owner will, as part of its normal contractual arrangements, require the service provider to abide by the asset owners' statutory obligations, including ring-fencing. In AGL's view there is no case for particularising ringfencing.

## 8. Administrative and appeals processes

### 8.1 Timeliness

AGL notes the Commission's Draft Finding 11.1 that there are valid concerns about the inadequate timeliness of regulatory decisions in some cases under the Gas Access Regime. AGL agrees with the Commission that "*timely decision making is important for economically efficient outcomes*<sup>64</sup>."

#### **Draft Finding 11.1**

AGL agrees with this draft finding, although it notes that the Commission's concern about timeliness is really only applicable to access arrangement approvals, and welcomes the Commission's efforts to propose solutions to this problem.

AGL also agrees with the Commission that a number of recommendations in the Draft Report should indirectly help to improve timeliness and that issues of timeliness are likely to be less significant given that the first round of access arrangements is nearly complete<sup>65</sup>.

#### 8.1.1 Measures to improve timeliness

In Draft Recommendation 11.1, the Commission recommended that:

*The Gas Access Regime should be amended, whereby the regulator would:*

- *Be able to extend the period for approval of an access arrangement by two months only once; and*
- *Have the discretionary power to backdate processes.*

While AGL welcomes proposals designed to improve the timeliness of regulatory decisions in the Access Arrangement approval process, AGL has some concerns with the workability of the two solutions proposed by the Commission.

#### *Extensions and default decisions*

In its Draft Report, the Commission considered that one way to improve timeliness was to limit the ability of decision makers to extend time periods through either mandatory time limits or less discretion to extend time limits.

AGL notes that in the Commission's consideration of extensions and default decisions, it recognised the advantages and disadvantages reducing regulator discretion to extend time periods. AGL strongly agrees with the Commission that a:

*"disadvantage of reducing the discretion of the regulator to extend time periods is that good decision making might be compromised if the regulator has to speed up the decision*<sup>66</sup>*."*

AGL also welcomes the Commission's recognition of the complexity of access arrangements and that decisions about access arrangements should not be made lightly.

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<sup>64</sup> Draft Report – page 335

<sup>65</sup> Draft Report - page 340

<sup>66</sup> Draft Report - page 342

AGL agrees with the Commission on this point. AGL considers that in view of the complexity of access arrangements and decisions about access arrangements, it is important for the Code to allow regulators to extend time, if they consider it necessary and/or appropriate.

In addition, it appears, based on the Commission's Draft Report, that the changes to the Gas Access Regime are likely to be significant.

The Commission acknowledged the risks of proposing changes to legislated criteria in Chapter 6.

*“As acknowledged in the Commission's review of the national access regime, there is a need for considerable caution when proposing changes to legislated criteria. Making changes to reflect a particular interpretation more accurately can be risky, given judicial interpretation of those changes:....<sup>67</sup>”*

AGL is aware of the issues and risks associated with changing legislated criteria. However, AGL agrees with the Commission that there is a need to make changes to the Gas Access Regime. However, AGL considers that it is important to take account of the fact that these changes may have unexpected impacts. Accordingly, given the likely extent of the changes, AGL considers that it is important, at least in the first few years of operation of the revised regime, that regulators have the ability to extend access arrangement approval processes.

AGL considers that the Code should provide sufficient flexibility for regulators to grant extensions of time where there are unforeseen circumstances. To address concerns about timeliness, AGL suggests that an appropriate solution is for the Code to allow the regulator to extend time periods in situations where there been a material change in circumstances.

***Draft Recommendation 11.1 – Extension of access arrangement approval processes***

AGL considers that it is very important, particularly in light of the likely extent of changes to the Gas Access Regime, for regulators to have the ability to extend access arrangement approval processes. It is critical that the Gas Access Regime has sufficient flexibility to cope with situations where, for unforeseen reasons, extensions of time are required.

At the very least, AGL considers that a regulator should be able to extend the period for approval of an access arrangement where there has been a material change in circumstances.

***Backdating***

AGL also has concerns that backdating is likely to have a number of practical problems. Backdating will not only affect the service provider, but also industry participants downstream as well as end customers.

Notwithstanding the Commission's comments about businesses factoring the possibility of a backpayment into its business decision making, AGL is concerned that from a practical perspective, backdating is likely to be quite complex and create real implementation issues.

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<sup>67</sup> Draft Report - page 172

AGL is also concerned that the Commission's proposal is to allow the regulator discretion to decide when to backdate. AGL is concerned that such a proposal would create asymmetric risk for the regulated business. AGL also points out that the Commission has, in the Draft Report, recognised the problems that arise where regulators have wide discretionary powers. In the circumstances, AGL does not consider it appropriate to give regulators the discretion to backdate.

