

**2006 ESCoSA**

**GAS DISTRIBUTION PRICE REVIEW**

**OF**

**THE ENVESTRA REVENUE CAP**

**Observations In Relation to**

**ESCoSA's Discussion Paper, May 2005**

**by**

**The Electricity Consumers Coalition of South Australia**

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The content of this report and conclusions reached are the views of the Electricity Consumers Coalition of SA and its consultants.

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## **1. Introduction**

ECCSA welcomes the opportunity to provide comments to the ESCoSA on its Position Paper relating to the review of Envestra's access arrangements application. The Commission's regulatory approach must be consistent with the objective of the Code which 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 (our underlining); 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 (our underlining); and
- (e) provides for resolution of disputes".

ECCSA considers that the failure of SAIPAR to carry out a rigorous review in the previous regulatory period makes it essential that ESCoSA now undertakes a robust and rigorous review in order that users and potential users have access on conditions that are fair and reasonable.

The previous review was not transparent; lacked proper information disclosures; awarded excessive levels of regulated costs that were not sufficiently justified; and provided a rate of return substantially in excess of prevailing regulatory returns. The outcomes have been, inter alia, over-investments and gold-plating and disadvantaging of consumer interests. It is, therefore, essential that ESCoSA addresses these issues carefully in the current review.

## **2. Services Policy**

ECCSA considers that there is a need to clarify service standards. It should be remembered that the provision of the service by Envestra is considered a monopoly service and that users of the service should be permitted to identify the outcomes of the service, as these outcomes have a direct impact on the value users place on the service provision.

TXU's proposition that service standards (and the terms and conditions) must be sufficiently detailed and complete is consistent with Code provisions. They must enable a network user not only to determine the value of the reference service, but also to ensure enforceable agreements in the event of unacceptable service standards.

*ECCSA agrees with the Commission's preliminary view that a description of services that sufficiently identifies each service and distinguishes it from other services is necessary if the proposed Service Policy element of an Access Arrangement is to satisfy the requirements of the Code.*

*ECCSA is also of the view that Envestra should, prior to the submission of their application to ESCoSA for approval, be required to consult with network users to identify if there*

- are other reference services that should be included in the access arrangement*

- *is a requirement to provide a detailed breakdown of how the reference services have been developed.*

*ECCSA also considers that there is a need to unbundled reference services, consistent with Code provisions in relation to the requirement that users and potential users must be able to understand the derivation of tariffs in order to establish that they are fair, reasonable and efficient.*

*Moreover, ECCSA would support the Commission establishing a reliability-related incentive mechanism, especially with regard to unaccounted for gas and for service standards that fall below guaranteed service levels. ECCSA member companies have been dissatisfied with poor service standards over the past Access Arrangements period.*

### **3. Reference Tariffs: WACC**

ECCSA notes that Envestra has argued that "inadequate rates of return will provide sub-optimal investment outcomes". However, excessive returns can promote wasteful over-investment and cost padding. As well, excessive returns allow monopoly rents to be extracted and deter upstream and downstream investments. These are key reasons why ECCSA is stressing the importance of the WACC and of the various inputs to the CAPM.

While Envestra makes much of the regulatory risks that it faces, ECCSA would point out that regulatory risks can also work the other way and create a bias against consumers, thereby endangering upstream and downstream investments.

*ECCSA agrees with the Commission that it expects to take into account the possibility that setting a gas WACC on a basis significantly different to that underlying the electricity WACC may lead to inefficient investment decisions because of the likelihood of unwarranted differential returns.*

*ECCSA also agrees with the Commission's preliminary view in relation to the use of a single rate of return as outlined on page 19 of the Position Paper. It should be noted that if Envestra is permitted to select from a range of choices, it would be absurd to consider that Envestra would identify and use input values which would not lead to the highest return possible. For Envestra not to do so would imply that Envestra management was not meeting its implicit requirement to its shareholders to maximize returns (which is clearly not the case).*

### **4. Capex Prudence**

ECCSA has strong reservations with the Commission's preliminary view in relation to the use of the variance-against -trends approach (page 25). This approach may be reasonable, provided the previous access arrangements review had been undertaken with greater rigour and transparency. It was, unfortunately, less than acceptable on both counts. ECCSA considers that there was excessive capex cost padding allowed in the previous determination. To apply the variance-

against-trends approach is to not only accept previous cost padding, but also to escalate that cost padding into the future. This is unacceptable to consumers.

