

10 May 2013

Mr Jeff Cefai
Director of Energy
Essential Services Commission of Victoria
Level 2 / 35 Spring Street
Melbourne Victoria 3000

By email: energy.submissions@esc.vic.gov.au

Dear Mr Cefai

Re: Gas Distribution System Code – Review of Unaccounted for Gas Benchmarks – Draft Decision

This letter is in response to the ESCV's Draft Decision on Unaccounted for Gas (UAFG) benchmarks for the 2013 to 2017 period. SP AusNet welcomes a number of aspects of the draft decision. The ESCV has:

- Recognised that historical data from SP AusNet's network is the appropriate basis for setting benchmarks for 2013 to 2017.
- Recognised the efforts SP AusNet has made to better understand the drivers of UAFG (reflected in the AIA report that accompanied our original submission) and to develop further strategies to reduce UAFG in our network.
- In the case of SP AusNet's PTS-network,
 - accepted evidence that there is no downward trend in UAFG, recognising that the drivers of UAFG are complex and do not uniformly act to reduce UAFG over time.
 - used the average of settled data from the previous period to set the benchmark.

Notwithstanding, SP AusNet has some significant concerns with other aspects of the Draft Decision that it hopes the ESCV will revisit in making their Final Decision.

The most critical of these issues is how the ESCV is proposing to deal with the delay that has occurred in setting the benchmarks in the 2013 to 2017 period. As was highlighted in our submission (dated 20 Dec 2012), the failure to account for the late application of the new benchmarks "will unfairly penalise the businesses for millions of dollars through an unintended administrative oversight".

In the attached response to the Draft Decision, we set out in further detail the unfair consequences of the current approach and demonstrate adjustments that could and should be made to rectify the error.

SP AusNet also has concerns with the trend analysis applied to the benchmarks for its' non-PTS network. Consistent with our original submission, SP AusNet does not believe the evidence supports setting a benchmark with a significant declining trend.

Should you have any questions in relation to this matter please contact Katie Yates, Principle Economist, Asset Management on 9695-6622.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Tom Hallam', written in a cursive style.

Tom Hallam
Manager Economic Regulation
Asset Management
SP AusNet

SP AusNet – Response to Draft Decision

2013 Benchmarks

In its Draft Decision the ESCV proposes that the new benchmark for 2013 would commence from 1 July 2013. The ESCV pointed to administrative issues that would hinder retrospective adjustment to the benchmarks that had been requested by SP AusNet.

“The Commission does not consider it appropriate to make the benchmarks retrospective as the Order sets the benchmarks until the Order is repealed. In addition, the Commission notes there are practical issues for AEMO—who use the benchmarks prospectively for wholesale market settlement purposes—in making the benchmarks retrospective. There are also administrative issues for the Commission to consider in making the benchmarks retrospective. Specifically schedule 4 of the GDSC, which provides for the Commission to amend the GDSC, states that:

the date specified on the amendment must not be earlier than the date on which the amendment is made without the prior agreement from Distributors and the Commission's Customer Consultative Committee.”¹

As outlined in SP AusNet's original submission, the delay that has occurred in updating UAFG benchmarks has resulted in a penalty to SP AusNet and is inconsistent with the design of the scheme. This is because the effective benchmark that applies for the 2013 calendar year is different to the benchmark that has been deemed appropriate by the ESCV. Therefore, the updated benchmark for the second half of 2013 must be adjusted to correct this penalty.

Delay to benchmark adjustment

The UAFG benchmarks are intended to be updated every 5 years (in line with regulatory periods). This ensures that the benchmarks reflect current network conditions.

Victorian Gas Distribution Businesses (GDBs) are funded on the basis that they are expected to achieve the benchmark result on average (because the benchmark is based on historical results, with the incentive scheme working by rewarding improvements over time and penalising deteriorations). The recent GAAR Final Decision set prices on this basis.

The delay to the setting of the benchmarks has been due in no part to the actions of Victorian distribution businesses. SP AusNet submitted material as part of the Victorian Gas Access Arrangement Review with plenty of time for the new benchmarks to be set.

SP AusNet understands that the causes of the delay were bureaucratic, possibly due to the delay in implementing the National Energy Customer Framework in Victoria, and involving disputes between state and Commonwealth government agencies, including the AER, AEMO and the ESC (and potentially others), over whose responsibility it was to update the benchmarks. Whatever the detailed causes of the

¹ ESCV, March 2013, *Gas Distribution System Code – Review of Unaccounted for Gas Benchmarks – Draft Decision*, p.5

bureaucratic delay, the result was the requirement for a Ministerial Order to extend the existing benchmarks that were due to expire at the end of 2012.

