ALINTAGAS NETWORKS PTY LTD

MID WEST AND SOUTH WEST GAS DISTRIBUTION SYSTEMS

SUBMISSION ON FULL RETAIL CONTESTABILITY COSTS

20 June 2003

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1. INTRODUCTION

AlintaGas Networks Pty Ltd ("**AGN**") applied to the Western Australian Independent Gas Pipelines Access Regulator's ("**Regulator**") Office on 24 June 2002 to

- agree under section 8.21 of the *National Third Party Access Code for Natural Gas Pipeline Systems* ("**Code**") that the additional capital cost for Full Retail Contestability ("**FRC**") meet the requirements of section 8.16 of the Code; and

- acknowledge that the addition non capital costs for FRC are likely to meet the requirements of section 8.37 of the Code when they are incurred.

After considering AGN's proposal, legal and technical advice, and a public consultation process, the Regulator concluded that while the costs of the type proposed to be recovered by AGN were reasonable, they did not fall within the terms of section 8.21 and, accordingly, was unable to agree that the proposed New Facilities Investment will meet the requirements of Section 8.16.

The Regulator stated in an information statement issued on 27 December 2002 that were it not for the inapplicability of section 8.21 in this matter, AGN's costs relating to implementation of the NMIS would appear to meet the requirements of section 8.16 of the Code.

The issue was referred to the National Gas Pipelines Advisory Committee ("**NGPAC**") for consideration and 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 such costs.

The relevant responsible Ministers approved the amendment and on 17 April 2003 the Seventh Amending Agreement to the Code was gazetted. To that end, AGN re-submits its request to the Regulator to:

- agree under section 8.21 of the Code that the additional capital costs ("**FRC Capital Costs**") in relation to FRC-related new facilities ("**FRC New Facilities**") meet the requirements of section 8.16 of the Code; and

- acknowledge that the additional FRC-related non capital costs ("**FRC Non Capital Costs**") are likely to meet the requirements of section 8.37 of the Code when they are incurred.

In that context, this submission:

- provides background information on the nature and amount of FRC Costs that AGN estimates that it will incur;
- describes why the FRC Capital Costs satisfy the requirements of sections 8.16 and 8.21 of the Code;
- describes why the FRC Non Capital Costs are likely to satisfy the requirements of section 8.37 of the Code; and
- re-iterates AGN's commitment to assist the Regulator to deal with the requests set out in this submission in a transparent, cooperative and consultative manner.

To avoid doubt, this submission is, in fact, an application to the Regulator under section 8.21 of the Code.

2. BACKGROUND

2.1 Overview of this section

This section of the submission:

- outlines the nature of the FRC Costs incurred by AGN;
- provides information about the State Government's project for the implementation of FRC ("**FRC Project**"); and
- establishes the nature, timing and amount of FRC Costs that AGN is currently in the course of incurring and is likely to incur in the future.

2.2 Outline of FRC Costs

AGN is currently working with the Western Australian State Government and other interested parties to develop market rules, systems and processes to accommodate the introduction of full retail contestability in the Western Australian gas market. FRC became legally possible on 1 July 2002 due to the removal of restrictions on access to AGN's Mid-West and South-West gas distribution systems ("**GDS**").

The removal of the access restrictions provides prospective users with legally enforceable rights to access services provided by means of the GDS, regardless of the:

- purpose for which the prospective user will supply gas; and
- amount of gas consumed on a site.

This means that existing and prospective users (most likely gas producers and retailers) will be free to access services provided by means of the GDS[1] ("**GDS Services**") so that they can compete for all customers in the retail gas market. The freedom for users to compete for all customers, and the corresponding freedom for consumers to choose their gas supplier, are central objectives of the Western Australian Government's energy industry reform process. It is also consistent with the provisions of the *Competition Principles Agreement* 1995, to which the State of Western Australia, the Commonwealth and all other State and Territory Governments are parties. In general terms, competition between users for retail customers is intended to improve service delivery and reduce energy prices.

The commencement of FRC will significantly increase the complexity of transactions in the Western Australian gas market and necessitates the introduction of new market rules, information systems and processes. As a consequence, distribution businesses (including AGN), retailers and other gas market participants will need to establish systems that allow market participants to operate effectively in the competitive gas market. In addition, they will need to amend internal processes and other business systems.

The burden of developing, implementing, operating and maintaining some of the information systems and processes associated with FRC will fall on AGN as the major provider of gas distribution access services in Western Australia.[2] As a result, AGN will incur considerable FRC-related costs ("**FRC Costs**"), including FRC Capital Costs and FRC Non Capital Costs.

AGN is not currently in a position to quantify with certainty the precise level of FRC Costs that it will incur. Indeed, AGN may not be in a position to do so until full "open access" has been operating for some time. However, AGN's FRC Capital Costs are likely to be in the order of $12 million and FRC Non Capital Costs are likely to be in the order of $1.3 million per annum. As such, the anticipated FRC Costs are clearly substantial.

The FRC costs, which AGN would not incur but for the introduction of FRC, will form part of the total cost that AGN incurs in providing GDS Services. They are costs that AGN is entitled under the Code to recover from the users of those services.