ECCSA considers that there is no option but to adopt the IPART approach of testing the prudency of past and future capex. Consumers will regard this review as less than adequate given the circumstances involving the previous review unless it is conducted in a rigorous way. The Code-Sections 8.15 to 8.19 set out how the capital base is to be increased by actual capital expenditure incurred by a prudent service provider acting efficiently. ECCSA also reminds the Commission of the current problems that the ESCV is grappling with in regard to the current electricity distribution review, where excessive revenues have been earned during the previous access arrangements period, arising from an excessive regulated capex determination; substantial underspend on actual capex; and tariff rebalancing. The ESCV electricity review is being undertaken using the variance-against-trends approach for new facilities investment, and this was considered appropriate when it was identified that there has been over 10 years of regulatory experience and oversight. The recent ESCV review of gas distribution was carried out following the IPART approach because it was considered that insufficient history of the gas distribution businesses had been gathered.

*ECCSA strongly disagrees with the Commission's variance-against-trends approach on new facilities investments and strongly supports using the IPART approach of a rigorous firm-specific assessment of forecast capex.*

*ECCSA also considers that all related party contractual arrangement between Envestra and OEAM must be assessed for on prudency and efficiency criteria, and bench-marked against prevailing acceptable industry practice.*

*ECCSA supports the continuation of the practice of using straight line depreciation, with asset lives reflecting the technical based life expectancy of the assets.*

## **5. Past Capex**

ECCSA strongly disagrees with the Commission's preliminary to accept past capex as prudent,

"on the basis of the various incentive arrangements that apply to Envestra's expenditure" (page 32).

The previous access arrangements determination was based on an inadequately rigorous and non-transparent review, with an excessively high rate of return, which would have incentivised inefficient investments and other costs padding. To blithely state that the Commission's proposed approach is consistent with other Jurisdictions (where access reviews were conducted with significantly more rigour and transparency, with the award of substantially lower WACC) is not sufficient and certainly not a sufficiently robust reason for not undertaking a diligent review. We again remind the Commission of section 8.16 of the Code in relation to the prudency and efficiency tests. ECCSA strongly believes that it is because

"of the various incentive arrangements that apply to Envestra's expenditure" (page 32)

In the previous review that requires all past capex to be subject to the prudence and efficiency tests! The very history of the past review, commencing in early 1999, and finally being completed in April 2003, implies that the past review was carried out under less than ideal circumstances. To assume that all of the capex invested in the period between 1999 and 2006 is considered prudent and efficient whilst there was such a drawn out review process would have to be considered "a brave decision" in the extreme.

ECCSA also requires, consistent with the Code, that all redundant assets be removed from the Capital Base. (In this regard ESCoSA should examine the assets where both Mitsubishi and Mobil Port Stanvac have ceased to be used, partly as a result of high input costs which the Envestra high tariffs for the Southern zone were a contributor to). IPART has recently made redundant assets adjustments, consistent with the Code and we cannot see how the Commission is not abrogating its obligations under the Code by not seeking to adjust Envestra's capital base to account for redundant capital.

The Commission's arguments regarding the presence of a stranding threat are unconvincing. Firstly, that a stranding threat is a construction and could involve a substantial subjective element. Section 8.9 of the Code specifically requires that redundant capital be removed. There is nothing subjective about the removal of redundant capital. If an asset's utilization has declined as a result of a decline (or likely decline) in sales volumes, then the value of the asset should decrease. We refer to the simple methodology applied by IPART in its recent AGLGN determination. Having established a decline in utilization of the asset, IPART then considered the principles in Section 8.1 of the Code and the factors in Section 2.24 of the Code in assessing the appropriateness of reducing the capital base.

Secondly, for the Commission to suggest that the previous price cap and carryover mechanisms already provide Envestra with an incentive to reduce cost is somewhat surprising. Given that the previous review has been universally condemned for failing to meet rigorous standards, making such an assumption is fraught with risk for consumers. However, the key issue is that users should not have to pay for assets that are not utilized; and Section 8 of the Code says as much.

