



# **GAS ACCESS ARRANGEMENT REVIEW INFORMATION PAPER**

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Any comments on this paper should be directed to:

**Gas Access Arrangement Review: Information Paper**

Essential Services Commission of SA

GPO Box 2605

Adelaide SA 5001

**E-mail:** [escosa@escosa.sa.gov.au](mailto:escosa@escosa.sa.gov.au)

**Facsimile:** (08) 8463 4449

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## GLOSSARY

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<b>ACCESS ARRANGEMENT</b>	an arrangement, that has been approved by the relevant regulator, for third-party access to a covered pipeline; except where quotations are extracted from the Code, “Access Arrangement” refers to the particular arrangement applying to the South Australian natural gas distribution system and “access arrangement” refers generically to the arrangements applying to covered pipelines
<b>ACCESS ARRANGEMENT INFORMATION</b>	information provided by a service provider to the relevant regulator to enable network users and prospective users to understand the derivation of the elements in an access arrangement and to form an opinion as to the compliance of the access arrangement with the provisions of the Code
<b>ACCESS ARRANGEMENT PERIOD</b>	the period from when an access arrangement or revisions to an access arrangement take effect until the next revisions commencement date
<b>THE CODE</b>	<i>National Third Party Access Code for Natural Gas Pipeline Systems</i> , being Schedule 2 to the <i>Gas Pipelines Access (South Australia) Act 1997</i> , as amended from time to time
<b>COVERED PIPELINE</b>	the whole or a particular part of a pipeline or proposed pipeline which is subject to the provisions of the Code, including any extension to, or expansion of the capacity of, that pipeline which is to be treated as part of the covered pipeline in accordance with the extensions/expansions policy contained in the access arrangement
<b>DISTRIBUTION PIPELINE</b>	pipelines that transport natural gas from city gate stations and reticulate it to an end-user’s supply point; generally involves the transportation of gas in smaller volumes and at lower pressures than along the transmission pipelines, where the latter generally involves the transportation of large volumes of natural gas under high pressure from production fields to the city gate, or to large customers along the pipeline
<b>ENVESTRA</b>	Envestra Limited, owner and operator of the South Australian gas distribution system
<b>FRC</b>	full retail contestability
<b>GAS ACT</b>	<i>Gas Act 1997</i> (South Australia), as amended from time to time
<b>GAS ACCESS REGIME</b>	Schedules 1 and 2 to the <i>Gas Pipelines Access (South Australia) Act 1997</i> altogether, as amended from time to time; formally referred to as the “Gas Pipelines Access Law”
<b>GJ</b>	gigajoules, being a unit of energy consumption
<b>MDQ</b>	the maximum daily quantity of gas taken at a particular delivery point
<b>NETWORK SERVICE</b>	a service provided by means of a pipeline, including: (a) haulage services (such as firm haulage, interruptible haulage, spot haulage and backhaul); (b) the right to interconnect with the pipeline, and (c) services ancillary to the provision of such services, but does not include the production, sale or purchasing of natural gas
<b>NETWORK USER</b>	a person who has either a current contract for a network service or an entitlement to a service as a result of an arbitration
<b>NEW FACILITY</b>	any capital asset constructed, developed or acquired to enable the service provider to provide network services, including any extension to, or expansion of the capacity of, the associated pipeline
<b>PC</b>	the Productivity Commission



<b>PIPELINE</b>	a pipe, or system of pipes, for transporting natural gas, and any tanks, reservoirs, machinery or equipment directly attached to the pipe, or system of pipes; may refer to the whole or a particular part of a pipeline or proposed pipeline
<b>PIPELINES ACT</b>	the <i>Gas Pipelines Access (South Australia) Act 1997</i>
<b>TJ</b>	terajoules, being a unit of energy consumption
<b>REFERENCE SERVICE</b>	a service which is specified in an access arrangement as likely to be sought by a significant part of the market and, in respect of which, a corresponding tariff ("reference tariff") is specified in the access arrangement
<b>REVISIONS COMMENCEMENT DATE</b>	the date upon which the next revisions to an access arrangement are intended to commence, in accordance with the Code
<b>REVISIONS SUBMISSION DATE</b>	the date upon which the service provider must submit to the relevant regulator its proposed revisions to an access arrangement, in accordance with the Code
<b>SAIPAR</b>	South Australian Independent Pricing and Access Regulator; the relevant regulator under the Code until succeeded by the Commission on 1 July 2003
<b>SERVICE PROVIDER</b>	in relation to a pipeline or proposed pipeline, is the person who is, or is to be, the owner or operator of that pipeline
<b>WACC</b>	the weighted average cost of capital (debt and equity)

# 1 INTRODUCTION

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Since 1 July 2003, the Essential Services Commission of South Australia (the Commission) has been the local regulator under the *Gas Pipelines Access (South Australia) Act 1997* with respect to the South Australian gas distribution system. It succeeded the South Australian Independent Pricing and Access Regulator (SAIPAR), which undertook this role between April 1998 and June 2003.

Under the current approved Access Arrangement (and in accordance with section 2.28 of the National Third Party Access Code for Natural Gas Pipeline Systems (the Code)), Envestra Limited (Envestra) – as owner and operator of the South Australian gas distribution system – is required to submit to the Commission, on or before 1 October 2005,<sup>1</sup> the revisions it proposes to that Access Arrangement together with the applicable Access Arrangement Information.

The revisions as ultimately approved by the Commission will commence on the latter of 1 July 2006 and the date on which their approval takes effect under the Code.

This information paper is the first in a series of papers to be released by the Commission for its review of Envestra's Access Arrangement. The paper discusses the legal framework as well as the key issues to be addressed and the main phases of work to be undertaken.

Chapter 2 outlines the regulatory framework currently applying to natural gas distribution network in South Australia.

Chapter 3 briefly outlines the processes involved with the approval and administration of the first Access Arrangement.

Chapter 4 addresses the criteria to be applied by the Commission as regulator in approving any proposed revisions.

Chapter 5 addresses the scope of the forthcoming revisions review, contrasting it with the scope of the initial approval review.

Chapter 6 distinguishes between the roles to be played by a preliminary consultation stage and the formal review stage, to take place (respectively) before and after receipt of

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<sup>1</sup> In March 2004, the Commission provided its in-principle agreement to a proposal by Envestra that the Revisions Submission Date be deferred from 1 January 2005 to 1 October 2005 (see Attachment 1). The Commission's in-principle agreement was conditional on Envestra:

- agreeing to meet all relevant timeframes requested by the Commission for providing any necessary input into the consultation program the Commission intends to undertake on the Access Arrangement Revisions prior to the submission date;
- acknowledging that, in the absence of any formal changes resulting from the Productivity Commission's review of the gas access regime, it will be assumed that the current regulatory arrangements will continue to apply, and work on the revisions will proceed on this basis; and
- devoting appropriate resources once it submits its revisions to ensure that the tight timeframe for the formal part of the review process can be met.



Envestra's proposed revisions to its Access Arrangement. It sets out the processes and timelines the Commission expects to follow with regard to each of these stages.

The proposed timetable for the review is outlined in chapter 7.

The purpose of this paper is to establish a clear framework – and guide – for the conduct of the review. Interested parties are under no obligation to submit their views in response to this paper. However, the Commission will be happy to receive any views about the next stages in the review process where an interested party wishes to do so prior to the release of an Issues Paper which the Commission is planning for December 2004.

## 2 REGULATORY FRAMEWORK

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This chapter outlines the regulatory framework currently applying to third-party access to natural gas distribution network in South Australia.

### 2.1 Gas access regime

The national third-party access regime for natural gas pipelines (Gas Access Regime) is an industry-specific regime that is given legislative effect in a gas pipelines access Act in each State and Territory.

The *Gas Pipelines Access (South Australia) Act 1997* (Pipelines Act) implements the Gas Access Regime in South Australia. The Act was enacted pursuant to the Natural Gas Pipelines Access Agreement, which was endorsed by the Council of Australian Governments (CoAG) on 7 November 1997.<sup>2</sup> The Gas Access Regime comprises Schedule 1 (Third Party Access to Natural Gas Pipelines) and Schedule 2 (the Code) of the Pipelines Act.

The objective of the Gas Access Regime is to establish a framework for third-party access to gas pipelines that:

- (a) *facilitates the development and operation of a national market for natural gas; and*
- (b) *prevents abuse of monopoly power; and*
- (c) *promotes a competitive market for natural gas in which customers may choose suppliers, including producers, retailers and traders; and*
- (d) *provides rights of access to natural gas pipelines on conditions that are fair and reasonable for both service providers and users; and*
- (e) *provides for resolution of disputes.*<sup>3</sup>

The Gas Access Regime exists alongside, and interacts with, the national access regime operating for all essential services in Australia, as contained in Part IIIA of the *Trade Practices Act 1974* (Cwth).

