OFFICE OF GAS ACCESS REGULATION

OffGAR WESTERN AUSTRALIA

# DRAFT DECISION

## RECOVERY OF COSTS ASSOCIATED WITH THE INTRODUCTION OF FULL RETAIL CONTESTABILITY IN THE MID-WEST AND SOUTH-WEST GAS DISTRIBUTION NETWORKS

**Independent Gas Pipelines Access Regulator**

**Western Australia**

25 August 2003

## DECISION

1. On 26 June 2003, AlintaGas Networks Pty Ltd ("**AGN**") applied in writing seeking that I exercise my discretion to agree, under section 8.21 of the *National Third Party Access Code for Natural Gas Pipeline Systems* ("**Code**"), that the capital costs amounting to approximately $12 million of developing systems associated with the introduction of Full Retail Contestability ("**FRC**") in Western Australia meet the requirements of section 8.16 of the Code. The effect of my agreement of these costs would be to bind the Regulator's decision when the Access Arrangement is reviewed so that the agreed costs will be included in the capital base for the pipeline system with the result that distribution tariffs will increase from the time that AGN's reviewed Access Arrangement is approved. The review of the Access Arrangement for the Mid-West and South-West Gas Distribution Networks is scheduled to commence on 1 April 2004 and to be completed by 31 December 2004.

2. In its application, AGN also requested that I provide a non-binding acknowledgement that FRC-related non capital costs estimated at about $1.3 million per annum are likely to satisfy the requirements of section 8.37 of the Code. Section 8.37 of the Code makes provision for the recovery of non capital costs by a prudent Service Provider acting efficiently in accordance with accepted and good industry practice and to achieve the lowest sustainable cost of delivering the Reference Service.

3. AGN first submitted an application seeking approval of costs related to FRC on 24 June 2002. On 27 December 2002, I issued an information paper explaining that costs of the type proposed to be recovered by AGN did not fall within the terms of section 8.21 of the Code and that, accordingly, I was unable to provide a binding approval of the proposed investment. There was no other specific power under the Code enabling me to give a binding approval that would enable AGN to be assured of recovering its FRC development costs.

4. This limitation of the Code was subsequently referred to the National Gas Pipelines Advisory Committee ("**NGPAC**"), which has responsibility for recommending changes to the Code. NGPAC recommended to the Ministers responsible for the Gas Pipelines Access Law in each jurisdiction that the Code be amended to provide for the recovery of capital costs incurred in the provision of ancillary Services. The necessary amendments to the Code, incorporated in the Seventh Amending Agreement, were gazetted in South Australia on 17 April 2003 and also became effective in Western Australia on that day.

5. The current application by AGN was made possible by the amendment of the Code.

6. As required under the Code, a notice was issued and advertisements were published on 4 July 2003 advising that the application had been lodged by AGN. Public submissions were requested to be received by 4:00 pm on Friday 1 August 2003 and an information paper was published on 4 July 2003 to assist interested parties with submissions.

7. One submission was received from the office of the Deputy Premier, Treasurer and Minister for Energy. This submission is available on the O*ff*GAR website (www.offgar.wa.gov.au).

8. Under the Code, I am required to issue a Draft Decision approving or not approving the proposed application, giving my reasons for the decision.

9. After considering AGN's application, the submission that has been received, advice from technical consultants Evans and Peck (a copy of which is available from the O*ff*GAR website) and the relevant terms of the Code, including sections 8.16, 8.17 and 8.21, I have agreed that the capital costs proposed by AGN for the implementation of a Network Management Information System ("**NMIS**") to a maximum of $12 million will meet the requirements of section 8.16 of the Code.

10. In relation to the non capital costs of AGN's proposal, at the next review of the approved Access Arrangement, I will review all incurred costs and actual non capital costs. Costs which are determined to be directly related to the facilitation of FRC, and which meet the requirements of section 8.37 of the Code, will be approved.