Accordingly, AGN wishes to ensure that the FRC Costs are factored into the calculation of the reference tariffs that apply to those GDS Services that are "reference services". Under the terms of its Access Arrangement for the Mid West and South West Gas Distribution Systems ("**Access Arrangement**"), AGN offers the following reference services ("**Reference Services**"):

- Reference Service A;
- Reference Service B1;

[1] The services provided by means of the GDS include, without limitation, haulage services, interconnection services and ancillary services.

[2] As described in section 2 of this submission, other participants in the gas market (REMCo and Retailers) will also bear some of the burden of developing, implementing, operating and maintaining information systems and processes in relation to the operation of the retail market.

- Reference Service B2; and
- Reference Service B3.

If FRC Costs are appropriately factored into the reference tariffs for the Reference Services, AGN will effectively be able to pass the costs through to users as envisaged by the Code. That will promote economic efficiency and equity through ensuring that the beneficiaries of competition (i.e. the user) incur the establishment costs.

2.3 The State Government's FRC Project

As noted in section 1 of this submission, AGN is currently working with the State Government and other interested parties to develop market rules ("**Rules**"), systems and processes to accommodate the introduction of FRC. That work is taking place as part of the "Gas Retail Deregulation Project" ("**GRDP**") that is being managed and facilitated by the State Government through the Gas Retail Deregulation Project Steering Group ("**Steering Group**"). The following sub-sections of this submission briefly discuss the Steering Group, the key concepts on which the members of the Steering Group have reached agreement, and the level of costs that may be incurred across the gas industry in relation to the implementation of FRC.

(a) The Steering Group

The Steering Group, which consists of senior representatives from all facets of the gas industry, customer groups and Government (including observers from the Office of Gas Access Regulation), has been given the task of establishing the Rules and other arrangements that are necessary to support a competitive retail gas market. The Minister for Energy established the Steering Group under section 25 of the *Energy Coordination Act 1994*.

The major objectives of the Steering Group are to:

- achieve functional systems in Western Australia for customer transfer; and
- provide a smooth transition to a competitive retail gas market that delivers a net benefit to gas consumers.

The Steering Group has a number of working groups ("**Working Groups**").

(b) The Rules

In line with its objectives, the Steering Group is currently facilitating and expediting the development by industry and other stakeholders of the Rules and other arrangements necessary to support FRC. It has engaged, and continues to engage, in an open consultation process with actual and potential gas market participants, customer groups, State Government representatives and the Office of Gas Access Regulation. Upon determination of appropriate Rules and arrangements, industry (including AGN) will develop and implement supporting systems and processes.

Throughout its involvement in the FRC Project, AGN has maintained that a fundamental principle is that the gas market structure and Rules must be agreed prior to the commencement of significant systems development[3]. Whilst some requirements of the market structure and Rules may have been predicted, and some development work could have commenced, prior to the finalisation of the market structure and Rules, participants would have been exposed to an unduly high level of risk had they commenced early systems development. In addition, such premature investment would have resulted in an inefficient use of resources and funds. For those reasons, AGN decided not to make any significant investment in FRC-related systems until the nature and extent of the systems required became clearer.

The Steering Committee has made progress towards finalising the market structure and Rules. The majority of the key concepts have now been agreed at the Working Group and Steering Group level. The key concepts, in so far as they relate to the provision of gas distribution access services, are as follows.

- The key participants in the gas market will be:
  - gas distribution network operators ("**Network Operators**");
  - gas retailers ("**Retailers**");
  - gas consumers ("**Consumers**"); and
  - gas transmission pipeline operators ("**Transmission Operators**").
- Network Operators and Transmission Operators will provide gas access services to the Retailers. As such, Retailers will be "users" on the relevant distribution networks and transmission pipelines. The Network Operators and Transmission Operators will negotiate the terms of access (including prices) with users. At the same time, distribution networks and transmission pipelines covered by the Code will be subject to the provisions of the Code and access arrangements approved under the Code.
- The Rules will set out some of the procedures, obligations and rights of Retailers, Network Operators and, possibly, Transmission Operators in relation to the supply of gas to Consumers. The Rules will deal with matters such as: delivery point registration; delivery point transfer; data exchange between market participants; the allocation of gas withdrawals; reconciliations; the balancing of transmission pipeline withdrawals and deliveries; and delivery point discovery.

[3] For example, see the AlintaGas Limited "Public Offer Document", August 2000, page 28

- A separate legal entity, the Retail Energy Market Company ("**REMCo**"), has been established to administer the Rules. REMCo will, among other things: develop, modify and implement the Rules; interact with the State Government and regulatory authorities; oversee administration of the gas retail market arrangements; procure the systems and services required to administer and operate the retail gas market; and police compliance with the Rules. REMCo may engage other entities to perform some of its functions.

- The State Government will by legislation (*Energy Amendments Bill 2003*) require that Retailers and Network Operators become members of REMCo. By becoming members, Retailers and Network Operators will bind themselves to comply with the Rules.

