

ENVESTRA RESPONSE TO QCA PAPER ON REGULATORY ACCOUNTING GUIDELINES

1. Introduction

The Queensland Competition Authority (QCA) has sought comment on the draft General Accounting Guidelines for Gas Distribution Network Service Providers released on 20 March 2003. Envestra has already provided comments to the QCA on an earlier draft of the guidelines (refer to our letter dated 20 December 2002). Further comments are provided below.

2. Objectives

Envestra agrees that the Regulator is able to issue guidelines under section 4.2 of the Code to assist with monitoring compliance with section 4.1 (c), (d) and (e). However, the QCA objectives set out in section 2.2 of the draft Guidelines go well beyond the requirements to monitor compliance with section 4.1.

For example, QCA are seeking information to inform Access Arrangement reviews (p. 5 of the draft Guidelines). This issue has been discussed at length by NGPAC. Legal advice is that regulators are only able to specify guidelines for performance reporting requirements under section 4.2 to:

- Establish and maintain a separate set of accounts in respect of the services provided by each covered pipeline;
- Establish and maintain a separate consolidated set of accounts in respect of a Service Providers entire business; and
- Allocate any costs that are shared between any activity that is covered by a set of accounts for a covered pipeline and any other activity according to a methodology that is consistent with the general reference tariff principles and otherwise fair and reasonable.

The regulator's power under the Code does not extend to prescribing how information should be kept and maintained during an access arrangement period for the purpose of informing future reviews. This objective is therefore inconsistent with the Code and should be removed from the Guidelines.

The draft Guidelines also state that the information is required to perform the prescribed duty of monitoring compliance with the Code (p. 5 of the draft Guidelines). The power to monitor compliance under the Code is provided in section 41 of the Gas Pipelines Access Law.

Section 41(1) provides:

If a relevant Regulator has reason to believe that a person has information or a document that may assist the Regulator in the performance of any of the Regulator's prescribed duties under the Law, the Regulator may require the person to give the Regulator the information or a copy of the documents.

Section 41(2)(b) provides that the regulator must specify the form in which the information or document is to be given to the regulator. 'Prescribed duties' are defined in subsection (9) as:

- (a) deciding whether to approve an access arrangement under the Code;
- (b) deciding whether to approve changes to an access arrangement under the Code;
- (c) deciding whether to approve a contract, arrangement or understanding between a service provider and an associate if a service provider; and
- (d) monitoring compliance with the Code.

In other words, the Regulator can only seek information to undertake the prescribed duty of monitoring compliance with the Code under section 41(1) of the Gas Pipelines Access Law (not under section 4.2 of the Code). Furthermore information can only be obtained where it exists. Guidelines cannot be issued to require Service Providers to collect new information to assist in monitoring compliance with the Code. This objective must therefore be deleted from the Guideline.

Finally the draft Guidelines call for information to “assist with the verification of the calculation of future Reference Tariff proposals” (p. 5 of the draft Guidelines). Envestra notes that Section 4.2 states that guidelines may amongst other things enable verification by the Relevant Regulator of the calculation of the Reference Tariffs for Covered Pipelines.

Envestra is of the view that this objective cannot be achieved under the form of regulation required by the QCA in the Access Arrangement approved in December 2001. Specifically, the QCA approved a price path form of price control. The only information required to monitor compliance with a price path form of regulation is information on gas volumes, CPI and X factors. Envestra already provides this information separately to the QCA.

More importantly, information presented in regulatory accounts cannot be used to assist with the verification of Reference Tariffs under a price path form of regulation because regulatory accounts are based on actual costs whereas a price path is based on forecast costs. As a result, there will always be differences between the costs used to calculate approved Reference Tariffs and actual costs incurred by the business.

The objective in the Guidelines must be modified to recognise that it is not possible under certain types of regulation to use regulatory accounts to verify Reference Tariffs. The Guidelines could be modified by:

- at a minimum, inserting “where appropriate” at the end of the third dot point at the top of page 5 in the Guidelines; or
- preferably deleting the third dot point at the top of page 5. In this regard, we note that the reference to verifying Reference Tariffs in the Code has been included by way of an example of the nature of information that may be included in regulatory accounts. It is clearly not an obligation pursuant to the Code and not able to be implemented given the form of price control adopted by the QCA.