Based on the proposed benchmarks in the draft decision, the delayed start to updating the benchmarks will result in a windfall loss to SP AusNet.

Penalty to SP AusNet

To demonstrate the effect of the delay, SP AusNet has modelled the outcome that will result from the Draft Decision if we achieve the 2013 benchmark (that is, what happens if SP AusNet’s UAFG in 2013 is equal the benchmark level of 5.4% that ESCV determined to be the expected outcome based on historical results).

Figure 1 maps the relationship between SP AusNet’s actual UAFG for 2013 and the penalty or reward it will incur under various UAFG benchmarks.

Under the Draft Decision, a 4.9% benchmark will apply for the first 6 months of 2013 (as stipulated in the special gazette s460). This is shown by the red line. After 1 July an updated UAFG benchmark of 5.4% for the remaining 6 months of 2013, as shown in the blue line. The green line reflects the effective benchmark of 5.15% applied for Type B customers (for SP AusNet) for 2013 under the draft decision.

Figure 1.

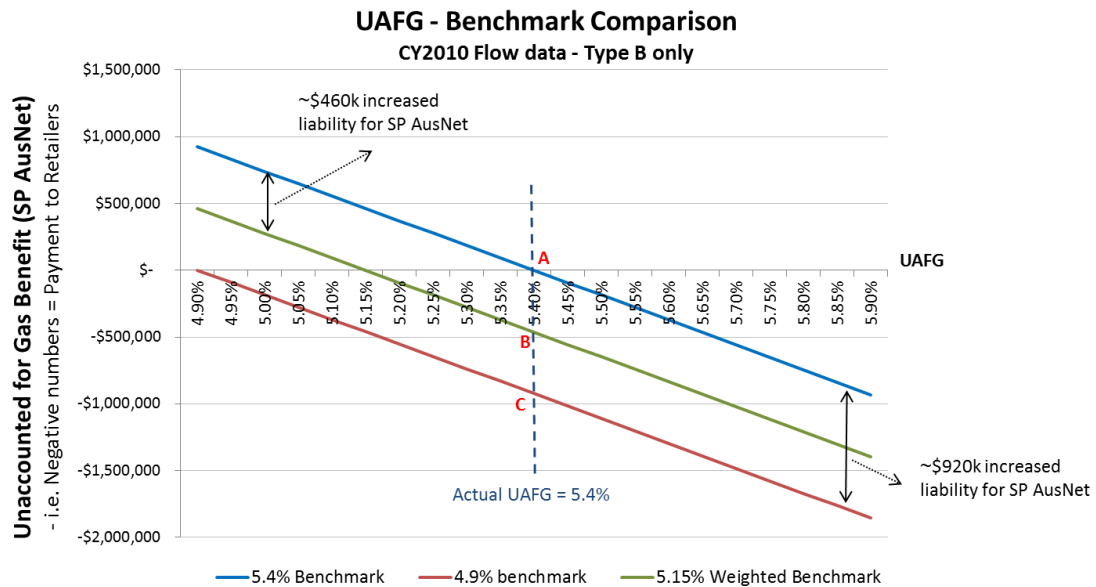


Figure 1 shows that regardless of the actual result, SP AusNet will pay more in penalty (or receive less in reward) in 2013 than if the benchmark had been updated at the start of the year – to the tune of half a million dollars.

The blue line represents the UAFG benchmark of 5.4% applied to SP AusNet’s network for Type B connections in 2013 (i.e. the ESC Draft Decision). Under the expected scenario where actual UAFG and Benchmark UAFG are equal, there is no financial reconciliation required. (Point A)

As the UAFG benchmark will increase under the ESCV Draft Decision, the delay in setting the benchmark has the impact of decreasing the effective benchmark for the period. The effective benchmark (i.e. the weighted average of 5.4% and 4.9% - based on time) is 5.15% for 2013. As UAFG is expected to be 5.4%, the effective reduction in UAFG benchmark increases SP AusNet’s financial liability. Using 2010

flow data as an estimate for 2013 flow data, this increased liability is in excess of \$450k (Point B).² A delay in updating the GDSC the last time the benchmarks were adjusted resulted in a 'delay penalty' to SP AusNet of over \$1 million in 2008 when the old benchmark of 4.5% was applied instead of the approved benchmark of 5.1%.

The delay to the benchmark adjustment results in a loss to SP AusNet and a windfall gain to retailers. However, if the benchmark was falling the situation would be reversed. Neither situation is desirable.