***Draft Recommendation 11.1 - Backdating***

AGL considers that, in light of the other changes the Commission has suggested to the Gas Access Regime, it is unnecessary to introduce backdating. AGL also considers that backdating will be complex to implement.

If the Commission still has concerns about timeliness, AGL suggests that one mechanism that could be used is "forward adjustments" over the forthcoming access arrangement period. While this may result in some inequities if there are changes to downstream participants, it would avoid the complex practical issues associated with backdating and is a mechanism that the ACCC has used in the past.

In Draft Recommendation 11.2, the Commission recommends that:

*The Gas Access Regime should be amended, whereby the National Competition Council's recommendation on coverage would be agreed in the absence of a Ministerial objection within 21 days.*

While AGL understands the Commission's reasons for recommending this change, AGL does not consider that this change is either necessary or appropriate. AGL considers that it is appropriate that the relevant Minister make the ultimate decision on coverage/revocation questions and it is also appropriate that the relevant Minister have a positive obligation to make that decision within a particular time frame. The draft recommendation put forward by the Commission would have the effect that the NCC, in some circumstances, becomes the defacto decision maker.

***Draft Recommendation 11.2 – Ministerial decision on coverage***

AGL does not support the Commission's draft recommendation. In AGL's view, the relevant Minister should have to make a positive decision one way or another. It is not appropriate for the NCC to become the defacto decision maker.

*Improving the access arrangement approval process*

AGL notes the Commission found in its Draft Report that one source of delay is the number of iterations in approving an access arrangement<sup>68</sup>.

In DR 11.3, the Commission recommends that:

*The Gas Access Regime should be amended whereby the further final decision should be removed from the approval process for access arrangements.*

Based on the discussion in the Commission's Draft Report, AGL understands the Commission's intention to be that, after the Final Decision, the Service Provider would either need to appeal the decision or implement the decision.

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<sup>68</sup> Draft Report - page 344

AGL further understands that the effect of Draft Recommendation 11.3 is to remove the ability for the service provider to otherwise address to the regulator's satisfaction the matters set out in its final decision, but leave the Service Provider with the ability to incorporate or substantially incorporate the amendments specified by the Regulator.

AGL considers that the Code would still need to provide for a procedural step of obtaining the Regulator's approval where the Service Provider has decided to implement the decision.

That is, at the Final Decision stage, the Service Provider would have three options, namely:

- Implement the Final Decision (and submit the Access Arrangement which either incorporates or substantially incorporates the amendments or nature of amendments specified by the Regulator for a final approval);
- Appeal from the Final Decision; and
- Do not submit a revised Access Arrangement so the Regulator drafts and approves its own (with no right of appeal from this).

AGL agrees with the Commission's view that asymmetry on appeal rights is appropriate given that the pre-eminent reason for a right to a merits review is the protection of the service providers' property rights and that the intervention is on behalf of the wider economy, including users<sup>69</sup>. AGL considers that it would be appropriate that, if a Service Provider sought merits review at the final decision stage, there should be provision for affected parties to be joined.

AGL considers that the Commission's recommendation to remove the further final decision is appropriate, provided that provision is made to resolve the potential prejudice to Service Providers if they are unable to put material to the Tribunal to (i) rebut material and/or findings in the Regulator's Final Decision and/or (ii) address a material change in circumstances. AGL suggests that this issue is most appropriately addressed by giving the Tribunal discretion to admit new material. AGL suggests that the Tribunal could admit new material where there was a material change in circumstances or where the evidence had not been reasonably available to a party.

***Draft Recommendation 11.3 - Removal of further final decision***

AGL agrees that the further final decision should be removed so long as the Tribunal is given discretion to admit new material.

*Date for Proposed Amendments to Access Arrangement*

In Draft Recommendation 11.4, the Commission recommends:

*The Gas Access Regime should be amended so that regulators can specify a date by which the service provider must submit proposed amendments to an access arrangement.*

AGL understands that this relates to the draft decision. AGL welcomes the Commission's recognition that "... it is important to allow service providers to propose amendments to their

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<sup>69</sup> Draft Report - page 360

*access arrangements after a draft decision.*<sup>70</sup> AGL understands that the Commission is seeking to deal with the issue of timeliness of decision making. However, AGL considers that there should be sufficient flexibility in the Code to deal with situations where there is a material change in circumstances.

***Draft Recommendation 11.4 – date for proposed amendments to access arrangement***

AGL considers that there should be provision for further amendments (including submissions) if there is a material change in circumstances.