Important features of the Code are:

- ▲ coverage – the mechanism by which pipelines (including distribution systems) become subject to the Code;
- ▲ reliance on an up-front access arrangement outlining services and reference tariffs applicable to a covered pipeline;

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<sup>2</sup> Under the agreement, South Australia became the lead legislator. All States and Territories (except Western Australia) as well as the Commonwealth have since adopted the South Australian legislation. Western Australia has complementary legislation to support enactment of the Code.

<sup>3</sup> See Preamble, *Gas Pipelines Access (South Australia) Act 1997*.



- ▲ pricing principles – which state the principles with which reference tariffs and the policies underlying the calculation of reference tariffs must comply;
- ▲ ring fencing arrangements – required of a service provider involved in using, as well as providing, the services of regulated pipelines;
- ▲ information disclosure requirements – to accompany proposed and approved access arrangements;
- ▲ binding arbitration where there is a dispute; and
- ▲ specific timelines for all processes.

The aim of the Code is to provide sufficient prescription so as to reduce substantially the number of likely arbitrations, while at the same time incorporating enough flexibility for the parties to negotiate contracts within an appropriate framework. The Code has also been designed to provide a clear national access regime, with consistency between different jurisdictions.

## **2.2 Covered distribution pipelines in South Australia**

The Code is implemented on the basis of separating pipelines into those that are ‘covered’ and those that are not.

Service providers of **covered pipelines** must comply with provisions in the Code. They must submit access arrangements to the relevant regulator for approval, and comply with other provisions (such as ring fencing).

In South Australia, the natural gas distribution network operated by Envestra is a covered pipeline. This network comprises the Adelaide, Barossa Valley, Berri, Peterborough, Port Pirie, Mount Gambier, Murray Bridge and Whyalla pipelines, as listed in Schedule A to the Code. Envestra fulfils the functions of the service provider under the Code with respect to these pipelines.

Owners or operators of pipelines that are not covered are not subject to any of the provisions in the Code; rather, they are subject to the general anticompetitive provisions of the *Trade Practices Act*. The pipeline might become covered at a later stage through one of the coverage avenues. Similarly, through a revocation process, a pipeline can move from being covered to uncovered.

## **2.3 Relevant regulator in South Australia**

Under the Gas Access Regime, a ‘local regulator’ is charged with the responsibility of administering the regulatory framework for natural gas distribution networks in each State. In general terms, the principal functions of the regulator under the Code are:

- ▲ the approval of an access arrangement under the Code;
- ▲ the approval of changes to an access arrangement;

- ▲ deciding whether to approve a contract, arrangement or understanding between a service provider and an associate of a service provider; and
- ▲ monitoring compliance with the Code.

SAIPAR commenced as the local regulator for South Australia under the Gas Access Regime in April 1998.

Following amendments made to the Pipelines Act, the Commission was appointed to succeed SAIPAR as the local regulator from 1 July 2003.

While the Commission's responsibilities generally accord with those previously assigned to SAIPAR, amendments made to the Pipelines Act now recognise the *Essential Services Commission Act 2002*. Most particularly, section 32 of the Pipelines Act states that section 6 ['Objectives'] and Part 5 ['Collection and Use of Information'] of the *Essential Services Commission Act 2002* do not apply when the Commission acts as regulator under the Code, as the Pipelines Act is self-contained in these respects.

## **2.4 Access arrangement**

The main regulatory instrument for third-party access to gas pipelines is an **access arrangement**. An access arrangement sets out the default terms and conditions on which access to a service provider's distribution system is provided to network users.

Under the Code, the service provider for a covered pipeline must submit an access arrangement to the relevant regulator for approval. An access arrangement is similar in many respects to an undertaking under Part IIIA of the *Trade Practices Act* and is designed to allow the owner or operator of the covered pipeline to develop its own tariffs and other terms and conditions under which access will be made available, subject to the requirements of the Code.

An access arrangement sets out the provisions under which access to a pipeline will be granted. Under the Code, access arrangements are generally approved for a period of five years – after which the service provider proposes revisions to the approved access arrangement for consideration and approval by the regulator.

The service provider and access seeker are free to negotiate terms of access that differ from an existing arrangement (except in relation to queuing policy). However, an arbitrator must apply the provisions of the access arrangement in resolving any dispute.

### **2.4.1 Minimum elements of an access arrangement**

Section 2.5 of the Code states that an access arrangement must contain at least the elements described in sections 3.1 to 3.20 of the Code, namely:

- ▲ a **Services Policy** (sections 3.1 and 3.2) including a description of one or more services that are likely to be sought by a significant part of the market, and any others which in the regulator's opinion should also be included. The

services policy should also allow, where reasonable and practical, prospective users to obtain, and be charged a separate tariff for, only the elements of a service that they want;

- ▲ a **Reference Tariff** for at least one service that is likely to be sought by a significant part of the market (a reference service) and for each other service that is likely to be sought by a significant part of the market and for which the regulator considers a reference tariff should be included (sections 3.3 to 3.4);
- ▲ a **Reference Tariff Policy** which describes the principles to be used to set reference tariffs (section 3.5) which must comply with the requirements in section 8 of the Code;
- ▲ the **Terms and Conditions** on which the service provider will supply each reference service (section 3.6);
- ▲ a **Capacity Management Policy** – a statement that the covered pipeline involves either contract or market carriage (sections 3.7 and 3.8);
- ▲ a **Trading Policy** which, in the case of contract carriage pipelines, describes the rights of a user to trade its right to a service to another person (sections 3.9 to 3.11);
- ▲ a **Queuing Policy** – a policy for determining the priority that a prospective user has to access spare and developable capacities, where such access may impede the ability to provide a service sought, or which may be sought, by another prospective user (sections 3.12 to 3.15);
- ▲ an **Extensions/Expansions Policy** – a policy which specifies the method for determining whether or not a pipeline extension or capacity expansion is to be treated as part of the covered pipeline for all purposes under the Code (section 3.16); and
- ▲ a **Revisions Submission Date** and a **Revisions Commencement Date** (sections 3.17 to 3.20), being the dates respectively when a service provider must submit revisions to its access arrangement and when the next revisions are intended to commence.

## 2.4.2 Access arrangement information

Sections 2.2 and 2.6 of the Code provide that certain **access arrangement information** must be submitted with an access arrangement and must contain such information as, in the opinion of the regulator, would enable network users and prospective network users to:

- ▲ understand the derivation of the elements in the access arrangement; and
- ▲ form an opinion as to the compliance of the access arrangement with the provisions of the Code.

Section 2.7 of the Code provides that the access arrangement information may include any relevant information, but must include at least the categories of information described in Attachment A to the Code. This Attachment requires six categories of supporting information to be included in an access arrangement:

- ▲ access and pricing principles;
- ▲ capital costs;
- ▲ operations and maintenance;
- ▲ overheads and marketing costs;
- ▲ system capacity and volume assumptions; and
- ▲ key performance indicators.

## **2.5 Regulatory approval of an access arrangement**

### **2.5.1 Approval criteria**

Section 2.24 of the Code states that the relevant regulator may approve a proposed access arrangement only if the regulator:

*“...is satisfied the proposed Access Arrangement contains the elements and satisfies the principles set out in sections 3.1 to 3.20. The Relevant Regulator must not refuse to approve a proposed Access Arrangement solely for the reason that the proposed Access Arrangement does not address a matter that sections 3.1 to 3.20 do not require an Access Arrangement to address. In assessing a proposed Access Arrangement, the Relevant Regulator must take the following into account:*

- (a) the Service Provider’s legitimate business interests and investment in the Covered Pipeline;*
- (b) firm and binding contractual obligations of the Service Provider or other persons (or both) already using the Covered Pipeline;*
- (c) the operational and technical requirements necessary for the safe and reliable operation of 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.”*

An example of the elements and principles to be considered by the regulator can be seen in section 3.4 of the Code. This section states that, unless a reference tariff has been determined through a competitive tender process (as outlined in sections 3.21 to 3.26 of the Code), any reference tariff included in an access arrangement must, in the regulator’s opinion, comply with the reference tariff principles set out in section 8 of the Code.

Overarching principles and factors to be observed in applying the reference tariff principles in section 8 of the Code are set out in sections 8.1 and 8.2.

Section 8.1 states that a reference tariff and reference tariff policy should be designed with a view to achieving the following objectives:

- ▲ providing the service provider with the opportunity to earn a stream of revenue that recovers the efficient costs of delivering the reference service over the expected life of the assets used in delivering the service;
- ▲ replicating the outcome of a competitive market;
- ▲ ensuring the safe and reliable operation of the pipeline;
- ▲ not distorting investment decisions in pipeline transportation systems or in upstream and downstream industries;
- ▲ efficiency in the level and structure of the reference tariff; and
- ▲ providing an incentive to the service provider to reduce costs and to develop the market for reference and other services.

