



Tel: 02 9921 2999
Fax: 02 9921 2552

The Australian Gas Light Company
ABN 95 052 167 405

St Leonards
72 Christie Street
St Leonards NSW 2065

Locked Bag 1837
ST LEONARDS NSW 2065
www.agl.com.au

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Manager, MCE Secretariat
Department of Industry, Tourism and Resources
GPO Box 9839, Canberra, ACT 2601.

By email to: MCETMarketReform@industry.gov.au

Review of Revenue and Network Pricing across the Energy Market

The MCE's Expert Panel has requested early comments for the Review of Revenue and Network Pricing across the Energy Market (the Review). This submission outlines AGL's views on the issues for consultation. AGL looks forward to contributing further to the Review at later stages in the consultation.

Distinction and Commonality

Consistent with views put to the MCE in previous consultations; AGL supports the pursuit of a national approach to energy access, with alignment of the electricity and gas regimes where possible. AGL believes that in terms of economic regulation, there are significant opportunities for development of a common access framework (including pricing principles) between gas and electricity.

The Productivity Commission's (PC) review of the National Access Regime (NAR) and the Gas Access Regime (GAR) have both extensively investigated pricing and revenue issues in the context of national access regulation. A consistent set of pricing principles was developed in these reviews, which has since been accepted by the Government through incorporation into provisions of the *Trade Practices Amendment (National Access Regime) Bill 2005*. AGL notes that the pricing principles in chapter 6 of National Electricity Rules (formerly the National Electricity Code) are subject to extensive jurisdictional derogation, whereas the GAR has provided a consistent and largely workable national pricing framework for eight years for both gas transmission and distribution. AGL therefore believes the PC reviews provide a firm foundation for pricing principles for both gas and electricity.

As a demonstration that the access frameworks of the NAR and the GAR are equally translatable to electricity, AGL points to the example of the Western Australian electricity regime. The Western Australian *Electricity Networks Access Code 2004* is a recent development which takes an integrated view of access regulation for electricity distribution. It is especially notable that the Western Australian regime adopts the major features of the NAR and GAR, with an objects clause, submission of an access arrangement under a propose-respond model, and clear guidance to the regulator. AGL suggests that the Expert Panel investigate this regime, as it illustrates that many features of access regulation existing in the NAR and GAR are equally applicable to electricity and should be aligned across all three regimes as part of the ongoing reform of the energy market. AGL considers that the aligned

pricing principles for gas and electricity should be accompanied by an appropriate level of guidance for the regulator in their interpretation (see comments below).

While the key features of access regulation are likely to be substantially the same for gas and electricity, AGL acknowledges that there may need to be allowance for legitimate differences, recognising the different characteristics of electricity and gas markets and the different physical transportation assets in each market.

Possible Alternatives to Current Regulatory Methodologies

Scope of Regulation

The scope of regulation should take into account the degree of actual or potential competition for a service. In concept, it is possible to devise a test or tests for assessing the level of effective competition such that there would be a range of regulatory options for a service ranging from full price regulation to no regulation. The GAR has a coverage test for pipelines which addresses competition issues, and the MCE intends to align this test with that in the NAR.

It is inherent in the propose-respond model that the service provider should be able to nominate which service or services it intends to provide as the basis for access, and this proposal is then assessed by the regulator for adequacy. The current Gas Code includes a test that the service or services offered “are likely to be sought by a significant part of the market”. AGL considers this test could possibly be adapted to apply to both gas and electricity, recognising however that there is a large number of non-transportation and less widely used services provided by electricity distributors which would need to be accommodated in a propose-respond framework. As a starting point for electricity, AGL suggests that all significant “non-contestable” services (determined by a competition test as above) should be set out in a distributor’s access proposal.

Alternative Methodologies

AGL supports the adoption of a flexible approach to the gas and electricity access regimes which permits different regulatory methodologies. The new pricing principles should allow flexibility for the service provider to propose detailed methodologies that suit its particular operating environment as long as they conform to the overall objectives and principles of the regime. For example, the GAR permits the service provider to select other methods besides “cost of service” for deriving revenue as long as the alternatives would result in outcomes consistent with cost of service. The Productivity Commission has recommended moving further away from a cost-based form of regulation in the GAR by allowing service providers to develop other methodologies so long as they meet the overall requirements of the regime.

However, the principles should not mandate the conditions under which each methodology must be used. Methodologies such as benchmarking and Total Factor Productivity (TFP) may have merits if applied appropriately but they are known to have significant practical weaknesses¹ and their use should not be prescribed.

The Expert Panel’s scope of review makes specific mention of TFP which has been a live issue in Australian regulatory circles since around 2001. Its proponents argue that it offers a lighter handed alternative to the conventional building blocks approach for regulating prices. However, it is AGL’s understanding that the TFP

¹ Farrier Swier Consulting (2002) ‘Comparison of Building Blocks and Index-Based Approaches’ June 2002.

approach is essentially an alternative means of setting the gradient of the price control based on measured industry performance rather than firm-specific information. Apart from the question of how to quantify TFP, there remain unresolved issues of implementation. In the end a fully-specified TFP regime may offer little benefit over the current building block approach. Again, the use of TFP should not be mandated, but be available for a service provider to propose if suited to their particular operating environment.

