

By email

Australian Energy Market Commission

RE: Project Reference Code GRC0011 – Proposed Changes to Rate of Return for Gas Networks under National Gas Rules

ATCO Gas Australia welcomes the opportunity to be part of the consultation process being undertaken by the Australian Energy Markets Commission with respect to the rule changes being proposed by the Australian Energy Regulator and the Energy Users Rule Change Committee.


We are pleased to submit our response to the issues relating to the determination of rate of return for gas networks under the National Gas Rules raised in the consultation paper in the attachment to this letter. The matters raised in this submission relate to issues unique to ATCO Gas. Australia. The general concerns of ATCO Gas Australia in relation to the other rule changes put forward by the AER and EURCC have been addressed in industry submissions prepared by the Energy Networks Association and the Financial Investors Group.

ATCO Gas Australia supports retention of the current National Gas Rules on the basis that there is insufficient evidence and supporting analysis to demonstrate an objective need or benefit for change.

Energy infrastructure requires a stable, long term investment horizon. There have already been significant changes made over the past ten years to the Australian energy infrastructure regulatory framework and the proposed changes will have the impact of creating unnecessary instability.

Should you have any questions, please feel free to contact me on 08 6218 1718 or Deborah Evans on 08 6218 1722.

Yours sincerely



Brian Hahn
President
ATCO Gas Australia

11 December 2011

Attachment: Response to AEMC Consultation Paper on the Proposed Rule Changes to the Rate of Return under the National Gas Rules

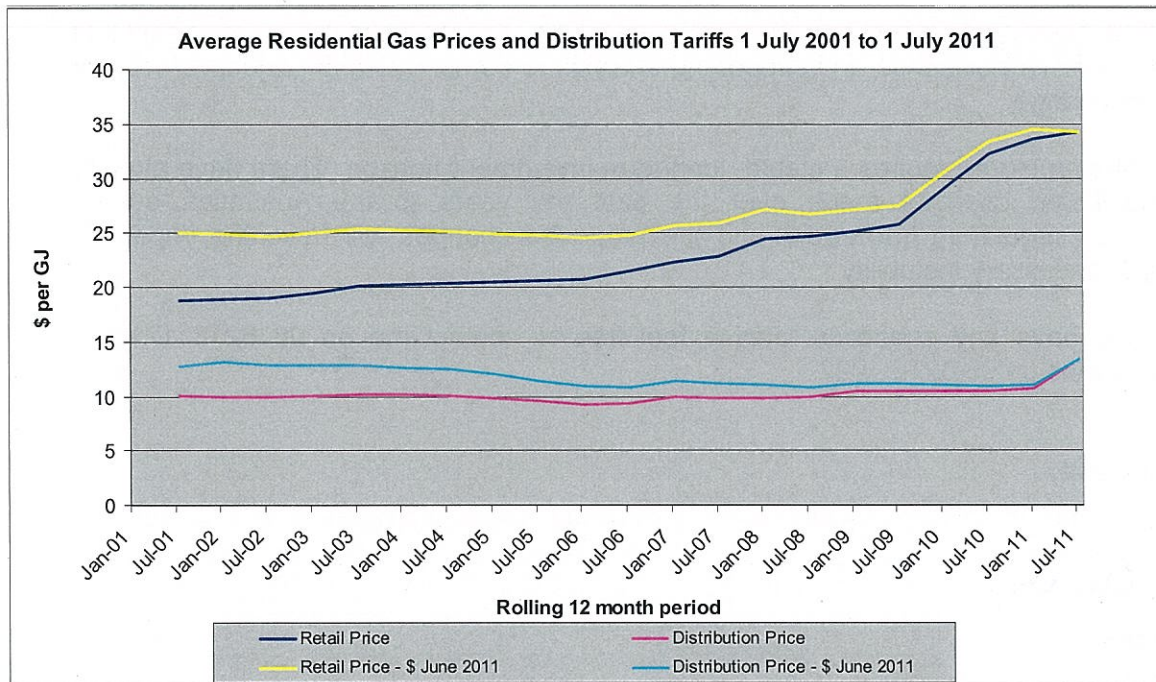
ATCO Gas Australia owns and operates the Mid West and South West gas distribution system (MWSWGDS) which is a covered pipeline located in the state of Western Australia, serving an area from Geraldton to Busselton including the greater Perth metropolitan area, together with two separate non-covered gas distribution systems in the regional centres of Kalgoorlie and Albany.