Section 8.2 provides that the regulator must, in approving a reference tariff and reference tariff policy, be satisfied that:

- ▲ the revenue to be generated from the sales (or forecast sales) of all services over the access arrangement period (the total revenue) should be established consistently with the principles and according to one of the methodologies contained in section 8 of the Code (comprising section 8.1 through 8.49);
- ▲ to the extent that the covered pipeline is used to provide a number of services, that portion of total revenue that a reference tariff is designed to recover (which may be based upon forecasts) is calculated consistently with the principles contained in section 8 of the Code;
- ▲ a reference tariff (which may be based upon forecasts) is designed so that the portion of total revenue to be recovered from a reference service is recovered from the users of that reference service consistently with the principles contained in section 8 of the Code;
- ▲ incentive mechanisms are incorporated into the reference tariff policy wherever the regulator considers appropriate and such incentive mechanisms are consistent with the principles contained in section 8 of the Code; and
- ▲ any forecasts required in setting the reference tariff represent best estimates arrived at on a reasonable basis.

## **2.5.2 Approval processes**

As laid down in sections 2.9 to 2.27 of the Code, the process to approve an access arrangement includes public consultation, leading to draft and final decisions.

The relevant regulator must seek comments on the proposed access arrangement and then may either accept it or reject it and specify amendments that the regulator requires to be made to the access arrangement. If rejected, the access arrangement must be modified and resubmitted. Under certain circumstances, the regulator may draft and approve its own access arrangement. The legislation which implements the Code provides for administrative review of certain regulatory decisions made under the Code.

## **2.6 Review of an access arrangement**

Section 2.28 of the Code provides that, by the date provided for in the access arrangement as the 'revisions submission date', the service provider must submit to the relevant regulator proposed revisions to the access arrangement together with the applicable access arrangement information.

Section 2.29 of the Code provides that the access arrangement as revised by the proposed revisions may include any relevant matter but must include at least the elements described in sections 3.1 to 3.20 of the Code.

In section 9.1 of the approved Access Arrangement, Envestra has undertaken to submit proposed revisions to its Access Arrangement to the Commission on or before 1 October 2005. Moreover, section 9.2 of the approved Access Arrangement provides that the revisions to this Access Arrangement which are finally approved by the Commission will commence on the latter of 1 July 2006 and the date on which their approval takes effect under the Code.

As a final sanction, section 2.4 of the Code empowers the relevant regulator to draft and approve its own amended revisions to an access arrangement, instead of the revisions proposed by the service provider, if either:

- ▲ the service provider does not submit amended revisions to the access arrangement by certain dates specified by the regulator (under section 2.38(a)(ii) or (b)(ii)); or
- ▲ the regulator does not in the end approve amended revisions to the access arrangement proposed by the service provider (under section 2.41).



### 3 FIRST ACCESS ARRANGEMENT

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This chapter briefly outlines the processes involved with the approval and administration of the first Access Arrangement.

#### 3.1 Processes and timetable followed by SAIPAR

Envestra submitted its *proposed Access Arrangement* for the South Australian Natural Gas Distribution Network to SAIPAR on 22 February 1999. The proposed Access Arrangement described the terms and conditions under which Envestra was prepared to make access to its pipelines available to third parties.

SAIPAR assessed the proposed Access Arrangement against the principles in the Code, which included a public consultation process. A *Draft Decision* was issued on 13 April 2000, in which SAIPAR did not approve the Access Arrangement as submitted and listed the amendments required. SAIPAR requested further public comment on the Draft Decision and received submissions from Envestra as well as other interested parties.

After consulting with Envestra over implementation of the amendments required and assessing the comments made by other interested parties in relation to the Access Arrangement, SAIPAR released its *Final Decision* in response to Envestra's revised application on 21 December 2001. This Final Decision did not approve Envestra's revised Access Arrangement documentation, and listed amendments that would be required to the Access Arrangement (and the accompanying Access Arrangement Information) before SAIPAR could state that Envestra's Access Arrangement complied with the requirements of the Code.

After Envestra modified the Access Arrangement (and the accompanying Access Arrangement Information), SAIPAR published its *Final Approval* with respect to Envestra's Access Arrangement on 17 April 2003.

#### 3.2 Key elements of the approved Access Arrangement

The first Access Arrangement documentation comprises the main body of the Access Arrangement itself, as well as Annexure C (Tariff Schedule), Annexure E (Standard Terms & Conditions) and an accompanying Access Arrangement Information document.

As required, the first Access Arrangement includes:

- ▲ a services policy;
- ▲ reference tariffs, and a reference tariff policy;
- ▲ the terms and conditions of supply;
- ▲ a capacity management policy;
- ▲ a trading policy;



- ▲ a queuing policy;
- ▲ an extensions/expansions policy; and
- ▲ a revisions submission date and a revisions commencement date.

The first Access Arrangement is based on three categories of network services, namely:

- ▲ **haulage reference services** (involving the acceptance of gas into the network at a receipt point and delivering an equivalent quantity of gas to a delivery point in the network after allowance has been made for unaccounted for gas), which in turn distinguish between domestic, demand and commercial delivery points;
- ▲ **ancillary reference services**; and
- ▲ **negotiated services**.

Details of the approved nature of each of the elements of the Access Arrangement are provided in the published Access Arrangement and in Envestra's Access Arrangement Information document available for viewing on the gas page of the Commission's website.

### **3.3 Administration of the approved Access Arrangement**

#### **3.3.1 Annual approval of reference tariffs**

Under the first Access Arrangement, the regulator is required to approve annual adjustments to Envestra's reference tariffs. These changes in tariffs are to take effect from 1 July each year.

##### **2003-04**

On 6 June 2003, SAIPAR approved an increase in reference tariffs to apply during the year commencing 1 July 2003.

##### **2004-05**

On 10 May 2004, Envestra submitted to the Commission an application to adjust its reference tariffs in accordance with the reference tariff policy set out in the Access Arrangement.

On 25 June 2004, the Commission approved Envestra's proposed 2004-05 reference tariffs on the grounds that they had been calculated in accordance with the requirements of the reference tariff policy in the Access Arrangement. As a result, Envestra's reference tariffs to apply from 1 July 2004 increased (on average) relative to the current reference tariffs by 1.4% for domestic haulage reference services and 0.3% for commercial haulage reference services. The average increase in reference tariffs for demand haulage reference services was 2.2%.

### 3.3.2 Pass-through of increased 2003-04 gas licence fee

On 24 December 2003, Envestra submitted a notice to the Commission to change its reference tariffs in response to an increase in its 2003-04 licence fee applicable under Envestra's SA gas distribution licence. On 30 January 2004, the Commission formally advised Envestra that it was satisfied that the pass-through sought complied with the requirements of the Code. In particular, the increase in 2003-04 licence fees was a specified event under the reference tariff policy of Envestra's Access Arrangement, which constituted an approved reference tariff variation method under the Code.

### 3.3.3 FRC Determination

Section 3.3.6.6 of the approved Access Arrangement made provision for the adjustment of reference tariffs on account of full retail competition (FRC) costs in accordance with a 'Trigger Event Adjustment Approach' of the type provided for under section 8.3 of the Code.

In the event, the FRC trigger event adjustment mechanism in the Access Arrangement has not been utilised. Instead, the Commission has used powers it also gained on 1 July 2003 under the *Gas Act 1997* (Gas Act) to make a price determination for a gas entity operating a distribution system. The Act provides authority for the Commission to make a price determination under the *Essential Services Commission Act 2002* regulating the prices which Envestra can charge gas retailers for the services it provides to them in accordance with the retail market rules applying to gas entities under FRC.

The Commission used its powers under the Gas Act to establish the costs that would be prudently incurred by a gas distributor undertaking the responsibilities that Envestra has under the retail market rules, taking into consideration industry circumstances. In its deliberations on this issue, the Commission has applied the factors and principles as required by relevant legislation. This includes the objectives and factors set out in the Gas Act; the factors set out in the price determination provisions of the *Essential Services Commission Act 2002*; the general factors given to the Commission under section 6 of that Act; and matters to which the Minister for Energy has directed the Commission to have regard under the Gas Act.

The Commission has different (and in some respects wider) discretions about the processes to be followed in making a determination under the *Essential Services Commission Act 2000* than when deciding on an approval under the Code.

The Commission determined the total revenue that Envestra should recover in respect of its FRC services using the same approach to calculating required revenue as used in the first Access Arrangement, namely as the sum of:



- ▲ the prudent operating expenditure determined in this price determination; plus
- ▲ a return on the prudent capital expenditure determined in this price determination; plus
- ▲ depreciation on prudent capital base.

Following advice that the Government had entered into a deed with Envestra in which the Government committed to pay \$54.6 million in respect of Envestra's prudent FRC costs excluding telemetry, the Commission determined that such funding would be sufficient to offset all of Envestra's prudent FRC costs, excluding telemetry, until 1 July 2006 and would leave a residual amount thereafter to be dealt with under the revised Access Arrangement.

