

# Submission to the Standing Committee of Officials of the Ministerial Council on Energy (MCE) on the Draft National Gas Law

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**United Energy Distribution**  
**1 Ricketts Road**  
**Mount Waverly Vic 3149**

**Phone: (03) 8540 7888**  
**Contact: Hugh Gleeson**  
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## 1 Overview

### 1.1 Introduction

This submission is from United Energy Distribution Pty Ltd and Multinet Gas Partnership ('the companies' hereafter). United Energy Distribution is one of five electricity distribution businesses operating under licence within the State of Victoria. UED's network provides services to some 600,000 end-use customers in Melbourne's southern and eastern suburbs. Multinet Gas is one of three gas distribution businesses in Victoria and is the only urban distributor servicing some 630,000 gas connections in Melbourne's eastern suburbs.

The companies support the establishment of a new National Gas Law to meet Ministerial Council on Energy's (MCE's) specific objectives of the current reform program. The Standing Committee of Officials (SCO) reiterated these objectives in its paper Statement of Scope – A National Legislative Framework for Gas and Electricity (July 2006, p. 6):

- strengthen the quality, timeliness and national character of governance of the energy markets, to improve the climate for investment;
- streamline and improve the quality of economic regulation across energy markets, to lower the costs and complexity of regulation facing investors, enhance regulatory certainty and lower barriers to competition; and
- further increase the penetration of natural gas, to lower energy costs and improve energy services, particular in regional Australia and reduce greenhouse emissions.

However, the companies are concerned that the objectives of the MCE reform program for gas have not been delivered in the current Exposure Draft of the National Gas Law (draft NGL) or the draft National Gas Rules (draft NGR). The companies consider that there are several significant aspects of approach taken to the draft NGL and NGR that will:

- reduce the quality of the governance of energy markets;
- reduce the quality of economic regulation; and
- increase the costs and complexity of regulation.

Our reasons for this and our comments on the draft NGL and NGR fall under the following four headings:

### 1.2 Governance

For the energy industry, the gas and electricity legislative frameworks have been strengthened by the establishment of an expert body, the Australian Energy Market Commission (AEMC), for the express purpose of developing regulatory rules and to ensure that the rules continue to reflect best practice regulation as knowledge and experience if the

industry and the energy market grows. This independent rule-making body stands appropriately separate from the MCE's policy role and the Australian Energy Regulator's rule enforcement role.

The companies are concerned that the extent and content of the draft NGL are not consistent with the application of the new governance model. In particular:

- In addition to core principles (which are appropriate for inclusion in the NGL), the draft NGL contains many provisions that constitute important procedural matters and detail of industry regulation that should be in the Rules. Consequently, these provisions would be outside the reach of the AEMC's valuable rule development process.
- The draft NGL allows the MCE to adjust by regulation the reach of the regime, directly control aspects of the rule-making process, and limits access to merits appeal, by regulation. Our concerns include the definition of associates, a prohibition on a form of regulation based in "total factor productivity" (TFP), and the scope of reviewable decisions. We argue that this is unexpected, unnecessary and detrimental to investor confidence.
- The draft NGL establishes and fixes a very broad discretion for the Australian Energy Regulator (AER) in that it enables the AER in all circumstances to readily replace a service provider's reasonable assumptions in an access arrangement with the AER's own.<sup>1</sup> Further, the draft NGL permits (as does the National Electricity Law) the AEMC to make rules that allow the AER to make binding guidelines. The combination of these two things concerns us in that it creates the potential for the AER to take on the conflicting roles of both a rule maker and a rule enforcer. This will in turn serve to undermine the achievement of the SCO's objectives listed above – in particular those aspects of the objectives relating to quality of governance and economic regulation, and the enhancement of regulatory certainty.

### 1.3 Merits review

The companies very much support accessible and effective merits review as a critical element of the regime for economic regulation of gas networks and as a driver for regulatory accountability, particularly in the light of any potential expansion of the AER's discretion. However, the merits review provisions set out in the draft NGL fall short of achieving this.

