Issues Paper on Proposed Revisions to the Mid-West and South-West Gas Distribution System Access Arrangement

Alinta Energy

Submission

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1 Introduction

Alinta Sales Pty Ltd (**Alinta Energy**) is pleased to provide comment on the *Issues Paper on Proposed Revisions to the Mid-West and South-West Gas Distribution System Access Arrangement* (**Issues Paper**) prepared by the Economic Regulation Authority (**Authority**). The Issues Paper raises the key points in the proposed revised *Access Arrangement for the Mid-West and South-West Gas Distribution Systems* (**AA4**) offered by ATCO Gas Australia (**ATCO**) and covering the five and a half year period from 1 July 2014 to 31 December 2019.

Alinta Energy has over 640,000 residential, business and commercial and industrial customers supplied directly from ATCO's Mid-West and South-West Gas Distribution System (**Network**) in Western Australia. To obtain access to the Network, Alinta Energy is a signatory of ATCO's Haulage Contract, which sets out the terms and conditions upon which ATCO will provide services to a user.

2 Executive Summary

Alinta Energy has a number of concerns with the proposals submitted by ATCO in its AA4 and recommends that the Authority:

- Considers the impact of any network price increases that may be worn exclusively by Alinta Energy if there is any misalignment between ATCO's new tariffs and the Government's retail tariff decision;
- Examines, in consideration of the above, whether the desired price signals to customers will be achieved;
- Assesses the detriment to customers and retailers of the introduced price volatility resulting from ATCO's proposal;
- Carefully scrutinises operating costs, which are forecast to be higher in the AA4 period than for the current access arrangement (**AA3**) period. In particular, the proposed spend on unaccounted for gas and marketing and business development should be reviewed;
- Determines whether costs incurred over the AA3 period were prudent and can be justified, given that the proposed conforming capital expenditure for the AA3 period is greater than forecast;
- Verifies the capital expenditure forecast for the AA4 period and satisfies itself that it is creditable, given the significant increase proposed;
- Considers permitting the fixing of the debt risk premium for a longer period to allow certainty for investors and consumers;
- Investigates whether a tariff variation mechanism that removes risk associated with declining customer volume and consumption incentivises ATCO to operate efficiently; and
- Explores the impact of the proposed increased standing charges, particularly on low-consumption residential customers.

These issues are discussed further in the sections below.

3 Pricing

3.1 Retail price setting

Alinta Energy's gas tariff is set by the Western Australian Government when it publishes the prices in the *Energy Coordination (Gas Tariffs) Regulations 2000* (**Tariff Regulations**). Under the Tariff Regulations, Alinta Energy is entitled to increase its regulated gas tariff by CPI each financial year. By default, if Alinta Energy wants to increase the tariff above this amount it must request that the Government amends the Tariff Regulations. There is currently no process for how this is to occur including:

- How an application should be made by Alinta Energy;
- What the Government should consider when considering the application;
- What consultation should occur; and
- The timeframes for a decision.

Importantly, there is also no requirement for an independent person/body to make an assessment of the application.

Accordingly, any request by Alinta Energy to the Government to amend the Tariff Regulations comprises a risk that the application won't be approved, even if the change was supported by all market participants, including the Authority.

It is therefore vital, in making an assessment of the AA4, the Authority understand that:

- Alinta Energy will wear the cost of any network price increase which the Government won't allow Alinta Energy to pass through to customers;
- Any change in tariff structure may not be able to be passed through by Alinta Energy unless the Government allows it;
- Any volatility in ATCO prices year to year increases the risk to Alinta Energy of not being able to pass through any cost increases. This is because the Government may not want to consider a retail tariff review on an annual basis; and
- If the Authority wants to send price signals to customers, it won't be able to achieve this without Alinta Energy obtaining agreement from the Government concerning the above.

In other words, unless there is alignment between what the Authority decides will be ATCO's new tariffs and the Government's retail tariff decision, Alinta Energy will be the only party impacted by the change in tariffs.

Ideally, the network and retail tariff reviews will be completely aligned and network costs will be a direct pass-through by retailers to consumers. This is best achieved in a competitive market through price deregulation, as has been introduced in the Queensland, NSW, Victorian and South Australian retail markets. Alinta Energy would welcome the opportunity to talk to the Authority and the Government about this matter.

3.2 The Impact of price volatility on customers

In an environment where retailers are able to pass through network cost increases, Alinta Energy notes ATCO's proposed AA4 will result in material price volatility worn by consumers. This is due to:

- The initial change in tariff structures, which will lead to a significant increase in gas tariffs for low consumption consumers;

- The move to a revenue cap methodology, so that consumers will wear gas volume risk and resulting annual price changes; and

- The annual setting of the debt risk premium, resulting in price volatility year on year.