As a result, and excluding telemetry, the Commission set prices of zero in respect of these prudent FRC costs for the two years up until the commencement of Envestra's revised Access Arrangement on 1 July 2006. The Commission indicated it would ensure that the benefit of the ex-gratia payment that is not required in the first two years of FRC is allocated to consumers in future years in a manner that is consistent with any Ministerial notice or direction issued. The Commission will consider how this is best achieved in more detail as part of the process of revising Envestra's Access Arrangement.

The Government requires the costs of telemetry to be recovered from demand consumers with an annual consumption of 10TJ of gas or more per annum. The Commission has determined prices to apply in respect of the prudent telemetry costs incurred by Envestra. These prices apply only to demand customers in respect of the telemetry services provided by Envestra in accordance with the retail market rules. These tariffs are to be adjusted by no more than the annual change in the March quarter CPI on 1 July 2005.

Envestra's reference tariffs to apply from 1 July 2004, incorporating the annual tariff variation, the change in impost and the Commission's price determination, are set out in the 2004-05 *Tariff Schedule* (which can be viewed on the gas page of the Commission's website).

## 4 ROLE OF THE REGULATOR IN A REVIEW

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Against the background of the regulatory framework and the approved Access Arrangement (as described in the previous two chapters), the remaining chapters in this Paper identify particular issues that will confront the Commission and interested parties in approaching the forthcoming review of Envestra's Access Arrangement.

In particular, this chapter addresses the criteria to be applied by the Commission as regulator in approving any proposed revisions.

### 4.1 Code's requirements regarding approval criteria

Section 2.46 states the following criteria are to be used by the Commission as the relevant regulator:

*"The Relevant Regulator may approve proposed revisions to an Access Arrangement only if it is satisfied the Access Arrangement as revised would contain the elements and satisfy the principles set out in sections 3.1 to 3.20. The Relevant Regulator must not refuse to approve proposed revisions to the Access Arrangement solely for the reason that the Access Arrangement as revised would not address a matter that sections 3.1 to 3.20 do not require an Access Arrangement to address. In assessing proposed revisions to the Access Arrangement, the Relevant Regulator:*

- (a) *must take into account the factors described in section 2.24; and*
- (b) *must take into account the provisions of the Access Arrangement."*

### 4.2 Recent developments

Recent judicial reviews have sought to clarify the powers conferred on a regulator under the Code when approving access arrangements and revisions to access arrangements.

Envestra has characterised such clarification in the following terms:

*"The Code operates under a propose-accept/reject model, where the Service Provider proposes a method/approach/value and the Regulator assesses the proposal against the relevant provisions of the Code. The Regulator then either accepts the Service Provider's proposal if it is compliant with the Code, or rejects it if non-compliant. It is not within the Regulator's discretion to impose their own view upon a Service Provider [where alternative methods/approaches/values are each compliant with the Code]." (letter to the Commission, 2 July 2004)*

Parties are also likely to raise whether Productivity Commission recommendations regarding improvements to access regimes in general and the gas access regime in particular should be anticipated in the forthcoming Access Arrangement review.

In addition, certain changes in regulatory responsibilities have been mooted by the Ministerial Council on Energy's energy market reform program.

The following sections briefly outline these developments.

## 4.2.1 WA Supreme Court Epic decision

The Court's declarations in its Epic decision<sup>4</sup> included the following:

- ▲ the factors in sections 2.24(a) to (g) of the Code are relevant to, and are given weight as, fundamental elements in the regulator's assessment of a proposed access arrangement, including the issue of whether the regulator is satisfied that the proposed access arrangement contains the elements and satisfies the principles set out in sections 3.1 to 3.20; and
- ▲ the factors in sections 2.24(a) to (g) should guide the regulator in determining, if necessary, the manner in which the objectives in sections 8.1(a) to (f) can best be reconciled or which of them should prevail.

In addition, the judgment was notable for the observation that the objective of section 8.1(b) seems to necessitate the application of economic methods and theory, albeit to replicate the outcome of a *workably competitive* market, because the achievement of *perfect competition* is, in fact, not possible. In simple terms, 'workable competition' indicates a market in which no firm has a substantial degree of market power. Expert evidence and written material tendered in evidence suggested that a workably competitive market may well tolerate a degree of market power, even over a prolonged period. The underlying theory and expectation of economists, however, is that with workable competition, market forces will increase efficiency beyond what could be achieved in a non-competitive market, although not necessarily achieving theoretically ideal efficiency.

The Commission will be guided by these judicial views as to the nature of the various provisions in the Code relating to the Code's objectives.

## 4.2.2 Australian Competition Tribunal GasNet judgment

In its *GasNet* judgment,<sup>5</sup> the Tribunal found that the role of the regulator under the Code is strictly limited. In particular, the Tribunal held that:

- ▲ the role of the regulator under the Code is to determine whether, in its opinion, a proposed access arrangement complies with the reference tariff principles described in section 8 (sections 3.4 and 3.5);
- ▲ the reasoning of the WA Supreme Court in the Epic decision makes it clear that there is no single correct figure involved in determining the values of the parameters to be applied in developing an applicable reference tariff: that exercise involved issues of judgment and degree;

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<sup>4</sup> Re Dr Ken Michael AM; ex parte Epic Energy (WA) Nominees Pty Ltd & Anor [2002] WASCA 231.

<sup>5</sup> Application by GasNet Australia (Operations) Pty Ltd [2003] ACompT 6 (23 December 2003).

- ▲ different minds, acting reasonably, can be expected to make different choices within a range of possible choices while remaining consistent with the reference tariff principles described in section 8;
- ▲ where there are tensions between the principles described in section 8, the regulator has an overriding discretion to resolve those in a manner best reflecting the statutory objectives of the Code;
- ▲ importantly, however, where there are no conflicts or tensions, if a proposed access arrangement falls within a range of choice reasonably open and consistent with the reference tariff principles described in section 8, it is beyond the power of the regulator not to approve the proposed access arrangement simply because the regulator prefers a different access arrangement which it believes would better achieve the regulator's understanding of the statutory objectives of the law; and
- ▲ the key message is that the role of the regulator under the Code is to determine whether the proposed outcome falls within a range of reasonable outcomes bearing in mind the principles set out in the Code – the regulator is not to make a decision based on what it thinks is best.

The Commission will be guided by this judicial clarification of a regulator's role under the Code.

### **4.2.3 Changes to Part IIIA of the *Trade Practices Act***

In response to the Productivity Commission's final report on the Review of the National Access Regime, in February 2004 the Commonwealth Government announced that it would introduce into Federal Parliament the legislative changes that give effect to its final response. Following this, the Commonwealth Government indicated it would consult further with jurisdictions to take forward appropriate changes to Clause 6 of the Competition Principles Agreement 1995 (CPA), to which all State and Territory governments are participants.

In particular, the Commonwealth has agreed to include the following pricing principles in Part IIIA of the *Trade Practices Act*:

*"The Australian Competition and Consumer Commission (ACCC) must have regard to the following principles:*

- (a) *that regulated access prices should:*
  - (i) *be set so as to generate expected revenue for a regulated service or services that is at least sufficient to meet the efficient costs of providing access to the regulated service or services; and*
  - (ii) *include a return on investment commensurate with the regulatory and commercial risks involved.*
- (b) *that the access price structures should:*
  - (i) *allow multi-part pricing and price discrimination when it aids efficiency; and*

- (ii) *not allow a vertically integrated access provider to set terms and conditions that discriminate in favour of its downstream operations, except to the extent that the cost of providing access to other operators is higher.*
- (c) *that access pricing regimes should provide incentives to reduce costs or otherwise improve productivity.”*

To the extent appropriate, the Commission will be guided by the policy clarifications implied in these proposed changes to the CPA and the *Trade Practices Act*. However, until the Code is changed as a consequence (and whether and how this might occur is by no means certain), the Commission must apply the Code as it currently stands.

#### **4.2.4 Productivity Commission’s review of the Gas Access Regime**

In June 2003, the Productivity Commission (PC) was asked to review the Gas Access Regime with the primary aim of examining the extent to which the regime balances the interests of relevant parties, provides a framework that enables efficient investment in new pipelines and network infrastructure and facilitates the development of competition in the natural gas market. The PC was also asked to identify and investigate the appropriateness of including minimum price and non-price requirements in the Code.

The review was undertaken within the framework of the national access regime (Part IIIA of the *Trade Practices Act 1974*), clause 6 of the CPA and the National Energy Policy Framework agreed to by COAG in June 2001. The PC was also required to take into consideration the Commonwealth’s response to the PC’s review of the national access regime and outcomes arising from the COAG Energy Market Review (Parer report).