This submission addresses the issues raised in the AEMC Consultation Papers published on 20 October 2011 and 3 November 2011 in relation to the AER and EURCC rule change proposals insofar as they concern the determination of the rate of return under the National Gas Rules in the Western Australian context.

Issue 1

- The problem: The AER is seeking to amend the rate of return provisions in the National Gas Rules as a response to increases in network charges and to promote administrative efficiency. The AER's proposed solution is to require that the cost of equity and the cost of debt be prescribed and reviewed on a 5 yearly cycle and thereby achieve consistency in approach between electricity and gas regulatory frameworks.

The delivered price of gas for small end use gas consumers, being the majority of the domestic gas demand market, has increased in Western Australia over the last decade. This is largely a function of increases in the commodity cost of gas and delivered price components other than network tariffs. Figure 1 shows the change in price of delivered gas and distribution tariffs over the past 10 years in both nominal and real terms.



The distribution tariffs have remained fairly constant in nominal terms and decreased in real terms until July 2011. The recent increases reflect a timing issue. The current access arrangement period commenced on 1 January 2010 but only became effective from 1 July 2011 following the determination of the Economic Regulation Authority of Western

Australia (ERA) made on 28 April 2011. The distribution tariff increase therefore reflects a 'make up' adjustment for the first 18 months of the current access arrangement period. The price path for the remainder of the access arrangement period to 30 June 2014 maintains distribution tariffs in real terms.

To date, the stability of the regulatory framework incorporating the National Gas Objective and revenue and pricing principles has facilitated investment in long life asset infrastructure. The MWSWGDS has been continuously expanded in response to the demand for access to gas infrastructure and due to the benefits of natural gas as an energy source. Average new connections of around 18,000 have been constructed annually and end use gas consumers have enjoyed delivery of safe and reliable services. In the absence of regulatory stability, investment decisions will become distorted.

Increases in commodity gas prices for industrial, commercial and domestic consumers in Western Australia have been the subject of a recent Western Australian parliamentary inquiry conducted by the Western Australian Legislative Assembly Economics and Industry Standing Committee. That committee was charged with investigating:

- (a) the price of gas for customers throughout Western Australia;
- (b) the comparison of the price of gas with other states, especially Victoria, and whether there is a significant price differential and, if so, why; and
- (c) the contrast between domestic gas prices in Western Australia and international LNG prices and the LNG contracts that govern these international prices.

The committee was also charged with making recommendations on any measures that could be implemented to reduce the price of gas in Western Australia.

The committee delivered its report¹ on 23 March 2011. Of particular note, Finding 31 of the report identified that:

"the distribution sector is a natural monopoly and usually requires ongoing regulatory oversight. The Committee is satisfied with the current regulatory regime for distribution networks in Western Australia."

and Finding 32 stated that:

"the government needs to consider policies that will mitigate the impact on retail residential gas bills that will emanate from the recent increases in the wholesale price of gas and from any move towards cost-reflective tariffs in gas and electricity."

Within the report, there is no suggestion that network charges (including distribution tariffs) are driving significant increases in delivered gas prices.

The gas supply chain within Western Australia is unique. Gas commodity producers which are privately owned and unregulated, currently supply buoyant international markets with their product. Gas transmission and distribution infrastructure is privately owned and

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[http://www.parliament.wa.gov.au/Parliament/commit.nsf/\(Report+Lookup+by+Com+ID\)/7895FF6E76A7CDB74825785D0013F234/\\$file/DGP+Report+\[Final\]+20110324.pdf](http://www.parliament.wa.gov.au/Parliament/commit.nsf/(Report+Lookup+by+Com+ID)/7895FF6E76A7CDB74825785D0013F234/$file/DGP+Report+[Final]+20110324.pdf)

largely regulated by the ERA. There is limited retail competition due largely to a combination of a lack of cost reflective energy services pricing and limited access to the electricity market. Further details including a detailed discussion and comparison of the structure of Australian energy markets, including the Western Australia market is available in the report by the Australian Energy Regulator (AER) "State of the Energy Market 2009"²

Furthermore, gas retail tariffs in Western Australia are subject to caps which are set under the Energy Coordination (Gas Tariffs) Regulations 2000³ and subject to Ministerial determination based on recommendations from the Western Australian Office of Energy.

The most recent review of gas retail tariffs is contained in the Gas Tariffs Review – Draft Recommendations Report December 2010.⁴ In the report it is noted that: 1) the cost of delivered gas has increased due to increases in commodity costs, 2) average consumption of residential gas consumers is decreasing and 3) the timing of changes to tariff caps can have impacts on security of supply and gas retailer viability.

