The Australian Pipeline Industry Association
Submission to the Economic Regulation Authority
regarding Dampier-Bunbury Pipeline's request
for agreement under section 8.21 of the Code

27 March 2006

The Australian Pipeline Industry Association (APIA) welcomes the opportunity to make submissions to the Economic Regulation Authority (ERA) on Dampier Bunbury Pipeline's (DBP's) application under section 8.21 of the National Third Party Access Code for Natural Gas Pipeline Systems (Code).

The Stage 5 expansion of the DBNGP is one of a number of major pipeline projects in Australia. Many of these projects require significant investments in pipelines which will be, or are already, subject to economic regulation under the Code. Organisations that are financing investments in pipeline systems must consider how the Code might be applied over the life of a long-lived asset, as well as the typical commercial risks associated with major construction projects.

The relevant tests to allow inclusion in a pipeline's capital base of new facilities investments (sections 8.16 and 8.21 of the Code) are critically important to ensuring prudent levels of investment are maintained. If a service provider cannot be reasonably confident of its ability to recover the required investment, it would be unlikely that the investment would be made, which would be to the detriment of prospective users and to the economy as a whole. DBP's application provides the opportunity to demonstrate that the Code is effective in facilitating investment necessary to meet the immediate needs of pipeline users and prospective users, and the needs of energy users in Western Australia.

To improve certainty for the Australian pipeline industry as a whole, APIA requests that the ERA include a full explanation of its approach and reasons for its decision, addressing each element of the tests that must be satisfied in section 8.16. This will assist the pipeline industry by increasing certainty about the application of this section of the Code which is centrally important to the development of Australia's pipeline infrastructure.

Timing and regulatory certainty

APIA considers that the Stage 5 expansion investment is required to meet the continued requirements of users. As acknowledged by the ERA[1], the benefits of investment in the DBNGP extend beyond shippers using the pipeline to users of gas, bringing broader public interest into the consideration of this application.

Facility owners may contribute equity to finance required new investment, but a substantial part of the financing is likely to be sought from providers of debt finance. Both the equity investors and the suppliers of debt will require that arrangements be put in place to ensure a relatively certain return on their investment. These arrangements must be put into place before the investment is financed, and before any construction of

[1] ERA (2005) Final Decision on Proposed Revisions to the DBNGP Access Arrangement.

new facilities can proceed. Regardless of the fact that a majority of the additional capacity of Stage 5 has been contracted to shippers, financers also require regulatory certainty with regard to the recovery of costs (including an appropriate return on and return of capital) of the expansion through regulated tariffs.

APIA therefore urges the ERA to make its decision on DBP's request under section 8.21 as expeditiously as possible within the Code framework in order to reduce uncertainty.

Application of section 8.16 of the Code

Section 8.16(a) of the Code permits the addition of new facilities investment to the capital base of a covered pipeline, allowing the recovery of that investment through reference tariffs if two conditions are satisfied. The first of these two conditions is set out in section 8.16(a)(i); the second condition is in section 8.16(a)(ii).

1. Section 8.16(a)(i)

Section 8.16(a)(i) requires the amount of new facilities investment added to the capital base not to exceed the amount that would be invested by a prudent service provider acting efficiently, in accordance with accepted good industry practice, and to achieve the lowest sustainable cost of providing services.

APIA submits that the fact that new capacity is largely contracted demonstrates that the expansion is required by the market and is therefore prudent.

Nevertheless, APIA notes that this test has a number of subjective elements. First, the options for pipeline expansion at any point in time are circumscribed by the initial pipeline design, and by the path of expansion which has been followed until that point in time. As such, what constitutes an efficient and lowest sustainable cost expansion is determined in part by the path of prior pipeline development.

Second, the new facilities which meet a current capacity requirement at the lowest sustainable cost in the short term may not be those which ensure the provision of capacity at the lowest sustainable cost over a longer, more appropriate, time frame. APIA considers that the ERA should have regard to what is the least cost expansion path over the longer term in assessing the application against these criteria.

APIA believes section 8.17 of the Code draws attention to issues relevant to determining "accepted good industry practice" and "lowest sustainable cost" which are likely to be important in the context of a significant expansion of an existing pipeline such as the Stage 5 expansion of the DBNGP. APIA submits that the Stage 5 expansion satisfies the principles of section 8.17 as the proposal demonstrates economies of scale and seeks to achieve the lowest sustainable cost of maintaining the required capacity over the life of the asset. Moreover, APIA believes it is accepted as good industry practice to consider the long-term capacity of the project to derive economies of scale, resulting in the lowest sustainable costs of delivering a service for a timeframe which is aligned to the life of the asset.

2. Section 8.16(a)(ii)

Investment by a pipeline service provider, which meets the requirements of section 8.16(a)(i) of the Code, may be added to the capital base if at least one of the tests of section 8.16(a)(ii) is satisfied. DBP has submitted that investment in the Stage 5 expansion of the DBNGP satisfies two of the three tests of section 8.16(a)(ii). These are the Anticipated Incremental Revenue test of section 8.16(a)(ii)(A), and the system-wide benefits test of section 8.16(a)(ii)(B).