AGL believes the Expert Panel should consider alternative regulatory methodologies in such a way as to allow their use if they prove practical in the future, but not to conduct an investigation into their application at this stage. AGL is concerned that an adequate consultation on alternatives to current options would not be possible in the timeframe of this review and may distract the Panel from the more fundamental tasks of recommending a consistent set of principles for revenue and network pricing and the associated regulatory guidance.

Revenue Capping vs Price Capping

AGL supports the use of price caps for the control of prices when it is desirable to give an incentive to develop a market. Revenue caps are limited in this regard. However, consistent with previous comments, AGL believes the service provider should be left with the option of choosing the appropriate mechanism for their individual operating environment.

Regulatory Discretion

AGL recognises that in any complex economic regulatory regime, a substantial amount of regulatory discretion is inevitable. However, AGL also considers that, given the complexity of the regulator's tasks, the risks and potentially adverse consequences of regulatory error are very significant.

Therefore, AGL supports a framework giving a significant level of guidance to the AER in setting regulated prices. The PC provided such guidance in its review of the GAR, which AGL believes is a valuable model for establishing guidance for the AER. AGL notes that the Expert Panel is to provide the MCE with proposed responses to the PC recommendations on guidance as required in the MCE's Proposal for Consultation in November 2005. AGL considers the PC's recommendations for guidance would be applicable to the consistent set of access pricing principles for gas and electricity which were supported above.

To ensure a consistent national framework, the NEL/NGL should require that any revision to established pricing principles be accompanied by the appropriate regulatory guidance for the AER.

Initial Guidance on Proposals

Rather than the AER releasing initial guidance on the items to be included in a service provider's pricing and revenue proposals, AGL considers that there should be guidance to the service provider on these matters in the regulatory framework, similar to the Gas Code. AGL's concern is that guidelines in some jurisdictions have been designed to mandate, rather than to guide the basic elements of a proposal. Under a new national framework this outcome should not be permitted. Given the AEMC's role as rule-maker, the AER's role should be limited to issuing non-binding guidelines which explain how the AER intends to interpret the regulatory framework. The relevant law and/or Rules should be specific enough for the service provider to understand what should be included in its proposal (including

information requirements) and to be confident that it has met its regulatory obligations.

Incentive Arrangements for Reliability and Efficiency

Performance standards and incentive mechanisms are an integral component of the access and pricing regime for networks. AGL cautions that this is an area that requires recognition of sectoral differences arising from the fact that there is a tighter relationship between costs and performance standards in electricity than exists in gas. As stated previously, differences may be resolved by adopting a common pricing framework applicable to both sectors with subsidiary details specifying the application of the principles between the sectors.

AGL considers that certain jurisdictional initiatives for incentive pricing in electricity distribution have proven worthwhile, including S-factors and efficiency carryover mechanisms. AGL also considers that benefit-sharing mechanisms which apportion efficiency gains between service providers and users should allow a service provider to share in all realised gains and not, as at present, only in gains which exceed a regulator-determined forecast of efficient costs.

Information Gathering Powers

AGL supports transparency in determinations as an important and necessary part of administrative decision-making but considers that this needs to be balanced with practical informational requirements. AGL suggests that the NEL/NGL or Rules should contain general principles specifying the information gathering powers of the AER in the way that the Gas Pipelines Access Law currently deals with this matter in respect of regulators under the Gas Code.

AGL proposes that the principles should include the following:

- information requests should be confined to matters relevant to the regulator's duties under legislative requirements. Information requests should not burden the business with excessively costly and/or impractical demands in terms of volume and availability;
- there should be appropriate confidentiality provisions; and
- information gathered for non-access related purposes or information gathered under powers outside the access regime should not be used in making regulatory decisions.

AGL supports the AER's stated intention of adopting wherever possible a less intrusive approach² and considers that the concern often expressed by regulators with asymmetry of information is overstated. Service providers can only give their best estimate forecasts of costs and market demand which will be incurred for the duration of the regulatory period.

AGL is concerned with any requirement for regulatory accounting information on an annual basis, rather than at each review. Annual reporting is contrary to the principles of incentive regulation under which access and pricing terms are reviewed every five years and service providers then seek to increase the efficiency of the business in the interim. Furthermore, AGL believes such a degree of reporting is an unnecessary diversion from safely and efficiently delivering services to customers.

² Speech by Steve Edwell, Chairman, 'National Electricity Reform – Address to Power and Electricity Congress', 21 November 2005.

If you have any questions regarding the above matters, please contact Paul Johnston, Manager Regulatory Analysis and Projects, on (02) 9921 2319 or by e-mail to pjohnsto@agl.com.au.

Yours faithfully,

A handwritten signature in cursive script, appearing to read 'R. Wiles', is centered on the page.

Dr Robert Wiles
General Manager, Regulation and Policy