

## Australian Pipeline Industry Association

### Submission to the AEMC on Draft Rule Determination

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12 September 2006

The Australian Pipeline Industry Association (APIA) welcomes the opportunity to make a submission to the AEMC on its Draft Rule Determination for the regulation of electricity transmission revenue. The Draft Rule represents another element in the emerging regulatory arrangements for energy transmission in Australia and, as such, is of considerable interest to APIA members.

#### **Differences between gas and electricity transmission**

While the Rule change proposal is not directly applicable to gas transmission, it could impact on gas transmission pipelines where policy makers seek to apply consistent policy arrangements at both a high level and at a lower level. APIA seeks an assurance that the decisions of the AEMC in regard to electricity transmission regulation will not be automatically extended to gas transmission.

APIA considers that there are significant differences between the economic drivers for electricity and gas transmission that are partly reflected in the current regulatory arrangements and which should be maintained. These differences include:

- *Physical differences* – gas has different physical characteristics to electricity. In particular, pipelines can also act as storage vessels for gas, allowing demand fluctuations to be met by stored supply. On the other hand, electricity flows must be instantaneously matched and electricity is not stored in the transmission infrastructure. In addition, gas transmission usually exists as a point-to-point pipeline, whereas electricity transmission exists as a multi-directional network. These differences explain why electricity dispatch requires a high degree of coordination through the transmission system, whereas gas does not;
- *Market operations* – the market role of the electricity grid differs from the market role of gas transmission pipelines. The electricity transmission grid operates as an integrated network, playing a key role in facilitating competition among generators (for example, through interconnectors), providing an additional source of competition (such as with localised electricity generation), and underpinning dispatch. By contrast, gas transmission pipelines tend to link individual production centres to market centres or specific industries, with varying degrees of interconnection;

- *Investment* – investment in gas pipelines tends to be market driven and underpinned by bilateral contracts. The great majority of gas pipelines are privately owned.<sup>1</sup> By contrast, electricity transmission investment tends to be centrally planned, developed incrementally at low risk, with large numbers of direct and indirect customers and recovered through averaged network charges. There is substantial government ownership of electricity transmission.

It is critical to ensure that decision-making bodies such as the AEMC account for these differences when developing regulatory arrangements for electricity and gas transmission. The goal of a common approach to energy market regulation should not be pursued where sound policy and practical reasons inevitably lead to differences.

For example, gas transmission pipelines have very few customers, typically these customers have relatively specific demands, and gas transmission pipelines have significantly more scope to tailor their service offerings to customer requirements. This means heavy-handed price-based regulation has the potential to impact far more negatively on the gas transmission sector than the electricity transmission sector. Intensive regulation of gas transmission is more likely to discourage innovation in gas transmission service offerings than in electricity, for example, where it imposes standardised return/risk arrangements to service offerings.

APIA would be extremely concerned if the AEMC were to apply an approach to gas transmission regulation that approximated the intensity and uniformity of regulation of electricity transmission.

### **Propose-respond**

In its earlier submission to the AEMC on its Rule Proposal<sup>2</sup> APIA argued in favour of the AEMC adopting a less intrusive and more effective approach to economic regulation than currently proposed. This less intrusive and more effective approach would help to reduce the costs associated with economic regulation while still ensuring that regulatory objectives are met. APIA remains strongly of the view that a genuine ‘propose-respond’ framework is a critical component of a light-handed and effective approach to regulation and is particularly suited to gas transmission.

In the context of this review, the AEMC has adopted the concept of a ‘propose-respond’ model in terms of process and procedural matters. That is, the AEMC has proposed to codify procedural matters in the Rules, such as the right of a regulated entity to make a proposal in accordance with the Rules, timeframes that apply to this proposal, publication of a draft determination and the opportunity for public

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<sup>1</sup> There is only one government owned major pipeline in Australia.

<sup>2</sup> AEMC, Review of the Electricity Transmission Revenue and Pricing Rules; Transmission Revenue: Rule Proposal Report, February 2006.

consultation. As this clarifies and establishes fundamental rights and obligations, APIA is supportive of this development.

However, the AEMC has adopted a 'propose-respond' approach for electricity transmission that is constrained when compared with the current Gas Code and even more so when compared with the recommendations of the Productivity Commission<sup>3</sup>. The AEMC has adopted its 'fit for purpose' rule. Under this approach, the extent of codification will be determined on a case-by-case basis through the rule-making process, including requirements for the decision making criteria. In applying its 'fit for purpose' rule the AEMC has substantially constrained the 'propose-respond' model by applying high levels of codification, prescription and pre-emption of regulatory decisions.

APIA supports a 'propose-respond' model that is not highly constrained by unnecessary prescription. This approach is consistent with the existing Gas Code, and in particular the Productivity Commission's recommended revisions, in terms of decision making criteria which would deliver better regulatory outcomes as it would provide the regulated business with a degree of flexibility in submitting a proposal reflecting its individual circumstances, while still meeting regulatory objectives by retaining the ability of the regulator to accept/reject a proposal as appropriate. This approach recognises that there is unlikely to be one 'best estimate' of a particular parameter value, but rather a range of reasonable values. It also requires a reasonable level of transparency in the process. By establishing rules that allow the regulator to impose its preferred estimates over the reasonable estimates of the service provider, there is increased risk – real or perceived – of regulatory error, with potentially significant disincentives for long-term investment in infrastructure assets.

