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Draft Report on Energy Access Pricing

AGL is appreciative of the opportunity to provide comments on the draft report of the Expert Panel on Energy Access Pricing.

AGL acknowledges that the issues underlying the development of a national energy access regime are complex – it is for this very reason that the Ministerial Council on Energy found it necessary to seek assistance from the Expert Panel in developing “a common set of arrangements for economic regulation of access to electricity and gas transmission and distribution networks”.

AGL also acknowledges that the timeframe for the Panel to undertake this work is very short. It appears to AGL, however, that the Panel has not focussed its efforts in the appropriate direction and that the draft report does not provide the MCE with the framework that it needs to consolidate the work undertaken to date into a national energy access regime.

CoAG and the MCE have already undertaken a number of key steps towards establishing the national energy market structure including the access framework. These include establishment of the regulatory bodies the AEMC and AER, and restructuring of the NEL and NER; implementation of amendments to the national access regime (ie Part IIIA of the Trade Practices Act) following an extensive public review; and consideration of recommended changes following a detailed review of the gas access regime.

The Panel has embarked on a study of a number of the underlying issues and the draft report provides a useful discussion, but even in this respect it is evident that the Panel has been unable to achieve a comprehensive position on key matters.

More importantly the draft report does not provide a balanced consideration of the factors by which a national framework can be developed consistently with other developments in the CoAG and MCE energy market reform processes.

AGL considers that the draft report, in focussing on the Panel’s particular views on key underlying matters lacks balance and, importantly, does not meet some explicit requirements of the Panel’s terms of reference:

- The MCE requested detailed and specific review of 17 of the Productivity Commission’s recommendations from its review of the Gas Access Regime. AGL has only been able to identify four for which substantial comment (though not comprehensive and systematic) has been made. This leaves 13 recommendations for which clear views have not been articulated.
- The Terms of Reference specifically identified a number of matters that were not to be addressed by the Panel, but which are nevertheless the subject of extensive discussion in the draft report. While of interest, the discussion is incomplete and consequently does

not have the balance that would come from a comprehensive and systematic review. AGL recommends that to avoid confusion these matters be removed from the final report.

- Conversely, a number of matters referred to the Panel in the Terms of Reference have received incomplete investigation. There are important matters for which all the advantages and disadvantages of different approaches have not been identified. For other matters, the draft report provides initial discussion and analysis which is balanced and well rounded, but then develops a direction which is inconsistent with the initial analysis. As a consequence there is a lack of balance in the findings and recommendations. AGL submits that treatment of all matters requested by the MCE should have a comprehensive and systematic review, with conclusions that logically follow from such review.
- The draft report makes mention of the National Access Regime (NAR) consisting of Part IIIA (including the current amending Bill soon to be made law) and the Competition Principles Agreement (including CoAG's recent endorsement), but the Panel's approach is not one which gives priority to these policy areas. This is clearly inconsistent with a nationally accepted policy approach to access regulation (ie one that has been endorsed by Commonwealth, State and Territory Governments). Key elements of the nationally accepted approach that are relevant to the draft report include: the use of a negotiate-arbitrate model as a foundation for access; the 'propose-respond' approach to regulatory determinations; a clear and appropriate objects clause and simple and effective pricing principles (which promote all three forms of economic efficiency).
- The draft report appears to suggest a preference for an electricity focused (ie NEL/NER) approach to regulation without due consideration of the many advantages of the Gas Access Regime (GAR). The GAR is effectively modelled on the NAR and has been tailored to the specific needs of gas network and pipeline infrastructure industries to deliver the consistency and streamlining that is desirable in an industry-specific regime. At the same time, the GAR has been certified under Part IIIA as effective. The PC's recommendations, among other things, have been designed to incorporate the changes to Part IIIA (currently progressing through the Senate) to deliver consistency across regimes.
- The Panel's analysis of the differences across electricity and gas, transmission and distribution represents a useful compilation of the nature of each of the four energy infrastructure sectors and identifies many of the resulting essential differences. However, in AGL's view there is a need to extend this analysis to comprehensively and systematically address each of the major aspects required in the Terms of Reference in the light of sectoral differences. The draft report only makes brief reference to these issues and does not give a complete picture providing the MCE with immediate insight as to which aspects of price regulation can appropriately be treated on a common basis and those best treated differently.
- AGL considers that the approach and recommendations of the Panel's draft report exhibit a preference for an intrusive and heavy-handed approach to regulation. This preference is reflective of only one side of the debate (as evidenced by Mr Morton's strong difference on 'propose-respond' and, implicitly, on pricing principles). This adds to the perceptions of a lack of balance in the draft report. AGL encourages the Panel to consider the advantages of approaches which are designed to constrain the monopoly power of regulated service providers, rather than approaches that intrude unnecessarily into the operation of energy infrastructure businesses.

