CMS GAS TRANSMISSION of AUSTRALIA

PUBLIC SUBMISSION No. 3

ALINTAGAS ACCESS ARRANGEMENT

Submitted to OffGAR 2 September 1999

INTRODUCTION

CMS Gas Transmission of Australia (CMS) makes this third public submission in response to the notice of 2 July 1999 published by the Office of Gas Access Regulation (OffGAR) which invites submissions on the proposed Access Arrangement submitted by AlintaGas for its Mid-West and South-West Gas Distribution Systems.

This submission complements CMS' previous Public Submissions No. 1 and No. 2.

GENERAL COMMENTS

Cost Plus Pricing

The proposed AlintaGas Access Arrangement effectively constitutes a cost plus pricing scheme.

The provisions which limit the magnitude of future variations in Reference Tariffs incorporate an adjustment factor K_t whose magnitude (positive or negative) depends on the difference between projected and actual revenues.

Thus, the proposed AlintaGas pricing is a "CPI minus X" scheme with under and over-recovery adjustment. This is effectively equivalent to cost plus.

Section 8 of the National Third Party Access Code for Natural Gas Pipeline Systems (the Code) provides for incentive mechanisms.

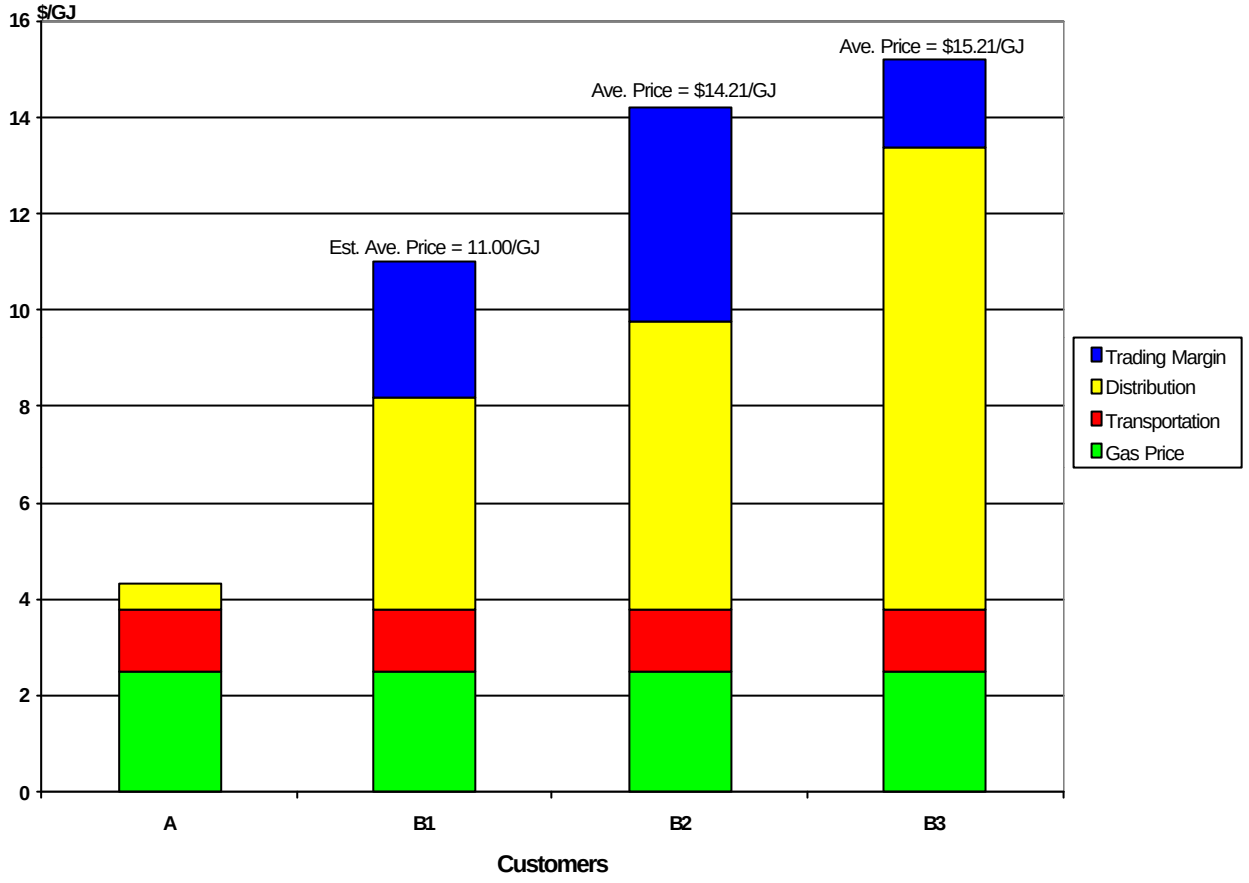
Under a cost plus regime, the only direct incentive to a Service Provider is to increase costs.