## **8.2 Appeal arrangements**

AGL welcomes the Commission’s findings about the importance of appeals and that:

*“There is a need for a merits review under the Gas Access Regime. In the Commission’s view, appropriate protection for property rights is the pre-eminent consideration. While the appeal process might take considerable time and expend considerable resources, the regulatory bodies and Ministers have powers to make decisions that have an impact on fundamental rights of service providers. The prospect of exposure to imperfect regulatory instruments means there is a strong case for a merits review.*

*In keeping with this view, the Commission considers there are good reasons for extending the grounds of appeal under section 39. Provisions in the merits review should not be confined to the grounds set out in s39(2) of the GPAL but should allow scope for a full merits review. Combined with the retention of limitations on the material that can go before the appeal body, this additional scope should not lead to unnecessary delays in the appeal process.*<sup>71</sup>

The decisions of the Tribunal on GasNet and MAPS which were handed down in December 2003 show clearly the importance of the appeals process. They demonstrate that the regulator’s approach on certain issues can be flawed.

AGL maintains its view that merits review is an important aspect of the gas regulatory regime. As the Commission has recognised, it provides appropriate protection for property rights. An independent appeals process is also essential to participants having confidence in the regulator’s decision making. Similarly, merits review is also essential to allow the regulator to develop the confidence to make robust or difficult decisions when necessary.

In Draft Recommendation 11.5, the Commission recommends:

*Limitations on the grounds of appeal under section 39 of the GPAL should be removed to allow a full merits review on access arrangements drafted and approved by the regulator.*

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<sup>70</sup> Draft Report - page 346

<sup>71</sup> Draft Report - pages 359-60

***Draft Recommendation 11.5 – Removal of limitations on grounds of appeal***

AGL welcomes this recommendation. AGL notes that the recent Tribunal decisions have reinforced the importance of and the need for appeal mechanisms.

In Draft Recommendation 11.6, the Commission recommends:

*The scope of material that can be introduced to the appeal body under section 38 of the GPAL should be restricted to material that has already gone before the primary decision maker.*

While AGL understands the Commission’s concern to address the timeliness of decision making processes, as set out above, AGL has some concerns with the proposed restriction, particularly in light of the proposed removal of the further final decision. As the Commission has noted

*“the purpose of a full merits review is to allow natural justice for those that might be adversely affected by a decision under the Gas Access Regime. The regime confers power on regulators and Ministers that can intrude on property rights and freedom to contract. Both the coverage and access arrangement decisions under the Gas Access Regime have the potential to affect the rights of service providers and others.”<sup>72</sup>*

AGL also notes the Commission’s findings that:

*“... under the Gas Access Regime, the merits review mechanisms currently available do not require the appeal body to undertake a fresh time consuming and costly public consultation. Rather the review process operates where the appeal body considers material already submitted in the course of the public inquiries by the primary decision maker. The Commission considers this to be an appropriate limitation on the scope of material that can be put before the appeal body. The limitation should also ensure merits reviews can be undertaken in an appropriate time frame.”*

AGL has concerns with restricting the material that is able to be put before the Tribunal (particularly if the further final decision is not retained). It is submitted that the appeal body should not be so limited and should be given the discretion to admit further material. The reasons for this are:

- Restricting the material able to be put before the Tribunal proposal may prejudice service providers if they are unable to put material to the Tribunal to rebut material/findings of the regulator. This is particularly the case if the further final decision is removed; and
- There may be a material change in circumstances which is relevant.

The same considerations apply in respect of Ministers’ decisions. Accordingly, AGL considers that it is appropriate for the scope of material that can be introduced to be restricted to material that has already gone before the primary decision maker provided that the appeal body is given discretion to admit further material.

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<sup>72</sup> Draft Report -page 356

***Draft Recommendation 11.6 – Limits on scope of material before appeal body***

AGL agrees that the scope of material that can be introduced to the appeal body under sections 38 and 39 should be restricted to material that has already gone before the primary decision maker, but recommends that the appeal body be given the discretion to admit further material.

## 9. Institutional Arrangements

In Draft Finding 12.1, the Commission found that:

*The Council of Australian Governments is still considering its response to the proposals arising from the Energy Market Review and the Ministerial Council on Energy's response to that Review. COAG's decisions are expected to have a direct impact on the deliberations of the Productivity Commission's Inquiry into the Gas Access Regime.*

The Ministerial Council on Energy (MCE) met on 11 December 2003 and announced that it had finalised policy decisions for its major energy market reform program, comprehensively responding to the 2002 CoAG Energy Market Review. The MCE indicated that the final report would be sent to CoAG for out of session endorsement and that implementation would commence in January 2004<sup>73</sup>.

The 11 December 2003 Communique indicated that further reforms in the gas market may be expected after the MCE responds to the current Productivity Commission review of the national gas access regime, due to report in mid 2004.