Each of these issues is discussed in detail in Alinta Energy's submission. However, it is important the Authority, when considering these matters, assesses the overall impact of price volatility on consumers, including:

- Retailers often provide customers, particularly small business customers which tend to contract for up to 3 years, with a bundled retail price which the consumer can then rely on for budgeting purposes. If prices are volatile the only way retailers can offer such a product is by adding a risk premium. Alternatively, contracts can have a network pass-through clause which allows retailers to pass through the impact of network cost changes – effectively passing on the volatility to customers;

- Price certainty is beneficial to customers when choosing energy appliances. Natural gas competes with electrical, solar and LPG products for cooking, heating and hot water. Volatile prices makes it more challenging for consumers to make an informed product choice based on energy costs; and

- Price volatility can make it more challenging for consumers to make a choice between gas retailers. When comparing gas retail offers a consumer needs certainty about price. Where prices are changing regularly this can make it more difficult, particularly where retailers are not aligned on the pass-through of network cost changes.

Alinta Energy therefore requests the Authority take into account the detrimental impact on customers of price volatility when assessing ATCO's AA4.

It is Alinta Energy's preference the Authority determine a smooth price path for ATCO, to limit any initial price volatility.

4 Costs

4.1 Operating expenditure

Operating expenditure is forecast to be some 30 percent higher in the AA4 period than for the AA3 period. ATCO attributes this marked increase in expenditure to Safety Case requirements and the cost of servicing the Network.

Alinta Energy advises the Authority to carefully scrutinise forecast operating expenditure in the following areas:

Unaccounted for gas

The forecast spend on unaccounted for gas (**UAFG**) in the Network for the AA4 period is some 15 percent higher than for the AA3 period. However, ATCO has recently gone out to tender for providers of UAFG for the AA4 period and it is likely the next wholesale gas price offered under the tender process will be lower than that under the AA3 tender process. The forecast expenditure on UAFG should be adjusted to reflect the outcome of ATCO's tender process.

UAFG is highly weighted to B3 tariff customers due to most gas leaks occurring in medium and low pressure residential areas, so any increases in UAFG will be borne primarily by residential customers.

Marketing and business development

ATCO has recently launched an extensive advertising campaign, including television commercials, outdoor ad shelters and press. It is interesting to note that ATCO considers this initial marketing activity uses “lowest cost channels”[1]. Alinta Energy would consider the advertising channels used by ATCO and the intensity of this initial campaign as high cost, at least from an energy retailer’s point of view.

ATCO’s proposed marketing and business development activities for the AA4 period support very small increases in new connections (on average 1,316 per annum[2]) at a cost of approximately $3,000 per new connection[3]. The Authority needs to determine whether this spend is reasonable and has the desired outcome.

Alinta Energy would question the value of marketing activities outside incentives for new customer connections and a general promotion of the “gas is good” message. Alinta Energy has fielded several calls recently from confused customers querying ATCO’s role in the natural gas market.

Alinta Energy also notes the *Access Arrangement Information* (**AAI**) incorrectly states “there has been very little activity in relation to marketing the benefits and use of natural gas in Perth”[4]. Alinta Energy’s ongoing “Save with Gas” campaign promotes the benefits of natural gas, informs customers as to savings that can be made and includes savings on natural gas appliances. Indeed, Alinta Energy partnered with ATCO for the Capricorn Estate project, which comprised a campaign promoting the conversion to natural gas appliances for residents of a recently reticulated Perth suburb. Alinta Energy would be happy to discuss with the Authority the benefits and challenges of such a program.

4.2 Capital expenditure

Alinta Energy urges the Authority to scrutinise the following components of capital spend:

Opening capital base

The opening capital base for the AA4 period includes $273.8m of conforming capital expenditure[5] for the AA3 period. This value is greater than the $232.316m[6] ($ Dec 09) forecast over the same period and should be scrutinised by the Authority to determine whether costs incurred over the AA3 period were prudent and can be justified in accordance with Rule 97(1) of the National Gas Rules[7].

[1] AAI S. 6.7.3(f) p. 82

[2] Calculated from AAI Table 16

[3] Calculated from AAI Tables 15 & 16

[4] AAI S. 6.3.7(b) p.78

[5] AAI S. 9.3 Table 74 p. 208

[6] *Access Arrangement Information for the WA Gas Networks Pty Ltd, now known as ATCO Gas Australia, Mid-West and South-West Gas Distribution Systems*, 28 June 2012, Table 12 p. 10.

[7] *National Gas Rules,* version 20, 1 April 2014.