These factors do not apply to the same extent in other Australian jurisdictions but have significant influence on the commercial environment within which gas distribution infrastructure is operated in Western Australia and therefore the risks faced by investors and operators on the one hand, and the cost impacts faced by end use consumers on the other hand. A "one size fits all" approach to rate of return clearly is not feasible or fair in these circumstances.

The regulatory framework in Western Australia is governed by the National Gas Access (WA) Act 2009. This legislation applies the National Gas Law (NGL) and National Gas Rules (NGR) with amendments to accommodate Western Australian energy policy requirements.

The amendments which are intended to accommodate Western Australian energy policy requirements are reflected in the National Gas Access (WA) (Local Provisions) Regulations 2009⁵ and the key elements captured in regulations 6 and 7 are:

Regulation 6: Uniform tariff for small use customers

- (1) The ERA must not approve or make an access arrangement for a distribution pipeline if the reference tariff for any small delivery service provided for in the access arrangement varies according to the geographical location of the small delivery point to which the gas is delivered.

and

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<http://www.accc.gov.au/content/item.phtml?itemId=904614&nodeId=9869703f185e78ab970a14ac5de95f43&fn=State%20of%20the%20energy%20market%202009%E2%80%94complete%20report.pdf>

³ http://www.austlii.edu.au/au/legis/wa/consol_reg/ectr2000419/

⁴ <http://www.energy.wa.gov.au/cproot/2318/2/Gas%20Tariffs%20Review.pdf>

⁵ http://www.slp.wa.gov.au/legislation/statutes.nsf/main_mrtitle_11267_homepage.html

Regulation 7: Impact on small use customers and retailers to be taken into account

- (1) When exercising a discretion in approving or making an access arrangement for a distribution pipeline the ERA must take into account the possible impact of the proposed reference tariffs, the method of determining the tariffs and the reference tariff variation mechanisms on —
 - (a) users to whom gas is or might be delivered by means of a small delivery service provided for in the access arrangement; and
 - (b) small use customers to whom gas is or might be delivered by those users.

These regulations further define the business environment resulting in additional obligations on the gas distribution business.

The NGL and NGR have only been in operation in Western Australia since January 2010. To make the proposed changes to the national framework that are being suggested before the framework has been in operation for a suitable period of time introduces a level of uncertainty which is unacceptable for investors and operators whose ability to efficiently plan investment and expenditure will be adversely impacted where there is instability to the long term regulatory horizon. It is also unacceptable for end use consumers, all of whom face declining service standards if required investment cannot be maintained.

The rate of return determination in access arrangements represents the largest component of regulated revenue recovery for the MWSWGDS. As such, and in common with other regulated gas distribution businesses in Australia, it is appropriate that significant effort and attention is invested by ATCO Gas Australia in providing detailed submissions on rate of return to enable the regulator to make its determination based on the best available information and in compliance with the requirements prescribed in the NGL and NGR.

As a privately owned business, there must be recognition that there are other options for owners to invest their funds when there is an absence of regulatory certainty and a lack of access to market rates of return.

NGR 87 provides the regulator with the methodology that enables it to take into account what is happening in the 'real world' at points in time rather than being bound to apply an abstract or theoretical methodology which does not reflect reality or prevailing conditions. The current methodology in NGR 87 provides the appropriate means of achieving a balance of certainty and flexibility which, when applied as prescribed, is able to cope with extraordinary events such as the Global Financial Crisis or other "extraordinary" or unforeseeable economic or market events including flow on consequences by operating as a safety valve. They recognise and safeguard state-by-state and business-by-business circumstances to achieve a "level playing field" under the national gas framework as implemented in each jurisdiction.

Issue 2

- Prescription and discretion. Have the proposed rules achieved the right balance between prescription and discretion?

As noted earlier, a consequence of codifying the approach to rate of return is to remove or at best adversely affect the ability to have regulatory determinations in this area subject to merits review. This translates into a significant increase in the amount of discretion available to a regulator without any commensurate accountability and reflects a significant change in regulatory policy. The rights for merit review are enshrined in the NGL rather than the NGR so it is questionable whether a rule change process can or should be used in such a way as to amend superior legislation.

In order to give effect to the objective of section 24(5) of the NGL, reference tariffs must allow for a return commensurate with the regulatory and commercial risks involved in providing the reference service to which that tariff relates and the specific circumstances of the businesses providing the reference services in question must be taken into consideration. In this respect a single rate of return cannot accommodate the differences in regulatory and commercial risks faced by a gas distribution business in Western Australia compared to an electricity transmission business in Victoria. Indeed, within the gas industry in each state, transmission pipelines have very different market exposures and cashflow volatility to gas distribution businesses and even other gas transmission pipelines in the same state.