Section 8.16(a)(ii)(A) – Anticipated incremental revenue test

APIA submits that DBP's application satisfies this test as DBP has demonstrated that the anticipated incremental revenue generated by the new facility exceeds the new facilities investment. That is, while the anticipated incremental revenue falls short of the new facilities investment for a relatively short period such as 10 years, the revenue exceeds the investment over the economic life of the new facilities investment and the remaining economic life of the DBNGP. APIA believes that the test should be applied over the economic life of the asset, rather than over some shorter period.

Section 8.16(a)(ii)(B) – System wide benefits test

The Code provides no guidance on what constitutes system wide benefits. APIA submits that, in interpreting this part of the Code, ERA should take a broad view of what might be considered to be a system wide benefit. That is, it should take into account the full economic benefits associated with the investment. This will include the benefits accruing to direct users of the pipeline, as well as consumers of gas and the broader public interest.

Consideration of this issue in the past by regulators has given rise to some differences in interpretation. For example, the ACCC[2] accepted GPU GasNet's view that benefits from enhanced system security and from increased competition in gas supply would, at least in the context of that application, justify investment in new facilities.

The Victorian Regulator-General's[3] view was that, in order to satisfy the system-wide benefit test, investment would need to: create identifiable benefit to users, other than those served by the facility or generate a positive externality (eg. lower gas prices to all consumers resulting from increased competition); estimated total benefits (including externalities) must exceed total cost; and reference tariffs should provide a close match between beneficiaries and those who contribute to the investment. This decision indicated that system-wide benefits from new facilities are identified as positive externalities resulting from the creation of those facilities. It noted that these externalities are limited to benefits accruing to users of the pipeline. APIA endorses the view that positive externalities are a relevant consideration; however, limiting them to users is an unnecessarily restrictive view of system-wide benefits.

[2] ACCC, Final Decision on proposed revisions to access arrangement for Victorian Principal Transmission System.

[3] Victorian Regulator-General, Draft Decision on Access Arrangements for Multinet, Westar and Stratus, May 1998

In previous assessments of this test, the ERA has adopted the view that system-wide benefits are positive externalities resulting from the creation of new facilities, but does not limit them to benefits accruing to users of a pipeline system. This extension has the important implication of bringing the public interest into the consideration of system-wide benefits. APIA believes the ERA is correct in taking a broad view, and considers that, in addition to satisfying the anticipated incremental revenue test, the proposed pipeline investment satisfies the system-wide benefits test due to the benefits the proposed investment will deliver to the whole system including pipeline users, end users and their markets. Furthermore, APIA submits that these benefits would justify the approval of a higher tariff than would otherwise arise without the new expansion.

The DBP application notes that these broader economic benefits include: lower cost generation of electricity; lower cost minerals processing; access to a wider range of potentially lower cost gas supplies; increased security of energy supply in WA; the potential for greater competition among producers supplying the WA market and also between existing and new shippers on the pipeline; and facilitation of further development of the State's mineral resources. APIA supports the view that these matters are relevant considerations in an assessment of system-wide benefits.

APIA believes that it is appropriate to incorporate public interest considerations into this test. In the case of DBP, APIA believes that this means the ERA should have regard to the importance of gas as a source of competitively priced energy to the WA economy. The WA economy has been rapidly growing and has, in fact, been one of Australia's fastest growing states over the last 10 years (to 2003-04), during which WA's Gross Domestic Product (GDP) has averaged 6.4 per cent growth per year,[4] representing the second-highest growth rate of all Australian states and territories.[5]

This rapid economic development has been underpinned by the availability of competitively priced energy. In particular, the WA economy has been reliant to a considerable degree on gas as a source of energy. APIA submits that, without this expansion, economic growth in WA would be constrained by lack of access to competitively priced energy.

The importance of access to competitively priced gas supplies to the WA economy is noted by Western Power, which considered that the outcome of its negotiations for access to DBNGP raised significant issues for the Western Australian energy industry and has an enormous bearing on the price consumers will pay for electricity in the future.[6]

APIA considers that the system-wide benefits test should have a role to play where an 'efficient' investment does not satisfy the anticipated incremental revenue test. Investments with high incremental costs (for example, the final stage of compression on a compressed pipeline or in the initial stages of looping) may be efficient (ie. satisfy the prudent investment test of s. 8.16(a)(i)), but not satisfy the anticipated incremental revenue test. These efficient investments may proceed only if a pipeline operator accepts inclusion of a part of the investment in the capital base for recovery via the reference tariff and secures recovery of the remainder through a surcharge levied on

4 Which contrasts with a national GDP average growth of 6.2 per cent.
5 Source: www.doir.wa.gov.au
6 Western Power Annual Report 2005, p. 13

users of the capacity created. Once these types of investments have been made, subsequent expansion can proceed at lower incremental cost.

APIA considers that it is unreasonable to require certain shippers to pay more for capacity because of the timing of their initial requirements. Further, the differential pricing that results may potentially restrict competition in downstream markets.

Accordingly, APIA is of the view that an appropriately broad concept of system-wide benefits is necessary if the Code is to facilitate efficient investments (those which meet the requirements of section 8.16(a)(i)), but which do not satisfy the test of section 8.16(a)(ii)(A)).

APIA considers that without the Stage 5 expansion of the DBNGP there will be significant unmet demand for natural gas in the WA market. Accordingly the expansion is important for the further growth of the State and National economies, demonstrating the system-wide benefits that accrue from the project.