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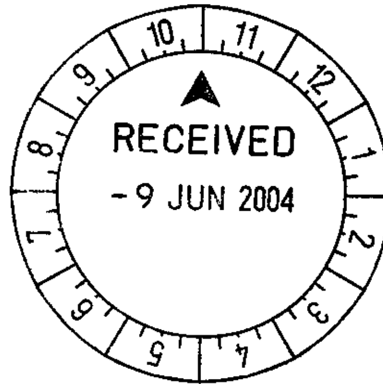

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4 June 2004

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

Dear Lyndon

Call For Submissions On Discussion Paper Regarding Incentive Mechanisms Under The National Gas Access Code

Goldfields Gas Transmission (GGT) wishes to comment on the call for public comment upon 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) dated March 2004 and released by your office on the 17 May 2004. GGT wishes to make the following comments, which it presumes will be made publicly available along with all other comment received on the Discussion Paper by your office.

From GGT's perspective, it is not apparent what has precipitated the commissioning and release of the Discussion Paper at the present time. The Notice from your office that accompanied the release of the Discussion Paper alludes to the generic possibility of incentive mechanisms being included in access arrangements and only specifically relates the issue to "consideration of proposed revisions to Access Arrangements". From this it is not clear whether the initiation of a public submission process is intended to relate to a need by the Economic Regulatory Authority (the ERA) to address considerations relating to a specific issue or whether the intention is to engage in a broader, generic deliberation over the functioning and rationale for a portion of the Code. Resulting from this GGT would request a response from the ERA on the question of who will pay for the conduct of the study and the subsequent collation of public submissions.

If the intention of the ERA is to address or augment considerations relating to a specific access arrangement process, then the GGT would note that the only current "proposed revision" to an access arrangement is that relating to the AlintaGas Distribution Network. If this proposal is the basis of the ERA's focus, then the Discussion Paper appears inconsistent with the intent by omission of any reference to the proposals put forward by Alinta. In addition, the costs associated with the production of the paper and the processing of subsequent submissions made in response need to be properly allocated to the cost of assessing that access arrangement. There is no basis or precedent for other Service Providers being required to bear the costs associated with an individual approval process.

If however the intention of the ERA is to engage in a general public discussion process regarding the rationale and functioning of a specific aspect of the Code, then GGT questions why this should not be more properly, transparently and effectively undertaken within the national public review process currently being undertaken by the Productivity Commission. As you will be aware, that review is both substantive in scope and likely to produce a nationally applicable resolution to the issues raised before it. Moreover, whilst at the time of releasing the Discussion Paper (and even now), the Productivity Commission was continuing to receive submissions, the expected release of the final recommendations does not appear untimely relative to the ERA's own likely consideration timetable, whether that is of a general nature or specific to the AlintaGas Distribution Network revision proposal.

The Discussion Paper itself appears to be an attempt to portray some level of analytical rigour, however in reality the discussion generally falls back upon unsupported normative statements, relying merely upon existing regulatory precedent for justification. Despite this, the paper attempts to arrive at some definitive quantified conclusions in regard to the effects it discusses and suggests that some amount of analytical modeling has been undertaken. No details of the nature of that modeling are provided however, nor any detail as to the input assumptions or nature of the sensitivities which the paper refers to as having been undertaken. Despite this, the Discussion Paper arrives at its quite specific conclusions in reliance upon this modeling, even though it also acknowledges (quite correctly) that, "*the percentage estimated for an individual situation will depend on a range of financial and modelling assumptions*" (page 40).

The benefits intended to be derived by Users from the proposed measures remain unquantified in the Discussion Paper. This is reflective of what appears to be a certain regulatory paradigm representing the traditional consumer bias that has become problematic in the implementation of economic regulation in terms of its consequence for investment in development infrastructure. It is worth noting that Users receive the double benefit of a predetermined degenerative price path (i.e. CPI-X, where "X" is the real terms benefit received by Users without any need for substantiation), as well as the majority of any efficiency gains (the Discussion Paper quantifies these as being 81% of returns arising from incremental capital expenditure and 65% of returns arising from incremental non-capital expenditure[1]) associated with the provision of the services they enjoy.