In its final report (made public by the Commonwealth Government on 10 August 2004), the PC came to the following conclusions:<sup>6</sup>

- ▲ the current Gas Access Regime, in effect, is a form of cost-based price regulation;
- ▲ while generating benefits, such price regulation involves significant costs, including a potential to distort investment;
- ▲ a less costly ‘monitoring’ form of price regulation should be added to the Gas Access Regime;
- ▲ cost-based price regulation should be invoked only when the net benefits would be markedly greater than those of the monitoring option; and
- ▲ other proposed improvements to the existing regime including:

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<sup>6</sup> Productivity Commission, *Review of the Gas Access Regime*, Report No. 31, Canberra, June 2004, p.xxii.

- sharpening the specification of the objectives by inserting an overarching objects clause with a focus on promoting efficiency and by removing inappropriate and conflicting objectives scattered throughout the regime;
- changing the test for coverage;
- replacing the current guidelines for approving reference tariffs with a clear set of pricing principles;
- including scope to use non-building block approaches to setting reference tariffs; and
- to reduce the potential 'chilling effect' of regulation on greenfield investments, including scope for binding rulings of 'no coverage' for fifteen years, on a case-by-case basis.

The Commonwealth Government has decided that the Ministerial Council on Energy (MCE), which comprises Commonwealth, State and Territory Ministers with responsibility for energy policy, should develop the response to the PC's recommendations.

The Commission will be mindful of concerns expressed about the regulation of gas *distribution* systems in the context of the PC's inquiry, particularly those contained in the PC's report. However, much of the PC's analysis related to matters of coverage (as opposed to implementation), and focused mainly on the regulation of transmission systems at that. In addition, the resultant changes that might be made to the Code by the MCE may depart from the PC's recommendations in some (as yet unknown) respects.

In the meantime, the Commission has no choice but to apply the Code as it currently stands. The Commission will aim, however, to learn from any past mistakes or concerns associated with implementation of the Code when considering approval of revisions proposed by Envestra to its Access Arrangement.

#### **4.2.5 Prospective role of an Australian Energy Regulator**

In June 2001, COAG agreed that:

- ▲ the MCE's tasks would include a review of electricity and gas market regulatory structures to facilitate efficient and competitive energy services with adequate investment and benefits for users; and
- ▲ a key objective of energy market reform is to streamline economic regulation across energy markets, lowering the cost and complexity of regulation facing investors, enhancing regulatory certainty and lowering barriers to competition.

In December 2003, the MCE recommended a reform package to COAG, and COAG has accepted the recommendations contained in that package. The reforms include the establishment of a single, national regulator to regulate the energy market, named the Australian Energy Regulator (AER). The AER's functions are to include responsibility for the regulation of energy distribution and retailing (other than retail

pricing), following development of an agreed national framework. At this stage, the AER is expected to assume responsibility for national regulation of distribution by end-2006.

While it is still early days (with the requisite national framework for electricity and gas distribution and retailing yet to be developed and agreed), the implementation details that are emerging imply that local regulators such as the Commission will retain responsibility for completing regulatory tasks commenced before 2006 and which are due to be completed before 2008. Hence, the establishment of the AER does not have a **direct** bearing on the Commission’s responsibilities for the first review of Envestra’s Access Arrangement.

However, the strong likelihood is that the second review of Envestra’s Access Arrangement (due for completion by around 2011) will be undertaken by the AER rather than the Commission. In this sense, establishment of the AER could have **indirect** implications for the Commission’s approach to the upcoming first review.

Most obviously, there is the eventual desire to see a greater degree of uniformity in the access arrangements applying in different jurisdictions. It is noteworthy that Envestra also owns:

- ▲ gas distribution systems in Queensland, Victoria, New South Wales (at Albury) and Alice Springs; and
- ▲ transmission pipelines from Angaston to Berri, from Berri to Mildura, and from the Palm Valley gas field in the Northern Territory to Alice Springs.

Most notably, Envestra’s distribution systems in Queensland and Victoria (including Albury) are subject to access arrangements that have been approved by the Queensland Competition Authority and the Essential Services Commission of Victoria, the respective local regulators.<sup>7</sup> There is clearly scope in this first review of Envestra’s South Australian Access Arrangement to incorporate the best of the arrangements approved in other States, with a view to progressing uniformity.

However, this opportunity will be influenced by the proposed revisions that Envestra brings forward, and it is only possible where such proposals are consistent with the Code as it currently stands. The Commission will be mindful, however, of generally accepted regulatory practice as it has evolved in other jurisdictions when considering approval of revisions proposed by Envestra to its South Australian Access Arrangement.

<sup>7</sup> The timelines associated with review and expiry of Envestra’s other access arrangements are as follows:

	SUBMISSION DATE	COMMENCEMENT DATE
Qld distribution system (QCA)	1 October 2005	1 July 2006
Albury distribution (ESCV)	30 March 2007	1 January 2008
Vic distribution system (ESCV)	30 March 2007	1 January 2008

## 5 MATTERS SUBJECT TO REVIEW

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Besides the criteria to be applied by the Commission as regulator in approving any proposed revisions, also confronting the Commission and interested parties in approaching the forthcoming review of Envestra's Access Arrangement is the scope of the Review itself.

Other things being equal, a revisions review may be expected to be less intense and controversial than the initial approval of an access arrangement. The regulatory value assigned to the existing assets – which has probably been the most contentious of all issues in the first round – is set and locked-in by the initial approval. Many of the other elements in an access arrangement – the terms and conditions, capacity trading policies, etc – may also be expected to remain relatively stable.

This chapter addresses the scope of the forthcoming Review.

### 5.1 Code's requirements regarding scope of revisions

#### 5.1.1 Role of fixed principles under the Code

In many respects, the Code leaves the scope of the review of an access arrangement to the service provider.

By implication, however, there are few limitations on the matters that a regulator can choose to revisit at the time of a review. This is apparent because of the provision made in the Code for 'fixed principles'.

Notably, section 8.47 of the Code provides that certain reference tariff principles are not to be subject to periodic review as follows:

*"The Reference Tariff Policy may provide that certain principles are fixed for a specified period and not subject to change when a Service Provider submits reviews to an Access Arrangement without the agreement of the Service Provider. A Fixed Principle is an element of the Reference Tariff Policy that can not be changed without the agreement of the Service Provider (Fixed Principle). The period during which the Fixed Principle may not be changed is the Fixed Period (Fixed Period)."*

Section 8.48 in part provides that:

*"... The Fixed Period may be for all or part of the duration of an Access Arrangement, but in determining a Fixed Period regard must be had to the interests of the Service Provider and the interests of Users and Prospective Users."*

By implication, all other aspects of an access arrangement are subject to change when a service provider submits revisions to that access arrangement.

### **5.1.2 SAIPAR's rejection of proposed fixed principles**

In its initial proposed Access Arrangement, Envestra put forward thirteen fixed principles.

In the end, SAIPAR's Final Decision required Envestra to delete all proposals for fixed principles except that relating to the pass-through of imposts. Some of the others were rejected by SAIPAR on the grounds that they reproduced certain sections of the Code or, in one instance, involved a 'market variable element'.

The remaining proposed fixed principles were all rejected on the basis that:

*"SAIPAR will not allow Fixed Principles that limit the discretion of the Regulator upon review of the Access Arrangement without good reason." (Draft Decision, p.147)*

SAIPAR cited the Queensland Competition Authority's final decision for Envestra's Queensland distribution network, which also required Envestra to delete references to its reference tariff policy as a fixed principle of its proposed Access Arrangement. The Queensland regulator noted the following:

*"It is the Authority's view, as outlined in the Draft Decision, that there may be benefits attributable to the use of fixed principles, namely increased market certainty. However, given the context of the access arrangement, that is, the first access arrangement for Queensland gas distribution networks, the Authority requires sufficient scope to modify aspects of the access regime as lessons are learned. The Authority therefore maintains its view that fixed principles should not be included." (quoted in Final Decision, p.203)*

### **5.1.3 Is the Commission bound by precedents set by SAIPAR?**

Unique to the forthcoming review of Envestra's Access Arrangement is the fact that the Commission will be reviewing arrangements approved by a predecessor regulator (SAIPAR).

The Commission's own legislative framework is different to that which faced SAIPAR, and with it comes different perspectives and approaches. Moreover, the Commission has accumulated a good deal of experience in regulating monopoly service providers in other industries.

These factors, and subsequent changes in circumstances as well as in generally accepted regulatory practice, mean that it is not appropriate for the Commission necessarily to feel bound by the stance taken by its predecessor.

## **5.2 Issues for review flagged in the first Access Arrangement**

The first Access Arrangement itself nominates a number of matters for review. Two are of particular note.

## 5.2.1 Incentive mechanism

The first Access Arrangement involves a ‘cross period incentive mechanism’ (section 3.3.7). This involves Envestra retaining 100% of the full value of any efficiency gains, including reductions in the costs of providing reference services and any revenue from reference services greater than forecast. While not formally designated as a fixed principle, the Access Arrangement states that it is for a period of two Access Arrangement Periods.