AGL notes that the MCE has agreed to development of national approach to energy access under the *Trade Practices Act (Cth) 1974*. AGL would be concerned if the development of a national approach resulted in a delay in the implementation of the recommendations from the Commission's report, if it resulted in a further inquiry, or if the regulatory structure that applies in electricity was applied indiscriminately to gas (as in a number of instances, the electricity structure is not relevant or appropriate).

AGL urges the Commission to make recommendations that its reform package is fed into MCE process so that the processes converge and there is a unified approach.

AGL further notes that the MCE has recommended that new national energy regulatory and rule making body are to take over gas transmission in 2005. It is important that appropriate transitional arrangements are made and that there is sufficient industry consultation.

The MCE has recommended that the new regulatory arrangements are to provide for consultation and co-operation between the AEMC, AER and ACCC and that the Code change and authorisation process are to be streamlined to avoid duplication, and that end user and industry consultation in developing code changes is to be strengthened. AGL considers that it is critical that the arrangements provide for a better Code change process (refer to comments below).

In Draft Finding, 12.2 the Commission found that:

*Prima facie, there would be benefits in having a National Energy Regulator oversighting both electricity and gas markets. The reforms to gas regulation in this report would fit within the structure of a National Energy Regulator.*

The MCE recommended that two new statutory commissions be established on 1 July 2004, funded by industry levy:

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<sup>73</sup> Ministerial Council on Energy Communique – Perth 11 December 2003

- The Australian Energy Regulator (AER) with responsibility for market regulation; and
- The Australian Energy Market Commission (AEMC) with responsibility for rule making and market development.

The MCE recommended that the new bodies would initially be responsible for electricity wholesale and transmission in the connected (NEM) jurisdictions, extended in 2005, to include gas transmission for all other than WA. AGL considers it critical that appropriate transitional arrangements are made with sufficient industry consultation and the new arrangements provide for a better Code change process (refer to comments below in respect of NGPAC).

**Draft Finding 12.2**

In relation to a National Energy Regulator, AGL would be concerned if the regulatory structure that was applied to electricity was imposed on gas as in a number of instances, this would not be relevant or appropriate. AGL also considers it is important that there is clarity about the roles of the AER and the ACCC in the gas context.

AGL considers it critical that appropriate transitional arrangements are made with sufficient industry consultation and the new arrangements provide for a better Code change process (refer to comments about NGPAC below).

Further, AGL notes that the reference to the NER overseeing gas markets is not correct. The National Energy Regulator is intended to oversight gas access, not gas markets.

In Draft Finding 12.3, the Commission found that:

*Similar considerations are relevant for making decisions about coverage and the form of regulation. (These considerations also apply to both transmission and distribution infrastructure for natural gas.) The same agency should make recommendations on these issues.*

**Draft Finding 12.3**

AGL agrees with this finding.

In Draft Finding 12.4, the Commission found that:

*There should continue to be separate agencies responsible firstly for administering the regulation of gas pipeline services and secondly for recommending whether to regulate and what form of regulation to adopt.*

**Draft Finding 12.4**

AGL strongly agrees with this finding.

In Draft Recommendation 12.1, the Commission recommended that:

*The agency responsible for making recommendations on pipeline coverage decisions (currently the National Competition Council) should be separate from the regulator responsible for administering the terms of pipeline access. The agency that recommends coverage of a pipeline, should also be responsible for recommending the form of regulation to apply to the pipeline.*

**Draft Recommendation 12.1**

AGL agrees with this recommendation.

In Draft Finding 12.5, the Commission found that:

*Ultimate responsibility for decisions on pipeline coverage and the form of regulation should continue to reside at the Ministerial level.*

**Draft Finding 12.5**

AGL agrees with this finding.

In Draft Finding 12.6, the Commission found that:

*The National Gas Pipelines Advisory Committee is not working effectively. Changes are essential.*

AGL agrees with the Commission's finding. AGL notes that the Commission considers that:

*The problem with NGPAC seems to be operation as a single committee composed of three diverse groups (officials representing all the governments, industry representatives and regulators). There is a role for all three, but policy making should rest with government officials who should sit on an advisory committee making recommendations to governments. Consultation by this committee with regulators and industry representatives is essential because of their experience and knowledge of industry. Prima facie, the Commission considers this is the preferred approach. With the Relevant Ministers making the final decisions on Gas Code changes, the principle of institutional separation of policy making from administration would be preserved<sup>74</sup>.*

While AGL welcomes proposals to improve the Code change process, AGL has concerns with the approach that the Commission has indicated it prefers. As noted in its initial submission to the Commission in September 2003, AGL considers that it is important that industry participants have a greater role in relation to Code changes.