In addition, Section 8.28 of the Code allows re-inclusion of redundant assets if they subsequently make a contribution to services, thereby implying that unutilized assets should be adjusted from the capital base. The Commission cannot and must not proceed with its preliminary view, given that it also has not provided any information or undertaken any assessment of the extent of redundant assets.

*ECCSA strongly disagrees with the Commission's preliminary views on the grounds that it is inconsistent with Code provisions, especially Section 8.*

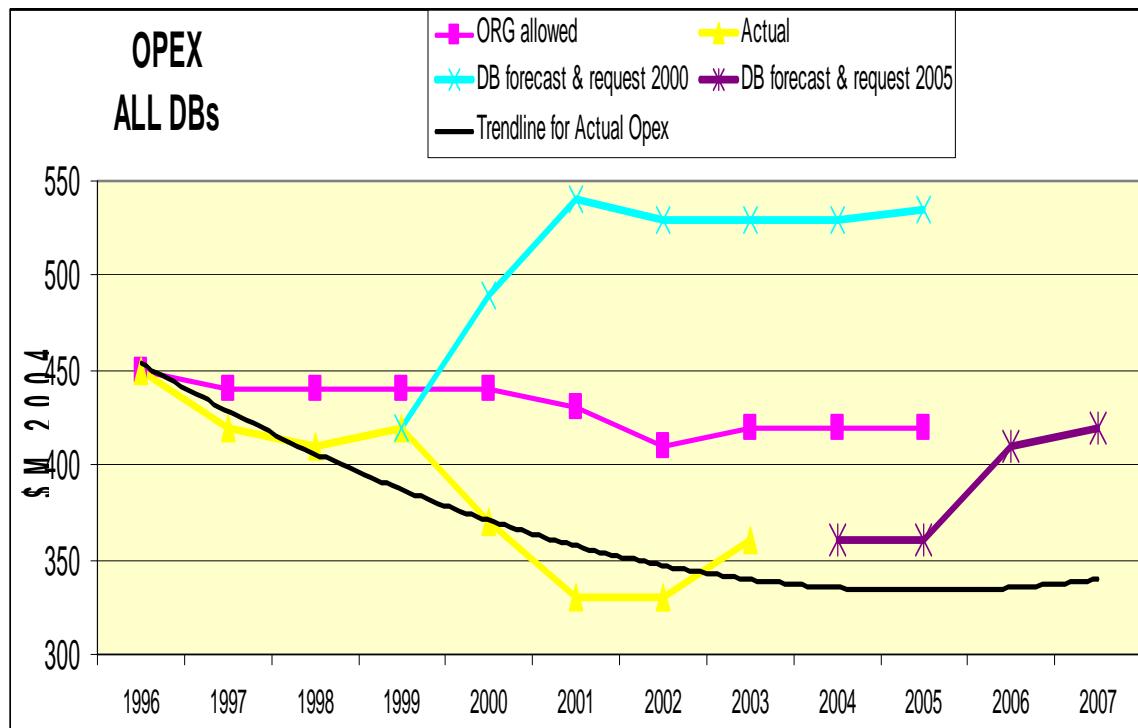
## 6. Non-Capital Costs

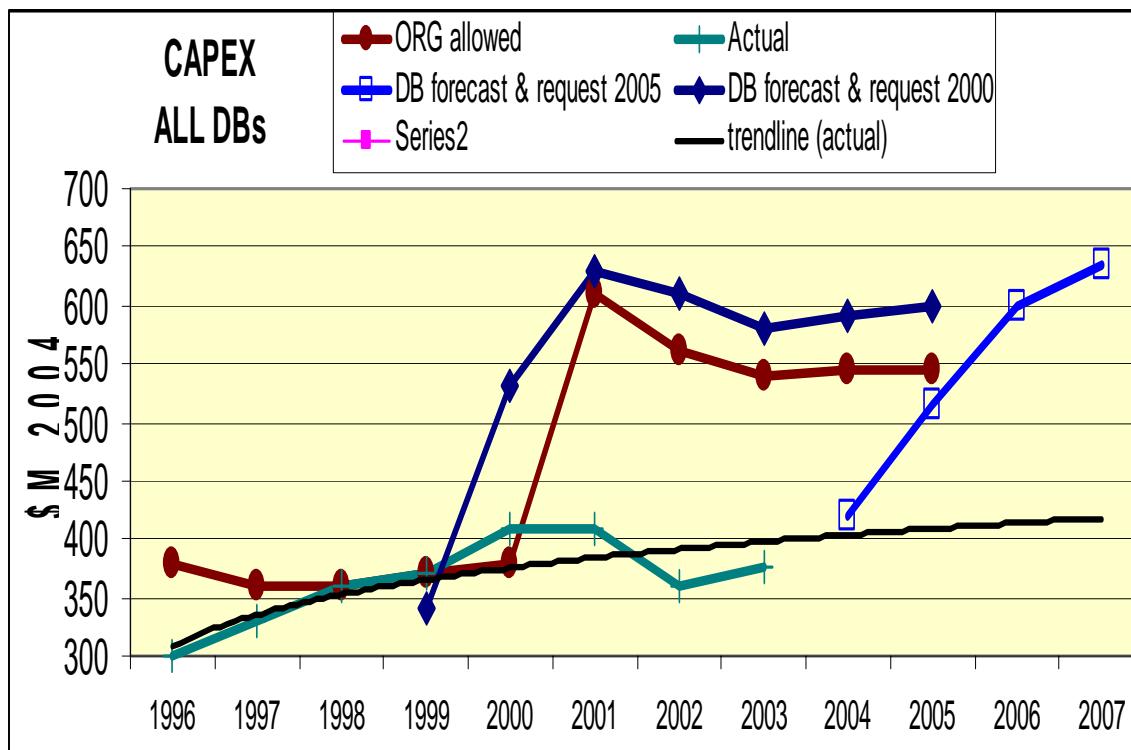
ECCSA is opposed to the Commission's proposal (excepting the two exceptions) to follow the same approach when assessing forecasts of non-capital costs as it is proposing to use when assessing new facilities investment. In the circumstances of a less than rigorous determination by SAIPAR, users are particularly concerned that such an approach will perpetuate cost padding into the future, to the detriment of users. It is not sufficient that the Commission points to the ESCV practice for its proposal, as at least the previous Victorian Regulator General had conducted the second gas review following a professional review of the previous access arrangement. It is the ESCV third review of electricity distribution assets where they have attempted to use the variance against trend approach. Discussions with the ESCV indicate that even with over ten years of actual costing, there are still challenges facing the use of this approach to setting future costs.