AGL has contributed to and supports the views of the Energy Networks Association and the Australian Pipeline Industry Association in the submissions made by them.

To assist the Panel, AGL provides the following specific comments on key matters:

Policy Guidance to the AEMC and the AER

A basic principle of sound regulatory design is that guidance on key matters should be in the law and should guide both the AEMC in making Rules and the AER in applying the Rules. This principle should not only apply to the Objects Clause but also the Pricing Principles. While guidance from the law on these matters is essential, there may well be other matters of high level policy that both bodies need to reflect in their respective roles. The PC's review of NAR and GAR resulted in a very clear conclusion about the importance of high level guidance to the regulator.

The framework discussed in the draft report does not provide a basis for dispensing with the need for the AER to be aware of the policy intent in making its decisions. It is inappropriate that the AER rely only on the detailed rules of the AEMC without regard to the policy context in which they were made. The AER should not only act within the letter of the Rules, but also within the legal context behind the Rule-making power. The conclusion that having to have regard to the high level policy matters in interpreting the Rules creates potential for uncertainty and inconsistency is not sustainable. The AER's recognition of the guidance of the law in the development of the objects and pricing principles will strongly align the application of the Rules to the policy purpose for which they were made. Moreover AGL submits that the Panel's proposed approach does not represent a sound approach to administrative law.

Guidance on Regulatory Prescription

The Panel has proposed that no policy guidance be given to the AEMC in the law about the level of the prescription to be included in the Rules. The Panel believes it is a matter which is not susceptible to this approach and militates against a "common approach" to access regulation in the law. As evidenced by the Terms of Reference, the issue of regulatory discretion is a key policy issue on which the MCE has requested advice, but in AGL's view, the draft report has not provided this adequately. AGL submits that the level of prescription is an essential feature of an energy access regime, as it constrains the discretion of both the regulator and the service provider. Both the level of prescription and the level of the regulator's discretion are matters that go to the level of confidence of all stakeholders and is therefore a matter on which the MCE must provide a clear policy position on both these matters. AGL believes that not only is this essential, but that it can be done. One significant expression of the level of regulatory discretion will be the adoption (or otherwise) of the 'propose-respond' approach to regulatory process and decision making.

Objects Clause

AGL agrees with the Panel that it is desirable for a single objective to be common to the NEL and NGL. However, in AGL's view the strong reasoning in the draft report about an appropriate objects clause for energy access regimes that has been developed as part of the Panel's first principles analysis inevitably leads to an objects clause which is based on that in the NAR¹. The Panel's subsequent rationale for citing a reference to long term consumer interests and *not* including referring to economic efficiency appears to be a concern about the perception of conformity to the Australian Energy Market Agreement.

Another matter that does not appear to have been recognised is the central role of the NER in the operation of the NEM and consequently the promotion of competition as an essential element to be considered in the design of the NEL. AGL submits this consideration provides an even more compelling basis for the application of an objects clause based on the NAR as the single objective rather than that in the NEL.