Expenditure by network businesses across Australia has greatly increased overall prices to consumers over the last ten years. Alinta Energy notes the National Gas Rules allow the Authority to reference past capital objective against a range of criteria such as efficiency, good industry practice and sustainable cost. Alinta Energy urges the Authority to assess **all** of ATCO's past capital expenditure against the relevant criteria contained in the National Gas Rules.

Forecast capital expenditure

Forecast capital expenditure over the AA4 period ($605.7m) is significantly greater than the (forecast/proposed conforming) capital expenditure for the AA3 period; on an annualised basis more than an 80 percent higher. ATCO attributes this marked increase in expenditure to Safety Case requirements and the cost of servicing the Network.

Alinta Energy questions ATCO's ability to actually undertake the level of capital expenditure proposed and requests that the Authority compare the proposed spend against other network industry benchmarks. In particular, given the age, size and growth forecasts for the Network, the level of capital expenditure seems excessively high; for example, spend on ATCO's high pressure system is forecast to increase three-fold.

Alinta Energy cautions against network tariffs that reflect a level of capital expenditure that seems unreasonable, as this places an unnecessary burden upon users of the Network.

4.3 Total Revenue

4.4 Price volatility caused by annual changes to the debt risk premium

In its accompanying AAI, ATCO explains[8] that it has departed from the Authority's *Rate of Return Guidelines* in relation to the estimation of the cost of debt. ATCO believes that the adoption of a five year term for debt does not provide an opportunity to recover efficient costs and an annual update to the debt risk premium would introduce additional risks.

Alinta Energy considers it important to consider the impact on end use customers of regulated assets when determining the rate of return to apply during an access period. Network customers such as Alinta Energy require price certainty to minimise financial risks when entering into energy contracts with end use customers. In addition, consumers benefit from price certainty.

Greater volatility in the debt risk premium will flow through to end use customers via higher and potentially more volatile prices. It is not in the best interests of end use customers to be subject to tariffs that vary significantly year on year. Without certainty, the only way to manage this risk is by passing it on to customers via higher overall energy prices.

Given the significant value that investors and end use customers place on price certainty, Alinta Energy considers the Authority should permit the fixing of the debt risk premium for a longer period to allow certainty for investors and consumers and ensure continual investment in the Network.

[8] AAI S. 10.3.7 p. 229

5 Reference Tariffs

5.1 Tariff variation mechanism

The *National Gas Access (WA) (Local Provisions) Regulations 2009* (**Access Regulations**) require the ERA to take into account (Reg. 7):

“the possible impact of the proposed reference tariffs, the method of determining the tariffs and the reference tariff variation mechanisms on —

(a) users to whom gas is or might be delivered by means of a small delivery service provided for in the access arrangement; and

(b) small use customers to whom gas is or might be delivered by those users.”

ATCO has proposed a tariff variation mechanism for B2 and B3 customers that affords a revenue yield per customer, rather than employing the weighted average price cap approach applied over previous access arrangement periods.

This means B2 and B3 reference tariffs will increase by more than forecast if anticipated consumption per customer declines and will decrease if consumption per customer increases.

The primary purpose of the price cap regime is to incentivise ATCO to operate efficiently given it would be able to keep the benefit of any efficiency gains obtained during the access arrangement period. The alternative approach of a revenue yield provides no such incentive for ATCO.

In addition, the traditional price cap methodology places the risk of declining customer volume and consumption onto the entity accountable, thereby incentivising it to at least maintain its customer base at forecast consumption levels. This methodology is employed in the setting of retail prices and Alinta Energy does not believe it is equitable for retailers to wear price risk whilst the network operator does not wear any. Gas is a viable fuel and network and retail businesses should be encouraged to work hard to obtain new customers and increase demand. Alinta Energy would also question the benefit of ATCO’s proposed spend on an intensive marketing campaign if it has the benefit of remaining whole regardless of whether the campaign is effective or not.

ATCO notes[9] that the actual impact on customers will “depend on any changes that the retailers make to their charges to reflect the changes in the network charge” and that their analysis assumes changes to the reference tariff are passed directly through to customers. As noted earlier in this submission, Alinta Energy will wear the cost of any network price increase which the Government won’t allow Alinta Energy to pass through to customers.

Alinta Energy considers that the proposed tariff variation mechanism is inconsistent with the Access Regulations and does not fairly apportion risk amongst participants in the gas market.

[9] AAI S. 12.5.1 p. 273

5.2 Standing charge increase

ATCO proposes an increase of 125 percent to the current standing charge for B3 customers, with a corresponding decrease in the variable charge. It is understood the purpose of the increase is to ensure ATCO is able to recover a greater proportion of its fixed costs.

