



# **Public Forum**

## **Mid-West and South-West Gas Distribution System**

### **Draft Decision**

**Dr Ken Michael  
Independent Gas Pipelines Access Regulator**





# AGENDA

- ◆ **Draft Decision Overview** - Ken Michael
- ◆ **Draft Decision Key Issues** - Ray Challen & Robert Pullella
- ◆ **Morning Tea**
- ◆ **Presentation by AlintaGas**
- ◆ **Open Forum**





# **OVERVIEW**

## **Mid-West and South-West Gas Distribution Systems**

### **Draft Decision**

**Dr Ken Michael**

**Independent Gas Pipelines Access Regulator**





# The Forum

- Purpose of Forum is to:
  - receive comments on Draft Decision
  - provide sound basis for Final Decision
  - aids transparency





# Regulator's Role & Objectives

- Ensure Access Arrangements conform with Code
- Promote a competitive environment
- Encourage greater economic activity
- Achieve value for users and consumers
- Provide reasonable rate of return to owners





# The Draft Decision

- The AA needs to be amended before it is approved
- Amendments relate to both Tariff and Non-Tariff Issues





# Key Amendment

- Apply a minimum retail margin across services
- AlintaGas to propose a margin
- Retail margin to allow retail competition
- Retail margin to be reviewed by end of AA period





# Initial Capital Base

- Draft Decision is for a ICB of \$510.4 million as at 31 December 1999  
*AlintaGas proposed an ICB of \$539.4 million as at 31 December 1999*
- Representing a reduction of 5.4%







# Rate of Return

- Return on Equity of 13.2% (nominal post-tax).
- WACC of 7.9% (real pre-tax).





# Distribution Tariffs

- Draft Decision results in overall reduction of 5%





# Summary

Draft Decision promotes competition, encourages investment and provides value to the users and consumers, while maintaining a reasonable rate of return to AlintaGas.





End





# **Reference Services and Reference Tariffs**

**Mid-West and South-West  
Gas Distribution Systems  
Draft Decision**

**Dr Ray Challen  
Environmental Resources Management Australia**





## Reference Services

AlintaGas proposed four reference services covering a range of User requirements from delivery to very large commercial end users of gas to delivery to domestic households:

- ◆ Reference Service A
- ◆ Reference Service B1
- ◆ Reference Service B2
- ◆ Reference Service B3





## Reference Tariffs

Provide the Service Provider with the opportunity to earn a stream of revenue that recovers the efficient costs of delivering the corresponding Reference Services:

- ◆ operating costs;
- ◆ capital costs;
- ◆ depreciation costs; and
- ◆ a return on capital.





# Procedure for Tariff Determination

- ◆ Initial capital base
- ◆ Capital expenditure
- ◆ Non-capital costs
- ◆ Rate of return on capital
- ◆ Depreciation schedule
- ◆ Total revenue
- ◆ Revenue allocation across services
- ◆ Reference tariff structure
- ◆ Incentive mechanisms







## Initial Capital Base

- ◆ Code provides for the value ascribed to the initial capital base to normally be in the range of the depreciated actual cost (DAC) of assets and the depreciated optimised replacement cost (DORC) of assets.
- ◆ General approach of regulators in Australia has been to consider a balance of interests between the service provider and users in selecting a value of the initial capital base within this range.
- ◆ AlintaGas' "deprival value" of the initial capital base is consistent with this general approach.





## Initial Capital Base (cont.)

- ◆ AlintaGas methodology: determination of an initial capital base that is consistent with achieving an a priori forecast of retail and distribution revenues.
- ◆ Regulator accepted the general methodology used by AlintaGas but questioned several assumptions made in determining the target distribution revenue.
- ◆ Changes to the assumed retail margin in deriving a forecast distribution revenue from forecast retail revenue.





## Initial Capital Base (cont.)

- ◆ AlintaGas assumed declining retail margins over the Access Arrangement Period.
- ◆ Acceptance of these assumptions would be contrary to the obligations of the Regulator under s38 of the *Gas Pipelines Access (WA) Act* to consider effective competition in gas markets.
- ◆ Regulator revised assumptions to provide for a minimum 2 percent retail margin for all services over the Access Arrangement Period.





