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Dr J C Tamblyn  
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Level 2, 35 Spring Street  
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Attention: Gas Regulatory Accounting Guideline Development

01 February 2005

Re: Draft Gas Industry Guideline No 17 -- Regulatory Accounting Information Requirements

Dear Dr Tamblyn

I attach AGL's submission in response to the Commission's Draft Gas Industry Guideline No 17 and associated Consultation Paper.

Your sincerely,

Robert Wiles  
General Manager, Regulation and Policy

**SUBMISSION BY AGL IN RESPONSE TO ESSENTIAL SERVICES  
COMMISSION OF VICTORIA CONSULTATION PAPER ON THE "DRAFT GAS  
INDUSTRY GUIDELINE No 17 – REGULATORY ACCOUNTING  
INFORMATION REQUIREMENTS"**

**1. OVERVIEW**

This submission has been prepared by the Australian Gas Light Company (AGL) in response to the Essential Services Commission of Victoria (the Commission) Consultation Paper on the Draft Gas Industry Guideline No 17 – Regulatory Accounting Information Requirements. While AGL will not be directly affected by the proposed Guideline, AGL is the owner and operator of both a Gas Distribution Network in New South Wales and an Electricity Distribution Network in Victoria. With that experience AGL is well placed to comment upon both the policy issues raised by the Draft Guideline and practical problems that will arise from implementing the Draft Guideline in its current form.

In commenting on the Consultation Paper AGL notes with concern that the Commission apparently intends to rely on its broad guideline-making powers and objectives under the Victorian Essential Services Commission and Gas Industry Acts to impose requirements on distribution businesses for the purpose of, among other things, informing Access Arrangement reviews conducted under the National Third Party Access Code for Natural Gas Pipeline Systems (the Code). AGL questions whether this would actually be an action that is within the Commission's powers or, if it is within power, whether it is an appropriate use of them.

Regulators' powers to obtain information under the Code have been considered and debated at length both within the Code change process and more recently before the Productivity Commission. It is clear from those processes that the Code does not support the collection of information in the manner proposed in the Draft Guideline.

The form and scope of the proposed Guideline is such that, in AGL's view, the document could not be regarded as a valid Guideline for purposes of section 4.2(a) of the Code. In AGL's view, if the Commission is of a mind to publish a general accounting guideline for purposes of Code section 4.2(a) it should do so separately from any requirements to report other information for other purposes such as licence monitoring.

If the Commission were to proceed as proposed then, in AGL's view, it would be inappropriate for it to use information obtained by way of the Guideline to inform future Access Arrangement reviews to the extent that such information has not been obtained as provided in the Code and legislation related directly to it.

The balance of this submission is divided into commentary on issues where AGL believes the Draft Guideline runs contrary to accepted regulatory policy and commentary on practical problems that will result if the Guideline is implemented in its current form.

## **2. POLICY ISSUES**

### **2.1 The relationship between the Draft Guideline and the National Gas Access Regime**

The National Gas Access regime, which includes the Code and its related legislation, is intended to be the sole source of Regulatory power for economic regulation of the gas industry. Victoria is a party to that regime which imposes obligations on Service Providers to report and provide information, and confers specific information-gathering powers on the Regulator.

It is arguable from a legal perspective that it is in excess of power, and from a policy perspective that it is unnecessary and inappropriate, to:

- impose accounting guidelines under the Victorian licensing regime when the only circumstance in which the regulator has a justifiable requirement for accounting information is at the time of an Access Arrangement review under the Code;
- use information obtained under the Victorian licensing regime to inform Access Arrangement reviews which are conducted under another head of legislation i.e. the Code.

Section 4 of the Code deals with ringfencing and includes obligations on the Service Provider to keep accounts. There is provision for the Regulator to issue general accounting guidelines specifying the manner in which those accounts are to be kept. However, in AGL's view the Draft Guideline would not be a valid form of guideline under section 4.2(a) of the Code on at least four grounds:

#### *Annual provision of accounts*

AGL accepts that accounts must be kept under Sections 4.1(c) to (e) of the Code. However, the only provision of the Code that deals with periodic ringfencing compliance reporting is section 4.13 where the focus is on the form, adequacy and effectiveness of compliance systems and procedures. In AGL's view, there is no basis in section 4.13, or elsewhere in section 4, to require the annual provision of accounts which can be characterised as the "product" of compliance. Such a requirement would also be inconsistent with the scheme of the Code, and the underlying proposition of light-handed incentive regulation, which is to allow the Service Provider to manage its affairs between Access Arrangement reviews without ongoing regulatory intervention.