SP AusNet does not believe there is any basis for the penalty it faces under the Draft Decision proposal and believes that ESCV should adjust the 2013 benchmark appropriately to achieve a fair result.

Addressing problems from delay to updating benchmarks

SP AusNet accepts that a mechanism for retrospective adjustments to benchmarks may not exist. However, the administrative hurdles identified by the ESCV do not negate the need to ensure a fair outcome for the 2013 calendar year. ESCV could redress the penalty that has been imposed on the SP AusNet from the delay by making appropriate adjustments to the benchmark that will apply from 1 July 2013.

ESCV identified three concerns with respect to setting a 'blended target' (a target adjusted to reflect the wrong benchmark being used for the first six months) for 2013:

1. They do not have the data to set an accurate blended benchmark;
2. Seasonal factors may affect UAFG; and
3. A blended figure would exacerbate the uncertainty in UAFG over the full calendar year.

These concerns can be substantially addressed and do not justify the blunt 'do nothing' approach of the draft decision.

It is true that it is not possible to prospectively know all of the information required to perfectly set a blended UAFG benchmark. For example, total annual gas volumes and flow will affect the annual UAFG outcome. Similarly, seasonal factors will affect at what time of year most gas is consumed. However, this information can be forecast reasonably accurately. A blended benchmark based on such forecast information would be far more accurate than using a benchmark that assumes no error from the first six months.

The difficulty faced with setting a blended 2013 benchmark is similar to that faced by the AER in setting tariffs for 2013 in its recent Victorian Gas Access Arrangement Review, where the start of new tariffs was also delayed by six months. The AER was able to address this by using historical weather and consumption data to set simple assumptions about gas demand for 2013, to ensure that over the year the revenue collected from customers was in line with that approved in their Final Determination.

Below, SP AusNet provides two possible mechanisms that could be used to set a blended target for 2013. Both would substantially reduce the error over the 2013 year relative to the Draft Decision.

In relation to the third of the ESCV's concerns, SP AusNet does not believe that setting a blended target would result in uncertainty with respect to any material issues associated with UAFG. Firstly, the incentive rate will be the same throughout 2013 regardless of the benchmark that is set, so there will be no effect on actual UAFG volumes. Secondly, given there will be a new benchmark from July 1, it is not

² The actual penalty is affected by the volume and flow of gas in 2013. The model uses 2010 data to model flow through 2013. SP AusNet can provide further details if required.

clear what additional uncertainty setting the benchmark at the blended rate would cause.

Mechanisms for calculating a 'blended benchmark'

To provide equity, due to the delay in publishing the revised UAFG benchmarks, an adjustment is made to the part year 2013 (i.e. Jul to Dec) benchmark so that the weighted average benchmark for the full calendar year remains consistent with the ESCV Final Decision on UAFG benchmarks (i.e. 5.4% within the Draft Decision).

The simplest approach to setting a blended benchmark is an adjustment based on the number of days each benchmark would apply. The following formulae shows the calculation of the pro-rata benchmark based of the full calendar year benchmark provided for in the Final Decision.

$$B_{CY} = \left(B_1 \times \frac{D_1}{365} \right) + \left(B_2 \times \frac{(365 - D_1)}{365} \right)$$

B_{CY} = Full Calendar Year Class B Benchmark as per ESC - Final Decision

B_1 = Interim 2013 SP AusNet Class B Benchmark (Victoria Government Gazette No. S 460)

B_2 = Adjusted 2013 SP AusNet Class B Benchmark

D_1 = Period in days that the Benchmarks provided for in Gazette S 460 was applied over.

The following example provides a final adjusted benchmark that would be declared in the amended Schedule 1, Part C Unaccounted For Gas of the GDSC for the period remaining in the 2013 calendar year post the final decision on UAFG benchmarks.

B_{CY} = 5.4% as per the ESC Draft Decision – SP AusNet 2013 Class B Benchmark

B_1 = 4.9% as per the Victoria Government Gazette No. S 460 - SP AusNet 2013 Class B Benchmark

B_2 = Final adjusted 2013 SP AusNet Class B Benchmark

D_1 = 181 days based on the period from 1 January 2013 to 30 June 2013 (proposed GDSC amended effective 1 July 2013).

$$5.4 = \left(4.9 \times \frac{181}{365} \right) + \left(B_2 \times \frac{(365 - 181)}{365} \right)$$

$$B_2 = \left(\frac{5.4 - 2.43}{0.504} \right) = 5.89\%$$

A slightly more sophisticated approach to setting the blended benchmark would be to base it on historical gas consumption patterns. The formula shows how this could work using data from a nominated 'benchmark year', although this could also be done using historical averages.

$$B_{CV} = \left(B_1 \times \frac{F_1}{F_{Bench}} \right) + \left(B_2 \times \frac{(F_{Bench} - F_1)}{F_{Bench}} \right)$$

B_{CV} = Full Calendar Year Class B Benchmark as per ESC - Final Decision,

B_1 = Interim 2013 SP AusNet Class B Benchmark (Victoria Government Gazette No. S 460)

F_1 = Total Type B consumption in corresponding period of benchmark year (as per Victoria Government Gazette No. S 460),

B_2 = Adjusted 2013 SP AusNet Class B Benchmark, and

F_{Bench} = Total Type B consumption in the selected benchmark year.