11. However, the Code does not give me discretion to provide any approval of the non capital costs at this time and I am of the view that it would be inappropriate in the circumstances for me to provide a non-binding acknowledgment that such costs would be likely to satisfy section 8.37 of the Code.

**Submissions on Draft Decision**

12. Submissions are now invited on this Draft Decision, which should be in both written and electronic form and addressed to:

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13. In general, all submissions from interested parties will be treated as in the public domain and placed on the O*ff*GAR web site. The receipt and publication of any submission lodged for the purposes of the Code shall not be taken as indicating that the Regulator has formed an opinion as to whether or not any particular submission contains any information of a confidential nature.

14. Where an interested party wishes to make a submission in confidence, it should clearly indicate the parts of the submission in respect of which confidentiality is claimed. Any claim of confidentiality will be considered in accordance with the provisions of section 7 of the Code.

15. Submissions must be received by 5:00 pm WST on Tuesday 9 September 2003.

16. After considering any further submissions, I will issue a Final Decision on AGN's application relating to capital costs of developing systems associated with the introduction of FRC in Western Australia.

## REASONS

### AGN's Network Management Information System

17. The proposed FRC-related capital costs which are the subject of AGN's application are estimated by AGN to be approximately $12 million. These are attributable to the investment that is proposed to be undertaken in relation to implementing a NMIS. The NMIS will cover all FRC system requirements including:

    - responding to market transactions;
    - providing data to the market administrator;
    - network usage billing;
    - managing e-commerce work flows;
    - providing public access to internal data;
    - meter reading management; and
    - meter data management.

18. In its application, AGN advised that it expects to enter into a capped price contract (or contracts) with a system vendor in July 2003. AGN has further advised that it is currently negotiating the details of the contract for the delivery of the NMIS with LogicaCMG. AGN stated that it was undertaking considerable investment at the time of its application in preparation for the major phase of the NMIS project, which will commence once the capped price contract is entered into.

19. AGN submits the estimate of FRC capital costs reflects the additional capital costs that are attributable to the development, acquisition and implementation of the NMIS. It has also factored into this cost an allowance for a return on the capital invested for the period between the time of the investment and the commencement of the next Access Arrangement period.

20. AGN has noted that the NMIS will also give rise to ongoing operating and maintenance costs, require staff to manage, control and administer associated processes and functions performed by the NMIS and involve costs relating to FRC generally. AGN does not expect to be able to provide firm estimates of FRC non capital costs until FRC is fully implemented or close to implementation. The FRC non capital costs are currently estimated by AGN to be in the order of $1.3 million per annum.

### Code provisions

21. Section 8.21 of the Code (as amended by the Seventh Amending Agreement) gives the Regulator the discretion to agree to the recovery of proposed costs associated with New Facilities Investment, stating that:

    > 8.21 The Relevant Regulator may at any time at its discretion agree (with or without conditions or limitations) that actual New Facilities Investment by a Service Provider meets, or forecast new Facilities Investment proposed by a Service Provider will meet, the requirements of Section 8.16(a), the effect of which is to bind the Relevant Regulator's decision when the Relevant Regulator considers revisions to an Access Arrangement submitted by the Service Provider. Before giving any agreement under this section 8.21, the Relevant Regulator must conduct public consultation in accordance with the requirements for a proposed revision to the Access Arrangement submitted under section 2.28. For the avoidance of doubt, if the Relevant Regulator does not agree under this section that the New Facilities Investment meets, or (in the case of

forecast New Facilities Investment) will meet, the requirements of section 8.16(a), the Relevant Regulator may consider whether those requirements are met when it considers revisions to an Access Arrangement submitted by the Service Provider.

22. As set out in the Information Paper of 27 December 2002, I was unable to agree that the New Facilities Investment proposed by AGN in its application of 24 June 2002 would meet the requirements of section 8.16 due to the terms in which section 8.21 of the Code was then drafted. At that time, the power in section 8.21 was expressed in terms of "New Facilities", and the Code definition of "New Facilities" at that time was limited to Services provided "by means of" a Covered Pipeline which, in my view, did not extend to costs such as the NMIS-related costs proposed by AGN, which are not provided "by means of" the Covered Pipeline, even though they are related to haulage services.

