Envestra

Investing in energy infrastructure

Submission to the National Gas Amendment (Optimisation of Regulatory Asset Base and Use of Fully Depreciated Assets) Rule 2011

GRC0013

January 2012

Introduction

Envestra is pleased to have the opportunity to comment on the AEMC Consultation Paper on the National Gas Amendment (Optimisation of Regulatory Asset Base and Use of Fully Depreciated Assets) Rule 2011 released on 1 December 2011 (GRC0013).

About Envestra

Envestra is the largest listed specialist natural gas distribution company in Australia, owning over 22,000 kilometres of networks in Victoria, South Australia, Queensland, New South Wales and the Northern Territory. The Company delivers around 120 Petajoules of natural gas to over 1.1 million consumers across its networks. Envestra listed on the ASX in 1997 and has extensive experience as a regulated business operating under both the National Third Party Access Code for Natural Gas Pipelines Systems (1998 to 2008) and more recently the National Gas Rules. Since 1998, the Company has submitted ten Access Arrangements to either the Australian Energy Regulator (AER) or other jurisdictional regulators, including the Essential Services Commission of Victoria, the Essential Services Commission of South Australia, the Queensland Competition Authority, IPART and the ACCC.

This experience has provided Envestra with a very detailed understanding of both the theory and administration of network regulation for natural gas distribution businesses.

The Major Energy Users (MEU) Rule Change

The MEU's proposed changes to the National Gas Rules (NGR) are summarised in Section 3 of the AEMC Issues Paper (p. 5). The MEU summarise the rule change as follows:

1. the regulator should review the valuation of assets at the time of a review to ensure that the value of assets used in the building block approach reflects the minimum value necessary to ensure the provision of the services required: and
2. when approving a replacement for an asset that has been fully depreciated, the regulator must ensure that the asset to be replaced has passed its useful life and cannot be used productively for further service.

The MEU proposal would require the AER to consider a re-optimisation of the Regulatory Asset Base (RAB) at each review, with a potential amendment to the asset base reflecting the AER's assessment of the depreciated replacement value of the assets required to provide regulated services.

Overall Comment

Envestra opposes the Rule change proposed by the MEU. The MEU has not provided any evidence in its proposal that investment decision making by natural gas distribution businesses has been inefficient, or that the RAB has been inflated. To the contrary, evidence on actual capex relative to regulator approved benchmarks demonstrates that private sector companies actively ration capital investment and invest according to long term asset management plans to ensure that expenditure is necessary, prudent and efficient, in accordance with commercial incentives.

Implementation of the proposed rule change will increase the costs of regulation by requiring the AER to adopt a more forensic and time intensive approach to assessing regulatory proposals. It will also increase risk to distribution businesses, as the AER would be able to modify the RAB, with a consequent risk of stranded assets.

Increased risk may lead businesses to under-invest to minimise the risk of having assets stranded. Including this additional risk in the building block model would also require rates of return approved by the AER to increase above current levels. The increased costs of regulation and the addition to network prices (to accommodate the additional risk) would be detrimental to consumers.

For these reasons, the proposed rule change would be contrary to the national gas objective in the National Gas Law, namely to:

> "*promote efficient investment in, and efficient operation and use of, natural gas services for the long term interests of consumers of natural gas with respect to price, quality, safety, reliability and security of supply of natural gas."*

The MEU justify the change as being necessary to ensure regulation is applied to minimise over-investment, inefficient investment and early replacement of assets. However, the NGR already contain mechanisms to deal with these issues eg:

- distribution businesses are required to demonstrate to the regulator at the time of each review that capital expenditure in the preceding regulatory period meets the requirements to be classified as conforming capital expenditure (Rules 77(2) and 79);
- the regulator can require that the Access Arrangement include a capital redundancy policy such that assets that cease to contribute in any way to the delivery of pipeline services are removed from the RAB (Rule 85); and
- Rule 84 also provides for a speculative expenditure account to be established such that underutilised assets (non-conforming capital expenditure) can be removed from the RAB and added back in future Access Arrangement Reviews when capital expenditure that was non-conforming becomes compliant with the requirements of Rule 79.

What would be the impact of the Rule Change on Investment?

The Rule Change is likely to reduce investment as there will be an increased risk that the AER will disallow capital expenditure incurred in the previous regulatory period, thereby stranding assets.