Whilst Alinta Energy accepts that a large proportion of ATCO's costs are fixed, it does not support this change given the overall impact on consumers if Alinta Energy is permitted to pass on this cost.

If Alinta Energy is not permitted by the Government to pass through the change in standing charges to customers it will wear the full impact of the increase. This will be exacerbated in a competitive market where new entrant retailers are able to make offers to high value customers, leaving Alinta Energy to supply low use consumers at below cost.

Furthermore, those customers with the least consumption will wear the burden of network charges rather than those who consume more, such that usage becomes less relevant in allocating costs. Customers with low consumption (0-5GJ) may choose to disconnect due to the increased cost of running appliances. This would be contrary to ATCO's proposed marketing campaign which is aimed at increased connections and consumption. In addition, if a customer disconnects without paying for the removal of the meter, Alinta Energy will continue to pay ATCO the standing charges for the site. Again, this will leave Alinta Energy in a position where it wears the consequence of the changed tariff structure.

The apportionment of network costs can be achieved in a variety of ways. Alinta Energy does not consider recovering a higher portion of the revenue requirement through fixed charges necessarily sends more appropriate price signals to consumers. Alinta Energy considers that costs should be apportioned across those consumers incrementally utilising the Network, not through higher fixed costs.

Given the above, Alinta Energy does not agree with the increased standing charges, particularly to low-consumption residential customers who will wear a disproportionate amount of cost in comparison with their overall usage.

6 Other Issues

6.1 Sharing responsibility for customer debt

Energy is one of the few products where the customer receives supply prior to making payment. This exposes the retailer to a greater risk of non-payment as the goods and services have been consumed prior to seeking the recovery of costs. The regulatory framework, in particular the consumer protection provisions under which retailers are required to operate, contains stringent obligations on how a retailer is to interact with a customer in managing issues of non-payment. Arguably, the tools afforded to a retailer under the current framework limit the retailer's ability to efficiently and effectively manage their risk.

Further, retailers, as the end point in the energy supply chain, face the greatest level of exposure, as they continue to be obligated to meet their financial responsibilities to suppliers (network, wholesale and generation) regardless of whether the retailer's customer has met their financial obligations.

Retailers carry the responsibility for customer non-payment whilst the network remains financially whole regardless of whether the retailer receives payment from the customer. Where a customer fails to pay their account, which consists of retail and network charges, the retailer must continue to meet its financial obligations to the network operator. In addition, the retailer may be required to provide credit support to the network operator to cover a potential possibility of non-payment by the retailer for incurred network costs. This creates an unsustainable ongoing level of risk for retailers. There is also a cross subsidy by customers that pay their bills to those who don't.

Alinta Energy seeks to implement market reform that would see a shared allocation of both the consequence and risk from customer non-payment to the parties that benefit from the supply of energy to customers. Specifically, this reform would see ATCO taking on a shared responsibility for customer non-payment.

This reform includes a proposition whereby retailers are not required to make network payments where customers are delinquent in meeting their financial responsibilities for the supply of energy. In return, a higher risk premium in ATCO's regulated rate of return may be acceptable.

A shared responsibility may introduce whole-of-market benefits. In a competitive retail market, a significant issue faced by retailers is habitually non-paying customers "retailer shopping" in order to maintain supply whilst continuing to default on their financial obligations. A market reform change that sees the network operator incurring a partial debt management responsibility may result in such a customer being disconnected at a network level, requiring the customer to extinguish its debt with the network operator before supply is re-established, limiting any value to the customer switching retailers to re-establish supply.

Alinta Energy would be pleased to discuss this matter further with the Authority.

7 Terms and Conditions

The Template Haulage Contract sets out the terms and conditions upon which ATCO will provide services for the haulage of gas from specified receipt points to specified delivery points on the Network. Provisions in the Template Haulage Contract should ensure that customers are provided with acceptable standards of service and retailers are treated equitably, ensuring fair and robust competition in the retail gas market.

Alinta Energy's major concerns with the Template Haulage Contract are:

- Security (clause 16 and Annexure B) – it is unreasonable for all Users to be required to provide a Bank Guarantee upfront. Previously, a Bank Guarantee was only required where there was a material adverse change in a User's financial condition. Also, Annexure B should able to be negotiated because each of the User's banks will have different requirements for the contents of the guarantee.
- Liability (clause 17) – this clause is too broad and does not allocate liability where the risk is best controlled. All of the liability is placed on the User whereas Alinta Energy considers the Service Provider is the party best able to control the risk.
- Curtailment – Alinta Energy believes it is the Service Provider's role to determine priority for delivery of gas in the case of curtailment because the Service Provider has visibility of the network as a whole and can best advise where the curtailments should occur.