3. National versus State Guidelines

One of the outcomes from discussions on information gathering issues at NGPAC has been the realisation that there would be significant benefit in having one set of uniform guidelines applied throughout Australia rather than having individual jurisdictions developing their own guidelines.

It is clear that a nationally consistent approach to developing guidelines will enable companies that operate in multiple states like Envestra to develop uniform reporting systems. This approach will reduce the costs to regulated businesses of complying with guidelines, to the benefit of all consumers. We bring to the QCA's attention one of the aims of the Code, which is "to provide a clear national access regime, with consistency between different jurisdictions" (p1 of the Code).

Thus rather than developing a Queensland version of these Guidelines, Envestra believes it is incumbent upon the QCA to work together with other regulators to develop a nationally consistent set of guidelines. Implementation of the guidelines in Queensland should be deferred until this work is completed. Reporting arrangements should only be implemented once agreement has been reached with other regulators on the scope of guidelines and it has been confirmed that regulated businesses have the necessary reporting systems in place to provide the information.

On a more strategic level, QCA would also be aware that the Ministerial Council on Energy agreed in November 2002 for a review of the gas access regime to proceed in 2003. Given that this review is likely to result in changes to the Code, Envestra believes that it is premature to publish any regulatory accounting guidelines now. Rather regulatory efficiency dictates that it would be prudent to wait for the review to be completed and then put in place regulatory accounting reporting arrangements consistent with a revised Code. Envestra believes that there is no material disadvantage to Users or consumers in this approach, and that this should be an important factor for consideration by the QCA.

We reiterate that the competitive nature of the Queensland gas market is such that the industry cannot tolerate regulatory compliance activities that unnecessarily increase costs. An increase in costs reduces the competitive advantage of natural gas relative to alternative fuels. There will be cost savings to both regulated entities and regulators by delaying implementation of the Guidelines so that they can be aligned with the outcomes of the Gas Code review. We expect the Gas Code review to be completed in 2003.

4. Scope of the Regulatory Accounts

The Draft Guidelines require preparation of a profit and loss statement, a balance sheet and a cash flow statement. Envestra has previously advised the QCA that it is not possible to prepare a separate cash flow statement and balance sheet for part of our business (in this case, Envestra's Queensland covered assets) in a way that will convey meaningful information. Furthermore, QCA have been unable to explain why this information is necessary for the purpose of monitoring compliance with sections 4.1 and 4.2 of the Code.

To explain our point further, Envestra's Queensland business has been ring fenced from an operations perspective but it is financed as part of overall funding arrangements for the Envestra group. These arrangements can only be disaggregated on an arbitrary basis, as would be the case for most businesses. As a consequence, it is not possible to meaningfully disaggregate financial arrangements to create a cash flow statement and balance sheet as proposed by the QCA.

This is acknowledged in the Australian Accounting Standard, AASB 1005, Segment Reporting. In paragraph 5.2.1 it states that:

“ ... nor is it appropriate to force allocations of assets, liabilities, revenues and expenses of the entity that relate jointly to two or more segments, if the only basis for making those allocations is arbitrary”.

In terms of complying with sections 4.1 (c), (d) and (e) of the Code, the critical information required is details on allocation of costs to the covered network. The operating cashflows are evident from the profit and loss statement. Capital expenditure can be provided separately. A balance sheet and cash flow statement is not necessary to monitor compliance with sections 4.1 (c), (d) and (e) of the Code.

Finally, and separately to these other arguments, we also note that a cash flow statement is not required in the QCA guidelines for regulatory accounts in respect of electricity network businesses (version 3.0, QCA web site). It is therefore inconsistent to require gas businesses to submit cash flow statements.

We have previously proposed a draft structure for a profit and loss statement (reproduced in Attachment 1). The Code (Attachment A) provides guidance on the scope of information that regulators require to fulfil their statutory duties. The format of the proposed profit and loss statement is consistent with Attachment A of the Code. Envestra acknowledges that it will be necessary to present data for the Excluded Customers as defined in the Access Arrangement separately. Two profit and loss statements are proposed for covered assets and excluded assets.