#### *Auditing and assurances*

The Draft Guideline would impose significant auditing and assurance requirements. AGL notes that the Queensland Competition Authority, in its Decision on General Accounting Guidelines for Gas Distribution Network Service Providers dated May 2003<sup>1</sup>, has conceded that the Code does not empower the

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<sup>1</sup> See: <http://www.qca.org.au/www/getfile.cfm?fid=525&lib=6&LibraryID=6&PageID=50>, Pages 10-11.

Regulator to impose auditing and assurance requirements of the type now proposed in the Draft Guideline.

*Mandated allocation and depreciation bases*

In order to prepare the accounts to be kept under section 4.1 of the Code, it is sufficient to allocate costs between the relevant Covered Pipeline and other activities of the Service Provider. There is no basis in section 4.1 to require the allocation of costs to "Gas Distribution Business Segments" i.e. to the particular Services provided by the pipeline. Likewise, there is no support in section 4.1 for mandating that depreciation be calculated on a straight line basis or for excluding avoidable cost as an allocation basis. If anything, the allocation and depreciation bases should be consistent with those adopted in the applicable Access Arrangement.

*Accounting information pertaining to Related Party providers.*

The Code does not contemplate the provision of Related Parties' cost information. While the Productivity Commission has made recommendations for changes to the Code in that regard, those recommendations have not been adopted and there is no existing power for the regulator to seek to obtain such information by way of an accounting guideline under the Code. (Note also that regulatory intrusion into Related Party costs is likely to have significant implications for the realisation of potential efficiency gains as discussed in section 2.3 below).

The Commission would be aware that the ACCC proposes to introduce an accounting guideline under Code section 4.2 to apply to covered pipelines within its jurisdiction. The threshold question of the ACCC's powers to make a guideline in the form proposed has been the subject of a number of submissions, some of which include independent legal advice. Given that the ACCC's proposed guideline and the Commission's Draft Guideline are broadly similar in scope and content, we suggest that the Commission should review the submissions made to the ACCC in the course of its consultation<sup>2</sup>.

**2.2 The overly-intrusive approach to regulation adopted in the Draft Guidelines is contrary to the current policy direction**

The Consultation Paper states that the proposed Guideline will assist in the continued evolution to a reflective and more light handed regulatory regime.<sup>3</sup>

The problems with increasing regulatory intrusion and the need to revert to a more light-handed regime have been regularly highlighted in recent years. The Productivity Commission in its final report on the Review of the National Access Regime and its final report on its Review of the Gas Access Regime addressed this issue. The Federal Government's interim response to the Productivity Commission in its final report on the Review of the National Access Regime highlighted the problems with increasing regulatory intrusion and the need for

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<sup>2</sup> See: <http://www.accc.gov.au/content/index.phtml/itemId/549581>

<sup>3</sup> ESC Consultation Paper page 4

less intrusive regulation with a greater focus on providing incentive for long term investment.

The prescriptive and detailed approach adopted in the Draft Guideline would appear to be inconsistent with this clear policy direction and the Commission's stated desire to evolve to a more light-handed regulatory regime. This issue is compounded when much of the information required to be reported by the Draft Guideline is not relevant to the stated objectives of implementing the Guidelines. This issue is further addressed in section 3.1 below.

### **2.3 The regime will remove the incentive for businesses to pursue efficient arrangements**

The Draft Guideline requires that, where services are provided by a Related Party, the value of those services recorded in the Regulatory Accounts must be the actual costs incurred by the Related Party.<sup>4</sup> This clause implies that only the actual cost incurred by the Related Party will be considered in future Access Arrangement reviews and has the potential to remove any incentive for businesses to incur the costs and risks that would be required to achieve significant potential efficiencies.