¹ That is the Objects Clause in the *Trade Practices Amendment (National Access Regime) Bill*.

The Form of Regulation

AGL is concerned that the Panel's discussion of the form of regulation to apply in a broadly common access regime appears to show a lack of recognition of the differences between gas and electricity and the MCE's response to the PC's recommendation on the Gas Access Regime. In AGL's view the Panel's approach is appropriate where price regulation for a particular regulated asset is mandated, as for all electricity infrastructure and for gas infrastructure where pricing regulation under an access arrangement is mandated. In these cases, it is appropriate that the regulator have power to relax the scope of regulation on some services. However, where a decision is being made about the overall level of regulation to apply to a particular asset (ie monitoring or price regulation) a decision on the form of regulation is appropriately made by the body determining coverage and not the regulator.

In addition, the Panel appears to be making recommendations for a further investigation of the monitoring option when the MCE has already appropriately signalled its intentions on this matter.

Pricing Principles and TFP

The Panel has been directed to consider regimes including the NAR, the *Trade Practices Amendment (National Access Regime) Bill 2005*, GAR and the PC's recommendations on that regime and the WA Electricity Networks Access Code. AGL considers these regimes to contain effective pricing principles upon which a national approach for energy should be modelled unless there are sound reasons for differences. However, the Panel has given inadequate recognition to these pricing principles and recommended the principles of the NEL, with variations, that further impinge upon investor's expectation to recover efficient costs. There has been significant policy debate over pricing principles in the NAR and the GAR confirming the importance of the requirement of ensuring recovering efficient costs. In contrast, the principles in section 16 and 35 of the NEL preferred by the Panel have been developed with very little consultation and are counter to very clear policy guidance.

One of the Panel's justifications for recommending the NEL objective is the desire to implement TFP. The chain of reasoning appears to be inverted. High level principles need to be determined initially, then methodologies designed to achieve those principles. Compromising the pricing principles in order to facilitate the introduction of a TFP approach is flawed. Clearly if TFP, as it is now understood, does not meet the pricing principles, then it is the TFP methodology that needs to be amended, not the pricing principles.

The Terms of Reference direct the Panel to address CPI-X building block revenue control and potential alternatives, including TFP. As in the previous round of consultation, AGL supports a regime that allows different forms of price control to be used as long as they conform to the overall objectives and principles of the regime and are at the service provider's discretion to propose, subject to the regulator's approval. AGL considers the Panel has provided no consideration of a range of alternatives, has given undue consideration to the TFP methodology and has made inappropriate recommendations to implement the methodology. While the Panel's initial analysis of TFP appears balanced, the conclusions reached are not supported by it.

AGL considers that the Panel's recommendation to implement TFP is premature. The Panel correctly notes that the approach is still very much in the development stage and that much work needs to be done before it can be applied to the Australian energy industry. AGL is seriously concerned that the Panel has recommended that an undeveloped and unproven methodology, which risks the service provider's ability to recover efficient costs, be mandated as a form of price control.

'Propose-Respond' Approach

In AGL's view the analysis of the 'propose-respond' approach is deficient and lacks balance. In particular:

- It wrongly suggests that the key element of the approach is a presumption in favour of the service provider's proposal. In practice, the model is simply one where the service

provider designs and develops its access arrangement and the regulator's role is to test whether the proposal meets the requirements of the Rules. If it does, the regulator is bound to accept it, if it does not, the regulator is required to nominate what changes are necessary for the access arrangement to be approved.