It needs to be clearly understood that in respect to investors in gas delivery infrastructure, the so-called "incentive mechanisms" thus contemplated are punitive in nature (and hence from a commercial perspective, a misnomer).

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1 i.e. (1 - 19%) = 81% and (1 – 35%) = 65%, per section "6.2.4 Proposed Incentive Mechanism" page 42.

It is also a relevant consideration to recognise that (within the context of the Discussion Paper) Users enjoy protection from any downside risk associated with the provision of gas delivery services due to the provision for carry forward of negative return variances. Hence Users effectively share only the favourable variances that might arise in returns, with the Service Provider having to carry any negative variances until such time as they can be absorbed, whilst at the same time being constrained to a reducing price path in real terms. The Discussion Paper does not balance its arguments with such considerations.

Similarly, despite some inconclusive allusions to the likely consequences of the proposed profit sharing mechanisms on the disincentives for future incremental investment in expansion or expansion (or greenfields investment which is marginal depending upon levels of specific risk), the matter is not adequately dealt with in the Discussion Paper. This is an unfortunate omission, particularly in light of the significance given by the Productivity Commission in its current review to the effects of the Code on investment risk.

In the present context, it needs to be considered that the criteria for evaluating incremental investment opportunities often differ from those used for evaluating a new (particularly greenfields) investments. Once the "base project" is established (e.g a new transmission pipeline), the investment risks associated with incremental expenditure (e.g. a lateral pipeline or compressor) may be considered to be lower. It may be considered acceptable by the investor to accept a lower incremental rate of return. However doing so will lower the overall return from the total investment. In a regulated context, the rate of return permitted represents (by current definition) only that associated with efficient provision of the service (however "efficiency" might be defined). A consequence of making incremental investments that lower the total return from the project available to the investor would therefore reduce overall returns below what is established (by the regulator) as being "efficient". Hence it would be "inefficient". In any event, it is unlikely to be attractive to the investor.

In circumstances where capital rationing applies (that is, the funds needed for investment are constrained for any of a number of possible reasons, including the prospects of less than attractive rates of investment return limiting funds available to a given investment sector), this situation is exacerbated. In such circumstances, it is normal for corporate investors to apply investment ranking techniques, such as "discounted profit to investment ratios" for example, and to consider more closely investment opportunity costs.

The apparent effect of the profit sharing arrangements being proposed under the guise of "incentive mechanisms" is 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 returns thereby generated. This would not be an attractive commercial decision for commercially driven investors.
The reality is that the incentive mechanisms as presently implemented under the Code, and as proposed in the Discussion Paper, represent a further manifestation of risk to investment, in this case primarily to incremental investment in capacity expansion and pipeline extensions.

GGT has raised the issue of these consequences for investment in its submissions to the Productivity Commission.[2] The conclusions of the Discussion Paper merely repeat the

[2] See section 4.3, DR 88, March 2004, page 17 and section 5, DR 118, 3 May 2004, page 15.

erroneous proposition of the ACCC that financial losses can be capitalised in a manner that will not distort the investment decisions of Service Providers. Unfortunately, despite lengthy rhetoric, the Discussion Paper brings no new perspective to bear and arrives at a series of conclusions which appear to merely be a justification of the regulatory outcomes previously employed by the Western Australian Regulator two and a half years ago for the relatively minor (and certainly atypical) Tubridgi Pipeline System (refer page 43).

Otherwise, the concluding paragraphs of the Discussion Paper appear to suggest that the focus of the ERA's concern is in fact with regard to its current approval process in regard to the AlintaGas Distribution Network. In fact, in respect to application to distribution networks, the final conclusion of the Discussion Paper contradicts the main conclusion of the paper (i.e. in regard to the carry forward of variances relating to capital expenditures), which it had derived from the previous forty pages of argument.

In consequence of the preceding comments, GGT is of the view that the production and release of the Discussion Paper is unjustified, particularly given the current federal review of this national regulatory regime.

Given the events which are currently unfolding nationally in terms of the evolution of the Code, and particularly in regard to its own regulatory access arrangement approval process, GGT considers that the Discussion Paper adds no value.

Accordingly, GGT wishes to advise of its objection to incurring any pass through of costs from your office associated with the production of the paper or the subsequent processing by regulatory staff or consultants of submissions made in response to the paper.

Yours sincerely

David A King
General Manager