During the review of the electricity distribution pricing in Victoria, some very useful analysis was undertaken. This analysis compared capex and opex approved by the regulator over the whole time since commencement of regulation against capex and opex forecast by the DB, to the actual capex and opex incurred. This showed that forecasts were significantly and consistently overstated, and that actual capex and opex consistently under-run approved capex and opex.

*ECCSA would strongly recommend that ESCoSA carry out a similar analysis of the claimed, approved and actual capex and opex applying to Envestra to ensure that a fair and equitable analysis of the capex and opex claims is undertaken.*

These charts for the Victorian electricity distribution review are as follows.





ECCSA strongly considers that the Commission should undertake, via consultants, a firm specific assessment of capex and non-capex assessments. The reasons advanced by the Commission are insufficient to support such an approach at this time, and therefore is considered unacceptable.

ECCSA considers that the two exceptions (relating to marketing costs and costs incurred by purchasing services from a related party, OEAM) for 'zero-based budgeting' should be extended to all other capex and non-capex items. With regard to non-capital costs, especially marketing, it is considered that benchmarking against other network service providers should be made. These studies have been undertaken by IPART.

## 7. Reference Tariffs: Total Revenue

ECCSA agrees with Minister Colon and the Commission that recommendations of the Productivity Commission for legislative changes are not relevant to the assessment of Envestra's proposed access arrangements, and must be undertaken under the existing regime, i.e. the current Section 8.1 criteria in the Code.

