

20 October 2014

**QGDN Application
National Competition Council
GPO Box 250
Melbourne VIC 3001**



By email: gas@ncc.gov.au

Re: Draft decision and Statement of Reasons - Light regulation of Envestra's Queensland Gas Distribution Network

Envestra Limited (Envestra) applied to the National Competition Council (NCC) for the light regulation of its covered Queensland Gas Distribution Network (QGDN) which distributes gas in the Brisbane Region (Brisbane CBD, Ipswich and suburbs north of the Brisbane River) and Northern Region (Rockhampton and Gladstone). The NCC Draft decision was released on the 29 September 2014 and concluded that light regulation is appropriate.

AGL Energy Ltd (AGL) would like to take this opportunity to respond to this Draft decision and make comment on the NCC's Statement of Reasons.

AGL is a significant retailer and generator of energy with around 3.8 million electricity and gas customers and over 10,000 MW of generation located in Queensland, New South Wales, South Australia and Victoria. This includes being a significant gas retailer utilising the QGDN.

AGL has been a strong advocate for the deregulation of energy markets and agrees with the NCC that the Envestra application has some theoretical merit when judging against the criteria of the National Gas Law (NGL) and National Gas Rules (NGR). Furthermore, if the economic assumptions and incentives identified in the NCC's Statement of Reasons are realised, then light regulation may well be as effective as full regulation, as well as less costly.

However, AGL doubts these theoretical constructs.

AGL believes the NCC analysis has been limited by ignoring the economic situation of the QGDN. Such analysis is informative with regard to the previous and current behaviour of gas users, end-users and the network provider and tends to suggest that the NCC findings:

- overstate the countervailing or bargaining power of users and end-users with a monopolistic distribution network;
- overestimate the influence that possible substitution of gas by other fuels has;
- underestimate the likelihood of disputes and therefore the cost of arbitration under light regulation; and as a result,
- do not provide sufficient weight to the long-term interest of consumers as specified in the National Gas Objective (NGO).

These concerns are described in further detail in the attached comments.



AGL would hope that light regulation of a distribution gas network can be effective but is not as confident as the NCC of this outcome.

Instead, AGL is concerned that light regulation will be more costly, not as effective as full regulation and as a result, not in the long-term interest of Queensland gas consumers.

If you have any queries, please contact me on (03) 8633 6207 or Patrick Whish-Wilson on (07) 3403 2426.

Yours sincerely

A solid black rectangular box used to redact the signature of Elizabeth Molyneux.

Elizabeth Molyneux
Head of Structured Pricing

AGL Comments: NCC Draft Decision and Statement of Reasons

1. Background - QDGN Economic Situation

When assessing the Envestra application for light regulation against the NGL criteria, AGL expected the NCC to analyse (or procure AER analysis) of the QDGN in order to better inform its decision.

In order to highlight some of the concerns it has with the Draft decision, AGL has looked at actual financial data for the QDGN from a recent Independent Expert's Report¹ on Envestra. The following tables summarise the results.

Table 1: Envestra Financial Performance, Queensland v Rest (\$million)

	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14p
Queensland						
Ending RAB	278	292	319	336	358	388
Revenue	57.6	59.4	60.3	70.7	75.2	83
Operating Cost	-15.9	-16.1	-15.2	-17.8	-18.7	-18
EBITDA	41.7	43.3	45.1	52.9	56.5	65
EBITDA Margin (%)	72.4%	72.9%	74.8%	74.8%	75.1 %	78.3%
Other Regions						
EBITDA Margin (%)	70.3%	67.4%	68.9%	70.8%	70.1%	73.6%

P Estimated based on Actual 6 months to 31 December 2013

Table 1 shows the Queensland network is the most profitable Envestra gas network in Australia with an EBITDA margin consistently above all other networks over the last 6 years.

Table 2: Envestra operating ratios, Queensland v Rest (\$/GJ)

	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14
Queensland						
Asset Base	16.8	18.5	19.2	20.4	21.8	23.7
Revenue	3.49	3.76	3.63	4.28	4.59	5.06
Operating Cost	-0.96	-1.02	-0.92	-1.08	-1.14	-1.10
EBITDA	2.53	2.74	2.72	3.21	3.45	3.96
Other Regions						
Asset Base	20.1	21.8	20.8	23.0	25.0	25.5
Revenue	3.30	3.37	3.55	4.05	4.48	4.95
Operating Cost	-0.98	-1.10	-1.10	-1.18	-1.34	-1.31
EBITDA	2.32	2.27	2.45	2.87	3.14	3.65

Table 2 extends this analysis by calculating financial ratios on a \$/GJ basis. It highlights that when compared to all other Envestra networks, the Queensland network has the:

- lowest asset base investment and lowest network operating cost per GJ;
- the highest average price or revenue per GJ; and therefore
- the highest profit (EBITDA) per GJ of throughput.