(c) **Industry wide costs associated with FRC**

The development and implementation of the market structure and Rules described above will require considerable investment by parties involved in the gas industry, including the State Government, Retailers and Network Operators.[4] In November 2001, the Steering Group determined that costs will be incurred across the gas industry in relation to following broad categories of activity.[5]

- Developing the Rules and market arrangements, including:
    - project management and secretariat support provided by Government (Office of Energy) for the Steering Group and its Working Groups;
    - industry participation costs associated with the provision of staff and services to the GRDP; and
    - consultancy costs and other third party expert assistance required for the GRDP.

- Capital and operating costs associated with the establishment of REMCo and associated systems.

- Market participants' (both the Network Operator's and Retailers') costs in establishing and operating an interface with REMCo's systems and amending internal processes and systems.

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4 The major Network Operator is AGN.

5 Gas Retail Deregulation Project Steering Group, "Funding and Cost Recovery: Discussion Paper", November 2001, page 5.

Setting aside the costs of representation at the GRDP, project management, coordination and secretariat support, the Steering Group estimated that the industry-wide costs of implementing FRC would be as set out in the following table.

	Estimated Costs ($m)						
Process	**Year -1**	**Year 0**	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Total**
Development (rules, policies & framework)	1-2						1-2
Market Systems and Operation (5 year period)		2.4-3	2.4-3	2.4-3	2.4-3	2.4-3	12-15
Network Operator's Systems	5-10						5-10
Retailer's Systems (each)	3-5						3-5
Total cost ($m)	9-17	2.4-3	2.4-3	2.4-3	2.4-3	2.4-3	$21-32

As is apparent from the table, the Steering Group estimated that the total cost of FRC over a 6 year period was likely to be in the range of $21-$32 million. Of that total, it was estimated (under the process identified as "Network Operator's Systems") that some $5-$10 million would need to be invested by AGN in developing and implementing a new information system. In other work, the Steering Group recognised that the new information system is required to enable AGN to provide GDS Services under the new market structure and Rules.

2.4 The FRC Costs

Based on its understanding of the market structure and Rules, AGN has been able to ascertain with considerable certainty the nature of the processes, obligations and rights that will apply to it, in respect of the provision of GDS Services, once FRC is implemented.

Stemming from that, AGN has also been able to identify the systems and processes that it must implement to accommodate the commencement of FRC. It has developed a requirements specification and scoped the functional requirements for systems to support FRC. AGN's work represents a significant advance on the work undertaken by the Steering Group to produce the estimates set out above. Although it is possible that there may be some change to the requirements specification and functional requirements, it is currently anticipated that any change will not be substantial.

Further, AGN has been able to estimate the FRC Costs that it needs to incur in relation to the provision of GDS Services. The extensive and detailed process followed by AGN to estimate the FRC costs involved:

- the development of the requirements specification and scope for functional systems requirements;
- holding discussions with a number of similar businesses in Australia about the systems that those businesses implemented or are in the process of implementing, and the level of associated costs;
- seeking and obtaining detailed proposals from system vendors, including via the placement of Australia-wide advertisements; and
- undertaking internal investigations and analyses.

AGN held discussions with similar businesses and obtained proposals from systems vendors to leverage from experience in Australian jurisdictions that are more advanced in the implementation of FRC. As the majority of work undertaken by the Steering Group was based on the New South Wales and Victorian FRC models, there was considerable value in investigating the situation in respect of those jurisdictions. In addition, a central objective of the process was to ensure that AGN's estimated FRC Costs reflect the level of costs that would be incurred by a prudent service provider acting efficiently, in accordance with accepted good industry practice, and to achieve the lowest sustainable cost of delivering services, as specified in the Code.

Having undertaken the detailed assessment AGN is confident that the information systems it is implementing are consistent with, and do not differ significantly from, the systems being implemented by distribution businesses in other jurisdictions. AGN is also confident that the level of estimated FRC Costs reflects the level of costs that would be incurred by a prudent service provider acting efficiently, in accordance with accepted good industry practice, and to achieve the lowest sustainable cost of delivering services.

AGN's estimates of FRC Capital Costs and FRC Non Capital Costs are set out in the following sub-sections of this submission. In providing the estimates, AGN stresses that the FRC Capital Costs are those costs that AGN is in the course of incurring, or will incur, in providing GDS Services. They do not include any costs associated with: developing market rules and arrangements; the establishment of REMCo and its associated systems; or Retailers' costs in establishing and operating an interface with REMCo's systems and amending internal processes and systems to allow for FRC.

(a) **FRC Capital Costs**

FRC Capital Costs are estimated at $12 million. AGN is confident with this estimate, as it has undertaken a detailed requirements study that incorporates the latest release of the Retail Market Rules from REMCo.

The FRC Capital Costs are attributable to the investment that AGN is currently in the process of undertaking in relation to a "Network Management Information System" ("**NMIS**").[6] AGN will implement NMIS to cover all deregulation systems requirements, including:

[6] To avoid doubt, note that NMIS is different to the system that REMCo will develop to administer and manage the Rules in the retail gas market.

