



SUBMISSION 49: Response to Specific Amendments

Date Submitted: 18 April 2011

DBNGP (WA) Transmission Pty Limited
ABN 69 081 609 190
Level 6, 12-14 The Esplanade
Perth WA 6000

Contact: Trent Leach, Manager Regulatory and Government Policy
Telephone: 08 9223 4357
Email: trent.leach@dbp.net.au

TABLE OF CONTENTS

1.	INTRODUCTION.....	1
2.	PIPELINE DESCRIPTION	3
3.	PIPELINE SERVICE DESCRIPTION	5
4.	THE CORRECT MEASURE OF CPI.....	7

1. INTRODUCTION

- 1.1. As per its obligations as a Complying Service Provider under the *National Gas Access (WA) Act 2009* (**NGA**), DBNGP (WA) Transmission Pty Ltd (**DBP**) filed the following documents with the Regulator on 1 April 2010:
 - (a) proposed revisions the Access Arrangement.
 - (b) proposed revised Access Arrangement Information; and
- 1.2. These documents contain the information that the NGA (which includes the WA National Gas Access Law text (**NGL**) and the National Gas Rules (**NGR**) requires to be included in order to enable them to be approved by the Economic Regulation Authority (**ERA**).
- 1.3. Subsequently, DBP has also filed a number of supporting submissions and responded to requests for further information from the ERA and its consultants.
- 1.4. Pursuant to rule 59 of the NGL, the ERA released its Draft Decision on 14 March 2011. The ERA's Draft Decision is not to approve DBP's proposed revisions to the Access Arrangement for the DBNGP. The ERA proposes some 109 amendments to the proposed revisions to the Access Arrangement.
- 1.5. The Draft Decision requires DBP provide revisions to its access arrangement proposal by 4:00pm (WST) Monday 18 April 2011. Additionally The NGR requires the ERA to allow at least 20 business days from the end of the revision period for public submission on the Draft Decision. Therefore interested parties are able to make submissions on the ERA's Draft Decision up until 4:00pm (WST) Friday 20 May 2011.
- 1.6. In addition to the revised Access Arrangement and revised Access Arrangement Information DBP makes the following submissions responding to amendments required by the ERA's Draft Decision:
 - (a) Submission (48) Overarching Submission
 - (b) Submission (49) Response to Specific Amendments (being this Submission)
 - (c) Submission (50) Reference Service
 - (d) Submission (51) Terms & Conditions
 - (e) Submission (52) Opening Capital Base
 - (f) Submission (53) Roll Forward of Capital Expenditure
 - (g) Submission (54) Operating Expenditure
 - (h) Submission (55) Rate of Return
 - (i) Submission (56) Other Tariff Matters
 - (j) Submission (57) Non Tariff Matters
- 1.7. In this submission DBP makes submissions in response to the following amendments or aspects in the Draft Decision:

- (a) Amendment #1 – Pipeline description
- (b) Amendment #4 – description of pipeline services
- (c) Amendment #13 - relating to the CPI measure

2. PIPELINE DESCRIPTION

2.1. Amendment 1 in the Draft Decision is as follows:

The proposed revised access arrangement should be amended to include a full description of the DBNGP to the same level of detail as set out in the access arrangement information.

- 2.2. DBP has incorporated this amendment in the Amended AA Proposal by including the pipeline description document in Attachment 2.
- 2.3. In the Original AA Proposal, DBP had described the covered pipeline by reference to pipeline licences that apply (including the pipeline licence for the BEP) and then by reference to a pipeline description document on DBP's website.
- 2.4. In paragraph 33 of the Draft Decision, the ERA states that "the pipeline description document on DBP's website does not appear to be kept up to date. At the date of the draft decision, this pipeline description does not include the leased capacity in the BEP despite the BEP lease having come into effect"
- 2.5. The pipeline description document is not out of date. It reflects the pipeline as it is currently regulated. The document is simply not consistent with the definition of the DBNGP in cl. 2 of the Original AA Proposal.
- 2.6. The reason why the pipeline description document in the website differs from the definition of the DBNGP in clause 2 of the access arrangement is that the pipeline description document can only be amended and published to align with cl. 2 once the revisions to the access arrangement have been approved. It is only at that point in time that those assets will form part of the covered pipeline and therefore only at that time will the pipeline description document be updated.
- 2.7. While DBP has addressed Amendment 1 in the Amended AA Proposal, DBP considers that it would have been more appropriate for the pipeline description document to:
- (a) remain separate from the access arrangement (which is what is envisaged under the NGR in any event);
 - (b) be placed on the DBP website; and
 - (c) be referenced in the access arrangement by the inclusion of a hyperlink to the DBP website page that contains the pipeline description.
- 2.8. This is so for a number of reasons:
- (a) By including the pipeline description document in the access arrangement (i.e as an appendix) then it will remain a static document until the next revisions are made to the access arrangement (currently scheduled for 2015). The pipeline may change during that period (e.g. through extensions or expansions) and any such additions should be part of the covered pipeline. If changes occur (although DBP has not proposed any such changes), DBP would only be able to update the pipeline description before 2016 by submitting a revised AA proposal to the ERA for approval.

