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GOLDFIELDS GAS TRANSMISSION

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8 July 2004

Mr Lyndon Rowe
Chairman
Economic Regulatory Authority
Gas Division
Level 6, 197 St. George's Terrace
PERTH WA 6000

Dear Lyndon

Response to GGT Submission on Discussion Paper Regarding Incentive Mechanisms Under the National Gas Access Code

Thank you for your response of the 24 June 2004 to the public submission made by Goldfields Gas Transmission (GGT) concerning the discussion paper (the Discussion Paper) relating to "incentive mechanisms" under Section 8 of the National Third Party Access Code for Natural Gas Pipeline Systems (the Code) released by your office on the 17 May 2004.

GGT notes your reference to the discretion open to the Economic Regulation Authority (the ERA) under Section 2.1 of the Code to undertake public consultations "at any time" and "on any matter" relevant to its functions. Indeed, given the broad powers which are available to the ERA without any need for justification under Section 27 of the Economic Regulation Authority Act 2003, GGT appreciates that you have sought to explain the ERA's rationale for commissioning the Discussion Paper and initiating a public consultation process at this time.

Nevertheless, GGT remains concerned regarding a number of aspects of the timing, content, application and cost of the Discussion Paper. Consequently, whilst acknowledging that the specified public submission period is now closed, GGT requests that the ERA give consideration to the issues raised in this submission. In this regard it should be considered that the comments contained in this submission are an extension of the issues raised in GGT's earlier submission which require elaboration as a consequence of the propositions contained in your response to that submission. Further, GGT notes that no other public submissions have as yet (at the time of writing) been published on the ERA website and hence the inclusion of this correspondence can not be seen to have enjoyed any particular privilege when the body of submissions received on this issue are so published.

Timing of the Discussion Paper

GGT notes your explanation in regard to the commissioning and release of the Discussion Paper being related to the diligent execution of the ERA's responsibilities in regard to the pending draft decisions relating to the Goldfields Gas Pipeline (the GGP) and the AlintaGas Distribution Network (the AGDN), as well as the prospective submission of a new access arrangement for the Dampier to Bunbury Natural Gas Pipeline (the DBNGP). GGT also notes that a revised access arrangement for the Tubridgi Pipeline System is also due prior to the end of this year.

Notwithstanding your clarification, but having regard to advice from your office that the release of a draft decision regarding the access arrangement for the GGP is imminent, GGT must question the scope which exists for any results from the present public consultation process regarding incentive mechanisms to be incorporated into the ERA's decision relating to the GGP. For the current consultation process to be of relevance to the ERA's decision in regard to the GGP, the draft decision will presumably need to provide sufficient expression of intention in regard to any incentive mechanisms such that specific public comment can be made during the public submission period which precedes your final decision. GGT would expect that your decision will therefore include consideration of at least the issues raised by GGT in its previous submission, specifically:

- The need to substantiate any revenue sharing mechanism in terms of the intended objectives and the specified proportions, including the provision of justifiable assumptions regarding model inputs and expected benefits, with provision of adequate time for analysis and fair public comment.

- Appropriate consideration of the relative allocation of risk and balanced consideration of the extent to which Users might benefit from being even further protected from exposure to negative variances in return on investment than presently provided under the Code, particularly with respect to investment in regional infrastructure.

- Acknowledgement of the distinction in required rates of return for base and incremental project investment and the effect of mandating regulatory returns for incremental investments which are below that necessary to underscore a major project (due to the imposition of revenue sharing and degenerative real terms price-path mechanisms), including how the risk and/or effect of sub-efficient overall investment returns is to be addressed.

- The consequences of disincentives to investment in extensions and expansions of the pipeline given the current utilisation of the GGP.

