



**Submission to the Independent Pricing and  
Regulatory Tribunal**

**Revised Access Arrangement for AGL Gas  
Networks**

**Response to Draft Decision**

**25 February 2005**

**National Office**

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## Executive summary

The Energy Networks Association (ENA) welcomes the opportunity to comment on the *Draft Decision – Revised Access Arrangement for AGL Gas Networks* (Draft Decision) released by the NSW Independent Pricing and Regulatory Tribunal (IPART).

The ENA has a number of concerns with the Draft Decision. An overriding concern is that the decision does not appear to adequately reflect the policy context flowing from independent reviews of access regulation and specifically the findings of the Productivity Commission's *Review of the Gas Access Regime*. In particular, the Productivity Commission reviews of Part IIIA and the gas access regime have highlighted the importance of avoiding costly medium-term underinvestment in essential infrastructure through ensuring access prices provide adequate investment signals.

The Tribunal's initial conclusions on the Productivity Commission's proposal to amend Section 2.24 of the Code evidence an approach which does not appear to weigh both the long and short term interests of consumers, and the potential for tension between these interests. The ENA views it as critical that the Tribunal's final decision appropriately recognises the long term interests of the community in network investment and expansion, as well as the shorter-term interests of existing users in lower access charges.

The Tribunal has maintained its past approach of reaching a weighted average cost of capital (WACC) estimate by adopting feasible ranges for input parameters and the resultant WACC estimate. A further step the Tribunal should add to increase the robustness of this process is assuring itself using common statistical methodologies – such as probabilistic assessment – that its approved rate of return does not place AGL Gas Networks (AGLGN) at a significant risk of a WACC estimate which is materially below its true cost of capital. In ENA's view this analysis would be likely to result in a WACC estimate significantly higher than that contained in the Draft Decision.

A third area of concern with the Draft Decision is the requirement for AGLGN to implement a capital redundancy mechanism, without it being clear that IPART has had regard to the National Gas Code's requirements in relation to these mechanisms. Under the Gas Code, IPART has an obligation to consider the additional risk that the inclusion and activation of a capital redundancy clause may impose on a service provider. The Draft Decision does not appear to contain consideration of this matter. Due to the increased risk which a capital redundancy mechanism is likely to impose on AGLGN, the ENA would expect this factor to be explicitly considered in IPART's final decision on AGLGN's revised Access Arrangement.

## Background

This submission responds to the *Draft Decision – Revised Access Arrangement for AGL Gas Networks* released by the Independent Pricing and Regulatory Tribunal in December 2004.

The Energy Networks Association is the national representative body for gas and electricity distribution network businesses. The members of the ENA include:

- ActewAGL
- AGL Energy Networks
- AlintaGas Networks
- Aurora Energy
- Citipower
- Country Energy
- ENERGEX
- EnergyAustralia
- Envestra
- Ergon Energy
- ETSA Utilities
- Integral Energy
- Multinet Gas
- NT Power and Water Corporation
- Powercor
- SPI Networks
- United Energy Distribution
- Western Power

Energy network businesses deliver electricity and gas to over 12 million customer connections across Australia through approximately 800 000 kilometres of electricity lines and 75 000 kilometres of gas distribution pipelines.

These distribution networks are valued at more than \$33 billion, and each year energy network businesses undertake investment of more than \$5 billion in network operation, reinforcement, expansions and greenfields extensions.

## **Context for IPART Draft Determination**

The Draft Determination by IPART should fully consider the impacts on energy network regulation of wider economic and public policy contexts.

Three important elements which should inform IPART's final decision are:

- the Independent Panel *Report on Electricity Distribution and Service Delivery for the 21<sup>st</sup> Century* (Somerville Report)
- recent public inquiries by the Productivity Commission into operation of the national and gas access regimes
- an increasing focus in recent price reviews in other jurisdictions (e.g. South Australia and Queensland) on ensuring future energy network tariffs take into account refurbishment and expansion needs arising from ageing network infrastructure and expanding energy demand

A consistent theme of these reviews has been the need for cautious and balanced regulatory outcomes on access pricing issues which protect the medium-term interests of the community by ensuring the avoidance of costly underinvestment in essential infrastructure.

## **Interpretation of Section 2.24 Factors**

IPART indicates in the foreword to its Draft Decision that it is making its assessment of AGLGN's revised Access Arrangement against the back drop of potential changes to the gas access regime.

The Tribunal also offers its commentary on one recommendation of the Productivity Commission's final report in the *Review of the Gas Access Regime* which involves changes to Section 2.24 of the existing National Gas Code. IPART states that:

The Tribunal is concerned that the Productivity Commission's recommendation to remove several of the factors in section 2.24 of the Code fails to recognise what it considers to be the key role of an economic regulator – that is – balancing the conflicting interests of the various stakeholders. The Tribunal considers that the section 2.24 factors are critical to providing guidance for the exercise of regulatory discretion, and to ensure a practical outcome.<sup>1</sup>

IPART was one of the few energy regulatory bodies not to make a submission to the Productivity Commission review, however, the Commission did address the issue of appropriate guidance to regulators to ensure practical outcomes in its many other recommendations. In particular, the Commission recommended simplified and clarified objectives and pricing principles to guide future regulatory decisions.