¹ Grant Samuel and Associates, *Financial Service Guide and Independent Expert's report to the Independent Board Sub-committee in relation to the Proposal by APA Group*, 3 March 2014

AGL has also compared the actual data from the Samuel report to the allowances derived from the AER 2010 Determination for the Envestra regulated network in Queensland.

Table 3 indicates that the Queensland network is more efficient than forecast in the last AER Determination as Envestra has:

- maintained the regulatory asset base around 4 per cent below forecast;
- underspent operating cost by almost 20 per cent;
- collected an additional 20 per cent in revenue; which resulted in
- an extra \$55 million in EBITDA over the three years considered.

Table 3: Queensland Actual Financial Performance v AER Determination 2010

Actual Variance to AER	2011-12	2012-13	2013-14p	Three year Variance	
	\$m	\$m	\$m	\$m	%
Ending RAB	-11.7	-22.1	-17.8	n/a	-4.4%
Revenue	+16.7	+12.6	+12.6	+41.9	+22.4%
Operating Cost	-4.0	-4.2	-4.9	-13.1	-19.4%
EBITDA	+20.7	+16.8	+17.5	+55.0	+46.1%

P Estimated based on Actual 6 months to 31 December 2013

A final consideration is whether current regulated network prices are at efficient levels.

In order to estimate this, AGL compared the regulated revenue of the last year of the regulated period (2015-16) with the revenue expected under full regulation if:

- operating cost is reduced \$4m (as indicated by Envestra's actual financial performance over the period); and
- the current rate of return of 10.28 per cent is reduced to 7-8 per cent as suggested by the AER's recent Rate of Return Guideline.

This is not controversial as noted in the Samuels report:

"the current Access Arrangement in Queensland has a favourable regulatory rate of return (10.28%) which is expected to decline at the next determination period."

The result is a reduction in network revenue of around 15-25 per cent. This is a fair indication of the level that current network prices are above cost reflective rates (if full regulation is applied).

2. Effectiveness of regulation alternatives

4.9 The critical issues in an application for light regulation are: whether light regulation is likely to be as effective as full regulation in constraining the use of market power and promoting access to pipeline services; and the relative costs of the two approaches. If light regulation is similarly effective as full regulation but involves lower costs, light regulation is the more appropriate form of regulation.

In examining whether light regulation is as effective as full regulation, the NCC generally accepted Envestra's views with regard to the Form of Regulation Factors (s 16). Most importantly, this included criteria:

- (d) the extent to which any market power possessed by a service provider is, or is likely to be, mitigated by any countervailing market power possessed by a user or prospective user (countervailing market power); and
- (e) the presence and extent of any substitute, and the elasticity of demand, in a market for a pipeline service in which a service provider provides that service

AGL note the NCC believed that Envestra played down its market power and also confirmed that Envestra will continue to enjoy market power in distribution of gas in the relevant parts of Queensland. However, the NCC did not consider this an impediment to light regulation due to the constraint provided by fuel substitution (e) which we discuss further below.

With regard to any countervailing market power, AGL believes it is important for the NCC to recognise that:

- regulatory necessity for a retailer to utilise a network in the short to medium term cause difficulties when negotiating with a monopoly distribution network;
- retailers and other large users experience with negotiation for access are generally with transmission pipelines, where supply alternatives exist; and
- it is usually driven by commercial incentives. The regulatory framework for network cost pass through means that retailers have no direct commercial incentive for negotiating reduced network charges. AGL will always act on behalf of consumers but there is a clear misalignment of the ability to negotiate and the incentive to do so.

In AGL's view, these are important considerations given network prices are above efficient levels and large network charge reductions should be provided to consumers in the short-term.

4.28 The most significant constraint on market power associated with the QGDN is the ability for end users to substitute other forms of energy—electricity and LPG. The Council acknowledges the precarious competitive position of gas in the areas served by the QGDN. These factors offset some of the market power which the QGDN would otherwise enjoy.

4.32 In the Council's view it is the risk of losing business as users switch to other energy forms that is the most significant constraint on Envestra's actions in relation to the QGDN. The Council does not see how that constraint is diminished by a move to light regulation.

