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# INFORMATION PAPER

## RECOVERY OF COSTS

## INTRODUCTION OF FULL RETAIL CONTESTABILITY

## MID-WEST AND SOUTH-WEST GAS DISTRIBUTION NETWORKS OF WESTERN AUSTRALIA

**Acting Independent Gas Pipelines Access Regulator**

**Western Australia**

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## RECOVERY OF COSTS FOR THE INTRODUCTION OF FULL RETAIL CONTESTABILITY IN THE MID-WEST AND SOUTH-WEST GAS DISTRIBUTION NETWORKS OF WESTERN AUSTRALIA

### Purpose

The purpose of this information paper is to outline the approach I propose to take regarding the submission by AlintaGas Networks Pty Ltd (“AGN”) for the recovery of certain costs it would incur in relation to the introduction of “Full Retail Contestability” (“FRC”) to the Mid-West and South-West Gas Distribution Networks.

### Background

On 24 June 2002, AGN submitted a proposal seeking approval under section 8.21 of the *National Third Party Access Code for Natural Gas Pipeline Systems* (“Code”) for recovery of the costs of developing systems associated with the introduction of FRC in Western Australia. As required under the Code, a notice was issued and advertisements were published on 4 July 2002 advising that the proposal had been lodged by AGN. Public submissions were called for by 4:00 PM on Friday 2 August 2002 and an information paper was published on 16 July 2002 to assist interested parties with submissions on the assessment of the AGN application for the approval of FRC capital costs under section 8.21 of the Code.

Submissions were received from:

- AGL Energy Sales and Marketing Pty Ltd;
- CMS Energy Gas Transmission Australia;
- Minister for Energy; and
- AlintaGas Networks Pty Ltd.

Copies of these submissions are available on the OffGAR website ([www.offgar.wa.gov.au](http://www.offgar.wa.gov.au)).

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

In its application, AGN also requested that I 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 allows for the recovery of prudent non-capital costs by a service provider acting efficiently in accordance with accepted good industry practice.

### Conclusion

After considering the submissions received, AGN’s proposal, the terms of sections 8.16, 8.17 and 8.21 of the Code and legal advice on the construction of these provisions, I have concluded that costs of the type proposed to be recovered by AGN do not fall within the terms of section 8.21 and, accordingly, I am unable to agree that the proposed New Facilities Investment will meet the requirements of Section 8.16 as requested. There is no other specific power under the Code enabling me to give any binding approval such as that provided for under section 8.21. This is discussed in further detail below.

This interpretation of section 8.21 has been referred to the National Gas Pipelines Advisory Committee (“NGPAC”) for consideration and NGPAC may recommend to the Ministers

responsible for the Gas Pipelines Access Law in each jurisdiction that the Code be amended to provide for the recovery of costs such as AGN's capital costs relating to its implementation of the Network Management Information System ("NMIS").

### **AGN's Network Management Information System**

The costs, principally the subject of AGN's proposal (being primarily FRC-related capital costs), are estimated by AGN to be approximately \$10 million. These are attributable to the investment that is proposed to be undertaken in relation to implementing a NMIS. The NMIS would cover all FRC deregulation 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.

In its application, AGN advised that it expected to enter into a capped price contract (or contracts) with a system vendor in August 2002. It is understood that to date this has been awaiting my decision in respect of its application under section 8.21 of the Code. 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 would commence once the capped price contract was entered into.

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.

AGN has noted 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. 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. The FRC non-capital costs are estimated by AGN to be in the order of \$1.1 million per annum.

### **Code provisions**

Section 8.21 of the Code provides for the early approval of certain cost recovery in a binding way, stating 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.

In turn, section 8.16 states:

- 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.

For the purposes 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.

### **Interpretation of section 8.21**

The power expressed in section 8.21 is a power that relates to "New Facilities". Consistent with the definition of "Covered Pipeline" contained in section 10.8 of the Code, a New Facility is defined in terms of "an extension to, or expansion of the Capacity of, the Covered Pipeline". The term "Capacity" means "the measure of the potential of a Covered Pipeline as currently configured to deliver a particular Service between a Receipt Point and a Delivery Point at a point in time". The term "Service" is defined to mean "a service provided by means of a Covered Pipeline" and includes, among other things, services ancillary to the provision of haulage services and the right to interconnect with the Covered Pipeline.

The difficulty that arises from these particular definitions is that the NMIS will not provide a service ancillary to haulage services or interconnection services as referred to in the definition of "Service". Importantly, the definition requires a Service to be provided "by means of" the Covered Pipeline. The NMIS is not provided by means of the Covered Pipeline itself, but rather is related to haulage services. Although the NMIS-related costs are those that a prudent Service Provider would incur in order to be able to provide the haulage services delivered by the Gas Distribution Systems, it is not a cost in respect of equipment "directly attached" to the physical pipes for transporting natural gas, as defined for the term "Pipeline" in Schedule 1 of the *Gas Pipelines Access (WA) Act 1998*. To put it another way, with or without the NMIS the haulage services that a customer can acquire from AGN by means of the Gas Distribution Systems remain the same.

Accordingly, I have reached the conclusion that AGN's costs relating to implementation of its NMIS cannot be pre-approved under section 8.21 and thereby included in the Capital Base, due to the terms in which section 8.21 is drafted.

### **Assessment of proposal**

To assist me in assessing AGN's proposal, I appointed Evans and Peck as technical consultants to carry out a technical assessment of the specifications, functionality and costs of the proposed system. The Evans and Peck report is published on the *OffGAR* website ([www.offgar.wa.gov.au](http://www.offgar.wa.gov.au)). In short:

- Evans and Peck's review of the NMIS architecture and functionality suggests that implementation of the NMIS will provide facilities needed to maintain the integrity of the Gas Distribution Systems when multiple gas users and retailers use it and the NMIS is required for the successful implementation of FRC;
- Evans and Peck conclude 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 associated 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;
- Evans and Peck report that 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
- Evans and Peck report that the estimated capital costs for implementation of the NMIS are, in its view, prudent and likely to satisfy the relevant sections of the Code.

I have reviewed AGN's proposal for the purposes of paragraph 8.16(a) and section 8.17 of the Code, taking into account the Evans and Peck's report and the submissions received as noted above. In my view, but for my conclusion expressed above regarding 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.

### **Application of section 8.37**

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.

For the reasons set out above, I consider the non-capital costs relating to AGN’s proposal appear to meet the requirements of section 8.37 at this time, based on their current nature and indications of their derivation. However, I am unable to provide any approval of those costs at this time, as section 8.37 is not drafted to provide pre-approval. Further, they are only forecasts at this stage and not actually 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 Gas Distribution Systems. 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.

### **Amendment of the Code**

The interpretation of section 8.21 of the Code as discussed above has recently been notified to NGPAC.

Given that there are indications in the Code that it intended for costs such as FRC-related costs to be recovered through Reference Tariffs, NGPAC may recommend to the Ministers responsible for the Gas Pipelines Access Law in each jurisdiction that the Code be amended to provide for the recovery of costs such as AGN’s capital costs relating to its implementation of the NMIS.

This intention is demonstrated in the descriptions of the IRR and NPV methodologies in section 8.4 of the Code. Both state that the relevant forecast is to be for “all costs to be incurred in providing such Services (including capital costs) during the Access Arrangement Period”.

Should the Code be amended, I am prepared, to the extent I am able to do so under the amended Code, to revisit this approval process at that time.

It should be noted that any such review would be carried out in accordance with the Code as amended and may not necessarily result in any approval.

**Further Information**

For further information relating to this information paper or the matters discussed please contact:

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