Draft Decision on Proposed Revisions to the Access Arrangement for the Mid-West and South-West Gas Distribution System

Alinta Energy

Submission

12 January 2015

1 Introduction

Alinta Sales Pty Ltd (**Alinta Energy**) is pleased to provide comment on the *Draft Decision on Proposed Revisions to the Access Arrangement for the Mid-West and South-West Gas Distribution System* (**Draft Decision**) prepared by the Economic Regulation Authority (**Authority**).

Alinta Energy notes the Authority's decision not to approve the proposed revised *Access Arrangement for the Mid-West and South-West Gas Distribution Systems* (**AA4**) offered by ATCO Gas Australia (**ATCO**) for the five and a half year period from 1 July 2014 to 31 December 2019.

Alinta Energy is generally supportive of the approach the Authority has taken in its Draft Decision to limit the costs incurred by ATCO which are ultimately passed through to customers in the form of higher prices, however Alinta Energy would like to raise a number of concerns in the sections below which question whether the Authority has set an appropriate balance between limiting ATCO's expenditure in the short term and ensuring the medium to long term interests of customers are maximised.

In making these comments Alinta Energy has considered ATCO's *Response to the ERA's Draft Decision on required amendments to the Access Arrangement for the Mid-West and South-West Gas Distribution System* (**Response**) dated 27 November 2014.

2 Background

2.1 Importance of continuing investment in gas infrastructure

It's important in considering ATCO's access arrangement that the Authority seek to achieve an appropriate balance between the price paid by consumers of gas in the immediate access period and the incentive for ATCO to continue to invest in gas infrastructure which benefits all current and potential gas consumers in the medium to long term.

This view is in keeping with the National Gas Objective[1] which states:

> *"The objective of the Law is to promote efficient investment in, and efficient operation and use of, natural gas services for the long term interests of consumers of natural gas, with respect to price, quality, reliability and security of supply of natural gas."*

Ongoing investment in gas infrastructure is vital for:

- Reducing the price paid by gas consumers in the medium to long term so the largely fixed cost of gas infrastructure is spread over a greater number of customers;
- Ensuring safety and reliability of the network; and
- Offering consumers the choice between electricity and gas appliances at their premises.

To ensure AA4 provides the incentive for ongoing investment, the Authority must provide a reasonable rate of return commensurate with similar businesses nationally and internationally, as well as ensuring all reasonable capital and operating costs are covered. In addition, the forecast average consumption should be as robust as possible given it is a clear driver of forecast revenue.

[1] *National Gas Access (WA) Act 2009*

Accordingly, Alinta Energy requests the Authority consider the comments below on the Draft Decision to ensure the best outcome for consumers in the long term.

2.2 Network and retail tariffs

As stated in Alinta Energy's submission[2] regarding the Authority's Issues Paper[3], there is currently a misalignment between how network and retail gas tariffs are set, which results in a risk that any new network tariffs and/or a revised tariff structure cannot be reflected in small use customers' retail tariffs.

In making its final decision in relation to AA4 the Authority must consider the impact of the tariff on retailers and customers in light of the current retail tariff setting mechanism, including:

- Whether price signals from the network operator can actually be sent through to end use customers; and
- Recognising that volatile prices both within and between access periods exacerbate the problem for retailers being able to pass through price changes to customers.

Further information on this issue is contained in this submission.

3 Rate of Return

Alinta Energy requests the Authority consider the impact of the rate of return on on-going investment in gas infrastructure.

In particular, Alinta Energy asks the Authority to consider whether reducing the rate of return to 5.94 per cent suggests network businesses – and by the nature of their relationship, retail businesses – are worth less in Western Australia than in other parts of the country. A low rate of return will indicate to potential equity and debt participants that there is no value in ongoing investment in local gas network infrastructure and this may have a flow-on effect to other assets within the state, including gas transmission and electricity infrastructure.

3.1 Debt risk premium

The provision of debt should be a cost recovery element similar to operational expenditure, not a source of profit or an unreasonable cost burden. Therefore the allowance the Authority needs to include for the debt risk premium (**DRP**) should reflect the actual costs an efficient network operator would incur.

It is noted the National Gas Rules (**NGR**) set out a number of additional requirements, including that the allowed rate of return must incorporate a return on debt that would be required by debt investors over a relevant time period[4]. Alinta Energy therefore agrees with the Authority's move to adopt a 10 year term[5] for its estimate of the DRP as this longer period, in theory, allows certainty for investors and consumers.

However, Alinta Energy understands that while a longer term view of the DRP has been taken by the Authority, the DRP is subject to annual updates which will then be reflected in the next access arrangement period. In addition, the Authority proposes to estimate the

[2] *Issues Paper on Proposed Revisions to the Mid-West and South-West Gas Distribution System Access Arrangement – Alinta Energy submission*, 21 May 2014

[3] *Issues Paper on Proposed Revisions to the Mid-West and South-West Gas Distribution System Access Arrangement,* Economic Regulation Authority, 2 May 2014

[4] *National Gas Rules Version 22*, Part 9 Price and Revenue Regulation, Rule 87 Rate of return

[5] Draft Decision, para. 832

DRP using more than one methodology and then apply the lowest cost methodology in its determination.