Thus, it may be seen that the tariff setting philosophy underpinning the proposed AlintaGas Access Arrangement is at odds with the spirit of the Code.

Cost Components in Gas Chain

The chart below presents CMS' best estimate of the cost structure faced by end users of natural gas supplied from the AlintaGas Distribution System. Assumed current values of gas purchase price faced by AlintaGas, current Dampier to Bunbury Natural Gas Pipeline (DBNGP) unit transport costs (assuming a load factor of 0.8), and average AlintaGas unit costs by Reference Service have been used.

BREAKDOWN OF DELIVERED GAS PRICE BY REFERENCE SERVICE



NOTE: ***B2 and B3 average prices from AlintaGas Annual Report 1999***

B1 estimated average price based on estimated range of A$10 per GJ to A$12 per GJ

It may be seen that the distribution component of total delivered gas price increases as customer load decreases.

It should also be noted that transport of gas via the Parmelia Pipeline (at the proposed Firm Extended Reference Tariff) rather than the DBNGP would result in a reduction of the transportation component of the delivered price.

Tariff Variation: Calculation of Under and Over-Recovery Amounts

Schedule 2 of the proposed Access Arrangement describes the means by which proposed Reference Tariffs will be escalated over time. Analysis of these indicates apparent inconsistencies in the methodology proposed.

The consequence of these apparent inconsistencies is that AlintaGas would appear to be able to unreasonably increase its revenue. This is because the under / over-correction factor K_t appears to assume a negative value when no under / over-correction is appropriate.

For example, if actual volumes equalled forecast volumes (i.e no under / over recovery correction were applicable) and the formulae as proposed by AlintaGas are applied, it would appear that the correction factor Ka, which is a component of K_t, would have a value of approximately minus 21 million dollars by review year 5. This would result in a correction factor K_t adjustment (i.e. an addition) to the maximum allowed average unit revenue of approximately A$ 0.76 / GJ.

In other words, an under recovery adjustment of this magnitude would be made under circumstances where forecast volumes equal actual volumes and no under / over recovery adjustment is required.

Furthermore, it would appear that under circumstances where actual volumes exceeded forecast volumes by five percent (and an over-recovery adjustment should be made), an under-recovery would still be realised.

This issue is addressed in greater detail below.

SPECIFIC COMMENTS

Access Arrangement

Chapter 3 -Reference Tariffs and Reference Tariff Policy

Division 1 - Reference Tariffs
Clause 21 (3)d

> (d) the *user* specific charge is to be an amount per *year* which reflects the costs to *AlintaGas* of providing the *user specific delivery facilities* under the *Haulage Contract*, which may consist of capital costs and *non-capital costs*.

The basis for determining the user specific charge is not stated. It is suggested that such a basis be provided.

Division 2 - Reference Tariff Policy
Clause 38 (1)d

Here:

> "the financing structure that has been assumed for the purposes of determining the rate of return ...."

is defined as a fixed principle.

