

17 April, 2003

Mr G Henry
Director, Gas
Queensland Competition Authority
GPO Box 2257
Brisbane QLD 4001

Dear Mr Henry

Draft General Accounting Guidelines for Gas Distribution Network Service Providers

The attached submission is made by AGL in response to the Draft General Accounting Guidelines published by the Authority in March.

AGL has a number of concerns with the Draft Guidelines, the most notable being that:

- The proposed regime will remove the incentive for businesses to pursue efficient arrangements;
- Section 4.2 of the Code does not confer power to issue Guidelines in the form proposed; and
- The overly-intrusive approach to regulation adopted in the Draft Guidelines is contrary to the current policy direction.

Given the impending review of the gas access regime, it is AGL's view that it would be inappropriate for the Authority to proceed with the Guidelines in any form at this time. However, if the Authority chooses to proceed, it should do so only after conducting a full cost benefit analysis, consistently with good regulation-making practice. Such an analysis should take into account all relevant factors including the potential of the Guidelines to stifle the development of a competitive market for the provision of services to infrastructure owners, and the consequent cost in terms of efficiency gains foregone. In addition, we believe the Guidelines require significant amendment to conform to the limited powers conferred by Section 4.2 of the Code.

Yours sincerely

Robert Wiles
General Manager
Regulation and Policy

**SUBMISSION BY AGL IN RESPONSE TO QCA DRAFT GENERAL
ACCOUNTING GUIDELINES FOR GAS DISTRIBUTION NETWORK
SERVICE PROVIDERS
APRIL 2003**

1. EXECUTIVE SUMMARY

This submission is prepared by the Australian Gas Light Company in response to the Queensland Competition Authority's (QCA) Draft General Accounting Guidelines for Gas Distribution Networks Service Providers. The Australian Gas Light Company has a number of concerns with the Guidelines, which are addressed in the following paper. Of those concerns the major issues are:

- **The proposed regime will remove the incentive for businesses to pursue efficient arrangements**

Infrastructure industries in Australia are on the verge of a process of further restructuring which is expected to lead to greater contracting out of asset management and operation services which are presently, and for the most part, provided in-house. This will lead to greater competition in the provision of those services, and compared with the alternative of independent stand-alone businesses or services, has the potential to produce significant economic efficiencies through sharing of resources and economies of scope and scale.

However, at least in the short to medium term, many shared service providers are likely to be associates of regulated businesses because it is regulated businesses themselves that have the knowledge and skills to manage and service infrastructure assets. If the restructuring is to proceed then investors in those new businesses must be able to foresee some reward, in terms of a share of the efficiencies created, for the costs and risks they will be incurring.

The effect of section 5.16 of the Draft Accounting Guideline will be to remove any incentive for businesses to incur those costs and risks and so the potential efficiencies will not be realised. This significant potential cost must be taken into consideration in any decision to proceed with the Guidelines.

- **Section 4.2 of the Code does not confer power to issue Guidelines in the form proposed**

It is stated that the Draft Guidelines are published in accordance with section 4.2 of the National Third Party Access Code for Natural Gas Pipeline Systems (the Code) which provides that in complying with the ringfencing requirements of the Code, Service Providers must comply with general accounting guidelines which may be published by the Relevant Regulator.

The Draft Guidelines are much broader in scope than is necessary to satisfy the purposes of section 4.2 of the Code. We concur with the view expressed by IPART in a submission to NGPAC on behalf of Regulators operating under the Code, that use of section 4.2 is limited and that it is questionable whether the power can be used in the manner and for the purposes proposed by QCA.

- **The overly-intrusive approach to regulation adopted in the Draft Guidelines is contrary to the current policy direction**

The Draft Guidelines represent a new level of regulatory intrusion into the commercial and operational details of regulated businesses. The problems with increasing regulatory intrusion have been highlighted by the Productivity Commission, the Energy Market Review and the Federal Government. It is now widely recognised that there is a need for less intrusive regulation with a greater focus on providing incentives for long term investment.