The following example provides a final adjusted benchmark that would be declared in the amended Schedule 1, Part C Unaccounted For Gas of the GDSC for the period remaining in the 2013 calendar year post the final decision on UAFG benchmarks.

Calendar year 2010 has been used for the benchmark year due to the similarity of outcomes that year to the benchmark from the ESCV draft decision. The Final Decision is assumed to be introduced on 1 July 2013.

B_{CV} = 5.4% as per the ESC Draft Decision – SP AusNet 2013 Class B Benchmark

B_1 = 4.9% as per the Victoria Government Gazette No. S 460 - SP AusNet 2013 Class B Benchmark

F_1 = Total Type B consumption in corresponding period of benchmark year (as per Victoria Government Gazette No. S 460)

B_2 = Final adjusted 2013 SP AusNet Class B Benchmark

F_{Bench} = Total Type B consumption in selected benchmark year

$$5.4 = \left(4.9 \times \frac{21.2}{45.046} \right) + \left(B_2 \times \frac{(45.046 - 21.02)}{45.046} \right)$$

$$B_2 = \left(\frac{5.4 - 2.30}{0.529} \right) = 5.84\%$$

Both of the above formulations would significantly reduce the error caused by the delay to the benchmark adjustment and minimise the resulting windfall transfers that will occur between retailers and distributors. This is because they are based on assumptions that more closely reflect the pattern of gas flow that will actually occur in 2013 than the draft decision, which effectively assumes that 100 per cent of gas that is delivered in 2013 will occur in the second half of the year.

Should the ESCV or other stakeholders have additional concerns, these approaches could be refined further, to achieve the best non-biased forecast of the blended target based on historical data. SP AusNet is happy to provide any further data necessary to assist in this process.

Benchmarks for non-PTS network

For SP AusNet's non-PTS network, which covers the townships of Ararat, Stawell and Horsham, ESCV accepted that historic UAFG levels should provide the basis for the determination of UAFG benchmarks. However, in contrast to the approach for

the PTS network where the historical average was applied, ESCV applied a declining trend to set the benchmarks for SP AusNet's non-PTS network.

ESCV reasoned that there had been a consistent reduction in UAFG in the network since 2006, and that "it was likely that the trend could continue."³

SP AusNet disputes the trend analysis and disputes the setting of a benchmark based on what is possible rather than what is expected under normal operating practices.

Benchmark should be based on historical average

The way the UAFG scheme is set up, and the way Victorian Gas Distribution Businesses' are regulated to fund costs for the efficient operation of their gas networks, the UAFG benchmark should be the neutral outcome. It should not be a stretch target.

If a trend analysis is used to forecast future UAFG and the benchmark is set on this basis, then the incentive properties of the scheme are undermined. This is because the improvements in the future period are never rewarded under scheme. The effective reward for improvements in the current period is decreased. Only costless initiatives to reduce UAFG would be unaffected.

What does the historical trend signal for future UAFG?

For the broader PTS-network, ESCV accepted the evidence that UAFG has complex drivers and applied a flat benchmark. The commission's position reflected evidence presented by SP AusNet that UAFG can vary significantly from year to year (as shown in actual PTS UAFG results).

SP AusNet believes that it is similarly appropriate to apply a flat benchmark based on average historical performance for the non-PTS network. While there has been a downward trend in actual UAFG, these recorded reductions (from 2008 to 2011) are not clearly linked to activity on the non-PTS network (i.e. it is likely the movement in UAFG occurred by chance). This is reinforced by initial estimates for UAFG on the non-PTS for 2012 of 7.56%, showing a departure from the downward trend⁴.

Further, the trend applied to SP AusNet's non-PTS network results in such a significant drop in the benchmark in the regulatory period, that by 2015 the benchmark actually falls below the benchmark for the broader network (i.e. the PTS benchmark is 5.4% compared to 5.3% for the non-PTS in 2015, falling to 4.9% in 2017). The achievement of such a reduction in UAFG is not credible.