- The suggestion that there was some step change in the regime in 2003 is incorrect. In 2003 the Australian Competition Tribunal (ACT) simply clarified the nature of the test to be applied by the regulator, namely that of 'reasonableness'. This approach had already been adopted to varying degrees in both before and after the ACT decision.
- The extended discussion of "plausible" versus "reasonable" is unnecessary and distracting. Clearly, the intention of the PC in using the phrase "plausible range" was to clarify and express the decision of the ACT - which intended that the regulator should not replace its own decision if the service provider's proposal was reasonable. The PC simply applied an approach that elucidates the means to determine reasonableness.
- The suggestion of the possibility of gaming discussed in the report seems to lack an understanding of the practical operation of the Gas Code and therefore this possibility is quite limited. In any event for the reasons set out in the next paragraph there should be little reason for concern.
- The Panel's concern about the service providers proposing prices that are at the upper end of a reasonable range is unnecessary. While such proposals are a real possibility, it is questionable that they be considered an undesirable or unreasonable outcome as the result will of necessity be reasonable.
- The draft report does not acknowledge that the very clear existing rights of gas service providers will be removed if the Gas Code approach is not continued and the Panel's approach is adopted.

Information Requirements

As the purpose of economic regulation is to constrain market power rather than control the operation of the service providers, AGL believes there must be a balance between ensuring regulators have sufficient information to determine the appropriate level of prices and minimising the burdens on businesses of the cost and distraction associated with provision of information. AGL is concerned that the Panel's recommendation of modelling the AER's powers of information collection on section 28 of the NEL moves away from a focus on constraining market power strongly in the direction of control of services providers' businesses.

Importantly, section 28 of the NEL empowers the AER to require information to be provided "for the performance or exercise of a function or power conferred on it under the Law or Rules" whereas the under the Gas Pipelines Access Law, the regulator is empowered to require information "in performance of any of the prescribed duties" which are clearly defined. The GPAL provides clear policy guidance about limiting the regulator's power to obtain information to those circumstances where it is necessary to fulfil specific duties. The NEL is considerably broader and imprecise, leaving considerable uncertainty about where the limits on the regulator's information gathering powers lie.

AGL considers that the current provisions in the Gas Code for obtaining information are more than adequate for the regulator to perform its economic regulatory functions. The PC's review of the GAR made a number of observations and recommendations with respect to the maintenance of information by service providers and the regulator's scope for collecting information which AGL believes are well founded and would apply to both gas and electricity. In particular, the Panel's concerns about appropriate allocation of costs are adequately resolved by the PC's recommendation about such matters.

In the initial round of consultation for this review, AGL expressed concern over the requirement for annual reporting to the AER, because frequent information provision is contrary to the principles of incentive regulation under which access and pricing terms are reviewed periodically and service providers then strive to increase the efficiency of the business in the interim. The draft report does not investigate the impact of annual reporting on this aspect of incentive regulation. Furthermore, it is a repetitive diversion of service providers from the efficient and safe delivering services to customers.

Conclusion

As will be evident from this submission, AGL is concerned with the fundamental direction of the draft report. The Panel's review has not yet delivered on the Panel's principal objective, which was:

to develop appropriate criteria for determining the level of prescription in the Law and subsidiary rules for a common energy access pricing model.

AGL considers that the report has addressed important aspects of its Terms of Reference in an incomplete manner. In a number of instances the recommendations propose no action where the MCE has clearly sought it. In addition, specific responses have not been developed for the majority of the Productivity Commission recommendations referred to the Panel by the MCE.

AGL is greatly concerned with significant sections of the report's analysis and recommendations, and particularly with the Panel's concept of the diminished role of the service provider in its recommended regulatory model, and a preference for a NEL based approach. The benefits and advantages of existing models cited in the Terms of Reference (such as the Part IIIA and Gas Regimes) have not been appropriately investigated. AGL considers that the draft report is not an adequate basis for policy guidance to the MCE. AGL submits that that the Panel should reconsider its conclusions and recommendations based on an expansion of the positive elements in the draft report, with the aim of submitting a complete and balanced final report focused on the issues on which the MCE needs clear advice.

Should you wish to discuss or clarify any of our comments please contact Chris Harvey, Manager Regulatory Development on 02 9921 2601.

Yours faithfully

Dr Robert Wiles
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