A review of the Code is about to commence and will address these concerns among others. Given the scope of the impending review of the Gas Access regime we consider it inappropriate, on those grounds alone, for the QCA to proceed to implement any Accounting Guidelines at this time.

2. THE PROPOSED REGIME WILL REMOVE THE INCENTIVE FOR BUSINESSES TO PURSUE EFFICIENT ARRANGEMENTS

Efficiency can be increased through arrangements that allow parties or services to share resources and costs where the joint cost is less than the sum of costs that would result if the parties acted separately. Businesses can be relied upon to pursue these opportunities if they have an incentive to do so.

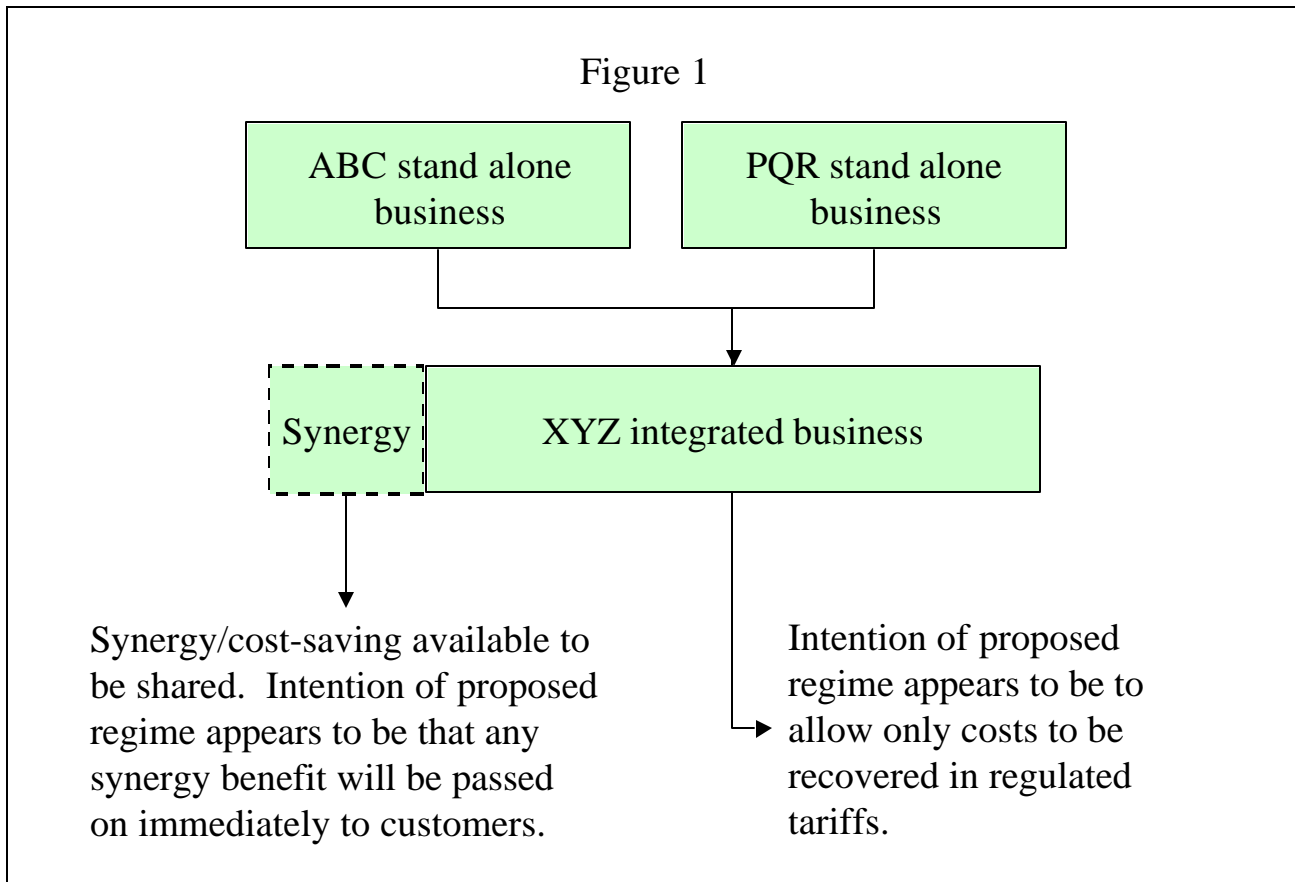
Infrastructure industries in Australia are on the verge of a process of further restructuring which is expected to lead to greater contracting out of asset management and operation services which are presently, and for the most part, provided in-house. This will lead to greater competition in the provision of those services, and compared with the alternative of independent stand-alone businesses or services, has the potential to produce significant economic efficiencies through sharing of resources and economies of scope and scale. McKinsey's have expressed a view that "the impact of this second wave of disaggregation will be at least as great as that of the first wave."¹