- handling CATS (Customer Transfer) transactions including;
  - responding to market transactions and;
  - providing data to REMCo;
- network usage billing;
- managing e-commerce work-flows;
- providing public access to internal data;
- meter reading management; and
- meter data management.

AGN expects to enter into a capped price contract (or contracts) with a system vendor (or vendors) in July 2003. Currently, AGN continues to undertake considerable investment in preparation for the major phase of the NMIS project, which will commence once the capped price contract (or contracts) are entered into.

The estimate of FRC Capital Costs reflects the additional capital costs that are attributable to the development, acquisition and implementation of NMIS. It includes 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 in respect of the Access Arrangement. The overall return on the investment will be such that the NPV of the investment would be zero when discounting the investment at the relevant weighted average cost of capital. Thus AGN is seeking only a return of its FRC costs, not any additional return. Any lesser amount would involve AGN making a loss on provision of these services.

(b) **FRC Non Capital Costs**

AGN estimates that the FRC Non Capital Costs will be in the order of $1.3 million per annum. In contrast to FRC Capital Costs, 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.

That total FRC Non Capital Costs are made up as follows.

Cost Item	Estimated cost
Operations & Maintenance Costs - Systems and Processes	$ 1.200M per annum
Retail Market Administrator & Gas Industry Ombudsman.	$ 0.100M per annum

(i) **Operations and maintenance costs - systems and processes**

NMIS will give rise to ongoing operating and maintenance costs. In addition, AGN will require staff to manage, control and administer the associated FRC processes and functions performed by NMIS.

(ii) **Retail Market Administrator and Gas Industry Ombudsman Scheme**

Work undertaken by Steering Group has identified other arrangements and entities required to support FRC. They include:

- a market governance entity (Retail Market Administrator); and
- an Ombudsman scheme (Gas Industry Ombudsman Scheme).

AGN is required to be a member of, and contribute to the operation of, those entities and schemes. The associated costs will be incurred by AGN in the delivery of GDS Services, including the Reference Services.

3. FRC CAPITAL COSTS

3.1 Overview of this section of the submission

This section of the submission:

- sets out AGN's request for the Regulator's agreement under section 8.21 of the Code in relation to FRC Capital Costs;
- explains why AGN makes the request; and
- details why the Regulator should give his agreement.

3.2 Request for the Regulator's agreement

As noted above, AGN requests that the Regulator agree that the FRC Capital Costs set out in section 2 of this submission meet the requirements of section 8.16 of the Code. AGN seeks the Regulator's agreement under section 8.21 of the Code.

3.3 Reason for requesting the Regulator's agreement

As noted above, AGN wishes to be able to recover from users of GDS Services (including Reference Services) the FRC Capital Costs that AGN will incur. To do so, AGN wishes to add the new FRC Capital Costs to the capital base for the GDS when it next submits revisions to the Access Arrangement. In basic terms, AGN will be entitled to add the FRC Capital Costs to the capital base if the FRC Capital Costs satisfy the tests set down in section 8.16 of the Code: see Code, sections 8.2, 8.4, 8.9, 8.15 and 8.16.

The next occasion on which AGN is to submit revisions to its Access Arrangement is expected to be 31 March 2004, less than a year away. AGN will face considerable uncertainty if it is required to wait until that time to ascertain whether the Regulator will approve the addition of the FRC Capital Costs to the capital base for the GDS. In effect, AGN will invest $12 million in FRC Capital Costs now without having certainty about whether the Regulator will, in the future, allow it to be recovered through the Reference Tariffs.

For that reason, AGN wishes to obtain the Regulator's agreement at this time (the time at which AGN is making its investment) that the FRC Capital Costs meet the requirements of section 8.16 of the Code. Under section 8.21[7] of the Code, the Regulator has the discretion to give his agreement, the effect of which is to bind the Regulator's decision when he considers revisions to the Access Arrangement.[8]

3.4 Reasons for exercising the discretion under section 8.21

There are a number of compelling reasons for the Regulator to exercise his discretion under section 8.21 of the Code. They are as follows.

- The implementation and successful operation of FRC in the Western Australian gas market depends upon the timely development and implementation of appropriate systems and processes within AGN. By agreeing at this time that the FRC Capital Costs meet the requirements of section 8.16, the Regulator can provide AGN with certainty as to the recovery of those costs. The provision of certainty will reduce AGN's risk in undertaking an investment that it would not undertake but for the commencement of FRC.

- In providing certainty to AGN, the Regulator will also provide certainty to other market participants and potential market participants in relation to the implementation of FRC related systems and the timing of efficient gas market processes. This will increase the chances of achieving the State Government's objectives in relation to the FRC Project, as outlined in section 2 of this submission.

- With an investment of the magnitude that AGN is undertaking there are administrative and practical advantages in assessing whether the capital costs meet the requirements of section 8.16 at the time at which they take place. These include having access to accurate, fresh and complete information concerning relevant expenditure that may be lost with the passage of time (thereby making a

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7 Note that clause 37 of the Access Arrangement is expressed in similar terms to section 8.21.