Financing structure is used to calculate the Weighted Average Cost of Capital (WACC). WACC varies depending on changes in interest and tax rates, and market returns. This item should not be fixed as it is a market variable element as defined by the Code section 8.48.

Clause 38 (2)

Includes the following condition:

> "The fixed period is a period of 10 years commencing on the commencement date."

This proposed fixed period is inconsistent with the AA period of five years.

Chapter 7 - Extensions/Expansions Policy

The extensions/expansions policy should include a qualifier that any extension/expansion will meet financial and asset planning criteria applicable to a prudent Service Provider. This would ensure that AlintaGas, whose Access

Arrangement proposes what is effectively a cost plus regime, does not boost up its capital expenditure to purely increase tariffs.

Chapter 9 - Interconnection with other Pipelines

Clause 63(3)b(1)

This clause should be amended to specify written notice of curtailment to interconnected pipelines. Such written notice should be provided to be consistent with other terms and conditions that provide written notice.

Schedule 2 - Variation of Reference Tariffs

Part B - Principles and Formulas

Section 2.7 of the Access Arrangement Information (AAI) states:

> The method by which the *reference tariffs* are to be adjusted in each year of the *Access Arrangement* after the first is set out in Schedule 2 of the *Access Arrangement*.
>
> Schedule 2 defines an average revenue, or revenue yield, control on *reference tariffs*. In each year of the *Access Arrangement* after the first, *AlintaGas* may, subject to the *Regulator* being advised of the proposed changes, vary its *reference tariffs*, provided the variation is such that forecast average revenue for the year (the *review year*) does not exceed the maximum allowed average revenue for that year.

AlintaGas proposes in Part B of Schedule 2 that it may at its discretion adopt any proposed reference tariff and any proposed tariff component, subject to:

(a) its Forecast Average Revenue (FAR) not exceeding its Maximum Allowed Average Revenue (MAAR); and

(b) each proposed tariff component not exceeding the Initial Reference Tariffs escalated by CPI plus 2 per cent.

However, Schedule 2 does not appear to state that AlintaGas can vary its forecast revenue (FR) for the next review year by an under/over recovery of revenue from the preceding years due to differences in forecast and estimated/actual gas volumes.

This appears to constitute an inconsistency, as the process as proposed would require original, rather than adjusted revenue forecasts to be used.

Clause 11(a)

The formula for Ka_t as shown appears to be inconsistent, as estimated revenue (EstR) should be equated with forecast revenue (FR); i.e., FR should be determined by multiplying the forecast volume ($V^{forecast}$) (and not $V^{estimate}$) by the forecast average revenue (FAR).

To be consistent, it would appear that the formula should read:

(a) for each other review year:

$$Ka_t = EstR_{t-1} - (V_{t-1}^{forecast} \times FAR_{t-1})$$

Clause 11(b)

The formula for Ka_t as shown appears to be inconsistent as estimated revenue (EstR) should be equated with forecast revenue (FR); i.e., FR should be determined by multiplying the forecast volume ($V^{forecast}$) (and not $V^{estimate}$) by the forecast average revenue (FAR) (and not MAAR).

Therefore, Clause 11(b) could be deleted, as the form of the equation would be the same as Clause 11(a).

Clause 12(b)

The formula for Kb_t as shown appears to be inconsistent as actual revenue (ActR) should be equated with forecast revenue (FR) in order to determine a correction factor; i.e., FR should be determined by multiplying the forecast volume ($V^{forecast}$) (and not V^{actual}) by the forecast average revenue (FAR).

Similarly, estimated revenue (EstR) should be equated with forecast revenue (FR) as per the suggested amended Clause 11(a) above.

To be consistent, it would appear that the formula should read:

(b) for each other review year:

$$Kb_t = ([ActR_{t-2} - (V_{t-2}^{forecast} \times FAR_{t-2})] - [EstR_{t-2} - (V_{t-2}^{forecast} \times FAR_{t-2})]) \times (1 + i_{i-1})$$

Clause 12(c)

The formula as shown appears to be inconsistent as actual revenue (ActR) should be equated with forecast revenue (FR), i.e., FR should be determined by multiplying the forecast volume ($V^{forecast}$) (and not V^{actual}) by the forecast average revenue (FAR) (and not MAAR).