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. The potential for efficiency improvements through such arrangements is significant. However, at least in the short to medium term, many shared service providers are likely to be associates of regulated businesses because it is the regulated businesses themselves that have the knowledge and skills to service those businesses.

There are also significant costs and risks associated with the formation and establishment of these integrated service operations. Businesses can be relied upon to pursue these opportunities only if they have sufficient incentive to overcome the associated cost and risk involved. It follows that the possibility that information about Service Providers' costs would form the basis for regulatory price-setting has the potential to remove any incentive for businesses to incur the costs and risks that would be required to produce the efficiencies. If that is the case, then the efficiencies will never be realised.

### **2.4 Predetermined Cost Allocation Bases**

The Code is based around a propose/response model where at each Access Arrangement review the Service Provider proposes the services it is to offer for the next Regulatory Period and the cost allocation methodology used to support the tariffs for each service.

This Code model is based around the knowledge that there are many valid approaches to allocating cost. The Regulator's role in an Access Arrangement review is to determine that the approach adopted by the Service Provider meets

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<sup>4</sup> ESC Draft Guideline 17 p 24

the objectives in section 8.1 of the Code and is otherwise fair and reasonable, rather than to impose the Regulator's own preferred approach.<sup>5</sup>

The Draft Guideline requires that cost allocation principles and methodologies be approved by the Regulator during each year of an Access Arrangement. It must be reasonable to presume that the Regulator would adopt this allocation basis for subsequent Access Arrangement reviews. If this is not the case then the usefulness of the annual Regulatory Accounts and the cost allocations mandated by those accounts must be questioned. If this is the case however then this imposes restrictions on the Service Provider that are not provided for in the Code and are contrary to the intent of the Code.

### **3. PRACTICAL ISSUES**

There are a number of practical problems that would arise if, despite the foregoing submissions, the Commission were to proceed with a Guideline in the form of the Draft.

#### **3.1 Reporting of information not relevant to the stated purpose of the Accounting Guidelines.**

The Consultation Paper<sup>6</sup> states that the purpose of requiring the preparation of Regulatory Accounts in line with the Draft Guideline is to provide an input to subsequent Access Arrangement reviews. It must be questioned then as to why the Guideline requires the reporting of information that is not relevant for the purpose identified. Some examples of information required by the Draft Guidelines that is not relevant for Access Arrangement review purposes are:

- Historic cost asset values
- Depreciation based on historic cost asset values
- Executive remuneration
- Income Tax (as determined using the historic cost asset values and gearing structure that does not relate to the gearing structure assumed for regulatory purposes)
- Interest and dividends (as determined using the historic cost asset values and gearing structure that does not relate to the gearing structure assumed for regulatory purposes)

While data such as revenue, capital expenditure and operating costs as recorded in the Base Accounts are clearly relevant in an Access Arrangement review, it is equally clear that other items recorded in the Base Accounts such as those listed above are not relevant.

If Regulatory Accounts are required for their stated purpose, then those accounts should be limited in scope to information that may be useful for that purpose.

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<sup>5</sup> National Third Party Access Code for Natural Gas Pipeline Systems s 8.38

<sup>6</sup> ESC Consultation Paper section 1.2

### **3.2 The requirement to provide the Commission with the Chart of Accounts**

The Draft Guideline<sup>7</sup> requires a Licensee to deliver to the Commission the Chart of Accounts that must be sufficient to enable the Commission to understand the relationship between the entity's general ledger codes and the mandatory headings disclosed in the regulatory accounting statements.

Information such as the mandatory headings disclosed in the regulatory accounts are generally not contained within the chart of accounts and/or the general ledger codes. It is generally maintained within costing systems that may or may not be integrated to the general ledger.

AGL Gas Networks Limited and its related entities has a chart of accounts containing almost 5,000 general ledger codes, but even a thorough understanding of those codes would give no insight into the relationship with the cost categories or mandatory headings as described in the Draft Guideline.

This requirement should be amended so that a Licensee is required to provide "sufficient information to enable the Commission to understand the relationship between the general ledger and the mandatory headings disclosed in the regulatory accounting statements".