However given the relative timing of the ERA's decisions relating to each of the regulated pipelines in Western Australia, it is curious that the only reference the Discussion Paper makes to any specific pipeline is by way of passing reference to the Tubridgi Pipeline System decision. This would appear to be the last of the currently impending decisions requiring consideration. Moreover, in that decision, the two pipelines which were amalgamated for regulatory purposes into a single "virtual" pipeline are anything but typical of other regulated pipelines, either in this state or anywhere else in Australia. One might have also thought that in regard to all of the other regulated pipelines to which the Discussion Paper is referred in your response as being applicable, sufficient distinction existed in terms of relative age, purpose, market context and scope for future growth in both capacity demand and application of operational efficiencies - and hence potential to realise any possible benefits from "incentive mechanisms" - that some discussion of individual relevance was warranted in the Discussion Paper. No such discussion of relevant differences is entered into however.

Whilst each pipeline involves its own characteristically unique issues and immediacies, the oversight of the Discussion Paper in failing to address the role which regulatory incentive mechanisms might have in facilitating specific market, regional and economic development needs, is most marked in respect to the DBNGP. There is an immediacy in regard to the need for expansion of the DBNGP which deserves a certain primacy of consideration due to both its overwhelmingly critical role in the Western Australian economy (and the associated social implications), as well as the pivotal role which the Code has had in determining the circumstances which now exist in relation to it. If the Code is otherwise incapable of looking after the public interests of Western Australians in having their essential infrastructure needs fulfilled (as seems to be the case), then it surely would be worthwhile to explore the extent to which disincentives to future investment which have arisen due to the application of the Code might be offset by more appropriate incentives for such investment to be undertaken as and when necessary.

Content and Application of the Discussion Paper

GGT identified in its previous submission that the Discussion Paper fails to balance the consideration of the effect of so-called incentive mechanisms on Service Providers with the relative magnitude of the benefits to be received by Users as a consequence of these mechanisms. Similarly the paper arrives at quantified conclusions which are purported to be based upon some unspecified amount of modeling. Unfortunately no details are provided of either the nature or scope of whatever modeling that may have been undertaken, nor of the nature or specific values of the input assumptions.

Confusingly, in respect to the application of the reasons and recommendations contained in the Discussion Paper to "*a major distribution system*"[1] (which in context can only be taken to refer to the AGDN), the final conclusion contradicts the paper's main conclusion which it had derived from the previous forty pages of argument, in regard to the carry forward of variances relating to capital expenditures. Unfortunately, the lack of analytical detail prevents any informed debate or comment regarding this apparent contradiction.

The general lack of detail in regard to the basis upon which the impact of the proposed incentive mechanisms has been quantified also prevents any positive view being formed as to whether the analytical rigor implied in the Discussion Paper is substantiated, or indeed whether the assumptions are valid or the modeling accurate or appropriate. In fact the lack of substantiation of proposed specific values, along with the apparent intention of the paper to merely justify the methodology that has been applied in previous regulatory decisions, greatly undermines any credibility, which the paper might otherwise carry. This is not helped by the fact that the Discussion Paper arrives at very specific conclusions which seemingly predetermine the outcome of the public consultation process.

Probably the most significant issue for GGT however is the apparent effect of the profit sharing arrangements being proposed under the guise of "incentive mechanisms" to limit the returns available to investors from incremental investment. The premise appears to be that investors would still be prepared to fund incremental expenditure, even though they will not be permitted to recoup more than a minor proportion of the revenue thus attributable and hence the investment returns thereby generated. This would clearly not be an attractive commercial decision for commercially driven investors.

The reality is that the incentive mechanisms presently implemented under the Code, and as proposed in the ERA's Discussion Paper, represent a further manifestation of risk to investment, in this case primarily to incremental investment in capacity expansion and pipeline extensions. This concern was raised in GGT's previous submission and, along with the demonstrated disincentives to further investment under the Code, GGT urges the ERA to consider that this should be a matter of significant weight of consideration in regard to the application of any incentive mechanism which might be contained in any access arrangement decision under this regulatory regime. Given the current status of the utilisation of the pipeline, this will be particularly relevant in respect to the pending GGP access

1 See page 43 of the Discussion Paper.

arrangement decision and the consequences for regional development and welfare which might ensue if the present disincentives to investment under the Code are allowed to persist.