- (b) Providing shippers with access to a potentially out of date document has caused confusion for shippers in the past and may continue to do so in the future.
- (c) A readily amendable document would still ensure that DBP complies with its obligations under rule 48(1)(a) of the NGR.

3. PIPELINE SERVICE DESCRIPTION

3.1. Amendment 4 of the Draft Decision provides the following:

The proposed revised access arrangement should be amended to include descriptions of the Tp, Tx and Ty Services and any other pipeline services that DBP is making available or will offer during the relevant access arrangement period.

3.2. Rule 48(1) of the NGR only requires DBP to include the following in the AA proposal in respect of pipeline services:

- (a) to specify each reference service; and
- (b) to include a description of pipeline services it proposes to offer.

3.3. Accordingly, Rule 48(1) does not require DBP to include a description of a service that DBP has previously offered but does not intend to offer in the future (i.e. the service is only available only under existing access contracts). DBP does not *offer* to provide a pipeline service to an existing shipper under an existing access contract – rather, DBP provides the pipeline service which was offered to the existing shipper at the time that DBP made the existing contract with it. There is no “continuing offer” to existing contracted shippers.

3.4. To require an AA proposal to include a description of such pipeline services which DBP will not offer during the AA period is an incorrect construction of the law and would therefore be *ultra vires*.

3.5. In relation to the three pipeline services listed in the Amendment, DBP makes the following submissions:

3.6. Tx service - A description of the Tx service has not been included in the Amended AA Proposal because:

- (a) DBP does not presently have a contractual obligation to provide it to any shipper;
- (b) DBP does not intend to make it available during the access arrangement period; and
- (c) there is no uncontracted capacity expected to be available on the pipeline during the period of the access arrangement that could be offered to a prospective user to access the Tx service.

3.7. As to the Tp service – A description of the Tp service has not been included in the Amended AA Proposal because:

- (a) although DBP presently has a contractual obligation to provide it to shippers but this service was only offered to shippers who accessed capacity as part of the Stage 5A expansion;
- (b) DBP does not intend to offer it available during the access arrangement period to any prospective shippers; and
- (c) there is no uncontracted capacity expected to be available on the pipeline during the period of the access arrangement that could be offered to a prospective user to access the Tp service.

- 3.8. Ty Service - This is a type of interruptible spot capacity service. DBP has therefore amended clause 3.6(a) of the Amended AA Proposal.

4. THE CORRECT MEASURE OF CPI

4.1. Rule 73 of the NGR requires, as the ERA noted in paragraph 101 of the Draft Decision:

- (1) *Financial information must be provided on:*
 - (a) *a nominal basis; or*
 - (b) *a real basis; or*
 - (c) *some other recognised basis for dealing with the effects of inflation.*
- (2) *The basis on which financial information is provided must be stated in the access arrangement information.*
- (3) *All financial information must be provided, and all calculations made, consistently on the same basis.*

4.2. Paragraph 102 of the Draft Decision noted that the proposed revised Access Arrangement Information of the Original AA Proposal set out, as the basis on which financial information was provided:

- *Financial information is provided in real terms with all values expressed in dollar values of December 2009;*
- *Real values of financial information have been calculated by applying escalation factors derived from December quarter values of the Consumer Price Index (All Groups, Perth); and*
- *Financial data is provided on a calendar year basis.*

4.3. The ERA advised, in paragraph 104 of the Draft Decision, that it was satisfied that the provision of financial information expressed in real values complied with the requirements of Rule 73.