It is important to keep in mind that, at the time the Gas Access Regime was being developed, service providers agreed to intrusion on their property rights, but on the understanding that they would be granted certain safeguards from arbitrary regulatory intervention and a continuing role in the evolution of the regime. As set out in the preface to the NGPAC Information Booklet:

*“Infrastructure owners refrained from any legal or constitutional challenge to what might otherwise have been seen as a substantial erosion of their traditional property rights. Their reward was a uniform, national approach to the new regulatory regime. In addition, they were granted certain important safeguards from arbitrary intervention by regulators and a continuing role in the evolution of the third party access regime through representation on the body constituted by the Inter-governmental Agreement to administer the Code – the National Gas Pipelines Advisory Committee (NGPAC)”<sup>75</sup>*

<sup>74</sup> Draft Report – page 382

<sup>75</sup> Page 1 – The National Gas Pipelines Advisory Committee (NGPAC) Information Booklet 2000

Having regard to the substantial erosion of their property rights, it is both important and appropriate that infrastructure owners should continue to be involved in the Gas Code change process, but that they have a greater role than has been the case to date.

AGL believes that the appropriate structure is for an industry endorsed body with well respected members and for proposals to be developed through an industry based process.

***Draft Finding 12.6***

AGL continues to believe that it is important to achieve a smooth transition to the new AER/AEMC regime which captures the following features:

- separation of the Code change decisions from the administration of the regime;
- an industry based body to develop proposals for Gas Code changes.

## 10. Summary of AGL's Response

### ***Draft Findings 5.1 and 5.2***

AGL strongly agrees with the Commission's Draft Finding 5.1 that there is a need to better specify the objectives of the Gas Access Regime in the enabling documentation.

AGL agrees with Draft Finding 5.2 that the insertion of an overarching objects clause in the Gas Access Regime legislation would enhance the effectiveness of the Regime (with the proviso that this overarching clause is appropriate).

### ***Draft Recommendation 5.1***

AGL supports the Commission's Draft Recommendation 5.1 and suggests that the key concepts contained in the proposed objects clause should be clearly defined or that some guidance should be given by the Commission so that there will be a clear and common understanding for decision makers and participants.

Consistent with the Federal Government's response to the Part IIIA inquiry, AGL also recommends that the regulator be required to have regard to the objects clause in carrying out its functions under the Gas Access Regime.

### ***Draft Recommendation 5.2***

On the basis that an appropriate overarching objects clause is inserted, AGL supports Draft Recommendation 5.2.

### ***Draft Finding 5.3***

AGL agrees with the Commission's finding that sections 2.24(b) and (c) should be retained.

### ***Draft Recommendation 5.3***

AGL agrees with the draft recommendation that sub-sections (d), (e), (f) and (g) should be deleted.

However, AGL considers that section 2.24 (a) should be retained in its present form as should section 6.15(a). At present, it is far from clear that the recommended objects clause will offer the same level of protection to a service provider's legitimate business interests that is currently provided in the regime.

### ***Draft Finding 6.2***

AGL agrees with Draft Finding 6.2, but notes that it is vital that there is a common understanding of the concept of "a significant improvement in economic efficiency".

### ***Draft Finding 6.3***

AGL agrees that the same coverage criteria should apply to both transmission pipelines and networks. Nevertheless, AGL refers to its earlier submission to this review which recommended that several provisions of the Code – mainly of a technical administrative nature – should apply only in a transmission context.

***Draft Recommendation 6.1***

AGL supports Draft Recommendation 6.1 on the basis that the term ‘substantial’ is appropriately defined. AGL considers that it is imperative that this term be defined satisfactorily to remove any potential ambiguity in the interpretation of 1.9 (a) and to make it clear that the threshold has been raised.

AGL also suggests that coverage should only apply where there is likely to be a substantial increase in competition by reason of the intervention of coverage.

***Draft Recommendation 6.2***

AGL agrees with the Commission’s Draft Recommendation 6.2.

AGL agrees with the factors the Commission has proposed and, in addition, suggests that the list could be expanded to include consideration of the dynamic characteristics of the market.

***Draft Finding 6.5***

AGL agrees that this test should be retained.

However, given that the relevant Minister raised concerns about the ‘point to point’ competition approach in the Moomba-Sydney pipeline revocation decision, there may be a need for guidance in assessing this criterion. Such guidance might say, for example, that the term “*another pipeline*” does not mean a pipeline following exactly the same route.

***Draft Recommendation 6.5 and Draft Finding 6.6***

AGL agrees with the Commission’s draft recommendation to remove criterion 1.9(c) and with the draft finding in relation to section 1.9(d)

***Draft Recommendation 6.4***

AGL supports the Commission’s intentions behind the new test, but points to the need for a common understanding of the concept of “*a significant improvement in economic efficiency*” and how it will be applied in coverage assessments. The NCC and Ministers could be furnished with guidance in this regard.

