OFFICE OF GAS ACCESS REGULATION

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# Information Paper

## Proposal for Recovery of Full Retail Contestability Costs for the Mid-West and South-West Gas Distribution Networks

16 July 2002

# 1. INTRODUCTION

The purpose of this information paper is to assist those seeking to make a submission on the proposal by AlintaGas Networks P/L (**AGN**) on the recovery of the costs associated with the introduction of "full retail contestability" (**FRC**) to the Mid-West and South-West Gas Distribution Networks.

On 24 June 2002, AGN submitted a proposal that seeks a binding approval, under section 8.21 of the *National Third Party Access Code for Natural Gas Pipeline Systems* (**Code**), to the costs of developing systems associated with the introduction of FRC in Western Australia.

A copy of the proposal from AGN is available at no cost from the Office of Gas Access Regulation (**O*ff*GAR**) web site (www.offgar.wa.gov.au). Printed copies of the documentation are available directly from O*ff*GAR for $10.00 per copy. Requests for the document can be made to:

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As required under the legislation, a notice was issued to interested parties and advertisements were published in *The West Australian* and *The Australian* on Thursday 4 July 2002, advising that the proposal had been lodged by AGN.

The notice and advertisements invited public submissions to be lodged with O*ff*GAR by 4pm Friday 2 August 2002 Western Standard Time.

After considering all public submissions, the Western Australian Independent Gas Pipelines Access Regulator (**Regulator**) is required to issue a Draft Decision. The Code requires that if the Regulator proposes to not approve the application for FRC costs, the Draft Decision must state the amendments (or nature of the amendments) that need to be made for it to be approved.

After publication of the Draft Decision, interested parties will be given a further opportunity to make submissions. The closing date for submissions on the Draft Decision will be specified at the time the Draft Decision is released. The Regulator is then required to issue a Final Decision on the application for approval of FRC costs after considering these submissions.

The purpose of this information paper is to:

- provide further information on the processes involved in a section 8.21 approval of new facilities investment under the Code as part of the public consultation process; and

- raise any issues that may assist those seeking to make a submission on the AGN application.

## 2. BACKGROUND AND CODE REQUIREMENTS

The AlintaGas network consists of those pipelines owned and operated by AlintaGas comprising the high pressure system and the medium pressure/low pressure system.[1] The networks covered by the Access Arrangement include the following natural gas reticulation areas:

- Perth Region, North Sheet
- Perth Region, South Sheet
- Country Region, Bunbury
- Country Region, Busselton
- Country Region, Eneabba
- Country Region, Geraldton
- Country Region, Harvey

The Access Arrangement for the Mid-West and South-West Gas Distribution Systems was approved on 18 July 2000.

The following is an extract of clause 37 of AGN's Access Arrangement for the Mid-West and South-West Gas Distribution Networks, which outlines the protocol for dealing with any new facilities investment that AGN proposes during the Access Arrangement period.

*37. (1) Before AlintaGas incurs new facilities investment, it may apply in writing to the Regulator requesting the Regulator to agree that the proposed investment meets the requirements of section 8.16 of the Code.*

*(2) For the purposes of public consultation, the Regulator may treat an application under subclause 37(1) as if it were a proposed revision to the Access Arrangement submitted under section 2.28 of the Code.*

*(3) If the Regulator agrees under subclause 37(1), that agreement binds the Regulator when he or she considers revisions to this Access Arrangement submitted by AlintaGas.*

*(4) Subject to the Code, AlintaGas may in its discretion (on any terms and conditions it thinks fit) fund a new facility whether or not the Regulator agrees under subclause 37(1) and whether or not AlintaGas is otherwise satisfied that the necessary new facilities investment meets the requirements of section 8.16 of the Code.*

[1] High pressure system and medium pressure/low pressure system are defined on pages 1 and 2 of the Access Arrangement document.

(5) *If AlintaGas undertakes new facilities investment, it may in its discretion deal with that investment in any way permitted by the Code, including by one or more, or a combination, of the following:*

(a) *in accordance with sections 8.18 and 8.19 of the Code by adding some or all of that investment to the capital base at the start of the next Access Arrangement period and the balance (if any) to the speculative investment fund;*

(b) *in accordance with sections 8.23 and 8.24 of the Code by seeking a capital contribution from one or more users; and*

(c) *in accordance with sections 8.25 and 8.26 of the Code by imposing a surcharge on users of incremental capacity.*

In its application, AGN submits that clause 37 of the Access Arrangement is expressed in similar terms to section 8.21 of the Code, which states that:

*8.21 If the Relevant Regulator agrees to Reference Tariffs being determined on the basis of forecast New Facilities Investment, this need not (at the discretion of the Relevant Regulator) imply that such New Facilities Investment will meet the requirements of Section 8.16 when the Relevant Regulator considers revisions to an Access Arrangement submitted by a Service Provider. However, the Relevant Regulator may, at its discretion, agree (on written application by the Service Provider) at the time at which the New Facilities Investment takes place that it meets the requirements of section 8.16, 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. For the purposes of public consultation, any such application must be treated as if it were a proposed revision to the Access Arrangement submitted under section 2.28.*

As the major provider of gas distribution access services in Western Australia, AGN expects to incur new facilities investment mainly in relation to information systems and additional operating costs necessary for the introduction of FRC.

The application by AGN has been made in accordance with clause 37(1) of its Access Arrangement for the Mid-West and South-West Gas Distribution Networks (refer above). This clause makes provision for AGN to seek approval that the new facilities investment meets the requirements of section 8.16 of the Code:

*8.16 The amount by which the Capital Base may be increased is the amount of the actual capital cost incurred (New Facilities Investment) provided that:*

(a) *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 delivering Services; and*

(b) *one of the following conditions is satisfied:*

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

(ii) *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*

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

As indicated above, section 8.21 of the Code allows the Regulator to agree at the time new facilities investment takes place that it meets the requirements of section 8.16 of the Code. For the purpose of administering section 8.16(a), section 8.17 provides that 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.*

The effect of any approval by the Regulator will be to bind the Regulator to allow the costs of this investment by AGN to be added to its capital base when its Access Arrangement is reviewed in March 2004. This in turn will have the result that reference tariffs for use of AGN's Mid-West and South-West Gas Distribution Networks would be adjusted accordingly.

In relation to public consultation, the Code requires that any application under section 8.21 of the Code must be treated as if it were a proposed revision to the Access Arrangement submitted under section 2.28 of the Code. This means the Regulator must comply with the following provisions:

2.31 *After receiving a proposed revision to an Access Arrangement the Relevant Regulator must:*

(a) *inform each person known to the Relevant Regulator who the Relevant Regulator believes has a sufficient interest in the matter that it has received the proposed revision to the Access Arrangement and the Access Arrangement Information;*

(b) *publish a notice in a national daily newspaper which at least:*

(i) *describes the Covered Pipeline to which the proposed revisions to the Access Arrangement relates;*

(ii) *states how copies of the revisions to the Access Arrangement and the Access Arrangement Information may be obtained; and*

(iii) *requests submissions by a date specified in the notice.*

2.32 *The Relevant Regulator must provide a copy of the proposed revisions to the Access Arrangement and the Access Arrangement Information to any person within 7 days after the person requests a copy and pays any reasonable fee required by the Relevant Regulator.*

2.34 *The Relevant Regulator must consider any submissions received by the date specified in the notice published under section 2.31(b) and it may (but is not obliged) to consider any submissions received after that date.*

2.43 *…The Relevant Regulator must also ensure that:*

> *(a)* *there is a period of at least 28 days between the publication of a notice under section 2.31(b) and the last day for submissions specified in that notice;*
>
> *(b)* *there is a period of at least 14 days between the publication of a draft decision under section 2.36(b) and the last day for submissions on the draft decision specified by the Relevant Regulator.*

Accordingly, in treating the AGN application as if it were a proposed revision to the Access Arrangement, the Regulator is required to call public submissions for a period of at least 28 days following the release of any notice. The Regulator is then required to issue a Draft Decision and call a further period of public consultation to receive public submissions for at least 14 days following the release of the Draft Decision.

AGN has also requested that the Regulator provide a non-binding acknowledgement that FRC related non-capital costs are likely to satisfy the requirements of section 8.37 of the Code which states that:

> *8.37* *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.*

# 3. ALINTAGAS NETWORK'S APPLICATION

AGN's estimates of FRC Capital Costs and FRC Non Capital Costs are set out below. In providing these estimates, AGN has stressed that the FRC Capital Costs are those costs that it is in the course of incurring, or will incur, in providing gas distribution systems services. AGN advises that these costs do not include those associated with:

- developing market rules and associated arrangements;
- establishment of the Market Operator and its associated systems; or
- Retailers' costs in establishing and operating an interface with the Market Operator's systems; and
- amending internal processes and systems to allow for FRC.

**FRC Capital Costs**

FRC Capital Costs are estimated by AGN at $10M. AGN advises that it is currently undertaking a detailed requirements study to further confirm this estimate.