8 The Regulator will then be required to treat the FRC Capital Costs as having met the requirements of section 8.16. The FRC Capital Costs will be added to the capital base for the GDS pursuant to sections 8.15, 8.16 and 8.9(c). The capital base at the commencement of the next access arrangement period will be determined on the basis that it includes the FRC Capital Costs: section 8.9. As such, the FRC Capital Costs will form part of capital base from which "total revenue" is derived: section 8.4. Total revenue will be calculated, in part, on the basis of a rate of return on, and depreciation of, the capital base, including the FRC Capital Costs: section 8.4(a) and (b). Depreciation will be calculated consistently with sections 8.32 and 8.33 of the Code and the "Reference Tariff Policy" in Chapter 3 of the Access Arrangement.

later assessment more difficult). It also allows for discussion about cost levels as they are occurring, rather than (in some cases) years after the event.

Accordingly, AGN submits that that the Regulator should exercise his discretion under section 8.21.

3.5 Section 8.16 of the Code

(a) Overview of section 8.16

AGN submits that the FRC Capital Costs meet the requirements of section 8.16 of the Code (as read with sections 8.15 and 8.17). Sections 8.16 and 8.17 of the Code are set out in the Annexure to this submission.

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" (as defined in section 8.10 of the Code). Under section 8.16 of the Code, provided that 2 tests are satisfied, the capital base can be increased by the actual capital cost incurred ("**New Facilities Investment**").

In summary terms, the 2 tests (or requirements) of section 8.16 are that:

- the amount of the New Facilities Investment must 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 services ("**Efficiency Test**"); and
- one of the following conditions is satisfied:
    - the anticipated incremental revenue generated by the new facility exceeds the New Facilities Investment ("**Economic Viability Test**");
    - the Regulator is satisfied that the new facility generates system-wide benefits that justify a higher reference tariff for all users ("**System-wide Benefits Test**"); or
    - the new facility is necessary to maintain the safety, integrity or contracted capacity of services ("**Integrity Test**").

AGN submits that the FRC Capital Costs:

- are additional capital costs that are in the course of being incurred in constructing new facilities for the purpose of providing "services"; and
- constitute New Facilities Investment that satisfies the Efficiency Test, System-Wide Benefits Test and Integrity Test.

The following sub-sections of this submission explain the basis for AGN's submission.

If the Regulator does not agree that the total amount of the FRC Capital Costs meets the requirements of section 8.16, AGN submits that the Regulator should provide his agreement in relation to that part that does meet the requirements of section 8.16 (see section 8.16 of the Code and clause 37(5) of the Access Arrangement).

(b) **Capital costs incurred in constructing new facilities**

AGN submits that the FRC Capital Costs are capital costs that are in the course of being incurred in constructing new facilities for the purpose of providing services. As such, the FRC Capital Costs fall within the scope of section 8.15 and may, subject to the tests in section 8.16 of the Code, be added to the capital base for the GDS at the commencement of the next access arrangement period.

The following points support this submission.

- The FRC New Facilities fit within the definition of "New Facilities" in section 8.10 of the Code.
- The FRC Capital Costs are "capital costs" in that they will give rise to an asset that will provide enduring economic benefits.
- As detailed in section 2 of this submission, AGN is in the course of incurring the FRC Capital Costs so that it can provide GDS Services. The fact that it does so as the result of changes in the retail gas market does not alter the fundamental purpose that AGN has in incurring the FRC Capital Costs: it incurs the costs in constructing the FRC Facilities (ie. NMIS) so that it can provide GDS Services, including the Reference Services. There is a direct connection between the functions that the FRC New Facilities will perform and the provision of GDS Services, including the Reference Services, interconnection services and ancillary services. In addition, as noted above, the FRC Capital Costs do not include any provision in relation to matters concerning the retail market, Retailers or the establishment of REMCo and its associated systems.
- If AGN did not provide or did not intend to continue to provide GDS Services (including Reference Services), AGN would not incur the FRC Capital Costs. AGN incurs the FRC Capital Costs to provide GDS Services.

(c) **Efficiency Test**

AGN submits that the FRC Capital Costs 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 services.

To determine the amount that would be invested by a prudent service provider under the Efficiency Test requires that a judgment be made. In making the judgment, the Regulator must consider factors such as economies of scale, the increments with which capacity can be added, and the matching of forecast demand and capacity over a reasonable time frame to meet forecast sales of services over that time frame (see section 8.17 of the Code).

As described in section 2 of this submission, AGN undertook a detailed assessment of the Rules, systems and processes that it must implement. That assessment included holding discussions with similar businesses and systems vendors, and seeking and obtaining proposals from systems vendors on a competitive tender basis. Having held those discussions and having received proposals, AGN is confident that the level of FRC Capital Costs that it has estimated reflects the level of costs that would be incurred by a prudent service provider acting efficiently, in accordance with accepted good industry practice, and to achieve the lowest sustainable cost of delivering services (in AGN's case, GDS Services). Based on what has occurred in other jurisdictions with comparable FRC programs, no service provider that is acting consistently with Efficiency Test would invest less than the FRC Capital Costs that AGN has estimated.