- The draft NGL allows for limits to be placed on the scope of reviewable regulatory decision, by regulation, which could make the review process inaccessible for a range of important regulatory decisions.

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<sup>1</sup> Section 170 and 178 of the draft NGL.

- The draft NGL requires an appellant to seek leave to appeal within 14 days of the decision and permits leave to appeal to be denied on grounds unrelated to the subject matter of the application for the review.

All economic regulatory decisions by the AER under the NGL or the NGR—including those associated with the exercise of the AER substantial new information gathering powers—should be reviewable regulatory decisions and their reviewability should be unchanged by regulation. However, if the NGL must specify as reviewable only limited number of the AER decisions that affect the outcome of an access arrangement, the NGL needs to enable AEMC to designate certain other AER’s regulatory decisions as reviewable at the time the AEMC creates the rules that give the AER the role to make those decisions.

The requirement in the draft NGL to seek leave is a substantial additional cost to the merits review process and that reduces the ability of merits review to be an effective driver for regulatory accountability. If such a requirement must exist, the time limit should be extended and grounds for denying leave should be limited to matters related to the review being sought..

#### 1.4 Information gathering

The expansion of the AER’s information gathering powers brings with it a need to establish appropriate checks and balances.

- The AER should have to conduct a cost/benefit analysis to ensure that the costs to the businesses of keeping and/or providing the information do not outweigh its benefits.
- The companies are of the strong view that the confidentially protections of section 42 of the GAPL should be re-instated as the SCO intended.
- Given the extensive penalties that also exist in the draft NGL for the provision of false or misleading information, the companies believe that a requirement for officer verification or auditing could create an unnecessary cost burden and should be limited by statute in its use.

Each of these matters is considered in more detail in the sections that follow.

#### 1.5 Form of regulation

The companies fully support the AEMC’s forthcoming review of TFP-based approaches to the form of regulation and agrees with the MCE that such a review would be a significant regulatory development. The review could provide even greater insight by examining all the new innovations in the form of regulation that may apply to energy network business, and not be constrained to a limited interpretation of what TFP might mean.

Further, to ensure that the quest for improved economic regulation is not limited to one single review, enhance the possible outcomes of the review, and give necessary overarching guidance, it would be beneficial for section 70 of the NGL to be reframed in a

manner that allows for, and in fact encourages, the development by the AEMC of the rules to evolve regulation or facilitate new forms of regulation that seek to reduce the costs of regulation and better promote the achievement of economic efficiency and the gas market objective.

## 1.6 Breadth of the Company's concerns

In this submission, the companies have concentrated on the matters of major importance listed above. There remain a large number of issues of detail and drafting in the draft NGL that the Energy Networks Association has addressed in its submission<sup>2</sup>, and which the companies support but have not replicated for conciseness.

The new NGL and NGR represent critical new legislation for the gas industry. Much of the form and content of the draft NGL and NGR are not as we had expected from the statements<sup>3</sup> the SCO has made or in the light of the success of the current National Gas Code<sup>4</sup>. We believe the draft NGL and NGR would have benefited from earlier consultation on the major changes to the current arrangements they represent. We encourage the SCO to engage more frequently and closely with the gas industry, through the industry associations and with individual businesses, from this point forward so that the industry is better able to contribute constructively during the energy reform process and assist with the early resolution of issues. The companies stand ready to participate in whatever capacity they can.

Multinet would very much like to examine and comment upon the transitional provisions that will apply. When the new NGL commences, Multinet will be part way through an access arrangement revision to be conducted under the old access law and a number of transitional issues arise. These include enforcement and the carry over of fixed principles.

## 2 Governance

In this chapter we reasons why the draft NGL and its application of the new legislative framework compromise the energy market governance model.

The new legislative framework for gas and electricity is constructed using five instruments:

- legislation;

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<sup>2</sup> Energy Networks Association, National Gas Law, Response to Exposure Draft, 19 December 2006.

<sup>3</sup> Standing Committee of Officials 2005, Statement of Approach – A New Legislative Framework for Gas, September; and Standing Committee of Officials 2006, Statement of Scope – A National Legislative Framework for Gas and Electricity, July.