However, if the restructuring is to proceed then the investors in those businesses must be able to foresee some reward, in terms of a share of the efficiencies created, for the costs and risks they will be incurring. At least in the short to medium term, many shared service providers are likely to be associates of regulated businesses because it is regulated businesses themselves that have the knowledge and skills to manage and service infrastructure assets. However, it is apparent from the Draft Guidelines that it is intended to deny such businesses any share of the synergy benefits that may be generated and instead pass them directly to customers:

¹ Birch D, and Burnett-Kant, E, "Unbundling the Unbundled", The McKinsey Quarterly, 2001 Number 4. Note that the "first wave" referred to by McKinsey's is the separation of production/generation and supply/retailing from the monopoly elements of transmission and distribution, which is largely complete in Australia.

“Transactions with Associates of Service Provider are considered part of the Service Providers accounts. The value of goods and services originating in those Associates must be recorded at cost in the Regulatory Accounting statements.” (section 5.16)

That is, the costs to be allocated and recovered in network tariffs are actual/efficient costs, net of any synergy benefits that may be derivable by virtue of the scale and scope of the business. This is illustrated in figure 1 below:



The proposals in the Draft Guidelines are likely to have adverse consequences for the development of at least three forms of arrangement involving associated entities:

- Arrangements where parties associated to the Service Provider operate in noncontestable markets e.g. a Service Provider and an associated electricity network operator – a multi-utility;
- Arrangements where a Service Provider obtains services from associated parties e.g. a gas network owner obtains network operation and maintenance services from an associated party contractor, or a corporate services group provides services entity wide to the Service Provider and other businesses within the entity; and

- Arrangements where a Service Provider is associated with parties that operate in contestable markets e.g. a Service Provider and an associated retailer.

In each case there is potential for efficiency/synergy benefits to be generated and investors will pursue those opportunities if there is an incentive to do so, that is, if the investor has the opportunity to retain a share of any synergy benefits that are generated.

The position outlined in the Draft Guideline gives no recognition to the significant costs and risks associated with forming new businesses such as multi-utilities and contracting operations. Neither does it recognise the time and effort required to “extract” the synergy benefits after a new arrangement has been established. Similar issues arise for a stand alone non-contestable business contemplating an expansion of its operations into a contestable market through a related party. Investors will not incur these costs unless there is an incentive to do so. That incentive is the prospect, for the investor, of being able to retain at least some of the synergy benefits created by the business.

The effect of implementing the Draft Accounting Guidelines, through their intended influence on the outcomes of future Access Arrangement revisions, will be to confiscate synergy benefits thereby removing any incentive for investors to undertake these forms of restructuring. The restructuring will not proceed, and the potential efficiencies will not be realised.

Do fixed regulatory periods help?

It might be argued that fixed length regulatory periods and price glide paths provide the opportunity for an investor to retain benefits created during the period and that this is adequate incentive to pursue the efficiencies. This overlooks two related matters:

- It takes significant time and effort, in addition to the up front costs, to reorganise a business or establish a new one and to actually realise the potential synergies. The process of establishing a new structure and then “extracting” the synergy benefits will invariably take longer than the three to five years which has become the norm for regulatory periods in Australia.
- Uncertainty. The current regulatory regime provides no certainty as to how efficiency gains will be treated within periods let alone between periods. Experience to date with the implementation of incentive regulation in Australia is that price paths are routinely set on the basis of anticipated efficiency gains rather than to transfer efficiency gains actually realised. Regulators have complete discretion as to whether and, if so, how, efficiency gains realised in one period will be recognised in any subsequent period(s).