In addition, AGN has no incentive to incur FRC Capital Costs in excess of what a prudent service provider acting consistently with the Efficiency Test would invest. Indeed, AGN has a strong economic incentive to ensure that the FRC Capital Costs meet the requirements of section 8.16(a) of the Code because:

- FRC is introduced by virtue of section 90 of the *Gas Pipelines Access (Western Australia) Act* in fulfilment of part of the State Government's obligations under the *Competition Principles Agreement*;
- as the only holder of a distribution licence under the *Energy Coordination Act* for the "Coastal Supply Area", AGN has no choice but to facilitate FRC and, therefore, incur the FRC Capital Costs; and
- the GDS is a "covered pipeline" under the Code.

The consequence of the GDS being a "covered pipeline" is that the reference tariffs that AGN is permitted to charge for Reference Services are determined by, amongst other things, the value of the capital base approved by the Regulator. Any capital costs incurred (whether they arise in connection with FRC or otherwise) that AGN seeks to recover must first be included in the capital base and be approved by the Regulator as satisfying the requirements of section 8.16. Any costs that are not included in the capital base are at AGN's risk in that AGN may not be able to recover them from users of reference services.[9] In these circumstances, AGN's only real incentive is to minimise the costs of FRC, which it is required by law to implement, to reduce the risk of not being able to recover the costs from users.

[9] Although, some costs may be treated as "speculative investment" and included in the capital base if they meet the requirements of section 8.16 at some stage in the future. In some circumstances, the costs could be recovered through a capital contribution or an approved surcharge on users of incremental capacity under sections 8.25 and 8.26 of the Code.

In this regard, AGN refers the Regulator to the September 2001 Position Paper for the 2003 Review of Gas Access Arrangements prepared by the Victorian Essential Services Commission (formerly the Office of the Regulator General). At page 51, the Essential Services Commission, in relation to the question of whether forecast capital expenditure had met the requirements of section 8.16 of the Code, stated:

> "...the Office is of the view that the incentives under the regulatory regime were reasonably clear and it has no reason to consider that the regime may have given rise to perverse incentives. As a result, it is reasonable to infer that the distributors' actual capital expenditure meets the Gas Code's requirements..."

Consistent with AGN's submission, the Essential Services Commission supports the view that the regulatory regime provides an incentive to minimise capital expenditure to "efficient levels".

For the purpose of the Regulator's consideration of the matters set out in section 8.17 of the Code, AGN notes that the FRC Capital Costs relate to an information system that has been, and continues to be, designed to most effectively deal with demand for varying GDS Services. Its design ensures that unit costs are set at the lowest sustainable level and ensures that it provides economies of scale and scope. In addition, NMIS will be capable of handling a significant volume of transactions for GDS Services across the entire spectrum of the gas market into the foreseeable future. In these circumstances, the sophistication and scale of NMIS could not be lessened if it is to successfully perform its function.

(d) **System-wide Benefits Test**

The systems and processes that will result from the FRC Capital Costs have system-wide benefits that justify the approval of a higher reference tariff for all users of Reference Services.[10] Accordingly, AGN submits that the FRC Capital Costs satisfy the System-wide Benefits Test.

The following sections of this submission discuss the legal requirements in relation to the System-wide Benefits Test, the system wide benefits that will arise as a result of the FRC Capital Costs, and why those system-wide benefits justify the approval of higher reference tariffs.

(i) **Legal requirements in relation to the System-wide Benefits test**

While the Code does not provide guidance in relation to the meaning of "system-wide benefits" and the threshold level of benefits that might justify the approval of higher reference tariffs, it is possible to discern a number of important principles. They are as follows.

- The test as to what is a "system wide benefit", and whether there is a system wide benefit in any particular circumstance, is objective

[10] Note the comments below under the heading "Justification of higher reference tariffs", which indicate that reference tariffs may not increase "for all users" as the result of the addition of FRC Capital Costs to the capital base. In particular, Reference Tariffs A and B1 may not increase.

and requires the Regulator to form a reasonable view based on the information available.

- The assessment must be based on information that is available and expectations at the time the service provider commits to the relevant investment. If new facilities satisfy the System-wide Benefits Test at the time a service provider commits to installing them, then that conclusion should not be altered by subsequent events.

- The Code is silent on the meaning of the words "system wide" in the phrase "system wide benefits". In AGN's view, the words are intended to capture a new facility that provides benefits that are generally available across the system. In particular, they are benefits that are not restricted to particular persons. Accordingly, 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, the requirement of the Code is not that each user must benefit simultaneously, or to the same extent. Rather, the Code requires system-wide benefits that justify the approval of a higher Reference Tariff for all Users. In its final decision on the Access Arrangement for the Principal Transmission System – Application for Revision by GPU GasNet Pty Ltd, dated 28 April 2000, the Australian Competition and Consumer Commission, stated:

  > "The Commission does not interpret the Code to require that system-wide benefits would accrue equally and simultaneously to all users... [r]ather, benefits should be available across the system and potentially be available to much of the customer base."