## Initial Capital Base (cont.)

AlintaGas Proposal		Regulator's Proposed Value
(31 December 1998)	(31 December 1999)	(31 December 1999)
\$530.3 million	\$539.4 million	\$510.4 million





# Total Revenue

## Revised Total Revenue (nominal \$million)

	2000	2001	2002	2003	2004
AlintaGas' proposed revenue	101.1	103.4	106.4	109.4	112.2
Regulator's proposed revenue	95.2	96.9	99.3	102.3	105.1





## Reference Tariffs

Tariff structure should be generally at the commercial discretion of the service provider subject to:

- ◆ consistency with broad criteria of efficiency and equity; and
- ◆ consistency with the extension of effective competition in supply of natural gas to residential and/or small-business end users of gas.

Three matters of concern to the Regulator.





## Reference Tariffs (cont.)

1. Differences in prospective gas distribution costs under Reference Service A and the gas distribution costs under the *Gas Distribution Regulations 1996*.

- ◆ Average gas distribution costs under the two tariffs structures may differ significantly.
- ◆ Large changes in average costs of gas distribution in the transition between tariff structures are inconsistent with equity considerations for Users.
- ◆ Amendment required to provide for a reasonable transition between the two tariffs.





## Reference Tariffs (cont.)

2. Differences in prospective gas distribution costs under Reference Services A and B1 at levels of gas use close to the “cross-over” between the two services.

- ◆ Substantial differences in average charges between the services at levels of gas use close to 35 TJ/year.
- ◆ Incentives for inefficient gas use.
- ◆ Amendment required to provide for a reasonable seamless transition in distribution charges between the two services.







## Reference Tariffs (cont.)

3. Inconsistency of distribution charges for Reference Service B3 with effective competition in the supply of gas to residential and small-business end users of gas.

- ◆ Negative retail margins for some gas quantity blocks would provide a disincentive to provide services to some end users
- ◆ Tariff structure for Reference Service B3 should be altered to provide for reasonable retail margins for all gas quantity blocks.





## Tariff Variation and Incentive Mechanism

- ◆ Proposed “revenue yield” form of price control.
- ◆ Escalation of tariffs subject to a CPI-X constraint on average revenue per unit of gas distributed.
- ◆ Re-balancing of tariffs (change in cost allocation across services) subject to CPI-Y constraint on changes to any particular tariff component.





## **Tariff Variation and Incentive Mechanism (cont.)**

Revenue yield form of Price control disallowed due to:

- ◆ incentives for inefficient pricing;
- ◆ potential for strategic pricing of services to discourage competition; and
- ◆ potentially high administrative and regulatory expense.

Amendment required to provide for a price cap form of price control on individual tariffs.





End





# **RATE OF RETURN**

## **Mid-West and South-West Gas Distribution Systems Draft Decision**

**Robert Pullella  
Office of Gas Access Regulation**





# Code Requirement

- Return which is commensurate with prevailing conditions in the market for funds and the risk involved in delivering the Reference Service
- Rate of Return should motivate investment in the pipeline assets





# Rate of Return

- AlintaGas proposed a real pre-tax WACC of 8 percent
- The Rate of Return determined by the Regulator is
  - 13.2 % (Nominal Post-tax) Return on Equity.
  - 7.9 % (Real Pre-tax) WACC
- How was this determined?





# Fundamental Parameters

- The Fundamental input parameters are:

<b>Parameters</b>	<b>AlintaGas</b>	<b>Regulator</b>
Nominal risk free rate (%)	5.65	6.85
Real risk free rate (%)	3.07	3.65
Inflation forecast (%)	2.5	3.09
Market risk premium (%)	6.5	6.0
Asset beta	0.51	0.55
Equity beta	0.85	1.05
Cost of debt margin over the nominal risk free rate (%)	1.53	1.3







# Other Parameters

Parameters	AlintaGas	Regulator
Gearing (Debt Ratio) (%)	55	60
Corporate Tax Rate (%)	36	36
Dividend Imputation Factor (gamma) (%)	30	50





# Converting Post-Tax to Pre-Tax WACC

- Market Practice and Reverse transformations
- Market Practice transformation 8.0 percent.
- Reverse transformation 6.3 percent.
- Real Pre-tax WACC of 7.9 percent determined on the basis of financial advice.