23. Following the Seventh Amending Agreement, gazetted on 17 April 2003, the Code now defines "New Facility" as follows:

'New Facility' means:

(a) any extension to, or expansion of the Capacity of, a Covered Pipeline which is to be treated as part of the Covered Pipeline in accordance with the Extensions/Expansions Policy contained in the Access Arrangement for that Covered Pipeline;

(b) any expansion of the Capacity of a Covered Pipeline required to be installed under section 6.22; and

(c) any capital asset constructed, developed or acquired to enable the Service Provider to provide Services including, but not limited to, assets required for the purposes of facilitating competition in retail markets for Natural Gas.

24. In the light of the amendments to the Code, AGN has made a new application for the recovery of its FRC costs.

25. In determining whether to agree costs under section 8.21, I must determine whether those costs meet the requirements of sections 8.16 and 8.17, discussed in detail in paragraphs 37 and 38 below.

26. Services are defined under the Code as follows:

'Service' means:

(a) a service provided by means of a Covered Pipeline (or when used in section 1 a service provided by means of a Pipeline) including (without limitation):

(i) haulage services (such as firm haulage, interruptible haulage, spot haulage and backhaul); and

(ii) the right to interconnect with the Covered Pipeline, and

(b) services ancillary to the provision of such services,

but does not include the production, sale or purchasing of Natural Gas.

**Submissions received**

27. One submission was received in relation to AGN's proposal, from The Hon Eric Ripper MLA, Deputy Premier, Treasurer and Minister for Energy. It is published on the O*ff*GAR website (www.offgar.wa.gov.au). Briefly summarised, the submission notes the following:

- the Government's commitment to the implementation of FRC in Western Australia by the Government's Go-Live target date of 1 May 2004;

- the proposal by AGN to provide the necessary systems to facilitate customer transfers is an essential element of achieving FRC, and the Government supports the principle of AGN's proposal to recover costs related to FRC; and

- the Government considers third party access charges should reflect prudent and efficient FRC-related costs.

**Technical assessment of AGN's proposal**

28. To assist me in assessing AGN's proposal, I appointed consulting firm Evans and Peck to carry out a technical assessment of the specifications, functionality and costs of the proposed NMIS system. Evans and Peck's report on AGN's earlier application was published on the O*ff*GAR website in December, 2002. In their report on the second application by AGN (published on the O*ff*GAR website on 25 August 2003), Evans and Peck focused on changes in cost and technical specifications and functionality subsequent to AGN's earlier application. The conclusions reached by Evan and Peck are discussed in detail below.

**Assessment**

29. In considering the proposed FRC capital costs, I sought to determine whether:

- the technical specifications (*scope*) of the system proposed by AGN are requisite for the implementation of FRC and compliant with the requirements for New Facilities Investment recoverable under sections 8.15, 8.16 and 8.17 of the Code; and

- the *scale* of the proposed costs are compliant with the Code.

30. I have also considered the application of section 8.37 of the Code to the FRC non capital costs proposed by AGN.

*Requirements for New Facilities Investment*

31. Section 8.15 of the Code provides that the Capital Base for a Covered Pipeline may be increased from the commencement of a new Access Arrangement Period to recognise additional capital costs incurred in constructing New Facilities for the purpose of providing Services.

32. The new Code definition of a New Facility includes any capital asset constructed, developed or acquired to enable the Service Provider to provide Services including, but not limited to assets required for the purposes of facilitating competition in retail markets for Natural Gas. The definition of Service in section 10.8 of the Code means

a service provided by means of a Covered Pipeline and includes (without limitation) haulage services, the right to interconnect with the Covered Pipeline and services ancillary to the provisions of such services.