4.4. However, the ERA was not satisfied that DBP had provided all information, and made all calculations, consistently on the same basis (Draft Decision, paragraph 105). Paragraph 105 set out the ERA's reasoning to arrive at this conclusion:

- (a) *the use of escalation factors based on the measure of inflation for Perth (the All Groups Perth CPI) is inconsistent with the rate of return applied in the calculation of the total revenue; and*
- (b) *the rate of return is estimated using a forecast of inflation for the Australian economy, consistent with an implicit assumption made in determination of the rate of return of the DBNGP that the DBNGP is being financed by Australian investors.*

4.5. For the purpose of deriving real values for the calculation of the total revenue, the ERA required escalation using the December quarter values of the Consumer Price Index (All Groups, Eight Capital Cities) (Draft Decision, paragraph 106).

4.6. In paragraph 133 of the Draft Decision, the ERA noted that, in "rolling forward" the capital base, DBP had applied escalation factors derived from the "all groups Perth" CPI. This, in the ERA's view, was incorrect. The roll forward of the capital base should have been undertaken using escalation factors derived from the "all groups eight capital cities" CPI (Draft Decision, paragraph 136).

4.7. Similarly, in paragraph 774 of the Draft Decision, the ERA noted that, in escalating actual operating expenditures for the purpose of applying the incentive mechanism in clause 7.12 of the Access Arrangement, DBP had used the “all groups Perth” CPI. In paragraph 775, the ERA advised that it had recalculated the amounts for the incentive mechanism by applying the “all groups eight capital cities” CPI.

4.8. The issue of the correct measure of CPI also arose in the ERA’s assessment of DBP’s proposed tariff variation mechanism in paragraph 971 of the Draft Decision. The ERA advised:

For reasons set out earlier in the draft decision (paragraphs 105 and 106), the Authority considers that the CPI values applied in the determination of reference tariffs should consistently be the “All Groups – 8 Capital Cities” consumer price index.

4.9. Amendment 13 of the Draft Decision therefore provided the following:

The proposed revised access arrangement should be amended to change the definition of CPI in the reference tariff variation mechanism to “CPI means the Consumer Price Index, All Groups, Eight Capital Cities.”
--

4.10. The requirement of Rule 73 to provide information, and to make calculations, consistently, is a requirement to provide similar information in the same way, and to make similar calculations in the same way so that the results are compatible or not contradictory. Requiring that information be provided, or that calculations be made, when that information, or those calculations, are not similar, leads to incompatibility and error.

4.11. The application of escalation in the roll forward of the capital base, and the treatment of inflation in calculations for a rate of return, may appear superficially similar but they are conceptually very different. To require, as the ERA does, in paragraph 106 of the Draft Decision, that they be treated in the same way leads to error.

4.12. The starting point for rate of return determination is, in accordance with Rule 87(2) of the NGR, a well accepted approach, and the approach which DBP has chosen to work with (an approach which the ERA has accepted in the Draft Decision) is calculation of a real pre-tax WACC.

4.13. The inputs to the WACC calculation, in particular the estimates of the cost of equity and the cost of debt, are initially calculated as nominal values, and the expectation of inflation which they contain must be removed in calculating a real WACC. Precisely what expectations of inflation these nominal values include will depend on the way in which expectations are formed by participants in financial markets. A vast body of economic research attests to the fact that this is not a straightforward matter. These expectations of inflation formed in financial markets are not conceptually or numerically the same as the past – actual – price changes for which a measure is sought for the purpose of rolling forward the capital base.

4.14. There is no issue of calculations being made, or not made, consistently when the CPI (All Groups, Perth) is used in the escalation factors used in the roll forward of the capital base, and a forecast of inflation is used as an estimate of expected inflation in determination of the rate of return. (The use of a forecast of inflation as an estimate of expected inflation is further examined below.)

4.15. The capital expenditures which DBP has made in the past, including the expenditures made during the period 2005 to 2010, and which have been escalated so that the opening

capital base for the period 2011 to 2015 is expressed in constant December 2009 prices, are expenditures largely incurred in Western Australia for the purpose of providing natural gas services to consumers of natural gas in Western Australia.

- 4.16. These capital expenditures are expenditures on labour, materials and services. DBP's operations are in Western Australia, and all of DBP's labour costs, irrespective of whether they are capitalised or charged to operations, are incurred in Western Australia.
- 4.17. Data drawn from DBP's procurement and materials management system indicates that, in 2010, expenditures with the fifty largest suppliers of materials and services for the DBNGP were distributed as shown in Table 1.