APIA considers that a regulated business should be allowed to propose an approach, as part of its access arrangements, that is consistent with the Rules and which reflect its individual operating circumstances. The AER's role should be to review whether a proposal meets the requirements of the Rules. It should not be able to reject the proposal where it is consistent with the Rules or where the overall proposal taken in its entirety results in values that are within a reasonable range.

## **Prescriptiveness**

APIA was concerned that the earlier Rule Proposal was too prescriptive in its specification of elements of the regulatory regime, unduly constraining the 'propose' part of the propose-respond model.

In view of this, APIA welcomes the changes in the Draft Rule that remove some of this prescriptiveness. These changes include less detailed specification of timeframes

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<sup>3</sup> Productivity Commission. Review of the National Access Regime, Inquiry report No. 17, 28 September 2001

applying to stages of the regulatory process and changes to reduce the extent of codification of some elements of the building blocks, in particular, in relation to the operation of the incentive regime.

Nevertheless, APIA believes that the Draft Rule may still be too prescriptive in some areas. There are other aspects of the proposed regime that appear to unduly constrain the proposal that a service provider may submit to the regulator, such as mandating the form of regulation to apply and the term of access arrangements. APIA is concerned that formally locking too many elements of the regulatory regime into the Rules will result in a more prescriptive and less flexible regime than is appropriate and which may preclude economically sound and reasonable alternative approaches. Ministers have indicated that they would prefer a less intrusive regulatory process and this should be taken into consideration when designing the Rules.

The AEMC has proposed to lock in the WACC methodology and parameter values for TNSPs for a five year period. This proposal is made in the context of electricity transmission and, while recognising that there may be some merit in providing certainty on this issue for the electricity transmission industry, the differences in gas transmission should be recognised, particularly the potentially greater variation in the market circumstances of individual pipelines. APIA notes that the approach in the Gas Code has generally been workable to date.

While gas transmission is not the subject of the AEMC's present review, APIA is concerned that this prescriptiveness might be inappropriately extended to gas transmission regulation.

APIA supports the AEMC's decision to follow a 'reasonable estimate' decision criterion for capital and operating expenditure as this recognises the inherent uncertainty attached to forecasting these values. However, the guidance provided to the AER to make its determination on the reasonableness of the submitted estimates seems to be unnecessarily complex, with the AEMC proposing twelve criteria which must be taken into account by the regulator in assessing reasonableness. APIA submits that the guidance currently in the Gas Code would be an effective and simpler approach. This defines efficient capital expenditure with reference to the amount a prudent service provider, acting efficiently and in accordance with good industry practice would expend to achieve the lowest sustainable cost of providing services.

In summary, APIA believes that, in making its interpretation of what is 'fit for purpose', the AEMC should seek a more balanced approach between providing certainty and flexibility. APIA considers that a highly prescriptive approach would be inappropriate for pipelines. While this determination represents a move in the right direction in terms of removing some of the excessive prescriptiveness of the earlier Rule Proposal, APIA believes that the AEMC take this approach further.

## **AER Guidelines**

APIA notes that the determination provides for the AER to develop guidelines/schemes on a number of matters, namely:

- Submission guideline;
- Information guideline;
- Cost allocation guideline;
- Service performance target incentive scheme;
- Efficiency benefit sharing scheme;
- Post tax revenue model; and
- Roll-forward of the regulatory asset base model.

APIA believes that retaining separation of rule-making and rule-application functions is an important policy principle. This principle is at risk of being breached by the extent to which the AER is being given what are effectively 'rule making' powers through the development of guidelines. This is an area where APIA sees considerable risk that regulatory requirements will, over time, increase the regulatory burden on business.

## **Other issues**

APIA supports the AEMC's proposal to rely on the 'locked in' value of the regulated asset base (RAB) and to roll this value forward. However, it would be more appropriate for the Rules to express this as a principle rather than include specific values.

An initial review should establish the value of the RAB, and provided that this valuation is comprehensive and reasonable, the RAB should be rolled forward. This will reduce the cost and risk associated with regulation. For new capacity/pipelines, there should not be the need for a comprehensive valuation. Rather, consistent with the Gas Code in its current form for new pipelines, the regulator should be obliged to accept the actual costs as the RAB. There should also be no ability to include a redundant capital mechanism in any pricing regime. This approach provides certainty for a regulated business and assists in creating a regulatory environment that is supportive of investment.

APIA also endorses the AEMC's decision to remove the option of an *ex post* review by the AER of the prudence of capital expenditure before it is rolled into the asset base. Such reviews are unduly invasive and represent a considerable risk for the regulated business which cannot have any certainty that actual capital expenditure during the regulatory period will be recognised.