The regulatory framework as it stands affords protection to all parties because of the way that the rate of return provision in the NGR is currently structured. The second limb contained within NGR 87(2) prescribes a methodology but NGR 87(1) ensures that there is a "reality check" so that the rate of return is commensurate with prevailing market conditions and so also constitutes a safety valve in times of significant uncertainty such as have occurred during the Global Financial Crisis and the current and future instabilities in economic and market conditions.

The merits review process has been established to deal with matters of material significance. If the matter is not material, it will not meet the financial impact threshold under the NGL/NGR and would not be pursued by a private company acting prudently. Defending a material matter is not the same as 'cherry picking'. The process accommodates the ability to review errors in interpretation or application of the law. The merits review process provides the counterbalance to the regulator's discretion to the extent that it has not been exercised appropriately. For example, ATCO Gas Australia has sought and been granted leave to appeal the access arrangement handed down on 28 April 2011 by the Economic Regulation Authority. The main ground for the appeal is in respect of the rate of return. It is the first time that ATCO Gas Australia has pursued a merits review process or appealed a decision since it has been subject to regulation under either the NGL/NGR or the previous Gas Code. However, as the rate of return represents a major component of the revenue (in excess of 40%) to be recovered through tariffs due to the level of investment in network assets, it is and will remain the most material component of the access arrangement determination process.

Principles based regulation/legislation is more flexible than command/control or prescriptive regulation. A balance between prescription and flexibility is required in rules and laws where there is a requirement for the parties to the process to submit and consider a mixture of available evidence and historic data on the one hand, and a requirement to make forecasts or assumptions that require modelled supporting materials

or estimates on the other. Over prescription in such laws and rules can result in the inflexible application and interpretation of rules and laws. This restricts the ability of those operating in, affected by and administering the system to adapt and respond to the inevitable consequences of change. Regulators are left with a heavier burden of monitoring, enforcement and investigation where they have limited resources and competing demands for their expertise. Changing to more prescriptive rules would also be likely to encourage service providers to seek judicial review to ensure procedural fairness leading to further cost and delay, including diversion of resources for the parties involved.

Issue 3

- AER's use of its discretion. Could the AER instead achieve the same outcomes through greater use of the discretions it currently has, avoiding the need for expanding these discretions?

The regulator has limited discretion in dealing with NGR 87. The framework which is driven by the National Gas Objective and revenue and pricing principles, which includes the merits review process, demonstrates an intention within the National Gas Objective to limit discretion in order to ensure there is flexibility in the framework to accommodate assessments of impacts of uncertainty and changes in market conditions and the commercial and regulatory risks facing providers of reference services.

Issue 4

- The solution. On the basis of the problems raised by the AER and the EURCC, are there any more preferable solutions to those problems?

ATCO Gas Australia has detailed that it does not agree with the premise that there is a problem with the rate of return provisions as laid out in the NGR and therefore is of the view that there is no need for the changes suggested by the AER.

Determination of the debt risk premium has been addressed by WA Gas Networks (WAGN) in the context of establishing a cost of debt for a gas distribution business which meets the requirement of NGR 87(1). The approach was developed by WAGN⁶ in response to the ERA's discussion paper dated 1 December 2010 – "Measuring the Debt Risk Premium: a Bond Yield Approach." While WAGN rejected the ERA's approach, it put forward an alternative approach which is detailed in its Public Submission – WA Gas Networks⁷. The approach is based on seeking advice from an experienced capital markets advisor on possible options for refinancing, and on the likely pricing of debt by lenders taking into account the commercial and regulatory risks involved in providing the reference service to which the reference tariff related, in accordance with section 24(5) of the NGL.

This approach allows an estimate of the cost of debt to be made on a reasonable basis - as a build-up of the costs which are likely to be incurred by a service provider with benchmark gearing requiring debt finance for investment in a gas pipeline system. The approach recognises the fact that the service provider will source finance in a number of markets, and this may include the sourcing of finance in international capital markets.

⁶ WA Gas Networks trades as ATCO Gas Australia

⁷ http://www.erawa.com.au/3/1143/48/wa_gas_networks_formerly_alintagas_distribution_sy.pm

Furthermore, the approach would be able to recognise the real limitations in these markets.

The above example illustrates that operators and regulators have the means under the NGL/NGR to deal with determination of specific issues that is underpinned by a robust and workable merits review framework.