The information set out in Attachment 1 is available and can be provided by Envestra to the QCA. Envestra believes that the QCA requires no more information than that proposed in Attachment 1 to monitor compliance with section 4.1 of the Code.

5. Cost Allocation Manuals

The Guidelines require service providers to prepare cost allocation manuals for approval by the QCA. Envestra has reviewed the cost allocation manual approved by the QCA for Queensland Rail (QR). We note that it is a 65-page document and contains details that go well beyond that necessary to monitor compliance with sections 4.1 (c), (d) and (e) of the Code.

While we are not aware of why the QR cost manual is in the form it is, it may be due to the nature of the rail business and the historical availability of financial information. We anticipate that a manual for Envestra will be significantly shorter. The main purpose of the cost allocation manual should be to identify costs that are allocated across Envestra's business. The manual will also outline the allocation methodology used by Envestra to allocate shared costs to covered assets in Queensland.

6. Directors Statement

The draft Guidelines seek cooperation of Service Providers in providing Directors' Responsibility Statements. There is clearly no power in the Code to require such statements. Furthermore these statements are unnecessary especially as QCA are proposing to audit regulatory accounts. Preparation of Directors' Statements only serves to increase compliance costs. Section 3.9 of the draft Guidelines must be removed.

7. Audit Reports

We have previously stated that additional audits of regulatory accounts is an unnecessary expense that will further reduce the competitiveness of natural gas in Queensland (refer to letter dated 20 December 2002). We recommended that the QCA could achieve the same objective by asking the auditor to confirm the cost allocation methodology rather than undertaking a full audit of regulatory accounts. The Guidelines should be amended to provide flexibility to specify an audit process that is appropriate for the purpose rather than requiring a full audit as currently specified. The proposed approach is not necessary and will only serve to increase compliance costs.

8. Information Requirements

Section 5 of the Draft Guidelines sets out information requirements. Some of the information sought is consistent with what Envestra has proposed in Attachment 1. However, there are two points worthy of special comment.

The first one relates to Capital Expenditure (section 5.6). The QCA seem to be implying that the ring-fenced accounts will be used to apply tests contained in section 8.16 of the Code. Envestra wishes to highlight that section 4.1 of the Code makes no reference to section 8.16. Tests referred to in section 8.16 can only be undertaken in the context of an access arrangement review process pursuant to section 2 of the Code. Using accounting guidelines under section 4 of the Code to undertake section 8.16 tests is clearly well beyond powers provided in the Code for the purpose of ring fencing.

The second issue relates to tax information. We have previously stated that it is not useful to include information on tax on operating profit in regulatory accounts because:

- regulatory tax calculations have been determined by the QCA using a separate methodology described in the Final Decision;
- tax is not even mentioned in the Gas Code;
- tax is not relevant for assessing compliance with sections 4.1 (c), (d) and (e) of the Code.

Envestra notes that the ESC does not require tax information in the guidelines issued for electricity businesses in Victoria (Electricity Industry Guideline No 3, 18 April 2000). This suggests that the ESC have determined that tax is not relevant for preparing regulatory accounts for the purpose of assessing ring fencing compliance. We recommend that the QCA adopt this position and amend the Guidelines to delete references to tax.

9. Principles of Preparation

Section 3 of the draft Guidelines sets out proposed principles for preparing regulatory accounting statements. Envestra generally agrees with the principles set out in the Guidelines. However, we note that the Guidelines (section 3.5) specify that the fixed asset values "may not be reflective of movements in the Initial Capital Base". We believe that this is inappropriate. As the guidelines relate to preparation of regulatory accounts, the correct measure of the book values of fixed assets is the Regulatory Asset Base.

We have also pointed out previously that the QCA do not require information on the Regulatory Asset Base to monitor compliance with ring fencing. Indeed the Regulatory Asset Base was determined by the QCA and, in accordance with Envestra's Access Arrangement, will be rolled forward at subsequent Access Arrangement reviews.