### **3.3 The extent of Non Causal Allocation Bases**

The Draft Guideline states that "Non Causal Bases of allocation shall only be applied to the extent that the aggregate of all the items subject to all Non Causal Bases of allocation is not Material to the Regulatory Accounting Statements."<sup>8</sup>

The nature of gas distribution networks is such that there is a very material level of cost for which it is not possible to identify causal bases of allocation. Prior to the 1999 review of the AGL Gas Networks (AGLGN) Access Arrangement, AGLGN in conjunction with Deloitte & Touche Consulting and IPART developed an extensive activity based costing system to trace and/or allocate cost to its various geographic regions and markets. The result of that analysis was that 34% of total costs could not be allocated using any causal basis, and a further 28% related to marketing related activities which were allocated direct to the tariff market. This leaves a balance of only 38% of total non-capital costs which could be allocated to covered pipelines and services using a causal basis.

The Draft Guideline should reflect the cost structure of a gas distribution network business.

### **3.4 The Exclusion of Avoidable Cost as an Allocation Base**

The Draft Guideline specifically excludes the use of "Avoidable Cost" as an allocation method.<sup>9</sup>

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<sup>7</sup> ESC Draft Guideline 17 section 5.2.3

<sup>8</sup> ESC Draft Guideline 17 section 3.6.6

<sup>9</sup> ESC Draft Guideline 17 section 3.6.6

Avoidable cost is widely accepted as a valid allocation method in accounting, economic, commercial and regulatory fields. In management accounting, avoidable cost is used for the costing of by-products and for the costing of services that are ancillary to the primary purpose of a business. Similarly avoidable cost is widely recognised in economic, commercial and regulatory fields as a valid and commonly used method for the determination of prices.

It is a stated aim of the Code<sup>10</sup> to replicate the outcome of a competitive market. It is doubtful that this can be achieved if Service Providers are prevented from adopting allocation approaches commonly used in competitive markets. The relevant test is set out in section 8.1 of the Code which is applied in setting tariffs. Avoidable cost may well meet this test. It is inappropriate to exclude avoidable cost as an allocation basis for purposes of preparing accounts under clause 4.1.

### **3.5 The mandated use of straight line depreciation is inappropriate**

The Draft Guideline<sup>11</sup> states that depreciation shall be accounted for on a straight-line basis.

While a straight line basis may be the most common method used for determining depreciation for accounting purposes, other methods such as throughput are also commonly used, including for such assets as gas pipelines. For economic and regulatory purposes a much wider range of depreciation approaches is available.

The Code does not prescribe the method that should be adopted for the calculation of depreciation<sup>12</sup> and specifically states that the depreciation schedule may involve a substantial portion of depreciation occurring in future periods. Straight line depreciation may well be inconsistent with the depreciation basis adopted in the Access Arrangement for the Covered Pipeline which is the subject of the accounts.

It is inappropriate for the Draft Guideline to mandate straight-line depreciation, in direct conflict with the Code.

### **3.6 The level of additional work is substantial and costly**

The preparation of the proposed Regulatory Accounts will impose significant workload and costs upon gas distribution businesses. The Consultation Paper<sup>13</sup> gives the impression that any additional costs and effort will be minimised as the Regulatory Accounts will be based on existing Statutory Accounts and the timing of the two sets of accounts has been aligned.

In fact the regulatory accounts require a considerable amount of analysis and allocation that are not contemplated in the preparation of Statutory Accounts. Statutory Accounts are specifically designed to report the financial performance

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<sup>10</sup> National Third Party Access Code for Natural Gas Pipeline Systems s 8.1 (b)

<sup>11</sup> ESC Draft Guideline 17 section 5.10.3

<sup>12</sup> National Third Party Access Code for Natural Gas Pipeline Systems s 8.32 et seq

<sup>13</sup> ESC Consultation Paper section 2.1

of legal entities, not to dissect that performance into specific assets or services. The requirements of the proposed Regulatory Accounts therefore go far beyond Statutory Accounting requirements.

The usefulness of requiring the level of detail set out in the Draft Guideline must therefore be questioned given that (as set out in section 3.1 of this Submission) much of the information required by the Draft Guideline will not be relevant for future Access Arrangement reviews.

The imposition of this cost should be of concern to network users, given that any additional costs will result in increased reference tariffs.

The Australian Gas Light Company  
January 2005