Alinta Energy is concerned the Authority's approach does not provide sufficient incentive for ATCO to invest on the basis of a chosen prudent debt risk management strategy at a point in time, given that it is with perfect hindsight that the Authority will decide the most efficient approach and adjust ATCO's return accordingly into the future.

In addition, the approach will import volatility into prices at the beginning of each access arrangement period as prices are adjusted in line with an ex-post review of the DRP.

Alinta Energy is concerned the Authority's approach to the DRP is not in consumers' long term interests.

4 Greenfield Growth and Customer Demand Forecasts

Alinta Energy understands the Authority has excluded ATCO's proposed customer initiated greenfield growth capital expenditure from conforming capital expenditure and reduced ATCO's forecast number of B3 customers accordingly[6].

ATCO submits in its Response that excluding greenfield expenditure will reduce new connections from the current annual rate of between 15,000 and 20,000 to approximately 2,000[7]. Alinta Energy is very concerned about this outcome given it means that over the access arrangement period up to 90,000 households will miss the opportunity to have gas connected at their premises.

Alinta Energy notes that without an appropriate incentive to invest through the AA4 period, ATCO is likely to discontinue its greenfield investment program; if the investment is deemed uneconomic by the Authority, ATCO will have no way of recovering this expenditure in the current or in any future access arrangement periods.

Therefore the Authority has a vital role to play in ensuring natural gas continues to be accessible to Western Australian consumers by providing sufficient incentive for ATCO to invest.

4.1 Efficiency of greenfield investment

Alinta Energy is particularly concerned about discontinuing greenfield investments that offer new subdivisions the opportunity to connect to natural gas. Installation of gas mains in shared utility trenches is highly cost-effective and connection rates are higher as new homes can be designed to incorporate gas appliances.

The Authority's proposal to allow only capital expenditure for the connection of so-called brownfield customers located within 20 metres of a main will deny customers in new subdivisions a choice of energy alternatives and have a significant flow-on effect to the market in terms of reduced customer numbers and total consumption.

Alinta Energy is therefore concerned that the Authority's Draft Decision may ultimately mean that it will never be economic for new subdivisions to access gas, given the best opportunity to lay gas pipelines (ie when the trench is open) will be lost. Alinta Energy recognises that such an outcome would be detrimental to these WA consumers and ultimately impact their ability to optimise or choose their preferred energy mix.

[6] Draft Decision, para. 119

[7] Response, para. 13

Alinta Energy therefore urges the Authority to consider including greenfield capital expenditure where ATCO can provide evidence that the initiative satisfies rule 79(2)(b) of the NGR, whereby capital expenditure is justifiable if the present value of the expected incremental revenue to be generated as a result of the expenditure exceeds the present value of the capital expenditure. In this regard, Alinta Energy notes the importance of robust forecasts of consumption at new connection sites, as well as ensuring a reasonable rate of return on greenfield investments.

4.2 Customer demand

Alinta Energy notes the Authority has adjusted ATCO's annual demand forecast for new B3 customers to 12 GJ[8], which is based on the first year of demand from a site. Alinta Energy cautions against using a customer's first year of consumption for forecasting purposes. In the first year of connecting to gas, customers may consume less than in the second and subsequent years. For example, in the case of a newly-built home, a customer may initiate the gas connection several months before moving into the premises. For an established home newly connected to gas, a customer may purchase an initial gas appliance and gradually add further appliances over a number of years.

Weather also plays a role in determining a customer's demand. For instance, 2013 experienced an unusually warm winter and Alinta Energy observed lower gas usage than forecast.

Alinta Energy's current forecast indicates an average residential consumption of approximately 16 GJ.

The Authority's proposed demand forecast of 12 GJ for new B3 customers may make it uneconomic for ATCO to connect these customers. Alinta Energy is of the view that 12 GJ may be too low given average residential consumption is 16 GJ.

Alinta Energy urges the Authority to revise its forecast consumption in line with the comments above.

5 Safety Requirements

The Draft Decision notes that ATCO identified safety requirements as a key driver for the proposed increase in both forecast operating expenditure and capital expenditure over the access arrangement period[9].

The Draft Decision asserts that the Authority's consultant, Energy Market Consulting associates (**EMCa**), is concerned that the risk thresholds adopted by ATCO when conducting Formal Safety Assessments (**FSAs**) are low by industry standards and are neither prescribed by the relevant safety standards nor mandated by Energy*Safety*[10]. The Authority therefore considers that the risk thresholds adopted by ATCO would give rise to inefficient levels of incremental recurring network operating expenditure.

Furthermore, EMCa is concerned that ATCO has not justified the Mid-West and South-West Gas Distribution System (**GDS**) Safety Case thresholds that it has applied for supply security levels[11] and has adopted a risk threshold for catastrophic events lower than that employed

[8] Draft Decision, para. 119

[9] Draft Decision, para. 21

[10] Draft Decision, para. 226

[11] Draft Decision, para. 442

by other gas distribution networks[12]. The Authority is therefore not satisfied that projects pertaining to supply security are justifiable.