SAIPAR approved this mechanism in order:

*“...to give Envestra a degree of longer-term certainty for its operations and an incentive for the early introduction of changes to save costs.” (Final Decision, p.12)*

It also stated that:

*“The application of this Incentive Mechanism is subject to Envestra continuing to manage and operate the Network in accordance with accepted industry practice and any service standards prescribed by any relevant law or applicable regulatory instrument”. (Final Decision, p.191)*

Relevant to the forthcoming review is the provision in section 3.3.7(2) of the first Access Arrangement for an examination of the “estimates relevant to the efficiency gains for the previous period”. In particular:

*“...At the completion of the re-examination process, if it is discovered that:*

- (i) all or a component of the actual efficiency gains were the result of significant decreases in input prices that were reasonably foreseeable at the time that the estimates relevant to the efficiency gains were made, or*
- (ii) the actual efficiency gains achieved were based on excessive under-estimations of sales that were reasonably foreseeable at the time that the estimates relevant to the efficiency gains were made, then*

*the proposed estimates relating to efficiency gains for the following Access Arrangement Period may be adjusted accordingly by the Regulator (however the efficiency gains for the first Access Arrangement Period will still be retained by Envestra within the first Access Arrangement Period).”*

Finally, the Commission considers that the nature of the incentive mechanism going forward will need to be examined in light of generally accepted regulatory practice in the area as well as the Code’s own provisions regarding such mechanisms.

## 5.2.2 Capital base roll-forward during first period

In the Access Arrangement, the capital base is adjusted each year for:

- ▲ forecast new facilities investment;
- ▲ depreciation calculated on a straight-line basis;
- ▲ redundant capital; and
- ▲ inflation.

Relevant to the forthcoming review is the provision in section 3.3.3.2 of the first Access Arrangement that:

- ▲ when reviewed, the capital base will be adjusted to reflect the above factors; and
- ▲ at the commencement of the second Access Arrangement Period, the capital base will be adjusted to account for any difference between actual and forecast new facilities investment in accordance with section 8.22 of the Code.

Section 8.20 of the Code provides that reference tariffs may reflect the value of new facilities investment forecast to occur within an access arrangement period. In order to do so, this investment must reasonably be expected to pass the requirements of section 8.16(a) and (b) of the Code when it is forecast to occur.

Section 8.16 requires new facilities investment:

- ▲ not to exceed the amount that would be invested by a prudent service provider acting efficiently, in accordance with accepted good industry practice, and to achieve the lowest sustainable cost of delivering services; and
- ▲ to meet one of the following criteria:
  - the anticipated incremental revenue generated by the new facility exceeds the new facilities investment; or
  - the new facility has system-wide benefits that justify a higher reference tariff; or
  - the new facility is necessary to maintain the safety, integrity or contracted capacity of services.

In accordance with section 8.2(e) of the Code, forecasts of new facilities investment must also represent best estimates arrived at on a reasonable basis. A significant portion of the new facilities investment forecast during the first Access Arrangement Period involved the mains replacement program (MRP). SAIPAR accepted that the MRP met the economic test of the Code.

The Commission acknowledges that the initial capital base as determined by SAIPAR at the commencement of the first Access Arrangement Period is now locked in under the Code. Moreover, when it comes to rolling-forward the regulated capital base to the commencement of the second Access Arrangement Period, the Code obliges the Commission to add to the initial capital base that portion of investment in new facilities during the first Access Arrangement Period that was both (a) anticipated at the commencement of that period and (b) approved by SAIPAR. Consistent with regulatory reliance on forward looking (and efficient) costs – the amount added should be the (approved) forecast capital costs involved.

In addition:

- ▲ unless an appropriate mechanism is part of the reference tariff policy in the approved Access Arrangement (and which, additionally, is classified as a 'fixed principle' under section 8.47 of the Code), section 8.22 of the Code empowers the Commission to determine how the capital base should be adjusted at the commencement of the next Access Arrangement Period if the actual cost of investment in anticipated and approved new facilities during the current period turns out to differ from forecast costs; and
- ▲ unless approved as part of a trigger event adjustment mechanism, section 8.21 of the Code only binds the Commission to roll actual or forecast spending on unanticipated (and so not yet approved at the commencement of the Access Arrangement Period) new facilities into the capital base at the commencement of the next Access Arrangement Period if the relevant regulator has agreed, at its discretion and only after conducting a public consultation in accordance with section 2.28 of the Code, that such investment meets the prudence requirements of section 8.16(a) of the Code.

### **5.3 Issues foreshadowed by SAIPAR**

In its Final Decision and Final Approval documents, SAIPAR indicated it regarded those documents as providing a reference to resolve any uncertainty as to the interpretation of aspects of the Access Arrangement.<sup>8</sup>

In this regard, SAIPAR nominated a number of particular matters deserving review at the end of the first Access Arrangement in its Final Decision and Final Approval papers.

#### **5.3.1 WACC**

SAIPAR indicated that it wished to re-examine the WACC in the next Access Arrangement Period both in terms of its input variables and also with regard to developments in the generally accepted WACC methodology.<sup>9</sup>

The Commission also considers this necessary because, unlike other regulators, SAIPAR chose not to divulge its WACC input parameters on the grounds that the Code does not require such detail to be divulged in decision papers.<sup>10</sup> SAIPAR approved the use of a real pre-tax WACC of 7.60% for the first Access Arrangement.

Section 8.30 of the Code requires that the rate of return used in determining a reference tariff provides a return that is commensurate with market conditions for funds and the risk of delivering the reference service.

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<sup>8</sup> For example, see Final Approval, p. 6.

<sup>9</sup> Final Decision, p. 10.

<sup>10</sup> Final Decision, p. 84.

Section 8.31 provides that the rate of return may be based on a weighted average of the return applicable to each separate funding source (for example, debt and equity) and that the returns may be determined using a well-accepted financial model such as the Capital Asset Pricing Model (CAPM). This section also provides that, in general, the weighted average return on funds should be calculated by reference to a financing structure that reflects standard industry structures, but that other approaches may be adopted where the regulator is satisfied that to do so would be consistent with the objectives in section 8.1 of the Code.

### **5.3.2 Non-capital costs and sales of services**

SAIPAR also indicated that it wished to re-examine estimates of non-capital costs and sales of services (and other relevant estimates) when the Access Arrangement was reviewed, and to require appropriate adjustments to the estimates for the next Access Arrangement Period.<sup>11</sup>

SAIPAR was concerned to ensure that, for example, estimates of non-capital costs are not overstated, or sales of services understated, in order to achieve returns that exceed those that would have arisen from accurate estimates. In order to ensure that additional returns that result from estimates of non-capital costs or sales of services, or other relevant estimates that could reasonably have been foreseen to result in such higher returns, SAIPAR considered it important that estimates of non-capital costs and sales of services (and other relevant estimates) be re-examined when the first Access Arrangement was reviewed, and for appropriate adjustments to be made to the estimates for the second Access Arrangement Period.

Section 8.36 of the Code defines non-capital costs as being the operating, maintenance and other costs incurred in the delivery of a reference service.

Section 8.37 of the Code provides that reference tariffs may recover all non-capital costs (or forecast non-capital costs) except for those that would not be incurred by a prudent service provider, acting efficiently, in accordance with accepted and good industry practice, and to achieve the lowest sustainable cost of delivering reference services.

Pursuant to section 8.2(e) of the Code, any forecasts for non-capital costs must represent best estimates arrived at on a reasonable basis.

### **5.3.3 Efficiency factor**

In its Draft Decision, SAIPAR proposed that an additional 3% efficiency factor be targeted in the fourth and fifth years of the first Access Arrangement Period to recognise *synergy factors*. This was to be additional to the CPI-4% efficiency factor applying to all non-capital costs (excluding system use of gas, licence fees and

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<sup>11</sup> Final Decision, p. 12.

contaminated sites which are subject to specific amendments) in each year of the Access Arrangement. Envestra had indicated that this additional 3% efficiency would be achieved via acquisition of the Stratus Network in Victoria.

After reviewing the Draft Decision and relevant information, submissions, Code provisions and jurisdictional decisions, SAIPAR accepted that an assessment of the 'synergy factor' may be more suitably addressed in the next review period. In view of this, it dropped the requirement for an additional 3% in years 4 and 5 of the first Access Arrangement, deferring consideration of this whole issue until the forthcoming review when the competing arguments might be properly assessed.

## **5.4 Other possible issues**

There are other issues that the Commission recognises may need to be considered as part of the forthcoming Review.

### **5.4.1 Form of, and basis for, price/revenue paths**

Reference tariffs for each of the haulage services were set to follow a *price path* (as provided for in section 8.3 of the Code) as set out in section 3.3.6 of the first Access Arrangement.

The price path was developed in order to smooth revenue over the Access Arrangement Period. For this purpose, SAIPAR:

- ▲ used a forecast annual change in inflation (CPI) of 2.5%; and
- ▲ determined that the forecasts in load growth initially proposed by Envestra were inappropriate, with the 2001-02 forecast finally endorsed representing nearly a 4% (total volume) increase on Envestra's initial forecasts.