33. AGN submits that it is in the course of incurring the FRC Capital Costs so that it can provide its Mid-West and South-West gas distribution systems ("**GDS**") Services including the Reference Services. It submits that there is a direct connection between the functions that the FRC New Facilities will provide and the provision of GDS Services, interconnection Services and ancillary services. If AGN did not provide or intend to continue to provide the GDS Services, it would not incur the FRC Capital Costs.

34. Further, as set out above, in the submission made by the Hon Eric Ripper MLA, it was noted that the proposal by AGN to provide the necessary systems to facilitate customer transfers is an essential element of achieving FRC which the Government has committed to implementing in Western Australia by 1 May 2004.

35. The first Evans and Peck report (2002) concluded that:

- the NMIS's architecture and functions suggest that implementation of the NMIS will provide facilities needed to maintain the integrity of the GDS when multiple gas users and retailers use it and the NMIS is required for the successful implementation of FRC;

- the estimated expenditure for the NMIS has been calculated so that AGN is only seeking approval for NMIS–related costs: ring fencing arrangements are in place to avoid benefits being derived by associate companies;

- the Western Australian Government is committed to the objective of ensuring FRC in the Western Australian gas industry, as it anticipates increased competition between producers and retailers will improve service delivery and reduce energy prices, to which the new NMIS proposed by AGN relates directly.

36. In the circumstances, in light of the expanded definition of New Facility in the Code, I am satisfied that the FRC costs are costs of an asset constructed or developed for the purpose of facilitating competition in retail markets for natural gas for the purpose of providing the GDS Services, including Reference Services.

*Compliance with Code Requirements*

37. In accordance with section 8.16(a) of the Code, I may allow the costs associated with the NMIS to be added to the Capital Base, provided that:

(i) they do not 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 delivering the services; and

(ii) one of the following conditions is satisfied:

(A) the Anticipated Incremental Revenue generated by the New Facility exceeds the New Facilities Investment; or

(B) the Service Provider and/or Users satisfy the Relevant Regulator that the New Facility has system-wide benefits that, in the Relevant Regulator's opinion, justify the approval of a higher Reference Tariff for all Users; or

(C) the New Facility is necessary to maintain the safety, integrity or Contracted Capacity of Services.

38. Under section 8.17, for the purpose of administering section 8.16(a), I must consider:

(a) whether the New Facility exhibits economies of scale or scope and the increments in which Capacity can be added; and

(b) whether the lowest sustainable cost of delivering Services over a reasonable time frame may require the installation of a New Facility with Capacity sufficient to meet forecast sales of Services over that time frame.

*Efficient and Lowest Sustainable Cost*

39. To assist me in assessing the costs associated with the NMIS against the criteria set out in sections 8.16 and 8.17 of the Code, Evans and Peck (2002) reviewed both the tendering process carried out by AGN in appointing a contractor for the development and implementation of the NMIS and the estimated capital costs themselves.

Tender Process

40. AGN has provided me with details of the tendering process that was used to select a vendor for the development and implementation of the NMIS. In addition, Evans and Peck (2002) reviewed the tender process carried out by AGN and concluded that costs arising from the process could be deemed to be consistent with outcomes required by section 8.16(a)(i).

41. Subject to the technical specifications of the NMIS being compliant with the requirements of the Code (which I consider below), and upon reviewing the Evans and Peck analysis and the material provided to me by AGN, I am satisfied that the capital expenditure determined through the tender process adopted by AGN is an amount of capital expenditure that does not exceed the amount that would be invested by a prudent Service Provider acting efficiently, in accordance with good industry practice, and will achieve the lowest sustainable cost of providing services.

42. Evans and Peck (2003) note that, subsequent to revised pricing by their suppliers, AGN sought further market information to confirm that staying with their selected suppliers was still the most economic choice for the NMIS implementation.

43. I am satisfied that the process adopted by AGN to revise its estimate of costs for the NMIS subsequent to the tender process has been reasonable and is consistent with a Service Provider acting efficiently and in accordance with good industry practice.