***Draft Finding 6.7***

AGL endorses the intent behind the Commission’s proposed monitoring regime, but notes that very significant interpretation and operational issues need to be resolved to achieve that intent. Moreover, AGL is concerned to ensure that the Commission remains focussed on improving the existing heavier handed option.

***Draft Recommendation 6.5***

We are concerned at the potential complexity and confusion involved in the distinction between ‘material’ and ‘substantial’ increases in competition and suggest that at the very least, the terms should be defined in such a way as to give clear guidance to the NCC and Ministers as to their intended application.

***Draft Recommendation 6.6***

The new framework is complex and untried. AGL considers that rather than providing certainty, it could generate greater uncertainty.

However, if the concept is taken forward, it is critical that the terms “material” and “substantial” are appropriately defined. AGL notes the Federal Government’s response to Part IIIA on 19 February 2004, and points out that this emphasises the uncertainty around the meanings of the terms and the need for appropriate definition.

Other concepts requiring clarification include ‘economic efficiency’ and ‘economically efficient investment’ and the extent to which ‘improving economic efficiency’ and ‘increasing competition’ can be used as different criteria.

AGL is not clear how Draft Recommendations 6.1 and 6.6 fit together and welcomes clarification from the Commission.

***Draft Finding 6.9***

AGL agrees that regulators should not be able seek coverage for a non-covered pipeline. Applications for coverage should be made only by genuine access seekers.

***Draft Recommendation 6.7***

If price monitoring is adopted, then AGL accepts that there should be a role for the regulator in any application for heavier handed regulation by providing factual material to the decision-maker.

In relation to revocation, AGL considers that there should be no restrictions on when applications can be made or who can apply.

AGL also agrees with a minimum period that precludes an application for regulation.

If price monitoring is to be adopted, then AGL seeks clarification that price monitoring would continue after the five-year period expired, until a successful application was made for heavier handed regulation.

***Applications for coverage/revocation under heavier handed regime***

In relation to pipelines covered under an access arrangement with reference tariffs, AGL agrees with the Commission that there should be no restrictions on either when applications can be made or who can apply.

***Draft Recommendation 6.8***

AGL agrees with this recommendation.

***Draft Recommendation 7.1***

AGL considers that improving access arrangement regulation is the most critical task facing the Commission. While AGL generally agrees with the Commission's expression of pricing principles, AGL considers that additional pricing principles are required, that access providers should be able to choose the pricing methodology they prefer and that an earnings sharing model is appropriate.

***Efficient cost recovery***

AGL repeats the comments made in its September 2003 submission that the current access pricing methodologies are too intrusive and that regulated entities should be able to choose the access pricing approach they prefer.

***Treatment of efficiencies***

AGL remains convinced that an earnings sharing model would be appropriate. AGL repeats its call for an earnings sharing model. This will give managers of regulated businesses the appropriate signals to search for additional efficiency gains.

***Draft Finding 7.1***

Broadly, AGL sees greater value in focusing on clearer guidance for regulators in applying the components of the cost-based model to the determination of target revenue, rather than focusing on refinements to benchmarking approaches. AGL considers that benchmarking has some limited usefulness but not as a primary methodology of access regulation. This accords with the Commission's view that it is difficult to decouple access prices from costs. AGL's September submission recommended that the pricing principles should make clear that:

- Where the cost of capital is relevant, the parameters of the regulatory WACC should be determined by a panel of experts. Industry and the regulator should then apply the parameters which have been determined by a panel of experts;
- where the cost of capital is relevant, the risk component should be fixed for the life of the asset;
- capital investment deemed prudent at the time of investment should not be stranded;
- Where forward prices are fixed by regulation, they shall be set on the basis of actual costs and volume sales at the time of price fixing, not on the basis of forecasts; and
- Investors shall share in all realised improvements in efficiency, not only in the improvements that exceed regulator benchmarks.

AGL repeats its call for the adoption of these additional principles.

***Draft Finding 7.2***

AGL welcomes the Commission's finding and suggests that the principles AGL referred to under its recommendation in respect of Draft Finding 7.1 should be adopted as a solution to this issue.

***Draft Recommendation 7.2***

AGL agrees with Draft Recommendation 7.2 that *the Gas Code's competitive tendering provisions should be simplified to make them more flexible and less costly.*

***Draft Finding 7.3***

AGL agrees with Draft Finding 7.3 which is that *regulators are currently seeking to have their powers extended so they can obtain information between access arrangement reviews. This extension has the potential to add unnecessarily to service providers' compliance costs.*

AGL considers that the current information collection provisions are adequate. AGL sees no need whatsoever for the collection and submission of regulatory information between reviews.