In particular, for the second and subsequent years of the first Access Arrangement Period, the relevant regulator is required to approve annual adjustments to Envestra's reference tariffs, effective from 1 July each year, based upon set price paths:

- ▲ for demand haulage, annually adjusting the average price per GJ by the percentage change in the CPI minus 0.5%;
- ▲ for commercial and domestic haulage, annually adjusting the tariffs by the percentage change in the CPI minus 0.3%; and
- ▲ for ancillary services, annually adjusting the tariff by the percentage change in the CPI.

The change in CPI is measured by the latest March quarter over the previous year's March quarter.

The Commission wishes to explore whether there is an appropriate degree of consistency between the price path and cost of service approaches and the associated incentive mechanism currently applying in the Access Arrangement.

The Code defines these various terms as follows:

**“Cost of Service Approach** means a Reference Tariff Variation Method whereby initial Reference Tariffs are set on the basis of the anticipated costs of providing the Reference Services and are adjusted continuously in light of actual outcomes (such as sales volumes and actual costs) to ensure that the Reference Tariffs recover the actual costs of providing the Reference Services.” (section 10.8)

**“Price Path Approach** means a Reference Tariff Variation Method whereby Reference Tariffs are determined in advance for the Access Arrangement Period to follow a path or paths over time forecast to deliver a revenue stream, with that price path or paths not being adjusted to account for subsequent events until the commencement of the next Access Arrangement Period.” (section 10.8)

**“[An Incentive Mechanism is] ... a mechanism ... that permits the Service Provider to retain all, or any share of, any returns to the Service Provider from the sale of the Reference Service:**

(a) during an Access Arrangement Period, that exceed the level of returns expected for that Access Arrangement Period; or

(b) during a period (commencing at the start of an Access Arrangement and including two or more Access Arrangement Periods) approved by the Relevant Regulator, that exceed the level of returns expected for that period,

particularly where the Relevant Regulator is of the view that the additional returns are attributable (at least in part), to the efforts of the Service Provider. Such additional returns may result, amongst other things, from lower Non Capital Costs or greater sales of Services than forecast.” (section 8.44)

Moreover, the Commission considers that the nature of the incentive mechanism going forward deserves to be examined in light of generally accepted regulatory practice in the area as well as the Code’s own provisions regarding such mechanisms.

## 5.4.2 Revenue/price structure issues

The revenue to be obtained from the provision of demand haulage services in the first Access Arrangement Period was determined on a region-by-region basis, using a stand-alone network in each region as the applicable asset base. The return to this segment of the market was determined by applying the WACC to the optimised replacement cost of these stand-alone assets.

The revenue to be generated from commercial and domestic haulage reference services was calculated as the difference between the revenue required from all haulage reference services and the revenue to be generated from demand haulage services. This amount was then allocated between the domestic and commercial haulage services based on the forecast number of delivery points (as a measure of capacity) and gas deliveries (as a measure of utilisation of the network) for each reference service.

The reference tariffs for demand haulage services were established on a '\$/GJ of MDQ' declining block basis. This approach supports the concept of efficient pricing signals by providing the incentive for network users to flatten load profiles, thereby promoting more cost-effective utilisation of the network. Reference tariffs for the demand haulage service were also designed to:

- ▲ achieve a smooth transition across the threshold between reference tariffs for provision of the demand and commercial haulage services respectively; and
- ▲ achieve simplicity in the tariff design, using the minimum number of rate blocks, while maintaining sufficient resolution to manage bypass risk.

Zonal pricing was then adopted (for demand haulage services only) within the Adelaide Region based on four zones, with price increments between zones determined on the basis of the average length of mains required to transport gas from the receipt points.

To minimise the 'price shock' to customers in the central and southern zones, SAIPAR required a transitional approach which will be completed by the end of the first Access Arrangement Period.

The tariff structure for the commercial and domestic haulage reference services comprises a quarterly charge and declining blocks based on the quantity of gas delivered. Taking into account the factors in section 8 of the Code, Envestra has established reference tariffs for commercial and domestic haulage services on a network-wide (i.e., **postage stamp**) basis.

The Commission is aware that concerns have subsequently been expressed in some quarters about aspects of the tariff structure, particularly in comparison with the structure implemented in Victoria.

Pricing structure issues therefore warrant further consideration in the Review.

### 5.4.3 Information disclosure

There seems to have been general disquiet among network users about the adequacy of information disclosure and reporting associated with the first Access Arrangement, including the acceptance by SAIPAR of Envestra's claims of confidentiality over most of the information submitted. The Commission will need to consider the degree of transparency of regulatory decisions warranted under the Code.

Furthermore, the extent of information disclosure by the service provider outside the review process also deserves consideration. The Commission is aware that, under the Code, the preferred time to deal with information requirements is at reviews of access arrangements. During the review process, the Commission intends to examine the extent to which annual reporting of certain information may also be consistent with the Code.

## **5.5 Possible major projects**

Against the above background, it is evident that there is a range of issues that may have to be addressed by the Commission as part of the review process. These include:

- ▲ the nature of reasonable forecasts (both of non-capital costs and sales of services);
- ▲ the prudence of new facilities investment, and the roll-forward of capital base;
- ▲ the scope and form of the incentive mechanism;
- ▲ the form of, and basis for, price/revenue paths;
- ▲ the appropriateness of current pricing structures; and
- ▲ appropriate information disclosure.

This is not intended to be either an exhaustive or a final list of issues. They represent issues which the Commission sees as worthy of consideration at this early stage. The list will be further developed at the next stage in the review process, which is the release of an Issues Paper in late 2004.

## 6 PROPOSED REVIEW PROCESS

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The Code envisages a formal review process initiated by submission of the service provider's proposed access arrangement revisions to the regulator.

However, section 2.1 of the Code also states that:

*"The Relevant Regulator may at any time prepare and release for public comment, discussion or issues papers and hold public consultations concerning any matter relevant to its functions under the Code."*

In the circumstances, the Commission sees a role for a preliminary consultation process on selected matters – as well as the commencement of key projects – **prior to** Envestra formally submitting its proposed Access Arrangement Revisions. Such a preliminary consultation process has already been foreshadowed with Envestra as a condition of the Commission's earlier agreement to defer the Revisions Submission Date from 1 January 2005 to 1 October 2005.

This chapter explains the Commission's reasoning and, in doing so, acknowledges limits that would be appropriate to the scope of any guidance paper published by the Commission prior to the Revisions Submission Date.

### 6.1 Code's requirements regarding the formal review process

Sections 2.31 to 2.44 of the Code clearly set out the requirements to be met by the formal review process, once the relevant regulator has received the service provider's proposed revisions.

In particular:

- ▲ on the Commission's receipt of Envestra's proposed Access Arrangement Revisions, the Commission must:
  - invite submissions in response to the proposed revisions to the Access Arrangement and consider those responses in its draft decision;
  - issue a draft decision that either proposes to approve the Access Arrangement Revisions or proposes not to approve Access Arrangement Revisions and states the amendments (or nature of amendments) that are required in order for the revisions to be approved;
  - invite submissions on its draft decision and consider those responses in its final decision;
  - release a final decision that either approves the Access Arrangement Revisions or does not approve the Access Arrangement Revisions and states the amendments (or nature of amendments) that are required in order for the revisions to be approved; and
  - if need be, release a further final decision that either approves the Access Arrangement Revisions or does not approve the Access Arrangement Revisions and approves instead an Access Arrangement developed by the Commission;

- ▲ under section 2.43, the Commission's (initial) final decision must be made within six months of having received Envestra's proposed Access Arrangement Revisions, as well as ensure that there is a period of at least:
  - 28 days between the publication of a notice of receipt of the proposed Access Arrangement Revisions and the last day for submissions specified in that notice;
  - 14 days between the publication of a draft decision and the last day for submissions on the draft decision specified by the Commission; and
  - 14 days between the publication of a final decision and the date specified by the Commission as the last day for Envestra to submit amended revisions to the Access Arrangement; and
- ▲ under section 2.44, the Commission may increase the period of six months specified in section 2.43 by periods of up to two months on one or more occasions, provided it publishes in a national newspaper notice of the decision to increase the period.

## **6.2 Scope for pre-revisions consultation**

### **6.2.1 Practice and precedent in other jurisdictions**

The Essential Services Commission of Victoria (ESCV) undertook a comprehensive revisions review prior to the service providers' submission of proposed revisions, as part of its review of the Victorian gas distribution access arrangements concluded in mid-2003. In particular, a preliminary consultation process preceded the formal consultation process. Notable in this case was the fact that the review was the first time the regulator had assessed these access arrangements under the Code. In Victoria's case, the first access arrangements were approved under the Victorian code that preceded the National code. The Victorian code contained provisions developed by government in pre-privatisation pricing orders.