Table 1
Geographic distribution of 2010 materials and services expenditures

Location of supplier	Proportion of expenditure
Western Australia	72%
Australia (excl. WA)	17%
International	11%
	100%

- 4.18. During the period 2005 to 2010, prices were rising a little more rapidly in Western Australia than they were nationally. This can be seen by comparing the CPI (All Groups, Eight Capital Cities) with the CPI (All Groups, Perth). The two indexes, for the December quarter of each year, and the rates of price increase which they indicate, are shown in Table 2.

Table 2
CPI (December quarter) and year-on-year increase

	2004	2005	2006	2007	2008	2009	2010
All Groups, Eight Capital Cities	146.5	150.6	155.5	160.1	166.0	169.5	174.0
Year on year increase		2.8%	3.3%	3.0%	3.7%	2.1%	2.7%
All Groups, Perth	143.3	149.0	155.5	160.2	166.2	169.7	174.1
Year on year increase		4.0%	4.4%	3.0%	3.7%	2.1%	2.6%

Source: Australian Bureau of Statistics, catalogue number 6401.0.

- 4.19. Were the capital expenditures made during the period 2005 to 2010 to be expressed in constant December 2009 prices using as the measure of inflation the CPI (All Groups, Eight Capital Cities), when the prices of labour, materials and services were rising at a different rate – largely at the rate measured by the CPI (All Groups, Perth) – the reference tariffs for the period 2011 to 2015 would, other things being equal, diverge from the costs which they were intended to recover.
- 4.20. To the extent that reference tariffs for the period 2011 to 2015 under-recover the costs which DBP incurs, they would be an inducement for inefficient (inadequate) investment in the DBNGP, and for inefficient (excessive) use of natural gas services by consumers of natural gas. To the extent that reference tariffs for the next access arrangement period over-recover the costs which DBP incurs, they would be an inducement for inefficient

- (excessive) investment in the DBNGP, and for an inefficient (less than socially desirable) level of use of natural gas services by consumers of natural gas.
- 4.21. Reference tariffs which under-recover or over-recover DBP's costs would not promote economic efficiency, and would be inconsistent with the requirement of section 24(3) of the NGL that the service provider be provided with effective incentives to promote economic efficiency. They would not be consistent with the promotion of efficient investment in, and efficient operation and use of, natural gas services for the long term interests of consumers of natural gas.
- 4.22. Use of the CPI (All Groups, Eight capital Cities), instead of CPI (All Groups, Perth), in the roll forward of the capital base would not satisfy the national gas objective.
- 4.23. Similarly, in escalating actual operating expenditures for the purpose of applying the incentive mechanism in clause 7.12 of the Access Arrangement:
- (a) a large proportion of DBP's costs are incurred in Western Australia, and the appropriate measure of past – actual – price change to be applied is CPI (All Groups, Perth); and
 - (b) there is no issue of calculations not being made consistently when the CPI (All Groups, Perth) is used in the escalation of these operating expenditures, and a forecast of inflation is used as an estimate of expected inflation in determination of the rate of return.
- 4.24. There is no basis for recalculation of the amounts for the incentive mechanism by applying the CPI (All Groups, Eight capital Cities) as the ERA indicated it had done in paragraph 775 of the Draft Decision.
- 4.25. Required Amendment 8 of the Draft Decision also requires use of the CPI (All Groups, Eight Capital Cities), and not of the CPI (All Groups, Perth), so as to ensure all calculations are made consistently. Again there, is no issue of calculations not being made consistently when the CPI (All Groups, Perth) is used in the tariff variation mechanism, and a forecast of inflation is used as an estimate of expected inflation in determination of the rate of return.
- 4.26. In the case of reference tariff variation, a measure of actual inflation is to be applied to an allocation of total revenue which includes a large component of return on the capital base. The argument might then be made that the measure of escalation to be applied so as to ensure that the reference tariff provides DBP with a reasonable opportunity to recover the costs it actually incurs should be the measure of expected inflation in the rate of return, and not the CPI (All Groups, Perth). There is, however, no explicit measure of expected inflation in the rate of return. Expected inflation is not the same as actual inflation measured by either the CPI (All Groups, Perth), or the CPI (All Groups, Eight Capital Cities). Use of either actual measure of inflation would amount to approximation. Since a part of the total revenue comprises allocations of capital expenditures (via return and depreciation), and operating expenditures, a large part of which are incurred in Western Australia, the better approximation to use is the CPI (All Groups, Perth). For reasons similar to those set out above in relation to roll forward of the capital base, tariff escalation using of CPI (All Groups, Perth), rather than the CPI (All Groups, Eight capital Cities), would better satisfy the national gas objective.