Of particular relevance to this issue is the need to consider the effect of transferring onto Users the requirement to fund investment in pipeline infrastructure (as implied by the Code) given the much higher threshold rates of investment return demanded by the regional mining companies who form the GGP customer base (for example, WMC has previously cited a threshold investment hurdle of 25%).

The ERA is also urged to consider that the rationale for the application of regulatory incentive mechanisms is an intention to affect future performance criteria underlying the efficient utilisation of the relevant resources in order to pursue economic and social welfare objectives. This implies a need to monitor relevant performance measures in order to ascertain that the outcomes being sought are eventuating. It therefore demands that the intended outcomes are quantified in order that the effects resulting from any incentive mechanism can be measured. Incentive mechanisms which eventuate in no more than economic transfers but which yield no measurable net benefits are likely to be no more than an inefficient burden imposed by regulation.

By way of illustration, it has been recognised for instance that the promotion of competition under the National Access Regime is a means to an end, not an end in itself. Similarly it would be a mistake to design and measure the success of an incentive mechanism without consideration and measurement of the subsequent benefits which were the underlying objectives of the regulatory regime. Hence for example, the observation of a declining price path following the imposition of a CPI-X price cap, merely indicates that the price cap mechanism is working but says nothing about whether the incentive mechanism is achieving the wider objectives of advancing economic and social welfare. Price monitoring might indicate whether the mechanism is functioning, but other measures such as perhaps monitoring changes in downstream product demand directly attributable to competitive pricing or improved quality standards might be better indicators of the effectiveness of the mechanism.

Cost – Efficiency and Allocation

As it has identified in this and its previous submission, it is clear to GGT that the Discussion Paper commissioned by the ERA is deficient in terms of its contribution to developing better regulatory practice, substantiation of its conclusions or balance in its considerations. Notwithstanding the fact that the ERA is not required to provide any substantiation of the need for such a consultation process, or to justify the quality of any papers (or other work) commissioned, or even to confirm the extent to which such papers address their intended purpose, it hardly seems appropriate that service providers should be required to fund such efforts as are represented in this Discussion Paper.

In specific regard to the applicability of the public consultation process to the pending regulatory decision concerning the GGP, the relative timing appears to indicate that consideration of the issues raised by respondents concerning incentive mechanisms will not be sufficiently advanced for inclusion in the draft decision affecting the GGP. Such omission will prevent informed public comment being possible during the public consultation period following release of the draft decision and thus threatens to limit the rights of parties affected by that regulatory decision. Thus GGT is concerned that it should be unfairly allocated costs associated with the independent public consultation process regarding incentive mechanisms under the rather broad assertion that discussion of such an aspect of the Code has ramifications for all regulated assets.

Somewhat related to this concern is the question of whether the public discussion process relating to regulatory incentive mechanisms has been managed in a manner which is efficient, equitable or consistent with the Government's stated intention to realise the purported benefits of amalgamating regulatory agencies into the ERA so as to harness economies of scale in regulatory costs and expertise.

In this regard, GGT notes that the ERA released its Final Report regarding "Estimation of CPI-X in the WA Rail Industry" on the 1 July 2004, following a separate and apparently unrelated public consultation process, even though the consideration of CPI-X is a matter specifically related to regulatory "incentive mechanisms" in its considerations under the gas Code.

Obviously it is not for Service Providers (or other industry participants) - who already have to bear the burden of regulation within their own industries - to be required to monitor and become involved in the regulatory practices of other industry sectors. However, the ERA was formed largely on the strength of its promise to realise more efficient regulatory implementation, including the concentration of "scarce regulatory expertise". It is not apparent that the current approach provides any indication of any improvements in the efficient utilisation of regulatory expertise, either within the ERA itself, or in terms of its processes for engaging and considering the opinions of the consultants it has commissioned or of other interested and affected parties.

For these reasons, GGT wishes to reiterate its concerns and objections regarding any requirement to incur costs associated with the production of the Discussion Paper or the subsequent consideration and reporting of submissions by your staff or consultants.

Yours sincerely

DA King.

David A King
General Manager