OFFICE OF ENERGY – WESTERN AUSTRALIA

SUBMISSION ON THE ALINTAGAS ACCESS ARRANGEMENT:

MID AND SOUTH WEST DISTRIBUTION NETWORK

The Office of Energy (OOE) submits the following comments in respect of the proposed Access Arrangement for the AlintaGas Mid West and South West distribution network. The key arguments and assumptions of the access information are summarised below with comments made by the OOE presented in bold and italicised text.

It is noted that the purpose of the Access Arrangement Information is to permit interested parties to understand the derivation of the "elements" in the proposed Access Arrangement and to form an opinion as to the compliance of the Access Arrangement with provisions of the Code. In this regard, any person may request the Regulator to consider whether the Access Arrangement Information is sufficient in relation to any particular matter. It is from this perspective that the following comments are made.

Background

The services provided by means of the AlintaGas Network are:

- Reference Service A;
- Reference Service B1;
- Reference Service B2;
- Reference Service B3;
- an Interconnection Service; and
- listed ancillary services.

1. Provision of Services

In addition to the other services, AlintaGas offers an Interconnection Service, which provides a right to interconnect with the AlintaGas distribution network. The terms and conditions and prices upon which an Interconnection Service will be made available are to be negotiated by AlintaGas and the person to whom that service is provided. In addition every receipt point at which a designated supplier will deliver gas into a sub-network for transportation to a delivery point must be the subject of an Interconnection Contract.

> ***AlintaGas states that each of the services it offers in its Access Arrangement including the Interconnection Service is likely to be sought by a significant part of the market. The OOE agrees that with the opening of the retail market to become fully competitive during the operation of this Access Arrangement it is***

likely that the number of parties seeking to enter Interconnection Contracts with AlintaGas will increase. Therefore, the OOE considers that the Regulator should approve a set of standard terms and conditions, and prices of the Interconnection Service. Terms, conditions and prices, which are considered unreasonable for that service would have the potential to hinder access to the AlintaGas distribution system.

There are four listed ancillary services, which AlintaGas will offer to users of Reference Service B2 or Reference Service B3 at a set tariff. Each of the services is likely to be sought by a significant part of the market, which uses Reference Service B2 and Reference Service B3.

The OOE considers that given that these services would be utilised by a significant part of the market, the prevailing standard terms and conditions for those listed ancillary services mentioned in section 16 (2) should be approved by the Regulator.

Subclauses 19(1) and 19(2) of the Access Arrangement list pre-conditions to the provision of services. The "AlintaGas Applications Procedure", available from AlintaGas as part of the Information Package described in section 5.1 of the Code, may waive, add to or vary one or more of the pre-conditions to the provision of services listed in subclause 19(1) or 19(2) of the Access Arrangement. In addition, AlintaGas may in its discretion as a reasonable person waive one or more of those pre-conditions.

It is noted that under section 5.2 of the Code, the Regulator may require AlintaGas to amend or include additional information in the Information Package if the Regulator considers the amendment or additional information will assist Prospective Users to decide whether or not to seek Services or to determine how to go about seeking Services from AlintaGas. It is also noted that under section 5.3. of the Code, AlintaGas must provide a copy of the Information Package to any bona fide Prospective User within 14 days after the Prospective User requests a copy.

Section 7(5) of Schedule 7 to the Access Arrangement provides that AlintaGas will use reasonable endeavours to ensure that a revised Access Arrangement contains a service (with an associated tariff) which is materially the same as the contracted Reference Service. However, AlintaGas reserves its right to create new Reference Services or to develop new reference tariff policies and structures.

It is understood that any new reference service created by AlintaGas or any new reference tariff policy and structure developed by AlintaGas will be subject to the approval of the Regulator.

2. Reference Tariff Structures

The cost incurred by AlintaGas in providing a user with Reference Service A is determined by the location of the delivery point, the use the user makes of the capacity of the AlintaGas Network, and the volume of gas delivered to the user at the delivery point. Reference Tariff A recovers costs of use through a standing charge, a demand charge, a usage charge, and a charge for user specific facilities. The demand and usage charge have a distance based declining block structure.