10. Working Papers

The draft Guidelines provide for the preparation of certain working papers and supporting documents. As stated above, the intent of the Guidelines are to provide information to assist the QCA to monitor compliance with sections 4.1 (c), (d) and (e) of the Code. It is our view that few working papers will be required to achieve this objective. As a general rule, QCA should aim to minimise the number of additional working papers required.

More specifically, QCA must ensure that any additional guidelines that may be specified are in fact necessary to meet the Code objectives and that the costs of preparing statements do not outweigh benefits. We are concerned that the regulatory regime being developed and implemented by the QCA is inconsistent with the objective of light-handed regulation. QCA are calling for a plethora of additional reports that will provide little additional value but substantially increase compliance costs for both regulated businesses and the regulator, both costs of which will be passed on to consumers. We suggest that an appropriately defined audit of the cost allocation methodology is all that is required to verify the regulatory accounts.

11. Conclusion

Envestra recommends that the QCA halt further work on finalising the regulatory accounting guidelines for Queensland gas distributors until the pending Code review has been completed. Once the Code review has been completed, the QCA should work with other regulators to develop a set of nationally consistent procedures that can be applied uniformly across Australia, rather than developing independent guidelines for Queensland.

In making this recommendation, we recognise that regulators are able to, and will, issue Guidelines under section 4.2 of the Code. In formulating such guidelines, care needs to be taken to ensure that:

- guidelines are consistent with the Code and relevant for the purpose of monitoring compliance with ring fencing obligations in section 4.1
- obligations contained in the guidelines can be implemented in a meaningful way.

This submission identifies obligations in the draft QCA Guidelines that are not required to monitor compliance with ring fencing obligations in section 4.1 of the Code. We have also identified a number of obligations for which it is not practical or sensible to provide the requested information.

Envestra's key recommendations are that the draft General Accounting Guidelines for Gas Distribution Network Service Providers be amended as follows:

- Modify the objectives of the Guidelines to be consistent with the powers provided to the regulator pursuant to the Code;

- Recognise that the critical financial statement required to monitor ring fencing compliance is the profit and loss statement. Section 6 should be amended to remove the requirement for detailed cash flow and balance sheet statements;
- Remove section 3.9 (Directors Statements);
- Modify section 4 to provide increased flexibility in defining audits, thereby reducing compliance costs;
- Remove from the information requirements section clauses relating to section 8.16 tests;
- Remove the requirement to provide tax information as it is not necessary to monitor compliance with ring fencing obligations;
- Recognise that the appropriate asset base for regulatory accounts is the Regulatory Asset Base and this is not required to monitor compliance with ring fencing; and
- Minimise the number of additional working papers to reduce costs of regulation.

REGULATORY ACCOUNTING TEMPLATE

Covered Assets Income Statement (\$m)	2001/02
Revenue	
Tariff V	
Tariff D	
Ancillary Reference Services	
Other Regulated Revenue	
TOTAL REVENUE	
Operating Expenses	
Network Marketing	
Overheads	
Materials & supply	
Cost of services by others (inc rental equipment)	
Wages & Salaries	
UAFG	
Compressor fuel	
Government Charges (Licence fee)	
Property taxes	
Depreciation	
EARNINGS BEFORE INTEREST & TAX	

Excluded Customers Income Statement (\$m)	2001/02
Revenue	
Excluded Customers	
TOTAL REVENUE	
Operating Expenses	
Network Marketing	
Overheads	
Materials & supply	
Cost of services by others (inc rental equipment)	
Wages & Salaries	
UAFG	
Compressor fuel	
Government Charges (Licence fee)	
Property taxes	
Depreciation	
EARNINGS BEFORE INTEREST & TAX	

Covered Assets Regulatory Balance Sheet (\$m)	
Assets	
Plant, Property & Equipment	
TOTAL ASSETS	
Liabilities	
Interest Bearing Liabilities	
TOTAL LIABILITIES	
Equity	
Shareholders equity	
TOTAL EQUITY	

Excluded Customers Regulatory Balance Sheet (\$m)	
Assets	
Plant, Property & Equipment	
TOTAL ASSETS	
Liabilities	
Interest Bearing Liabilities	
TOTAL LIABILITIES	
Equity	
Shareholders equity	
TOTAL EQUITY	