Estimated Capital Costs

44. Evans and Peck (2003) reviewed AGN's estimated capital costs for the NMIS and concluded that a total project capital cost of $12 million was justified.

45. In addition to the findings set out above, the first Evans and Peck report (2002) concluded that:

- ring-fencing arrangements ensure that AGN is only seeking approval for NMIS-related costs, and benefits to associate companies are avoided;

- it would be more costly to implement the NMIS in phases over time compared with the approach proposed by AGN (being to install it all at once); the NMIS is an upgrade of an existing system which will minimise costs relative to purchasing a new application; and the work and the effort needed to implement NMIS is largely independent of the scale of implementation (that is, designing the NMIS to meet forecast services for thousands of gas consumers would cost the same as designing the NMIS to support fewer gas consumers);

- AGN proposes to use its existing intranet for information exchange between AlintaGas Sales Pty Ltd ("**AGS**") and the NMIS. As AGS is the sole supplier of retail services, the use of its intranet is an efficient and prudent means of providing such services. However, in the future, if competing retailers are to access the NMIS, then issues concerning access to the NMIS and service reliability (through the internet versus the intranet) may become an issue; and

- the estimated capital costs for implementation of the NMIS are, in their view, prudent and likely to satisfy the relevant sections of the Code.

46. The second Evans and Peck report (2003), on technical and cost changes following AGN's first application, concluded that:

- several of the individual cost items generating the overall increase appear excessive, such as the effort and, hence, labour costs for functionality changes to the NMIS, the cost of additional hardware and increased labour rates sought by LogicaCMG;

- notwithstanding this, the overall increase in costs of $2 million is reasonable and the new total of $12 million represents prudent expenditure for implementing the NMIS;

- expenditure beyond this current estimate may not be considered prudent if any such increase does not support further "value add" for the NMIS implementation, such as through significantly enhancing functionality which may be needed to better support FRC.

47. In response, AGN has stated that:

- The Chief Information Officer for AGN is currently negotiating the details of the contract for the delivery of the NMIS with LogicaCMG. The contract will provide many of the necessary control mechanisms to ensure that NMIS is delivered to specification to allow AGN to operate in a contestable environment, and within the defined budget and time constraints.

- AGN does not believe that there will be alteration to the proposed amount for delivery, except for external influences beyond its control such as legislative change and modifications to the Retail Market Rules.

- AGN has previously delivered Information Technology projects of this scale to time and budget. Consequently, AGN believes it has the requisite experience to effectively manage its supplier and its internal resources to ensure the successful delivery of NMIS.

<u>Economies of Scale</u>

48. Under section 8.16(a) and 8.17, I have also considered whether the NMIS exhibits economies of scale, the increments in which the system can be implemented, and whether the installation of the NMIS with capacity to meet forecast sales is necessary to achieve the lowest sustainable cost of delivering services.

49. Evans and Peck (2002) concluded that:

- it would be more costly to implement the NMIS in phases over time compared to the approach proposed by AGN, which is in accordance with good industry practice;

- the NMIS is an upgrade of an existing system, which will minimise costs relative to purchasing a new application; and

- the effort needed to implement NMIS is largely independent of the scale of implementation (i.e., designing the NMIS to meet forecast services for thousands of gas consumers would cost the same as designing the NMIS to support fewer gas consumers).

50. Following my review of the Evans and Peck analyses and the information provided by AGN regarding the tender process, the estimated capital costs and economies of scale in the NMIS, as set out above, I am satisfied that the proposed capital costs are compliant with sections 8.16(a)(i) and 8.17 of the Code.

*System-Wide Benefits*

51. AGN's submission includes the following points with which I agree:

- The test as to what is a "system wide benefit" is objective and requires the Regulator to form a reasonable view based on the information available at the time the Service Provider commits to the relevant investment;

- A new facility may be said to provide a system-wide benefit when it provides a benefit that is generally available, as opposed to being available to only a particular person or persons. However, this does not mean that each user must benefit simultaneously or to the same extent.