> ***In respect of the demand and usage charge for Reference Service A being structured into blocks determined by distance, an argument is being made that cost differs as a result of the distance. It is argued that users requiring Reference Service A for delivery of gas to delivery points located at distances greater than about 10 km from the nearest transmission pipeline are usually supplying at delivery points in urban fringe and rural areas, where the costs of pipe laying are lower than in more densely populated urban areas. The Regulator would need to seek information verifying this argument and especially the reasonableness of the 10 km distance.***
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> ***There also may be a need for the Regulator to verify the composition and cost structure for those within the 10 km distance to ensure that they are not subsidising the extension of the system.***
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> ***Again in respect of Reference Service A, the Regulator would need to be satisfied that the use of the distance from the nearest transmission pipeline is reasonable from the perspective that it effectively embeds a prudent discount which is shared by all other users.***
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> ***The Regulator should also consider whether the threshold for Reference Service A of 35TJ per year (delivery) and 10 GJ/hour (peak rate) is appropriate with reference to the benefits and costs of this threshold. Reference Service B1, Reference Service B2, and Reference Service B3 will be charged an average cost reflective price (referred to as a postage stamp pricing system) whereas Reference Service A will have distance related cost reflective pricing. In determining the appropriate threshold the Regulator should consider such matters as the administration cost savings of uniform pricing and the economic efficiency gains of distance related charging.***
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> ***In relation to Reference Tariff A the Regulator should also consider whether:***
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> - ***the parameter values in the demand charge and the usage charge block structures reflect the cost of providing capacity and delivering gas over a range of distribution distances; and***
> - ***the ratio of costs allocated to the standing, demand and usage charges reflects the cost of providing infrastructure and distributing gas for a range of capacities, volumes and distribution distances.***
>
> ***Particular consideration should be given to the effect of these matters on the economic efficiency of State's gas distribution system.***

3. Variation of Reference Tariffs

In each year of the Access Arrangement after the first, AlintaGas may, subject to the Regulator being advised of the proposed changes, vary its reference tariffs, provided the variation is such that forecast average revenue for the year (the review year) does not exceed the maximum allowed average revenue for that year.

> ***The Regulator would be advised to consider whether it is appropriate for AlintaGas to have the ability to vary its reference tariffs, subject to the Regulator being advised of the proposed changes. The OOE has concerns that only "advising" the Regulator would mean that there is no independent audit of the annual tariff review. At the least, the Regulator should be provided with detailed accounting information in advance of the review, and if the Regulator disagrees with the calculation of the tariffs then a proper review under the Code should be triggered.***

4. Cost Allocation

The forecast total cost of providing the Reference Services has been allocated to three cost baskets, and costs in the three cost baskets have then been allocated to three cost pools. The costs collected in the cost pools are allocated to Reference Service A, and to Reference Services B1, B2 and B3 (Figure 2.1 in the Access Arrangement Information).

The allocation of cost pools to Reference Services is the basis for the allocation of costs to users via the reference tariffs (Figure 2.2 in the Access Arrangement Information).

> ***The Regulator will need to verify the determination of the allocation percentages based on the principles adopted for the cost allocation methodology.***
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> ***An unverified estimate in relation to Allocator 3 (contribution to system peak flow), for example, has indicated that the allocation of HP System costs to Reference Service A may be based on an excessively high average load factor assumed for the usage of the HP System by Reference Service A users. The estimate was based on information provided in Table 6.2 (System average and maximum quantities 1998) and Table 6.4 (Forecast volumes by service). The Regulator would be able to verify this on the basis of an accurate average load factor of the Reference Service A customers. That information would be readily available, given that AlintaGas requires that metering installed by Reference Service A users is capable of measuring, storing and transmitting peak flow.***

5. Extensions and Expansions Policy and New Facilities Investment

Section 3.6.1 describes the nature of and justification for planned capital investment. The planned new facilities investment includes investment in expansion of capacity to accommodate growth in volumes of gas delivered to users during the access period. The forecast capital expenditure on new facilities is accounted for in determining reference tariffs. Tables 3.9 and 3.10 outline the capital expenditure for mains extensions and meters and service pipes to meet new demand.

> ***AlintaGas' forecast capital expenditure on new facilities contains considerable capital expenditures for mains extensions, meters and service pipes to meet new demand. Mains extensions expenditure over the period of the access arrangement ranges from $4.0M to $4.7M of which an estimated $2.2M to $2.7M (Table 3.9) is for low pressure extensions. This would need to be confirmed by the Regulator. It would appear, however, that part of the forecast capital expenditure for medium pressure mains (approximately $2M in each year; Table 3.9) is also scheduled for extensions. At the same time very little or no expenditure would appear to be forecast for high pressure mains extensions.***
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> ***It is understood that it is AlintaGas' current practice to construct new parts of the "low" pressure system with components designed to operate at medium pressure. Given that on average AlintaGas makes 16,000 new connections, most of which supply Reference Service B3 customers, it is possible that a substantial proportion of the capital expenditure is forecast for mains extensions to those customers.***
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> ***The tables also show considerable new capital expenditure for meters and service pipes including $8.2M in the year 2000. Meter and service pipes costs for Reference Service A1 and B1 are recovered from the users through user specific charges. In this respect if the $8.2M includes any expenditure for Reference Service A1 and B1, it would be inappropriate for that new investment to be allocated across all tariff groups.***
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> ***It may be prudent for the Regulator to request a clarification on expected new facilities investment already accounted for in the derivation of the tariffs for the period and on how this relates to the extension/expansion policy in the Access Arrangement. The Regulator will need to verify the allocation of future expenditure to the different services and determine whether they have been allocated reasonably.***