Summary

We have described three forms of arrangement involving businesses operating in non-contestable markets and their related parties, each of which has the potential to produce economic efficiencies through sharing of resources and economies of scope and scale. In our view,

implementation of the Draft Accounting Guidelines, and their intended influence on future Access Arrangement revisions, has the potential to remove any incentive for businesses to incur the costs and risks that would be required to produce those efficiencies. If that is the case, then the efficiencies will never be realised. This significant potential cost must be taken into consideration in any decision to proceed with the Guidelines.

3. THE OVERLY-INTRUSIVE APPROACH TO REGULATION PROPOSED IN THE DRAFT GUIDELINES IS CONTRARY TO THE CURRENT POLICY DIRECTION

Over the past two years there have been some significant developments in the area of access regulation that will have an important role in shaping the future of access regulation in Australia.

The final report of the Productivity Commission's Review of the National Access Regime and the Federal Government's interim response both highlighted the problems of increasing regulatory intrusion and the need for less intrusive regulation with a greater focus on providing incentives for long term investment.

The Ministerial Council on Energy agreed in November 2002 to undertake a review of the Gas Access Regime. This review is about to commence and will be carried out throughout 2003. A major driver behind this review has been the need for less intrusive regulation.

The Draft Guidelines however represent a new level of regulatory intrusion into the commercial and operational details of regulated businesses. Given the scope of the impending review we consider it inappropriate, on those grounds alone, for the QCA to proceed to implement any Accounting Guidelines at this time.

4. SECTION 4.2 OF THE CODE DOES NOT CONFER POWER TO ISSUE GUIDELINES IN THE FORM PROPOSED

It is stated that the Draft Guidelines are published in accordance with section 4.2 of the Code which provides that in complying with the ringfencing requirements of the Code, Service Providers must comply with general accounting guidelines which may be published by the Relevant Regulator.

The relevant ringfencing requirements of the Code are that a Service Provider must:

- Establish and maintain a separate set of accounts in respect of the Services provided by each Covered Pipeline in respect of which the person is a Service Provider; (s4.1(c))
- Establish and maintain a separate consolidated set of accounts in respect of the entire business of the Service Provider; (s 4.1(d))
- Allocate any costs that are shared between an activity that is covered by a set of accounts [for a covered pipeline] and any other activity according to a methodology for allocating costs that is consistent with the principles in section 8.1 [of the Code] and is otherwise fair and reasonable. (s4.1(e))

Section 4.2 of the Code also provides that such guidelines may, amongst other things, require the accounts to contain sufficient information, and to be presented in such a manner, as would enable the verification by the Relevant Regulator of the calculation of the Reference Tariffs for Covered Pipelines.

The scope of the Draft Guidelines goes far beyond that necessary to satisfy the purposes of section 4.2 of the Code. Similarly much of the information required by the Draft Guidelines has no relevance to the verification of tariffs. This is particularly the case when it is considered that cost allocation methodologies and other considerations relating to the calculation of future reference tariffs may bear no relationship to the procedures required under the Draft Guidelines. Future tariffs will be set through the process of submitting and approving the relevant Access Arrangement. The proposed Guidelines are therefore inconsistent with the scheme of the Code insofar as they can be viewed as pre determining the allocation of costs for purposes of setting tariffs in an Access Arrangement.

We concur with the view expressed by IPART in a May 2000 submission to NGPAC on behalf of Regulators operating under the Code, that use of section 4.2 is limited and that it is questionable whether the power can be used in the manner and for the purposes now proposed by QCA.