***Draft Recommendation 7.3***

AGL has some concerns about the implementation of Draft Recommendation 7.3

***Draft Finding 7.5***

AGL appreciates moves to overcome deficiencies of the current regime proposed by the Commission. Nevertheless – as indicated in this section of AGL's submission – there are many uncertainties and problems left unresolved by the Commission's recommendations. There is still likely to be a focus on unachievable accuracy in the regulatory assessment of efficient costs and rates of return, and the 'incentive' feature of shared efficiency gains can still be minimal for service providers under regulatory determinations.

AGL repeats its calls for:

- an earnings sharing model;
- regulated entities to be able to choose the pricing methodology they prefer; and
- additional pricing principles to be added in line with its recommendation (contained in the box headed "Draft Finding 7.1" above);

***Draft Finding 7.6***

While AGL agrees with this finding, the number of existing service providers who will be able to transfer to this new approach (ie lighter handed regulation as discussed in chapter 8) and whether it will in practice be as light handed as intended are still unknown quantities. Therefore, a focus on improving the existing regime as much as possible is clearly critical.

AGL agrees that these are worthwhile objectives; therefore, it is vital to ensure that the lighter handed regime can fulfil these aims, and is not, either by regulatory error or design fault, allowed to regress to heavier handed regulation. However, as previously noted, AGL is disappointed that the Commission has not made more comprehensive recommendations to address the deficiencies of access arrangement regulation.

***Draft Recommendation 8.1***

Subject to AGL's earlier comments about price monitoring, AGL supports the recommendation

***Ring fencing and associate contracts – price monitoring***

While AGL believes that ring fencing arrangements would be appropriate, AGL does not consider that it is necessary to have associate contract requirements approved under the proposed price monitoring regime. Rather, notification would be sufficient.

***Draft Recommendation 8.2***

Subject to AGL's earlier comments, AGL supports the concept of price monitoring.

However, AGL reiterates that its "workability" depends both on satisfactory resolution of the coverage issues identified by AGL in relation to chapter 6 and on the NCC, Ministers and jurisdictional regulators acting in accordance with the intended aim of the monitoring regime.

***Draft Recommendation 8.3***

AGL notes that the NCC's role is not to make coverage decisions, but rather recommendations to the relevant Minister. AGL has concerns with Draft Recommendation 8.3. In particular, AGL does not consider it appropriate that the NCC or the relevant Minister should specify the price monitoring information. Rather, this should be set out in Code.

***Draft Recommendation 8.4***

AGL notes this recommendation. However, it could be asked why it is necessary for the information to be published, and what value the regulator's comments would add. If the basic purpose of the information is for the regulator to assess whether market power is being used, the publication of data will add little to that process.

***Draft Finding 8.2***

AGL has no objection to compliance measures as such, but notes that this is a finding not a recommendation. It may be that the Commission does not see this as a basic element of a monitoring regime. AGL notes that if there are financial penalties, it is critical that the information that is required is not too onerous and should not be able to be changed without the agreement of the service provider.

***Draft Finding 9.1***

AGL agrees with the Commission's conclusion in Draft Finding 9.1 that the solutions proposed in the ACCC's Draft Greenfield Guidelines do not "substantially alter the potential for the Gas Access Regime to discourage investment"; that is, they cannot meet industry's concerns.

***Draft Finding 9.8***

AGL supports the Commission's Draft Finding that the right of a service provider to seek revisions to an access arrangement is no remedy for the distorting effects of asymmetric truncation.

***Draft Recommendation 9.1***

AGL considers that it will be necessary to define the term "greenfield pipeline".

***NPV Sharing Mechanism***

In past submissions, including its September 2003 submission to the Commission, AGL has proposed a NPV sharing mechanism modelled on the Petroleum Resources Rent Tax. AGL is aware that the Commission has considered that proposal and decided in favour of the alternative options set out in the Draft Report. In this submission, AGL notes simply that the NPV sharing mechanism would deal satisfactorily and automatically with the points raised in (a) and (b) at page 29 above.

***Draft Finding 9.6***

AGL agrees that a truncation premium would be of some benefit, however, notes that the truncation premium proposal would appear to require some development and refinement.

***Other matters relevant to new investment decisions***

AGL's view is that it is possible to remove elements of uncertainty:

- there is no practical reason why those elements of rate of return that are independent of the investment itself should not be posted in some way;
- Regulators should not be able to reassess the risk component of return downwards in the event that an investment proves to be successful; and
- Benefits from taxation investment incentives should not be able to be removed through regulatory price determinations after the investment has been made.

***Exclusive franchises***

AGL remains of the view that consideration should be given to allowing exclusive retail franchises for a reasonable period in association with greenfield developments.

Three forms of arrangement (including asset management contracting) have been described which involve businesses operating in non-contestable markets and their related parties. Each of these has the potential to produce economic efficiencies through sharing of resources and economies of scope and scale.