In theory, AGL agree with the NCC regarding the potential for substitution of gas by other fuels in Queensland and hence its ability to act as a constraint on market power. However, in reality, this ability is highly questionable when the history and current financial situation of the QGDN is considered as:

- network charges have continued to significantly increase in real terms (in line with the regulatory determination) but one would expect price moderation when there is a threat of fuel substitution; and

- the QGDN has continued to be Envestra's most profitable gas distribution network in Australia. This runs counter to expectations if the threat of fuel substitution was tangible.

That network charges are above efficient levels (ie. compared to if regulated today) but there has been little substitution away from gas to date raises further concerns on the market constraint provided by fuel substitution.

The lack of consumer response suggests that the elasticity of gas demand at the current price, or awareness of alternatives, remains low. The threat of fuel substitution may be a significant constraint on future price increases but it is unlikely that it can drive significant network price reductions from the relatively high price levels of today.

AGL would submit that electricity and LPG as alternate fuel sources are unlikely to drive customer outcomes that would be as effective as full regulation.

3. Cost of Light regulation

4.47 In the Council's view, a shift to light regulation has potential to result in significant cost savings for Envestra. Some savings for other parties such as the AER, retailers and end users are also likely, although these may be small...

The second principle behind the NCC Draft decision is that light regulation is a less costly process than full regulation. Envestra has identified significant cost savings in not having to comply with AER regulation when constructing a new Access Arrangement so this principle is inarguable if access disputes are avoided.

However, there is likely to be no benefit to retailers and end users. As evidenced by the increases in network charges in line with price determination and the resulting significant real increases in profitability to Envestra, it is unlikely that these cost savings will be passed through.

4.6 Although the Council has so far made light regulation determinations for three pipelines, to date, no access disputes concerning a light regulation pipeline have been notified to the AER.

4.30 The Council accepts that an aggrieved party may face significant costs if an access dispute requires arbitration and that it is less likely smaller incremental changes to terms and conditions of access will give rise to arbitration proceedings. However, the Council considers the position of gas in the Queensland energy market is such that Envestra is unlikely to push matters to that point given the likelihood that it would lose customers for its distribution services and face further reductions in throughput.

4.49 The Council considers that the likelihood of a significant number of access disputes in relation to the QGDN under light regulation is likely to be low. The Council notes that the opposition to this application from Origin, Simply Energy and the ERAA may indicate some greater prospect for disputation in relation to the QGDN than other pipelines which have been light regulated.

The NCC's assumption is that access disputes are unlikely which is based on the negotiation history of light regulation transmission pipelines. However, negotiating access to a distribution network due to legislative requirements is very different to transmission pipelines so this is not a relevant precedent.

AGL doubts this assumption as:

- commercial incentives in the short-term are in conflict with the findings of the NCC; and

- there is no assurance that an access proposal under light regulation will provide the customer benefits that would be obtained through full regulation.

The only bargaining power that users and end-users have is the ability to raise disputes through to AER arbitration. Consequently, AGL expects that this process will be required.

4.48 Whether the potential cost savings from a shift to light regulation will eventuate is critically dependant on the number and nature of any access disputes. A small number of arbitrations may be less costly than full regulation. However, if the outcome of light regulation is a series of access disputes and arbitrations, then the potential for cost savings will be quickly eaten up and the regulatory determination of tariffs and terms under full regulation is likely to be more cost effective.

To be clear, arbitration is not a costless exercise and will require additional costs in time, money and resources accruing to Users and end-users in order to initiate and proceed with disputes. This is addition to the arbitration costs that will accrue to Envestra and the AER, similar to a full regulation scenario.

The NCC Draft decision highlights that light regulation does not remove regulatory oversight however it fails to consider that the cost of regulatory oversight and information gathering will be imposed on other market participants under light regulation. Users and end-users will only be able to negotiate the provision of the monopoly service and raise disputes if they perform these activities and in doing so, incur these costs.

For these reasons AGL suspects the premise that light regulation is less costly than full regulation, although sound in theory, is unlikely to apply in practice.

4. National Gas Objective (NGO)

*4.51 In making a light regulation determination the Council must have regard to the National Gas Objective (NGO) contained in s 23 of the NGL. That section provides:
The objective of this Law [the NGL] is to promote efficient investment in, and efficient operation and use of, natural gas 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 NCC consideration of the NGO is limited to the assumption that light regulation is similarly effective to full regulation and involves a lower cost so it is the most suitable form of regulation and is consistent with the NGO.

AGL believes that light regulation is unlikely to be as effective as full regulation of the QGDN. The incentives under light regulation may constrain the distribution network's market power in the future but will not drive the immediate reductions in price that customers should enjoy under full regulation. Relying on arbitration with the AER is likely to be more costly than continuing with full regulation.

AGL believes a NCC Final Decision in favour of light regulation will therefore most likely end up being in conflict with the NGO.