<sup>4</sup> National Gas Code is the *National Third Party Access Code for Natural Gas Pipeline Systems*.

- regulations;
- rules;
- regulatory determinations; and
- regulatory guidelines.

In its advice to the ENA<sup>5</sup>, Gilbert and Tobin have set the circumstances in which each type of instrument is required. The companies fully support Gilbert and Tobin's view.

Specifically, legislation provides the means by which governments may set down the fundamental elements of the framework: the objectives, the powers and functions of the market institutions, the reach of regulation, the core principles and essential elements of regime, the means of enforcement and prescription of penalties, the scope of the rules and the rule change process;

- regulations are usually used to provide a level of legislative flexibility on non-technical matters that do not require extensive industry consultation;
- rules provide a means by which the important procedural matters and detail of industry regulation can be set down;
- regulatory determinations are made by the regulator in accordance with the rules and relate to the circumstances of specific businesses;
- regulatory guidelines can provide certainty as to how a regulatory will exercise its discretion.

For the energy industry, this framework is strengthened by the establishment of an expert body, AEMC, for the express purpose of developing the rules over time to ensure that the rules continue to reflect best practice regulation as knowledge and experience if the industry and the energy market grows. Such a process requires sophisticated (and subtle) economic conceptual models that can foster innovation and customer orientation, and can be tuned in the rules by an expert. The companies fully support the objectives and consultative process by which the AEMC undertakes this function. Within the energy regulation governance model that comprises<sup>6</sup>:

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<sup>5</sup> Energy Networks Association, National Gas Law, Response to Exposure Draft, 19 December 2006, Attachment B.

<sup>6</sup> Standing Committee of Officials 2006, Statement of Scope – A National Legislative Framework for Gas and Electricity, July, p. 6.

- The MCE, the national policy and governance body for the Australian energy market including for electricity and gas, with a power to direct reviews by the AEMC with respect to rule-making and market development;
- The AEMC responsible for rule-making and market development functions in respect of electricity and natural gas transmission and distribution networks and retail markets (other than retail pricing); and
- The AER responsible for enforcement and economic regulation of electricity and gas transmission and distribution networks and retail markets.

It gives us a great deal of comfort that the NGRs can be changed in a transparent process when they need to be and that all stakeholders will have opportunities to contribute their expertise to the AEMC's considerations.

However, there are a number of features of the draft NGL that compromise the appropriate use of each type of regulatory instrument, substantially constrain the ability of the AEMC to develop an appropriate set of rules, and enable the Australian Energy Regulator (AER) to effectively become a rule-maker in the AEMC's place.

## 2.1 Excessive provisions in the Law

In addition to core principles (which are appropriate for inclusion in the NGL), the draft NGL contains many provisions that constitute important procedural matters and detail of industry regulation that should be in the Rules, particularly in relation to matters such as:

- the content and determination of access arrangements;
- ring fencing;
- information and timelines for negotiation;
- dispute resolution; and
- procedural provisions from section 7 of the National Gas Code.

Curiously, Schedule 1 of the draft NGL allows for the NGR to contain these provisions but the draft NGR do not, and the NGR cannot if such provisions remain in the NGL.

As long as these provisions remain in the NGL, they will be outside the AEMC's valuable rule development process. The companies are even more concerned about this given that many of the related NGL provisions are different to those tried and proven in the current National Gas Code.

## 2.2 Inappropriate use of regulations

The draft NGL allows the MCE to adjust the reach of the regime, directly control aspects of the rule-making process, and limit access to merits appeal, by regulation. Most significantly, under the draft NGL, the MCE may determine by regulation:

- The application of TFP to regulatory determinations;
- The classification of a person prescribed to be an associate, and to whom all the new information gathering powers apply; and
- The decisions of a Minister, the AER or the AEMC that are reviewable regulatory decisions; that is, decisions that can be subject to merits appeal.