By contrast, NSW's Independent Pricing and Regulatory Tribunal (IPART) chose not to undertake such a consultation process prior to receipt of proposed revisions when undertaking its current revisions review of AGL's gas networks in NSW. The revisions submission date in this instance was 31 December 2003 and the (revised) commencement date was 1 January 2005. In this case, the review was the second time the regulator had assessed the access arrangements under the Code.

In Victoria, the preliminary consultation process was designed to facilitate informed and focused debate on the issues likely to be significant in the formal stages of the access arrangement revisions process. In particular:

- ▲ the process was intended to assist the gas distributors develop proposed access arrangement revisions that reflect the principles and requirements of the Code and the preferences of gas customers; and
- ▲ such a process also sought to assist customers to be able to better assess the proposed access arrangement revisions from their perspective.

The Victorian gas distributors accepted that such a preliminary consultation process could resolve many of the key issues that were likely to be addressed in access arrangement revisions, so that the actual process of assessing and approving the revisions could occur in a more timely manner.

In the end, ESCV concluded its preliminary consultation process by publishing a 'position paper', which it described as outlining its position on:

*"... key issues that are likely to underpin the gas distributors' proposed Access Arrangements. It is intended to provide the gas distributors' and other interested parties with greater certainty about the [ESCV's] proposed approach and to guide the preparation of the gas distributors' proposed Access Arrangement Revisions." (September 2001, p.i)*

## 6.2.2 Proposed scope of preliminary consultation

The Victorian circumstances are closer to those confronting the Commission in the upcoming review of Envestra's Access Arrangement than the circumstances in NSW, in the sense that this is the first time the Commission will be assessing access arrangements under the Code.

Moreover, the Commission sees merit in recognising that there will be a clear benefit to all concerned if consideration of certain matters is progressed prior to Envestra's finalisation of its proposed Access Arrangement Revisions. While there are clearly some issues that can only be progressed once Envestra has made its proposed revisions known, among the issues that might benefit from being progressed beforehand are the Commission's views on:

- ▲ the nature of reasonable forecasts (both of non-capital costs and sales of services);
- ▲ the nature of the prudence test for new facilities investment, and the resultant approach to roll-forward of the capital base;
- ▲ the scope and form of incentive mechanism;
- ▲ the form of, and basis for, price paths; and
- ▲ criteria for assessing the appropriateness of current pricing structures.

The Commission envisages identifying these appropriate issues, and canvassing the available options, in an issues paper to be published at the commencement of the preliminary consultation process.

Following the Commission's consideration of submissions received from interested parties in response to an issues paper, the Commission envisages concluding the preliminary consultation by publishing – where appropriate – its views on selected matters in the form of a guidance paper.

In developing any guidance, the Commission will be mindful that – consistent with the Australian Competition Tribunal's *GasNet* decision – its focus will need to be on identifying the types of access arrangement revisions, if any, that the Commission

might assess to be non-compliant with the Code's requirements, and the reasons for such views.

The Commission acknowledges that there will be little purpose served by arguments as to which approaches – from among those likely to be compliant with the Code – might be most effective in achieving the objectives of the Code. Under the Code, Envestra is free to exercise its own discretion on such matters.

### 6.2.3 Proposed process for preliminary consultation

The Commission will conduct the preliminary consultation by applying the same standards of public consultation as are required during the formal review stage (i.e., after receipt of Envestra's proposed revisions to its Access Arrangement).

The Commission will commence the preliminary consultation process by releasing an **Issues Paper** before the end of 2004. This paper will:

- ▲ identify the main issues deserving consideration *in advance* of Envestra finalising its proposed revisions; and
- ▲ for each such issue, outline the range of alternatives available and the basis on which such alternatives could be assessed as being compliant or non-compliant with the Code.

While a list of possible issues has been canvassed in chapter 5, the Commission has yet to settle on the range of issues appropriate in this regard.

A two to three month period will be allowed for submissions to be made by interested parties on the issues canvassed in the Commission's Issues Paper and on any other matters that parties consider appropriate.

After submissions have been received, the Commission will develop and refine its views on particular matters where it considers this necessary and appropriate in light of both the views expressed in submissions received and following the Commission's own further analysis of the requirements of the Code. These preliminary views will be published in a **Discussion Paper** to be released for public comment no later than two months after the closing date for submissions on the Issues Paper.

A six to eight week period will then be allowed for submissions to be made by interested parties on the Commission's Discussion Paper.

After submissions have been received, the Commission will consider whether it needs to modify its preliminary views on certain matters given the arguments presented in submissions. The Commission will publish its finalised views in a **Guidance Paper** to be released two months before the Revisions Submission Date to be observed by Envestra.

Once Envestra submits its proposed revisions, the Commission will follow the processes and timelines prescribed by the Code (see section 6.1 above).

## 7 NEXT STEPS

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### 7.1 Proposed review timetable

Chapters 4, 5 and 6 of this paper have discussed the detailed issues that need to be addressed by the Commission in conducting the forthcoming Gas Access Arrangement Review, and the types of processes considered appropriate in the circumstances.

The timelines that the Commission proposes to follow are summarised in the table below.

<b>EVENT</b>	<b>DUE DATE</b>
release of the Commission's Information Paper	August 2004
release of the Commission's Issues Paper	December 2004
submissions on Issues Paper due	March 2005
release of the Commission's Discussion Paper	April 2005
submissions on Discussion Paper due	June 2005
release of the Commission's Guidance Paper	July 2005
<b>Revisions Submission Date</b>	<b>1 October 2005</b>
circulation of access arrangement revisions proposed by Envestra, with Commission covering note	early-October 2005
submissions on Envestra's proposed revisions due	December 2005
release of the Commission's Draft Decision	February 2006
submissions on Draft Decision due	March 2006
release of the Commission's Final Decision	April 2006
release of the Commission's Further Final Decision (Final Approval)	May 2006
<b>Revisions Commencement Date</b>	<b>1 July 2006</b>

The Commission will consult with stakeholders if substantial changes need to be made to this timetable.

### 7.2 Call for registration of interests

Stakeholders are invited to register their interest in participating in the Gas Access Arrangement Review.

Registrations of interest in the Review should be addressed to:



## **Gas Access Arrangement Review**

Essential Services Commission of South Australia

GPO Box 2605

Adelaide SA 5001

E-mail: [escosa@escosa.sa.gov.au](mailto:escosa@escosa.sa.gov.au)

Facsimile: (08) 8463 4449

As the purpose of this paper is to establish a clear framework – and guide – for the conduct of the review, interested parties are under no obligation to make submissions in response to this paper. However, where an interested party wishes to make its views about the next stages in the review process known to the Commission prior to the release of the Issues Paper planned for December 2004, the Commission will be happy to receive such views at any time.

## ATTACHMENT 1: LETTER FROM COMMISSION TO ENVESTRA RE DEFERRAL OF REVISIONS SUBMISSION DATE

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02 March 2004

Mr I. Little  
Managing Director  
Envestra Limited  
Level 10  
81 Flinders St  
Adelaide SA 5000

Level 8  
50 Pirie Street Adelaide  
South Australia 5000

GPO Box 2605 Adelaide  
South Australia 5001

Telephone (08) 8463 4444  
Facsimile (08) 8463 4449  
Freecall 1800 633 592

Dear Mr Little

[www.escosa.sa.gov.au](http://www.escosa.sa.gov.au)  
escosa@escosa.sa.gov.au

### **ENVESTRA ACCESS ARRANGEMENT REVIEW**

I refer to your letter dated 24 February 2004, in which you request the Commission's approval for a deferral of the Access Arrangement revisions submission date to 1 October 2005.

ESCOSA is prepared to approve your request pursuant to S.7.19 of Schedule 2 of the Gas Pipelines Access (South Australia) Act 1997, subject to three requirements.

First, ESCOSA intends to commence its consultation program on the Access Arrangement revisions prior to the submission date. Deferral of the submission date will only be accepted if Envestra commits that it will meet all relevant timeframes requested by ESCOSA for providing any necessary input into this consultation program.

Secondly, in the absence of any formal changes resulting from the Productivity Commission's review of the gas access regime, it will be assumed that the current regulatory arrangements will continue to apply, and work on the revisions will proceed on this basis.

Thirdly, if the submission is received on 1 October 2005 and a final decision is required by June 2006, there is not a lot of time for ESCOSA to request changes to the proposal and for Envestra to respond. I should indicate now that, if responses are delayed, ESCOSA will have little option than to push ahead and insert its own Access Arrangement. I therefore seek a commitment from you that the appropriate resources will be provided to allow responses within a tight timeframe.

If you are happy to accept these terms of approval, could you please confirm this to me in writing by COB Friday 12 March 2004?



If you have any questions in relation to this matter, please contact Rajat Sarawat of this Office on 8463 4322.

Yours sincerely

Lew Owens

CHAIRPERSON