5. OTHER ISSUES

- **Extent of Non-causal Allocation Bases**

Section 3.4 of the Draft Guidelines states that “Non-causal Bases of allocation shall only be applied to the extent that the aggregate of all the items subject to all non-causal bases of allocation is not material to the Regulatory Accounting Statements.”

The nature of gas distribution networks is such that there is a significant proportion of cost for which it is not possible to identify causal bases of allocation. Prior to the 1999 review of the AGL Gas Networks (AGLGN) Access Arrangement in New South Wales, AGLGN, in conjunction with Deloitte Consulting and IPART, developed an extensive activity based costing system to trace and/or allocate cost to its various geographic regions and markets. The result of that analysis was that 34% of total costs could not be allocated using any causal basis, and a further 28% related to marketing related activities and were allocated directly to the tariff market. This leaves a balance of only 38% of total non-capital costs which could be allocated to covered pipelines and services using a causal basis.

Section 3.4 should be rewritten so that it recognises the cost structure of a gas distribution network business.

- **Notion of one “correct allocation of revenues and costs”**

One of the purposes to the Guideline is stated in the introduction to be to “ensure the correct allocation of revenue and costs between a Service Provider’s Covered Pipeline business and excluded Services” implying that there is one *correct* allocation of revenue and costs.

Similarly section 2.2 indicates that the accounting statements will be used as an input for future reviews of Service Providers’ Access Arrangements.

As discussed previously, no causal bases can be found for a significant proportion of a gas distribution network’s costs, and as such there will be many valid methods of allocating revenue and costs. The number of valid methods of allocation multiplies when various valid pricing methodologies ranging from stand-alone through fully distributed to avoidable are taken into account.

To predetermine that there is one correct method of allocating revenue and costs and that this correct method will be used to allocate revenue and costs for future Access Arrangement periods is contrary to the scheme of the Code and the pricing principles as set out in Section 8 of the Code.

- **Cost of Compliance**

To comply with the requirements of the Draft Guideline a Service Provider would be required to incur significant additional costs which would be passed on to end consumers.

Good regulation-making practice requires that, before an instrument such as the guidelines is imposed, a cost benefit study be carried out into the effect of the instrument. In the present case, such a study should also consider (among other factors) the cost of the efficiency gains foregone as a result of the Guidelines stifling development of a competitive market for the provision of services to infrastructure owners (see section 2 above).

- **The requirement for a full set of Regulatory Accounts sourced from the Statutory Accounts**

Section 5 (Information Requirements) and Section 6 (Regulatory Accounting Statements) call for a full set of Regulatory Accounting Statements (Income Statement, Balance Sheet, Cash Flow Statement and associated supporting Schedules) fully reconciled to the Statutory Accounts.

Costing analysis for regulatory purposes is carried out with a set of assumptions that often bear little relationship to accounting assumptions and only a portion of a gas distribution business's Statutory Accounts have any relevance for regulatory purposes. Examples of items that have no relevance are:

Income Statement

- Accrued Revenue
- Income from non-regulated activities

- Cost of non-regulated activities
- Depreciation & Amortisation
- Interest
- Income Tax Expense

Balance Sheet

- Property Plant & Equipment
- Deferred Expenditure
- Working Capital
- Future Income Tax Benefit (FITB)
- Deferred Income Tax Liability (DITL)
- Loan Balances
- Shareholders Equity

From the above it can be seen the only portion of the Statutory Accounts that are relevant for regulatory purposes is the Earnings before Interest, Tax, Depreciation and Amortisation (EBITDA), from the Income Statement. Virtually none of the Statutory Balance Sheet has any relevance. Therefore there is little value in requiring a full set of Regulatory Accounting Statements, sourced from the Statutory Accounting Statements.

If Regulatory Accounting Guidelines are to be required then they should be limited to information that is relevant for regulatory purposes.

• **Number of Directors to Sign Report**

The Pro Forma Directors' Responsibility Statement (attachment 2 of the Draft Guideline) requires the signature of two Directors. These requirements seems excessive given that under Corporations Law, the Directors Report accompanying the Statutory Accounts requires the signature of only one Director.