ECCSA agrees that the Commission must carefully consider and balance the tensions and conflicts between the various Section 8.1 objectives and the range of feasible outcomes or arrangements between alternative pricing methodologies that might be consistent with the stated principles.

## 8. Reference Tariffs: Average Prices

Revenue which is derived from use of the regulated assets must be included in the allowable revenue. As consumers are paying a return on the full value of the assets for Envestra to be permitted to use of the assets for other purposes and to retain the revenue from this is akin to a landlord renting a property to a tenant, and re-renting elements to another party. A tenant is entitled to the full value of any income that the property generates. If the landlord seeks to use some of the property for separate use, then he is required to pay the tenant for such use.

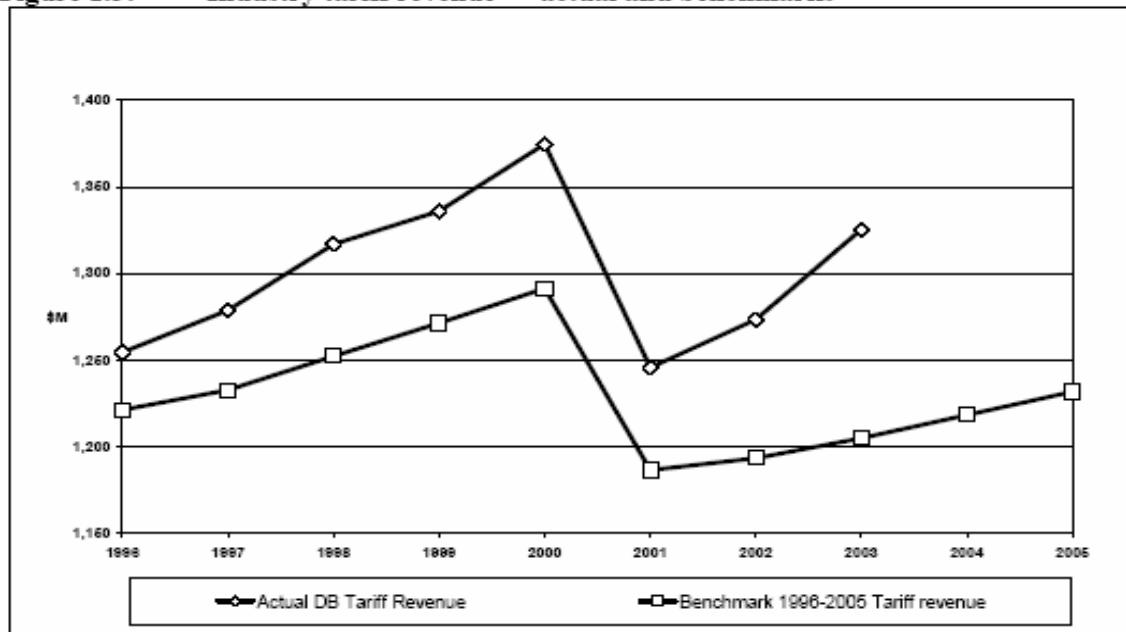
*ECCSA considers that any revenue (regardless of source) from use of the assets must be included in the total revenue permitted the regulated business.*

## 9. Demand Forecasts

There is no doubt that under a price cap arrangement, as required by the Gas Code, the forecasts of demand and volume are critical to ensure that tariffs set are appropriate, and do not permit either under-recovery of revenue or over-recovery. Reviewing past regulatory decisions shows that there is a tendency by the regulated business to overstate the increase in demand, as this justifies the increased demand for capex. Equally the is a tendency of the business to underestimate the expected volume as this inflates the tariff, permitting over-recovery of revenue as the tariff is overstated for the actual volumes transported.

During the review of the electricity distribution pricing in Victoria, some very useful analysis was undertaken. This actually identified the revenue expected from the last review (adjusted for volume variations for forecasts) and the actual revenue achieved. This analysis shows that by careful manipulation of tariffs and forecasts a regulated business can receive significantly more revenue than was anticipated at the time of the review. It is beholden on the regulator to ensure that such unearned income is prevented.