The role of TFP in the economic regulation of gas and electricity networks is a complex issue that requires expert consideration. The AEMC is best positioned to make this judgement unconstrained by government, as it has for its review of the economic regulation of electricity transmission. Rather than Ministers determining by regulation whether a TFP approach may apply, the NGL should remain silent and allow the AEMC to determine subsequent to its forthcoming review whether, and if so how, TFP or any other innovative new form of regulation should apply with regard for the gas market objective.

The specific determination (and potentially re-determination) of key attributes of the regulatory regime by regulation—the definition of associate and reviewable regulatory decisions—creates an unsatisfactory level of uncertainty, which will have a significant impact on investor confidence. The ENA outlines well the implications of such uncertainty and we endorse its analysis and conclusions.<sup>7</sup> The definition of associate and reviewable regulatory decisions cannot be defined as minor matters should be removed from regulations and included within the Law or the Rules.

In particular, the definition of “associate” has the potential to encompass a wide range of counter parties well beyond that previously been swept into the regulatory net. This has the potential to discourage contractors and significantly inhibit the efficiencies that can be achieved in distribution businesses.

The prescription by regulation of reviewable regulatory decisions amounts to the conferral by regulation of powers and functions on a statutory tribunal. In the development of the National Electricity Law (NEL), the conferral of such functions by regulation was removed between the exposure draft of the legislation and the Act (see clauses 14(g), 30 and 37 of the Exposure Draft and sections 15(g), 29(1)(c) and 38(2)(c) of the Act). If the Subordinate Legislation Act 1978 is not to apply to regulations made under the NGL (if the NEL is a guide) then the prescription by regulation of reviewable regulatory decisions may be an

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<sup>7</sup> Energy Networks Association, National Gas Law, Response to Exposure Draft, 19 December 2006, Sections 6 & 8.

impermissible abdication of the power to legislate (see *Giris v Federal Commissioner of Taxation* (1969) 119 CLR 365 at 373).

### 2.3 Wide discretion of AER and its ability to make binding guidelines

In its recent review of the economic regulation of electricity transmission, the AEMC examined and determined the extent of the AER's discretion in determining a range of matters associated with a revenue determination. It applied what has come to be known as the 'fit-for-purpose' approach, a term coined by the MCE's Expert Panel<sup>8</sup>. The Panel recognised the advantages of such an approach when it said<sup>9</sup>:

In the Panel's view the preferred approach is to recognise the desirability of the AMEC being permitted to develop its Rules on a 'fit for purpose' basis, but to do so within a legislative framework which provides clear principles (including a requirement to consider regulatory risk) to guide Rule making, as well as merits and judicial review and coverage arrangements which ensure that the riskier investments with lesser market power are excluded from price control.

In contrast, the draft NGL establishes and fixes a very broad discretion for the AER in that it enables to AER in all circumstances to readily replace a service provider's reasonable assumptions in an access arrangement with the AER's own.<sup>10</sup> Further, the draft NGL (as does the National Electricity Law) permits the AEMC to make rules that allow the AER to make binding guidelines; presumably to explain how the AER will exercise its discretion even though this is not prescribed. The combination of these two things concerns us in that it creates the potential for the AER to be given the power to create a wide range of new legal obligations for services providers and changes the nature of the regulatory regime; effectively the power to write rules. This is clearly an undesirable outcome given that need for clear separation between conflicting role of rule making and rule enforcement.

Consequently, the NGL should not fix the AER's decision making discretion, especially so broadly—this should be a matter for the AEMC and the NGR with regard for each type of decision and the overall regulatory design. And provisions within the NEL and the NGR should be reviewed to ensure that the AER is only ever given the power to make binding guidelines for the purpose of explaining how the AER will exercise its discretion and of binding itself.

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<sup>8</sup> Expert Panel, op cit, p. 60.

<sup>9</sup> Expert Panel, op cit, p. 84.

<sup>10</sup> Section 170 and 176 of the draft NGL.