Similarly, estimated revenue (EstR) should be equated with forecast revenue (FR) as follows:

$$[EstR_{t-2} - (V_{t-2}^{forecast} \times FAR_{t-2})]$$

Therefore, Clause 12(c) could be deleted, as the form of the equation would be the same as Clause 12(b).

Consequences: Inconsistencies in Formulae for Under / Over Recovery Correction

If the formulae in Clause 11 and Clause 12 are not amended as suggested, then it would appear that AlintaGas would be able to unreasonably increase its revenue. This is because the correction factor (K_t) would be negative unless actual volumes are sufficiently higher than forecast volumes to outweigh the multiplication effect of the maximum allowed average revenue (MAAR).

For example, if actual volumes equalled forecast volumes (i.e no under / over recovery correction were applicable) and the formulae as proposed by AlintaGas are applied, then it would appear that the correction factor (Ka) would have a value of approximately minus 21 million dollars by review year 5. This would result in a correction factor (K_t) adjustment (i.e. an addition) to MAAR of approximately A$ 0.76 / GJ.

In other words, an under recovery adjustment of this magnitude would be made under circumstances where forecast volumes equal actual volumes and no under / over recovery adjustment is required.

Furthermore, it would appear that under circumstances where actual volumes exceeded forecast volumes by five percent (and an over-recovery adjustment should be made), an under-recovery would still be realised.

Interpretation

Clause 15

Defines "**i_t**" as the

> Australian Financial Markets Association End of Day 1 Year Swap Reference Rate at 30 September in year t varied by: (a) subtraction of 50 basis points when K_t is a negative value; and (b) addition of 50 basis points when K_t is a positive value;

The Swap Reference Rate is an interest rate agreed by a bank for loans and/or investments. Usually the rate will depend upon the risk associated with a company. In the case of AlintaGas because it is a Government Trading

Enterprise and therefore the risk of default is very low then its interest rate will be set usually marginally above the bank bill rate.

Even if AlintaGas is privatised it is unacceptable to require 50 basis points as a spread to correct a revenue shortfall or deficit. A more realistic spread would be 20 basis points.

Schedule 7 - General Terms and Conditions Applicable to all Reference Services

Division 5 - Invoicing and Payment

Clause 15(1)

> "AlintaGas will invoice the user approximately 12 times each year at intervals of approximately 35 days, in arrears, with each invoice reflecting all meter readings taken during the invoicing period".

This clause appears to be relevant only to users receiving Reference Services A and B1, as customers receiving Reference Services B2 and B3 will have their meters read only four times per year at intervals of approximately 100 days. It is suggested that another clause be drafted to reflect this or Clause 15 be amended.

Division 11 - Miscellaneous Contractual Matters

Clause 47(1)

> "AlintaGas will not be liable to pay compensation for or in respect of, or make good any damage done to the land or premises of the user or the user's gas customer by AlintaGas, its officers, servants, or agents in the reasonable course of installing the user specific facilities or the standard delivery facilities whether that damage is of a temporary character or a permanent character."

This clause is unreasonable because it could possibly be used to allow AlintaGas to walk away with no liability if it caused damage to customers' land or property. In an extreme case, if there were a gas explosion during commissioning of user specific facilities which destroyed a customers premises, it is possible that this Clause could be used to avoid reasonable liability.

Access Arrangement Information (AAI)

The following analysis indicates that some users who will be designated to receive Reference Service B1 would appear to be financially penalised compared to their charges under Reference Service A. Chart 1 below has been constructed on the basis of customers being allocated a contracted peak rate at a load factor of 55%. This assumption is reasonable for smaller industrial customers who mostly operate 5 days per week. The chart shows that those customers whose consumption is above the line will be worse off under Reference Service B1 compared to Reference Service A.