**Figure 1.5: Industry tariff revenue — actual and benchmarks**



ECCSA disagrees with the Commission's preliminary view on demand forecasts and urge it to adopt the process undertaken by IPART, which in effect, engaged independent consultants to undertake the relevant forecasts. Adopting the ECSV approach which allows the access seeker to prepare and adopt forecasts is an abrogation of the interests of users. The Commission is strongly recommended to examine ECSV's current dilemmas with respect to its current review of the electricity distributors:- substantial under-spend in capex and opex; and excessively optimistic demand projections. The result is a very substantial over-recovery in revenues.

## **10. Tariff Structure**

ECCSA agrees with the Commission regarding a tariff basket approach similar to that used in Victoria. However, the recent Victorian experience has shown the imperative that the approach needs to be transparent as to cost allocators and the efficiency of individual tariffs. These must be established by the Commission under requirements of Sections 8.38 to 8.42 of the Code. It must not be left solely to Envestra to comply with the Code requirements.

All users and potential users must be able to understand the derivation of their tariffs and satisfy themselves that the tariffs are fair, reasonable and efficient. Any tariff rebalancing must be transparent and the requisite approval obtained from the Commission.

Additionally ECCSA would point out that the tariff structure must recognize that it is to be cost reflective. Whilst there are bounds for the structuring of tariffs such that revenue from a tariff must not exceed the stand alone costs for the provision of the service, nor be lower than the marginal cost of the service, neither of these approaches recognizes the benefit of aggregation of usage provided by consumers. It is by aggregation of usage that users cross benefit each other in the

provision of the service and the cost benefit of the service. It is imperative that each consumer pays its fair share of the revenue.

For example if there as major user of gas which underpins the viability of an element of the network, it is unreasonable for that user to pay a stand alone cost for the service provision, where other users who would not otherwise have received service at all, pay only the marginal cost for the service. For a lack of cost reflectivity to apply in such a way, enables the service provider to manipulate tariffs to maximize revenue.

If Envestra is permitted to develop tariffs using the wide scope permitted under the Code to establish its tariffs without justifying the equity in the development used will permit manipulation of tariffs to the detriment of consumers.

*ECCSA recommends that ESCoSA requires Envestra to develop tariffs which are truly cost reflective, and not arbitrarily set at the bounds of cost reflectivity. Such an approach must recognize that cost reflective tariffs should reflect the value of shared usage, and share the benefits of aggregation to all consumers. If this is not done, there is potential for Envestra to set tariffs which will allow it to over recover the target revenue (adjusted by volume changes) anticipated by the regulatory review.*

*Additionally, if the tariffs are truly cost reflective in the way identified by ECCSA, then the basket of tariffs used as the basis for tariff variations during the regulatory period should not result in allowing Envestra to increase its revenue above the target (adjusted by volume) expected by the regulator. Any distortions permitted in the tariffs away from true cost reflectivity can have a major impact on Envestra's ability to unreasonably over recover revenue*

## **11. Price Path**

ECCSA supports Energy Australia's view on the use of a productivity-based method of setting the price path.

## **12. Efficiency Carryover**

ECCSA agrees with the principle of encouraging efficiency gains and sees the long term value in sharing rewards with Envestra. However such rewards have to be earned and not be the result of over indulgence of earlier regulatory decisions or from wind fall benefits which have not been the result of actions to increase efficiency by the regulated business. Equally such "efficiency gains" resulting from tariff manipulation should not be the cause of efficiency carryovers either.

Whilst there is a preparedness to share the benefits of true efficiency gains, it should be remembered that these will arise from within the provision of opex and capex granted to Envestra to manage the provision of the service. Therefore care must be taken to ensure that any benefit

sharing recognizes that consumers have made a financial contribution for the achievement of these goals

*ECCSA agrees with the Commission's preliminary views (page 87). We believe that SAIPAR was exceedingly generous and the Commission is appropriately exercising caution.*

## **13. Information Disclosure**

This is a very critical issue and is the only key area where users and potential users can satisfy themselves that tariffs are fair, reasonable and efficient. Information disclosures must be in accordance with the Code requirements and not amended to fit in with the Productivity Commission's view of the world. Related party transactions, in particular, must be benchmarked against best practice before costs are accepted. The previous access arrangement determination was grossly deficient in the area of information disclosure, transparency and rigour.