- The concept of "benefits" should be given a broad interpretation and should include benefits such as enhanced competition (for example, facilitating FRC which, in turn, 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 a system-wide benefit, 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. In this regard, AGN submits that the Regulator must be satisfied that the benefit expected to flow from the new facility outweighs any cost associated with an increased reference tariff.

(ii) **The system wide benefits**

As noted in section 2 of this submission, the FRC Capital Costs will be incurred to develop and establish NMIS. Once implemented, NMIS will be used by AGN to administer the provision of GDS Services. In particular, the system will be used for:

- handling CATS (Customer Transfer) transactions;

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

The introduction and operation of NMIS will provide substantial benefits across the GDS - benefits which will not be restricted to users who supply gas to Consumers taking less than 1TJ per annum or less of gas. The benefits include improved efficiency in contract administration by ensuring that access services are:

- provided to users of access services in relation to delivery points in a timely and efficient manner; and
- terminated in relation to particular delivery points as and when requested with as little disruption as possible.

The benefits also include the facilitation of more efficient, sophisticated and timely information exchange between users of GDS Services and between users and AGN.

Benefits will also be generally available across the GDS in so far as the efficiency and effectiveness of NMIS promotes competition in the retail gas market. Users will benefit from being able to more easily enter, exit and operate in the major retail and distribution gas market in Western Australia. This will provide users and prospective users with the opportunity to expand their role in the gas market in an efficient and effective way. Further, the possibility of full market access for users is a significant benefit that will be materially facilitated by the operation of NMIS. Market entry, exit and operations would be significantly more difficult without NMIS - indeed, market entry, exit and operation may be practically impossible without NMIS.

Without AGN incurring the FRC Capital Costs to establish NMIS, FRC almost certainly would not be achievable in the Western Australian retail gas market. It would be administratively difficult for users (who will be the Retailers) to effectively transfer customers between one another without a system that permits AGN to properly interface with the users and REMCo.

Downstream benefits will also accrue because NMIS will facilitate retail competition in the gas market. The benefits include the freedom of choice of retailer for all gas consumers, improved and new services, new products, and lower prices that will be delivered as the result of increased competition (or as companies threaten to enter the gas market). Additionally, FRC will serve the public interest through productivity gains and cost savings in the industry as a whole.

AGN submits that increasing competition is in fact the fundamental rationale of the Code and its progenitor the National Competition Policy. Given that without recovery of FRC costs such competition would be restricted at best, this strongly suggests that the competitive policy environment of the gas industry requires FRC cost approval.

(iii) **Justification of higher reference tariffs**

The addition of the FRC Capital Costs to the capital base for the GDS will result in higher reference tariffs for some Reference Services. However, it will not necessarily result in higher reference tariffs for all Reference Services.

In particular, AGN does not expect Reference Tariff A and Reference Tariff B1 to materially increase as FRC Capital Costs added to the capital base will be allocated to Reference Services based on anticipated NMIS usage. Allocations to Reference Tariff A and Reference Tariff B1 are expected to be minimal, if any allocations are made at all.

In any event, to the extent that a particular reference tariff increases as the result of FRC Capital Costs, that increase is justified by the system-wide benefits that NMIS will provide (as outlined above). Those benefits will significantly exceed any detriment that arises by virtue of an increase in reference tariffs.

AGN submits that the Regulator is free to, and should conclude that, NMIS has system-wide benefits that justify the approval of a higher reference tariff for all users.

(e) **Integrity Test**

The systems and processes that will result from the FRC Capital Costs are also necessary to maintain the integrity of GDS services. Accordingly, AGN submits that the FRC Capital Costs also satisfy the Integrity Test.

The Code is silent on the meaning of the phrase "maintain the...integrity...of services". Accordingly, the phrase must be given its natural meaning. In AGN's view, in the context of the GDS, it means to maintain the sound, unimpaired or perfect condition of the GDS Services. Those services include haulage services (as enlivened in the Reference Services), interconnection services and ancillary services (such as connection, disconnection and additional meter reading services).

An important aspect of the GDS Services offered by AGN is the ability to provide the services in a timely and efficient manner, to provide information in relation to gas consumption and delivery points (such as delivery point identifiers), and to terminate the provision of services as and when required. These things are required of AGN by virtue of the Access Arrangement and under access contracts.

When FRC commences, there will be a significant increase in the complexity of transactions in the Western Australian gas market. Without NMIS, AGN would be unable to provide GDS Services as it currently does. In particular, AGN would not be able to provide GDS Services in as timely and efficient manner as it currently does or as required by the developing market place; it would not be able provide information as efficiently and effectively as it currently does; and it would not be able to respond to the termination of services as efficiently and effectively as it currently does. Indeed, without NMIS, FRC would be unworkable because users would be unable to re-allocate delivery points to customers that switch between competing users (ie. Retailers). For example, AGN will be informed of which users are being serviced by it at delivery points by REMCo, instead of the user itself (as is currently the case). Thus, with FRC, but without NMIS, AGN would not know who its users are at any point in time, nor how to charge them. For that reason, the integrity (or current condition) of the GDS Services would be adversely affected if NMIS is not established and implemented. NMIS is, therefore, necessary to maintain the integrity of GDS Services.