Alinta Energy notes that the GDS Safety Case was developed in consultation with Energy*Safety* under the relevant regulations. Alinta Energy also notes Energy*Safety's* considerable concerns about the Authority's Draft Decision and its specific comments[13] in relation to its safety concerns arising from the Draft Decision.

Alinta Energy is concerned about the conflicting advice the Authority has received from the specialist regulator (Energy*Safety*) and its consultants (EMCa). Alinta Energy urges the Authority to consult with Energy*Safety* concerning the risk thresholds and related security of supply projects proposed by ATCO as part of AA4 before finalising the associated forecast operational and capital expenditure. In this regard, Alinta Energy notes it agrees with Energy*Safety* that the societal costs of a major gas outage should be considered in any cost-benefit assessment of prospective supply security projects[14].

6 Reference Tariffs

Alinta Energy noted in its earlier submission to the Authority concerning AA4 that regulated gas tariffs are set by the Western Australian Government and only CPI increases are permitted each financial year without approval. This means that, in the current regulatory environment, any change to tariff structures may not be immediately achieved. In addition, year on year price volatility creates a significant concern for retailers as it is more difficult to pass price changes above CPI through to customers.

Alinta Energy also notes in this regard that it is very difficult for the Authority to define the overall impact of the Authority's final decision on customers given the Authority has no role in how the cost impacts are passed through to customers.

6.1 Tariff variation mechanism

Alinta Energy noted in its earlier submission that it did not support ATCO's proposed revenue yield tariff variation mechanism whereby B2 and B3 reference tariffs would increase by more than forecast if anticipated consumption per customer declined and would decrease if consumption per customer increased. Such a revenue yield approach would provide no incentive to ATCO to maintain its customer base at (at least) forecast consumption levels.

Alinta Energy therefore supports the Authority's decision not to accept ATCO's proposed revenue yield price control methodology[15].

6.2 Standing charge increase

Alinta Energy also noted in its earlier submission that it did not support ATCO's proposed increase to the current standing charge for B3 customers, as those customers with the least consumption would wear the burden of network charges and could choose to disconnect due to the increased cost of running appliances.

However, Alinta Energy notes the Authority's decision concerning standing charges for B3 customers and, given the Authority's decision to proceed with the increase in standing

[12] Draft Decision, para. 451

[13] Email response from Energy Safety to Authority concerning Draft Decision: *ATCO Access Arrangement Network Reinforcement Projects,* 26 Nov 2014

[14] Op. cit.

[15] Draft Decision, para. 1208

charges, supports the proposed gradual increase[16] in standing charges over the period 2015 to 2019.

7 Regulatory Process

Alinta Energy is concerned about the delay to the AA4 process, which has meant that neither ATCO nor retailers have price certainty in the short term. This is because ATCO's previous access arrangement formally ended on 1 July 2014 and it has not yet been replaced with a new access arrangement. Alinta Energy acknowledges the delay was not caused by either the Authority or ATCO.

However, in the future, the process for all access arrangements should begin in time for the new access arrangement to take effect on the due date. Importantly, any new prices should be announced at least 6 weeks prior to taking effect. This allows retailers time to consider the impact of the new prices on their own tariffs.

In addition, the delay in the AA4 process has meant that ATCO has had to continue to invest in new connections and operating costs on the basis of the previous access arrangement. Alinta Energy supports this outcome, although notes it comes at a risk to ATCO, which may find that retrospectively its expenditure is deemed uneconomic, resulting in it incurring a loss for the period. This appears to be an unfair outcome and should be considered by the Authority through this access arrangement review.

8 Conclusion

Alinta Energy is generally supportive of the Authority's approach in its Draft Decision to limit the costs incurred by ATCO which are ultimately passed through to its customers in the form of higher prices.

However, in making its final decision the Authority needs to take into account the long term impact on gas consumers, including whether there are appropriate incentives for ATCO to continue to invest in the distribution network which will ultimately benefit all gas customers by spreading ATCO's largely fixed costs over a higher gas volume. In this regard Alinta Energy notes both the allowable rate of return and forecast gas consumption are key drivers of ATCO's overall return (and therefore ATCO's incentive to continue to invest in the network) and each of these drivers needs to be carefully considered so as to create the right balance.

In addition, Alinta Energy requests the Authority consider the retail price setting regime in WA, which requires the WA Government to approve any retail price increase above CPI – this includes for individual tariff components. Accordingly, Alinta Energy would prefer any major change to tariff components be avoided, but if there are to be structural changes, that they occur over a period of time.

Further, whilst Alinta Energy believes the safety and reliability of the gas distribution network is vital, it also recognises the important balance between achieving a safe and reliable network and the additional costs this imposes on customers. Given the conflicting advice the Authority has received from the specialist regulator (EnergySafety) and its own consultants (EMCa), Alinta Energy believes further work should be done by the Authority to reconcile the differing views and resolve this issue to ensure the best long term outcome for gas consumers.

[16] Draft Decision, para. 1181