In this regard, ECCSA is considerably uneasy with much of the Commission's proposed approaches e.g. in the key areas of determining the acceptability of past and proposed capex and opex costs. A statistical approach, based on a hope that trends established under a hopelessly inadequate review by SAIPAR, is no substitute for detailed firm specific assessments by independent consultants. This is the greatest area of contention that consumers have with the Commission.

ECCSA would draw the Commission's attention to the very clear observations SAIPAR made with reference to this issue. Whilst ECCSA has been somewhat critical of the SAIPAR final decision on the last Envestra review, we do acknowledge that SAIPAR was not assisted in its tasks by Envestra's approach to providing information and the extent to which it disclosed the information quite rightly and reasonably needed by SAIPAR in executing its tasks.

Consumers were significantly disadvantaged in contributing to the review due to a lack of useful and accurate data which is needed for assessing the reasonableness of the review outcome.

## **14. Terms and Conditions**

ECCSA supports the Commission's proposal to convene a Terms and Conditions working group to consider Envestra's proposed terms and conditions once they are received. There is a need to clarify service standards and an incentive mechanism for ensuring maintenance or improvement of service performance delivery.

## **15. Capacity Management**

ECCSA has strong views on network capacity management, and the abilities of the monopoly service provider and the dominant gas retailer to cooperate and so control gas prices to

consumers. These views were clearly espoused in our response to the ESCoSA Issues Paper, and reiterated in the ESCoSA discussion Paper.

*ECCSA recommends that the Commission closely review the approach used by retailers (especially the dominant retailer which has affiliations with Envestra through ownership and operating contracts) to lock up capacity in key elements of the distribution networks and the preparedness of Envestra to work with the retailer to obviate true competitive pressures by which would benefit all consumers.*

## **16. Other matters**

*ECCSA supports some of the preliminary views of the Commission in relation to expansions and extensions. ECCSA considers such work should require some oversight to ensure that such is commercially viable and not become a cost burden to existing consumers. In this regard, ECCSA has noted that the Victorian Government has provided the necessary additional funds where an extension is in the interests of Victoria as a whole but has been identified to be non-viable when considered on a purely commercial basis. This approach is supported by ECCSA.*

*ECCSA agrees with the Commission that increased regulatory uncertainty (and therefore the potential for increased costs arising from such inherent risks) should preclude the regulatory period exceeding five years. From a consumer viewpoint the past period which effectively lasted seven years has prevented consumers from addressing the high cost of gas distribution for an additional 2 years.*

## **17. Conclusions**

ECCSA is concerned that the Commission is seeking to take a very light-handed approach to the review of Envestra's access arrangements application. Such an approach is completely inappropriate bearing in mind the circumstance of a less than rigorous review of Envestra's previous access arrangements by SAIPAR. The Commission, itself has acknowledged that in its Position Paper. It is therefore, a less than satisfactory approach to its duties under the Code, to even contemplate applying a statistical-trends approach in the determination of past and projected capex and opex, rather than a firm specific detailed assessment to satisfy the prudence and efficiency tests, required under the Code.

The Commission is also rather selective in its arguments for adopting the approaches practiced by other regulators. In some instances, regulatory practices, such as by IPART, are conveniently ignored, whilst the predilection for the ESCV practices means an apparent 'blind' adoption of those practices. The simple fact is that the earlier reviews conducted by the ORG in Victoria (which were at least of a more professional standard – in contrast to the SAIPAR review) would suggest the necessity to undertake a firm-specific detailed assessment in the current review.

Moreover, the Commission seems to have ignored – or is unaware of – the problems that have emerged with the ESCV's light-handed regulatory approach. These have clearly emerged in the current ESCV review of the Victorian electricity distribution businesses.

Overall, ECCSA considers that the Commission's light-handed regulatory approach will unfairly tip the balance against the interests of users and potential users. The result is that upstream and downstream interests will suffer for a benefit that will accrue to Envestra. We should remember that Envestra provides a monopoly service, and that the wealth of South Australia will not be enhanced by rewarding Envestra at the expense of the wealth creating upstream and downstream businesses in the State.

*June 2005*