Finally, AGN believes that its ability to viably and efficiently operate its business would be substantially prejudiced if NMIS was not implemented. In such a situation, AGN would not have in place systems and processes that are capable of appropriately dealing with the rapidly evolving gas market in which it operates. For example, if NMIS were not established, AGN would have considerable difficulty billing users for Reference Services B2 and B3 because it would not be able to act on advices from the Market Administrator. Consequently, NMIS is necessary to maintain the integrity of services provided by AGN.

4. FRC NON CAPITAL COSTS

4.1 Request for Regulator's acknowledgment

As noted in section 1 of this submission, AGN requests the Regulator's acknowledgment that the FRC Non Capital Costs that AGN will incur in the future are likely to meet the requirements of section 8.37 of the Code when they are incurred. When AGN submits revisions to the Access Arrangement under section 2.28 of the Code, it will seek to recover forecast FRC Non Capital Costs under the reference tariffs for the Reference Services: see Code, sections 8.2, 8.4. and 8.37, and Access Arrangement, clause 32.

To avoid doubt, AGN does not seek the Regulator's agreement that FRC Non Capital Costs are likely to satisfy the requirements of section 8.37. AGN merely requests that the Regulator provide a non-binding acknowledgment that FRC Non Capital Costs are likely to satisfy section 8.37.

4.2 Section 8.37 of the Code

(a) Overview of section 8.37

Section 8.37 of the Code provides that:

> "A Reference Tariff may provide for the recovery of all Non Capital Costs (or forecast Non Capital Costs, as relevant) except for any such costs that would not be incurred 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."

Clause 32 of the Access Arrangement states that AGN's "reference tariff policy" is that reference tariffs are to "provide for the recovery of all forecast non-capital costs to the extent permitted under section 8.37 of the Code".

Under section 8.36 of the Code, "Non Capital Costs" are the operating, maintenance and other costs incurred in the delivery of "the reference service".

(b) **Satisfaction of section 8.37**

The nature and likely magnitude of the FRC Non Capital Costs is described in section 2 of this submission.

In AGN's view, FRC Non Capital Costs are unlikely to ever exceed the non capital costs that would be incurred by a prudent service provider, acting efficiently, in accordance with accepted and good industry practice, and to achieve the lowest sustainable cost of delivering a reference service. The reasons for this are essentially the same as the reasons set out above in relation to why FRC Capital Costs satisfy the Efficiency Test under section 8.16 of the Code. In particular, AGN submits that the FRC Non Capital Costs are likely to be efficient for 2 reasons.

The 1st reason is that FRC Non Capital Costs will arise by virtue of an FRC model, systems and processes that are in themselves efficient. Accordingly, non capital costs that are incurred in operating and maintaining that model, and those systems and processes, are likely to be efficient.

The 2nd reason is that, as with FRC Capital Costs, AGN's economic incentive is to keep FRC Non Capital Costs as low as possible. If costs exceed the level that would be incurred by a prudent service provider acting consistently with section 8.37 of the Code, AGN is unlikely to be able to recover them from users via reference tariffs. Accordingly, AGN submits that FRC Non Capital Costs are likely to satisfy the requirements of section 8.37.

(c) **Satisfaction of section 8.36**

When AGN submits revisions to the Access Arrangement under section 2.28 of the Code, it will seek to recover the FRC Non Capital Costs that are incurred in the delivery of Reference Services. It will not seek to recover non capital costs that are not incurred in the delivery of Reference Services.

On that basis, AGN submits that the FRC Non Capital Costs will fall within the definition provided by section 8.36. In addition, FRC Non Capital Costs are clearly not of a "capital nature" and can only be characterised as being "operating, maintenance and other costs". Further, for the reasons set out above in relation to the purpose for incurring the FRC Capital Costs, the FRC Non Capital Costs will be incurred in the delivery of a Reference Service or Reference Services.

5. FURTHER CONSULTATION

To assist the Regulator in his assessment of the requests set out in this submission, AGN intends to consult and liaise with the Regulator in a transparent and cooperative manner. This includes providing further information and documentation that the Regulator may require for the purpose of considering the FRC Project and FRC Costs.

AGN would be pleased to meet with the Regulator to discuss any matters or issues raised by this submission or any submission made by an interested party in the course of public consultation.

ANNEXURE

Sections 8.16 and 8.17 of the Code

Section 8.16 of the Code provides that:

"(a) Subject to sections 8.16(b) and sections 8.20 to 8.22, the Capital Base may be increased under section 8.15 by the amount of the actual New Facilities Investment in the immediately preceding Access Arrangement Period provided that:

(i) that amount does 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 providing 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.

(b) If pursuant to section 8.20 the Relevant Regulator agrees to Reference Tariffs being determined on the basis of forecast New Facilities Investment, the Capital Base may be increased by the amount of the New Facilities Investment forecast to occur within the new Access Arrangement Period determined in accordance with sections 8.20 and 8.21 and subject to adjustment in accordance with section 8.22."

Section 8.17 provides that, for the purposes of administering section 8.16(a), the Regulator 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."