AGN has also advised that the FRC Capital Costs are attributable to the investment that is currently in the process of being undertaken in relation to a "Network Management

Information System" (**NMIS**).[2] AGN expects to implement the NMIS to cover all deregulation systems requirements, including:

- handling Customer Transfer Transactions (**CATS**) including:
  - responding to market transactions; and
  - 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.

AGN advises that it expects to enter into a capped price contract (or contracts) with a system vendor (or vendors) in August 2002. AGN has stated that it is currently undertaking 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.

AGN submits that the estimate of FRC Capital Costs reflects the additional capital costs that are attributable to the development, acquisition and implementation of 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. In calculating the return on this investment, it has stated that the overall return will be such that the Net Present Value of the investment would be zero when discounting the investment at the relevant weighted average cost of capital.

**FRC Non Capital Costs**

AGN has estimated that FRC Non Capital Costs will be in the order of $1.1M per annum. Unlike 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.

AGN has estimated total FRC Non Capital Costs as shown in the following table.

| Cost Item | Estimated cost |
|---|---|
| Operations & Maintenance Costs - Systems and Processes | $ 1.000M per annum |
| Retail Market Administrator & Gas Industry Ombudsman. | $ 0.100M per annum |

[2] To avoid doubt, AGN points out that the NMIS is different to the system that the Market Operator will develop to administer and manage the rules in the retail gas market.

Other Non Capital Cost related issues raised in the AGN application include:

(i) Operations and maintenance costs - systems and processes

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

(ii) Retail Market Administrator and Gas Industry Ombudsman Scheme

Work undertaken by the Gas Retail Deregulation Project Steering Group has identified other arrangements and entities required to support FRC. These are likely to include:

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

It is expected that AGN will be a member of, and contribute to the operation of, those entities and schemes. AGN expects the associated costs will be incurred by it in the delivery of gas distribution systems services, including the Reference Services.

AGN submits that it is not seeking the Regulator's agreement that FRC Non Capital Costs are likely to satisfy the requirements of section 8.37 but merely requests that the Regulator provide a non-binding acknowledgement that FRC Non Capital Costs are likely to satisfy section 8.37.

## 4. REGULATOR'S APPROACH TO THE ASSESSMENT

In assessing AGN's application, the Regulator will have regard to whether the costs to be incurred by AGN for the introduction of FRC would 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.

In undertaking this assessment, it is possible to distinguish three interrelated components of the Regulator's assessment of whether this expenditure is likely to meet the requirements of the Code. These are:

- whether the functions to be performed by the FRC-related expenditure meet the requirements of the Code;
- whether the amount of expenditure forecast to provide these functions meets the requirements of the Code; and
- as AGN has proposed recovering the cost of financing expenditure during the current regulatory period in future tariffs (that is, reference tariffs prevailing after the next price review), whether the expenditure proposed represents expenditure that would not have been undertaken in the absence of the introduction of FRC. In

other words, whether the expenditure proposed represents incremental expenditure.

Given the requirements of section 8.16(b)(ii), there is a need to establish that any costs have system-wide benefits that justify the approval of a higher reference tariff in the future for all users. To this end, the Regulator will have regard to the views arising from the work of the Gas Retail Deregulation Project and other information submitted as part of the public consultation process. The Regulator will also seek to establish whether the proposed NMIS is relevant to the facilitation of FRC.

With respect to the amount of expenditure that is forecast to provide these functions, the Code requires the Regulator to assess whether the proposed costs are efficiently incurred. While there is a degree of uncertainty at this stage about the expenditure that AGN will ultimately be required to commit, the Regulator will, amongst other considerations, have regard to the process that is used to source the capital items required for the introduction of FRC in Western Australia.

Lastly, in deciding whether it is appropriate for the cost of financing the expenditure during the current period to be reflected in future reference tariffs, the Regulator will have to consider whether all of the functions to be performed by the new expenditure are additional to the functions it otherwise would have delivered. In forming an opinion on this matter, the Regulator will need to understand how the new functions relate to functions that already are being delivered, taking account of the views of AGN and comments from any interested party.

Comments from interested parties are invited on any relevant matter. To avoid any doubt, the scope of the Regulator's assessment in this instance is specifically focused on AGN's application under 8.21 of the Code and will not affect reference tariff during the current Access Arrangement period.

Interested parties are also encouraged to provide comment on AGN's request that the Regulator provide a non-binding acknowledgement that FRC Non Capital costs are likely to satisfy section 8.37.