The ENA has significant concerns that IPART has apparently not recognised one of the key findings of reviews of the national and gas access regimes – that access regulation should aim to recognise the medium-term interests of the community in infrastructure provision and reliability, as well as the shorter-term interests of the community in lower access charges.

In the foreword, and in later deliberations of IPART on Section 8.1 of the Code, there appears to be an inaccurate and simplified equation of lower access charges with user benefits, and higher access charges with service provider interests (and *a priori* contrary to the interests of consumers). Under monopoly regulation it should be recognised that higher access charges indicate either greater investment in the network relied upon by users, or positive signals for ongoing investment in the expansion and maintenance of the underlying assets. The ENA considers that a sophisticated approach to balancing the short-term and medium-term interests of existing and potential users is more appropriate for the assessment of AGLGN's Access Arrangement than a view that considers only where the interests of service providers and users may conflict.

## **Appropriate approaches to estimating costs of capital**

The cost of capital for an individual business cannot be observed. Under the existing regulatory framework provided by the National Gas Code, however, AGLGN has the responsibility for proposing a rate of return to apply to its regulated assets which is

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<sup>1</sup> IPART Draft Decision Revised Access Arrangement for AGL Gas Networks, December 2004, Foreword

commensurate with the prevailing conditions in the market for funds, and the risk involved in delivering the regulated services.<sup>2</sup>

In relation to cost of capital issues, IPART's role under the Code is confined to assessing whether the rate of return proposed by the service provider is consistent with s.8.30-8.31, which states that the cost of capital may be calculated using 'well-accepted financial models'.<sup>3</sup>

IPART has set out indicative cost of capital parameter ranges in its Draft Decision, presumably as a guide for AGLGN in preparing its final revised Access Arrangement. The ENA acknowledges that estimates of cost of capital parameters, and cost of capital estimates themselves, are either not directly measurable or subject to considerable statistical uncertainty. IPART's approach of using feasible ranges has advantages over the practice of most Australian regulatory authorities of solely relying upon point estimates in cost of capital determinations. Recognition that cost of capital estimates are imprecise, and that the view of different stakeholders can reasonably differ on WACC input parameters in particular, has been provided by the Australian Competition Tribunal in its recent consideration of the *GasNet* matter.<sup>4</sup>

The ENA considers that a further enhancement to IPART's practice of using parameter ranges is possible. This enhancement involves the use of standard statistical techniques for dealing with uncertainty, such as probabilistic analysis. The use of simple ranges may give inappropriate final estimates unless cost of capital estimates incorporate explicit assumptions about at least two points, viz:

- the likely distribution of errors around estimates of cost of capital and the input parameters used to derive them
- the degree of certainty a regulatory authority wishes to have that the final cost of capital estimate will not materially underestimate the true cost of capital for an efficient firm

To date, Australian regulatory authorities have not engaged in such standard probabilistic analyses of the likely impact of their decisions.<sup>5</sup> Implicitly, many regulatory authorities appear to be satisfied with setting cost of capital estimates at a level which results in an up to 50 per cent probability of a regulated entity failing to earn its true cost of capital. The ENA considers this approach deficient, and inconsistent with the obligations on economic regulators of key economic infrastructure. In ENA's view an appropriate approach to estimating cost of capital should include the following steps:

- recognition of the significant uncertainty surrounding key cost of capital inputs
- full consideration of the likely distribution of errors with reference to current financial theory and practice

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<sup>2</sup> National Gas Code, Section 8.30

<sup>3</sup> *Application of GasNet Australia (Operations) Pty Ltd* [42]

<sup>4</sup> *Application of GasNet Australia (Operations) Pty Ltd* [29]

<sup>5</sup> With the possible exception of the ACCC - which emphasised a possible role for probabilistic analyses in regulatory decision-making in its Draft Greenfields Guideline relating to proposed gas transmission pipeline developments.

- conducting a probabilistic assessment of a range of plausible WACC values
- the use of this information to determine a cost of capital value that has a low probability of being a material underestimate – noting the asymmetric impact of underinvestment on the community

IPART should consider the approach outlined above in its assessment of AGLGN's proposed cost of capital.

## **Capital redundancy mechanism**

The National Gas Code Section 8.27 requires that before approving a reference tariff that includes a capital redundancy mechanism a regulator must take into account the uncertainty such a mechanism would cause and the effect that uncertainty would have on the service provider, users and prospective users. The Code also requires that if such a mechanism exists then the determination of the rate of return and the economic life of assets should take into account the resulting risk and cost to the service provider.<sup>6</sup>

To ENA's knowledge, IPART is the only regulator that has exercised its discretion to introduce a capital redundancy clause into the Access Arrangement of a gas distribution network and to now propose to activate that clause in an Access Arrangement review.

The activation of the capital redundancy mechanism adds significantly to the risk involved in incurring prudent and efficient investment in gas distribution infrastructure. As required by the Code IPART cannot impose that additional risk without considering that additional risk in determining the Rate of Return and economic asset lives.

A matter of concern for ENA with the Draft Decision is that there is no apparent allowance for this additional risk in the section of the Draft Decision assessing AGLGN's proposed rate of return. ENA considers that under Section 8.27 IPART is bound to give this issue specific detailed consideration in its final determination – or risk failing to appropriately apply the National Gas Code.

The Energy Networks Association  
25 February 2005

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<sup>6</sup> National Gas Code, Section 8.27