### 3 Merits Review

Both the Hilmer Report and the Productivity Commission emphasised the need to protect private property rights of access providers. In this regard, the Productivity Commission has argued in its Review of the Gas Access Regime that<sup>11</sup>:

Finally, a merits review might be desirable for the Gas Access Regime, given the intrusion of access regimes on property rights and the freedom to contract. The Hilmer Committee (1993, p. 242) noted that these are fundamental established rights in our legal system and are not to be disturbed lightly. It recognised that protection of these rights was an important concern:

The Committee is conscious of the need to carefully limit the circumstances in which one business is required by law to make its facilities available to another. Failure to provide appropriate protection to owners of such facilities has the potential to undermine incentives for investment. (Hilmer Committee 1993, p. 248).

In all Australian and overseas network regulatory contexts, merits review is one of three important parts to an overall framework for effective regulatory accountability. The other two elements which are important are that:

- the criteria for decision making rules for regulators are set out in the rules; and
- there is separation of rule making and regulatory decision making.

It was, therefore, an important step forward for the industry when the MCE made its decision of May 2006 to accept that there should be merits review for both energy sectors.

That decision was made well before the release of the new legislation/rules package and set out a list of reviewable regulatory decisions constant with all of regulatory discretions in the prevailing National Gas Code, thereby adopting a review scope consistent with that in that code. Since that time, the original National Gas Code has been substantially rewritten as the draft NGL and NGR, which have significantly increased the areas of regulatory discretion. The companies would suggest that merit appeal rights should be broadened if the regulator's discretion is to be increased.

The companies have some serious concerns with the implementation of merit review model in the draft NGL.

Each of these concerns is addressed in turn.

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<sup>11</sup> Productivity Commission, Inquiry Report No. 31, Review of the Gas Access Regime, 11 June 2004, pp. 488-9.

### 3.1 The scope of reviewable regulatory decisions

In keeping with our comment above, the companies' first concern is that the right to merits review of a decision of a Minister, the AER or the AEMC can be removed by the simple making of a regulation, and that this creates substantial uncertainty about the balance of regulator discretion and access to merits appeal.

All decisions by the AER on the economic regulation of gas networks under the NGL or the NGR—including those associated with the exercise of the AER substantial new information gathering powers—should be reviewable regulatory decisions and their reviewability should be unchanged by regulation.

However, if the NGL must specify as reviewable only a limited number of the AER's decisions that affect the outcome of an access arrangement, the NGL needs to enable AEMC to designate certain other AER regulatory decisions as reviewable at the time the AEMC creates the rules that give the AER the role to make those decisions.

### 3.2 The seeking of leave

The companies' second concern is that, under the draft NGL, leave must be sought for a merits review, it must be sought within 14 days of a decision, and there would be very onerous conditions under which leave may be denied. In particular, the Australian Competition Tribunal (ACT) may refuse leave where the service provider:

- failed to comply with a request by the original decision maker for information or a direction by the decision maker;
- without reasonable excuse, conducted itself in a manner that resulted in the making of the original decision being delayed; and
- misled or attempted to mislead the regulator.

The requirement in the draft NGL to seek leave is a substantial additional cost and risk to the merits review process that reduces the ability of merits review to be an effective driver for regulatory accountability. If such a requirement must exist, the time limit should be extended and grounds for denying leave should be limited to matters related to the review being sought.

The 14 day time limit for review is inconsistent with the Trade Practice Act for appeals before the Australian Competition Tribunal under Section 20 of the Act where a 21 day time period is allowed. This should also be the case for merit review for energy industries for consistency.

None of the conduct listed above for which the ACT may refuse leave need relate to the grounds for the application for merits review. The leave provisions provide an opportunity for the regulator to present a raft of damaging and otherwise irrelevant material concerning the conduct of the business during the initial decision making process. In addition, the

extensive information gathering powers of the AER could make such an outcome more likely.

The companies consider that the merits review structure would promote better regulatory accountability if the grounds for refusing leave could be limited to the subject matter of the application for review – for example, a more balanced approach could be that the ACT is able to refuse to grant leave if the error in the initial decision for which review is sought was because the service provider had refused to comply with a reasonable request for information.

## 4 Information Gathering Powers

The new Gas Law prescribes extensive information gathering powers for the AER that go beyond those set down in the National Electricity Rules.