SP AusNet's non-PTS network covers established gas networks with an aged pipe network dating back to the early 1950's. These networks exhibit UAFG rates similar to that of aged low pressure networks within the PTS network. Based on what is known about the drivers of UAFG, as SP AusNet has previously presented in the AIA research, the characteristics of the infrastructure in the non-PTS network do not support that a level of UAFG in line with the Draft Decision benchmarks is likely, let alone the expected outcome.

The Draft Decision also suggests that the installation of custody transfer meters will support the further improvements in UAFG suggested by the benchmark. SP AusNet does not agree with the assumption that a downward trend would continue if custody transfer meters are installed at Ararat, Stawell and Horsham. ESCV have not provided any evidence to support this statement. A reduction in UAFG is not

³ ESCV, 2013, p.30

⁴ Data for 2011 and 2012 are not final as settlement with all retailers has not been completed.

expected from the installation of custody transfer meters at Ararat, Stawell and Horsham, with their justification based on accountability and deemed injection points between GPV and SP AusNet (i.e. SP AusNet is not responsible for the operation, maintenance or UAFG borne from the GPV pipeline).

SP AusNet reiterates the uncertainty surrounding the drivers influencing UAFG is consistent for PTS and non-PTS networks. There is no basis to indicate that the level and trend of benchmark UAFG set in the Draft Decision for the non-PTS network is sustainable. Therefore, the benchmark for the non-PTS network should be set based on the historical average, with no decline over the period.

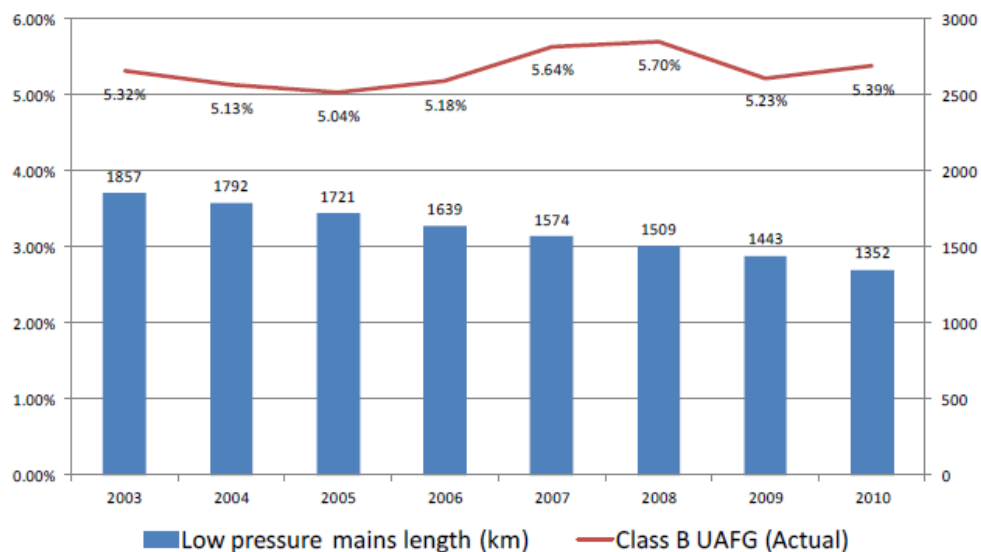
Flat or declining PTS benchmarks

ESCV accepted SP AusNet’s position that a flat benchmark is appropriate for the PTS-network but provided scope to apply a declining UAFG benchmark (linked to mains replacement) in the final decision.

SP AusNet refers ESCV back to the AIA report that assessed contributors to UAFG on SP AusNet distribution network. The report placed into perspective the expected UAFG benefit from the low pressure mains replacement program, and highlighted that any reduction in leaks (i.e. UAFG) resulting from mains replacement could be counterbalanced by increases from UAFG from other contributors (i.e. pressure and temperature variation, meter inaccuracies etc.) and the continued deterioration of the network.

Further to this and in relation to any declining factors, given that SP AusNet largely completed its funded 5 year low pressure mains replacement program, any benefit that may have resulted in a reduction in UAFG would be factored into the actual 2008-2012 results (where no declining trend was observed) and, therefore, would be carried forward into the 2013-17 period. As shown in the reproduced Figure 3.4 of the Draft Decision, mains replacement cannot explain levels of UAFG in SP AusNet’s PTS-Network.

Figure 3.4 SP AusNet comparison of mains replacement and UAFG, 2003–10



Reproduced from ESCV, 2013, p.15

As such SP AusNet reiterates its position that a flat benchmark based on the historical average is most appropriate for the 2013-17 period.