On the basis of this analysis, the consumption parameters dividing Reference Service A and Reference Service B1 might be changed.

Chart 1: Breakeven Analysis - Comparing Reference Tariff B1 to Reference Tariff A

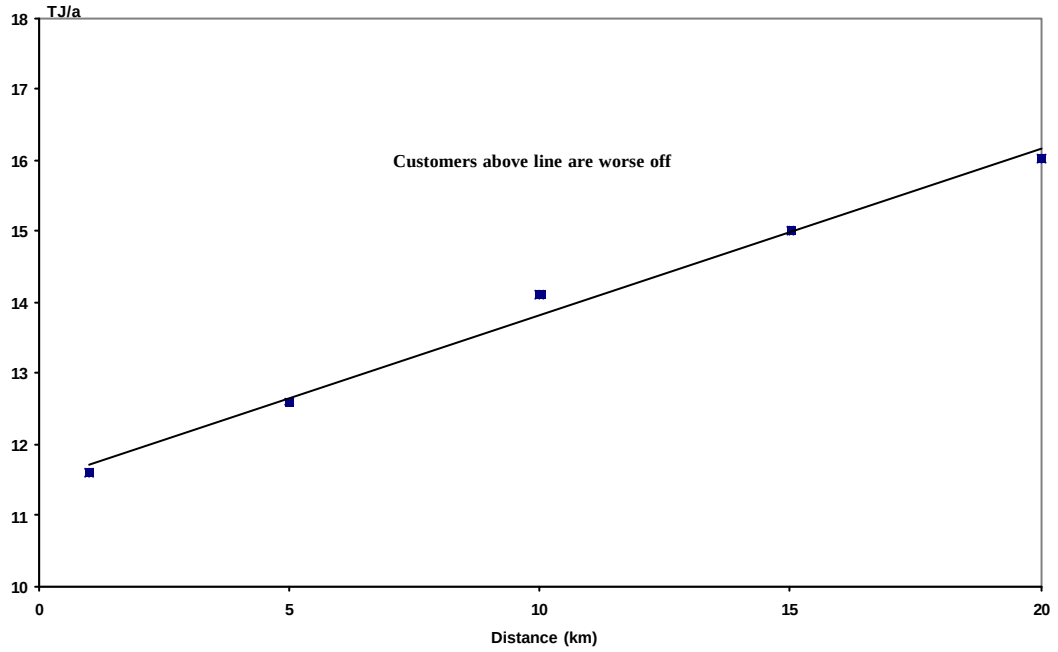


Table 1 compares the charges a customer consuming 20 TJ/a would incur on either Reference Service A or Reference Service B1. A customer who is only 1 km away from a pipeline would be paying about $36,000 or 69% more on Reference Service B1 compared to Reference Service A.

Table 1: Charge Comparison - Reference Services A and B1

	Distance (km)				
Tariff	**1**	**5**	**10**	**15**	**20**
A	$51,679	$58,396	$66,793	$70,990	$75,188
B1	$87,500	$87,500	$87,500	$87,500	$87,500

By way of reminder, Reference Service B1 applies to users consuming less than 35 TJ/a at their delivery point or having a contracted peak rate less than 10 GJ/h. This means that Reference Service B1 customers' consumption falls between about 1 TJ/a and 35 TJ/a.

Further comparison between customers on Reference Services B1 and B2 indicates that commercial customers nominated to receive Reference Service B2 who consume more than 437 GJ/a will be worse off than if they were receiving Reference Service B1.

Table 2 compares the charges a customer will incur on either Reference Service B1 or Reference Service B2 for various annual consumption's.

Table 2: Charge Comparison - Reference Services B1 and B2

	Annual Consumption (GJ/a)						
Tariff	**437**	**500**	**600**	**700**	**800**	**900**	**1,000**
B1	$2,401	$2,675	$3,110	$3,545	$3,980	$4,415	$4,850
B2	$2,401	$2,710	$3,201	$3,692	$4,183	$4,674	$5,165