While the companies support the AER having a sufficient level of powers to require information from regulated entities the companies find a number of problems with the powers proposed in the draft NGL. All of these concerns are outlined in the ENA's submission, four of which we repeat here for emphasis.

The companies note that the SCO has prepared a Regulatory Impact Statement (RIS)<sup>12</sup> as part of the 2006 gas legislation package and appreciate that it has been published with the package. The analysis within RIS in relation to information disclosure may benefit from consideration of the points we raise.

### 4.1 Costs and benefits

The very wide powers in the draft NGL for the AER to direct a business or its associate to keep information and to provide information have the potential to impose a great cost burden. The AER should have to conduct a cost/benefit analysis to ensure that the costs to the businesses of keeping and/or providing the information do not outweigh its benefits.

### 4.2 Confidential information

Businesses have a legitimate need to keep commercially sensitive information confidential. In recognition of this, the SCO undertook to retain the confidentiality protections of section 42 of the Gas Pipelines Access Law—which includes for appeal rights—in the NGL.<sup>13</sup> This

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<sup>12</sup> Standing Committee of Officials of the Ministerial Council on Energy, 2006 Comprehensive Legislative Package Regulatory Impact Statements on the Form of Regulation, Pricing Principles, Information Disclosure and Regulatory Decision-making, November 2006.

<sup>13</sup> Standing Committee of Officials 2006, Statement of Scope – A National Legislative Framework for Gas and Electricity, July, p. 22

has not occurred and businesses have little recourse under the draft NGL to prevent the AER from disclosing confidential information that could be commercially damaging. The companies are of the strong view that the confidentiality protections of section 42 of the GAPL should be re-instated as the SCO intended.

#### 4.3 Statutory declaration verification and audit

Under section 50 of the draft NGL, the AER may require that the information it requires from a service provide be verified by an officer of a service provider or its associate, and/or be audited. Given the extensive penalties that also exist in the draft NGL for the provision of false or misleading information, the companies believe that a requirement for officer verification or auditing could create an unnecessary cost burden and should be limited by statute in its use.

#### 4.4 Material in possession or control

There is an inconsistency between sections 41(1) and 45(1) of the draft NGL.

A requirement to provide information or prepare, maintain or keep information should only be made where the AER has reason to believe that a person is capable of so doing. Furthermore, it is clear from section 49(b) of the draft NGL that it is the MCE's intention that the information that may be the subject of a regulatory information instrument be within the possession or control of the service provider but this condition is not attached to the power to issue the instrument and its scope in section 48. The companies consider this inconsistency in the NGL needs to be rectified by an appropriate amendment to section 48.

### 5 Form of regulation

Like the Expert Panel<sup>14</sup>, the companies see substantial potential for a TFP-based approach to reduce the cost of regulation—consistent with the draft NGL section 12 in relation to pipeline coverage—and to provide stronger incentives for productive efficiency. We note that the Panel recommended that the MCE direct the AEMC to undertake a review, by 31 December 2008 that addresses<sup>15</sup>:

- the circumstances in which the application of a TFP-based price setting methodology would contribute to the NEL and NGL objectives;

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<sup>14</sup> Expert Panel on Energy Access Pricing, Report to the Ministerial Council on Energy, April 2006, p. 102.

<sup>15</sup> Expert Panel, op cit, p. 117.



- the data collection arrangements that need to be put in place to facilitate its application; and
- as appropriate, the development of draft Rules to support the application of a TFP-based form of control for any individual or group of electricity or gas distribution or transmission service providers.

The companies fully support this review and agrees with the MCE that such a review would be a significant regulatory development. The review could provide even greater insight by examining all the new innovations in the form of regulation that may apply to energy network business, and not be constrained to a limited interpretation of what TFP might mean.

To ensure that the quest for improved economic regulation is not limited to one single review, to enhance the possible outcomes of the review, and give necessary overarching guidance, it would be beneficial for section 70 of the NGL to be reframed in a manner that allows for, and in fact encourages, the development by the AEMC of rules to evolve regulation or facilitate new forms of regulation that seek to reduce the costs of regulation and better promote the achievement of economic efficiency and the gas market objective.