- The concept of "benefits" should be given a broad interpretation and should include benefits such as enhanced competition, for example, facilitating FRC which is likely to provide benefits to users and end customers in the form of greater price or service competition;

- Having determined that a new facility has system wide benefits, it is for the Service Provider and Users to satisfy the Regulator that the benefit justifies the approval of a higher reference tariff for all users.

52. The Western Australian Government is committed to the objective of full retail competition in the Western Australian gas industry. It anticipates that increased competition between producers and retailers will improve service delivery and reduce energy prices. The submission of the Hon Eric Ripper MLA to this review states that:

> I previously provided a submission on 27 July 2002, advising that the State is committed to a uniform national framework applying to access to natural gas transmission and distribution pipelines. Since this submission, the Gas Retail Deregulation Project (GRDP) has continued to fulfil the Government's commitment of implementing gas FRC in Western Australia, with the following objectives:
>
> - to provide the choice of retailer to all gas consumers; and
>
> - to facilitate a smooth transition from a regulated to a deregulated gas retail market.
>
> The proposal by [AGN] to provide the necessary systems for the ring-fenced distribution business to facilitate customer transfers is an essential element of achieving gas FRC and the above outlined objectives.

53. Evans and Peck (2002) concluded that the new NMIS proposed by AGN is requisite and directly applicable to the implementation of FRC.

54. Following my review of the Evans and Peck analyses as set out above, I am satisfied that the proposed capital costs are requisite to the implementation of FRC and that they have system-wide benefits that, *ceteris paribus,* justify the approval of a higher Reference Tariff for all Users (Code section 8.16(a)(ii)(B)).

*Safety and Integrity of Services*

55. Evans and Peck's (2002) review of the NMIS architecture and functions showed that the implementation of the NMIS will provide facilities needed to maintain the integrity of the system when multiple gas suppliers and retailers use the network, and that the NMIS is requisite for the implementation of FRC.

56. Upon my review of the Evans and Peck analysis and supporting material by AGN, I conclude that the NMIS is necessary to maintain the safety and integrity of the services (where the "Services" in this case are the GDS services under FRC) and that therefore the NMIS satisfies section 8.16(a)(ii)(C) of the Code.

*Conclusion*

57. Following my review of the Evans and Peck reports and the information provided to me by AGN, I am satisfied that the technical specifications of the NMIS are directly attributable to the activities and tasks associated with the implementation of FRC. Furthermore, I am satisfied that adequate ring fencing arrangements are in place to avoid or minimise benefits being derived by associate companies.

58. Further, based upon my review of the analyses by Evans and Peck and the information provided by AGN as set out above, I am satisfied that the specifications and costs associated with the NMIS to a maximum of $12 million are compliant with sections 8.16(a)(i) and 8.16(a)(ii)(B), alternatively 8.16(ii)(C), and 8.17 of the Code.

*FRC Non Capital Costs*

59. In its submission, AGN has requested that I provide a non-binding acknowledgement that FRC non capital costs are likely to satisfy section 8.37 of the Code. Section 8.37 of the Code provides for the recovery of all non capital costs subject to a prudence test. "Non Capital Costs" is defined as the "operating, maintenance and other costs incurred in the delivery of the Reference Service" under section 8.36 of the Code.

60. Evans and Peck note in their reports (2002 and 2003) that the FRC-related non capital costs proposed by AGN appeared reasonable. Notwithstanding this, I am unable to provide any approval of the non-capital costs relating to its proposal at this time as section 8.37 does not give me the discretion to provide pre-approval. Further, the costs are only forecasts at this stage and have not actually been incurred. Accordingly, the non capital costs actually incurred will be reviewed to assess whether they are prudent at the time of the next review of AGN's approved Access Arrangement for the GDS. It will be decided at that time whether in fact those costs are or are not capable of being recovered according to the standards prescribed under the Code.

**Further Information**

61. For further information relating to this Draft Decision please contact Mr Robert Pullella.

KEN MICHAEL
**GAS ACCESS REGULATOR**