While the stated objective of the Rule Change is to reduce the incentive to replace fully or partially depreciation assets, there is no evidence indicating that fully or partially depreciated assets are being replaced early. To the contrary, most private sector companies, through capital rationing and asset management plans, aim to defer investment as long as possible, and are more likely to underspend approved capital allowances[1]. The AER noted in its Draft Decision for the Victorian electricity distribution businesses that a major feature of an incentive based regulatory framework is that the regulated firm should achieve efficiency gains whereby actual expenditure is lower than the forecast (p. 292). There is no evidence that privately owned regulated natural gas distribution businesses are over-investing.

Is it appropriate for the AER to determined and assess the age and condition of assets?

Detailed assessment of the condition of assets will increase the costs of regulation, requiring the regulator to get more involved in capital expenditure decision making, an area where they have argued previously that they are not well qualified to opine. The AER has stated previously that:

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1 See for example AER (2011), Final Decision for Envestra Ltd Access Arrangement proposal for the SA gas network, p.16.

> "*The line by line assessment is resource intensive and includes consideration of engineering detail which may preclude the involvement of third party stakeholders such as consumer groups*" [2]

It is therefore not clear how the AER could administer the rule change.

Rather than pursuing a more forensic approach to regulation, it would be preferable to set up a regime that provides incentives for natural gas distribution businesses to make optimal investment decisions. This approach would achieve the outcome the MEU are seeking while minimising the costs of regulation. This issue is addressed in more detail in the ENA submission to the AEMC Review of Economic Regulation of Network Service Providers[3].

Does the increase in administrative burden outweigh the benefit of the proposed rule change?

As noted above, the proposed rule change would be costly to implement requiring detailed assessment of the RAB of each natural gas distribution company. The MEU has not provided any guidance on how the AER could administer the rule. However, we would expect that implementation of this change would be more difficult for the AER as it would require the regulator to assess both forecast capital expenditure as it is currently required to do, and capital expenditure from previous regulatory periods, which due to the long life nature of assets in the RAB, would require significant additional effort. It is most likely that natural gas distribution businesses would be required to keep more detailed information on capital expenditure to provide the information required by the regulator. The additional administrative burden would further increase regulatory costs. In effect, the AER would be required to employ a team of asset management specialists, effectively on a full time basis given the number of reviews, to fulfil the role. Duplication of such resources and expertise between industry and the regulator will result in efficiency and increased risk of "management by regulators".

Does rule 85(1) adequately address the proposed rules objective to remove under-utilised assets from the RAB?

The AER can require a capital redundancy clause which would address the matters raised by the MEU. This clause has not been widely used due to the rarity of assets in an interconnected network becoming redundant. The problems with determining redundancy demonstrates that it would be very difficult for the regulator to be able to administer the rule change prosed by the MEU.

Does the proposed rule provide appropriate signals for efficient utilisation of assets? If not, is there a better alternative approach?

The proposed rule change does not provide an appropriate signal for efficient utilisation of assets as it is too difficult and expensive to implement, with no guarantee that it will deliver a better outcome. A preferred approach would be to develop a regime that provides natural gas distributors with incentives to optimise capital expenditure. This would be much less costly to administer and places decision making responsibility with the business which is best placed to make capital decisions.

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[2] AER 2011, "Economic regulation of transmission and distribution network service providers", Proposed Rule Change to the AEMC, September

[3] ENA 2011, "Response to Economic regulation of transmission and distribution network service providers", Report submitted to the AEMC, December, p 33.

Does the rule change ensure that fully or partially depreciated assets that are still in use and useful are not replaced? If not, is there a better alternative?

A decision on when an asset is replaced is based on the cost effectiveness with which that asset is providing economic services. The rate of depreciation is an accounting concept which seeks to amortise the cost of the asset across its useful life. There is no guarantee that the theoretical life of the asset will be the same as the actual life. Thus whether an asset is partially depreciated is not relevant to deciding when an asset will be replaced. A preferred approach to the rule change would be to develop a regime that provides natural gas distributors with incentives to optimise capital expenditure.

Should the optimisation of the RAB be considered as an alternative to the "40/60 sharing factor" proposed by the AER?

The "40/60 sharing factor" does not provide a sound basis for optimising the RAB. As noted by the ENA, it would be preferable to develop a capital incentive scheme in accordance with consultation processes in the NGR to achieve efficient capital expenditure[4].

When should the proposed rule commence?

The proposed rule should not be approved.

[4] ibid., p.33.