In AGL's view, any move to subject these arrangements to regulatory oversight has the potential to remove any incentive for businesses to incur the costs and risks that would be required to produce those efficiencies.

If that is the case, then the efficiencies will never be realised. This significant potential cost must be taken into account in considering any proposal to extend regulatory powers.

***Draft Findings 10.1 and 10.2***

AGL welcomes the Draft Finding that *"The requirement under section 7.1 of the Gas Code that a service provider seek authorisation for the supply of a standard transportation service at the reference tariff imposes costs on the service provider, with little apparent benefit."* AGL agrees with this finding.

AGL notes Draft Finding 10.1 of the Commission that *"The ring fencing and associate contract provisions of the Gas Code are warranted and are important for an effective regulatory regime. They do not appear to have involved inappropriate costs"*.

AGL disagrees with this finding in respect of the need for approval of associate contracts.

***Draft Recommendation 10.1***

AGL welcomes Draft Recommendation 10.1

However, AGL maintains its recommendation that the Associate Contract provisions should be amended so that regulatory approval is not required:

- For associate contracts for Reference Services;
- Where an associate retailer requests a Negotiated Service to a customer site and the service provider informs the customer of the offer made to the retailer and advises the customer that the customer can accept the offer directly or through any retailer.

AGL also considers that it would be appropriate to make it explicit that the Associate Contract provisions only apply to agreements for transportation services.

***Draft Finding 11.1***

AGL agrees with this draft finding, although it notes that the Commission's concern about timeliness is really only applicable to access arrangement approvals, and welcomes the Commission's efforts to propose solutions to this problem.

***Draft Recommendation 11.1 – Extension of access arrangement approval processes***

AGL considers that it is very important, particularly in light of the likely extent of changes to the Gas Access Regime, for regulators to have the ability to extend access arrangement approval processes. It is critical that the Gas Access Regime has sufficient flexibility to cope with situations where, for unforeseen reasons, extensions of time are required.

At the very least, AGL considers that a regulator should be able to extend the period for approval of an access arrangement where there has been a material change in circumstances.

***Draft Recommendation 11.1 - Backdating***

AGL considers that, in light of the other changes the Commission has suggested to the Gas Access Regime, it is unnecessary to introduce backdating. AGL also considers that backdating will be complex to implement.

If the Commission still has concerns about timeliness, AGL suggests that one mechanism that could be used is “forward adjustments” over the forthcoming access arrangement period. While this may result in some inequities if there are changes to downstream participants, it would avoid the complex practical issues associated with backdating and is a mechanism that the ACCC has used in the past

***Draft Recommendation 11.2 – Ministerial decision on coverage***

AGL does not support the Commission's draft recommendation. In AGL's view, the relevant Minister should have to make a positive decision one way or another. It is not appropriate for the NCC to become the defacto decision maker.

***Draft Recommendation 11.3 - Removal of further final decision***

AGL agrees that the further final decision should be removed so long as the Tribunal is given discretion to admit new material.

***Draft Recommendation 11.4 – date for proposed amendments to access arrangement***

AGL considers that there should be provision for further amendments (including submissions) if there is a material change in circumstances.

***Draft Recommendation 11.5 – Removal of limitations on grounds of appeal***

AGL welcomes this recommendation. AGL notes that the recent Tribunal decisions have reinforced the importance of and the need for appeal mechanisms.

***Draft Recommendation 11.6 – Limits on scope of material before appeal body***

AGL agrees that the scope of material that can be introduced to the appeal body under sections 38 and 39 should be restricted to material that has already gone before the primary decision maker, but recommends that the appeal body be given the discretion to admit further material.

***Draft Finding 12.2***

In relation to a National Energy Regulator, AGL would be concerned if the regulatory structure that was applied to electricity was imposed on gas as in a number of instances, this would not be relevant or appropriate. AGL also considers it is important that there is clarity about the roles of the AER and the ACCC in the gas context.

AGL considers it critical that appropriate transitional arrangements are made with sufficient industry consultation and the new arrangements provide for a better Code change process (refer to comments about NGPAC below).

Further, AGL notes that the reference to the NER overseeing gas markets is not correct. The National Energy Regulator is intended to oversight gas access, not gas markets.

***Draft Finding 12.3***

AGL agrees with this finding.

***Draft Finding 12.4***

AGL strongly agrees with this finding.

***Draft Recommendation 12.1***

AGL agrees with this recommendation.

***Draft Finding 12.5***

AGL agrees with this finding.

***Draft Finding 12.6***

AGL continues to believe that it is important to achieve a smooth transition to the new AER/AEMC regime which captures the following features:

- separation of the Code change decisions from the administration of the regime;
- an industry based body to develop proposals for Gas Code changes.