According to the proposed Extensions/Expansions Policy, AlintaGas may, at its discretion and with the Regulator's consent, declare that an extension or expansion which would otherwise become part of AlintaGas is to be an excluded extension. An excluded extension is not to be treated as part of the AlintaGas Network for any purpose under the Code. If the Regulator does not consent to the proposed extension or expansion being an excluded extension, then AlintaGas may, in its discretion, decide not to undertake the extension or expansion.

In the context of the new facilities investment (which has already been taken into account in tariff determinations), it would be inappropriate for AlintaGas to discriminate against medium or low pressure extensions at its discretion when those extensions are within a reasonable predetermined range, say 20 m for connection to users to which access will be subject to a Reference Service B2 or B3. Extensions or infill connections of up to 20 m to tariff customers are understood to be at present implemented by AlintaGas without an economic test subject to "normal" technical circumstances. Extensions of up to 100 m to new groups of gas customers (eg a new residential estate) are understood to be at present implemented by AlintaGas, again without a detailed economic test. The Regulator would need to request a change of the Extension/Expansion policy which will provide for this initial "compulsory" extension length. It is noted that an extension which is treated as part of the AlintaGas distribution network under this Extensions/Expansions Policy will not affect reference tariffs for the remainder of the Access Arrangement period, the expenditure being already incorporated in the reference tariff determination via the forecast capital expenditure.

It is noted that the State proposes that AlintaGas be licensed as a Distributor under provisions of the Energy Coordination Act 1994 for licence areas encompassing the network covered by the proposed Access Arrangement. There is capacity within that licence regime to require an Extension/Expansion policy which makes these 20 m and 100 m extensions compulsory under the above criteria. The Regulator would need to treat extensions/expansions expenditure in a manner consistent with the licence conditions.

The planned new facilities investment have been taken into account in the determination of the reference tariffs because the investment is *reasonably* expected to pass the requirements of section 8.16 of the Code when the capital expenditures are forecast to occur. Under section 37(4) of the Access Arrangement, 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 and whether or not AlintaGas is otherwise satisfied that the necessary new facilities investment meets the requirements of section 8.16 of the Code.

The Regulator would need to conduct a review of forecast capital expenditure with a view to establishing that the new facilities investment meets the requirements of the Code. In addition, the Regulator will need to obtain all information necessary to distinguish between the planned new facilities investment, already accounted for in the proposed Reference Tariffs, and any unplanned future investment mentioned in section 37(4) of the Access Arrangement.

6. Optimised Deprival Value (ODV)

The deprival value of an asset is the value of the future economic benefits that a service provider would forego if it were deprived of the asset.

To establish the capital base of the AlintaGas Network and reference tariffs for Reference Services, the values of the assets that form the network have been adjusted (downward from their depreciated optimised replacement cost values or conversely upward from their depreciated actual cost). The extent of this adjustment has been just sufficient to achieve estimates of prices in the retail gas market consistent with the level of prices expected to prevail in that market during the period of the Access Arrangement.

The end result of applying this deprival value method in valuing the AlintaGas Network is a capital base of $530.3 million. Commencing at the depreciated optimised replacement cost, relatively larger reductions have been made in the values of the asset classes used to deliver gas to residential and small business consumers. The values adopted for each of the categories of assets which form the network are shown in Table 3.3 of the Access Arrangement Information.

> ***AlintaGas has not presented the full set of methodology and assumptions used to arrive at the asset values presented in Table 3.3. The OOE has been unable therefore to conclude that the ODV approach has been appropriately applied.***
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> ***The OOE considers that AlintaGas has not demonstrated it has applied consistently the deprival value methodology in valuing the AlintaGas distribution network capital base. Although the OOE acknowledges that the capital base value resulting from a systematic analysis using the ODV method may not be different from the value determined by AlintaGas, it is still preferable for the capital base value, and the components of it which reflect in each Reference Tariff, to be supported by applying a consistent set of principles in their determination. The OOE also acknowledges that information on the basis of which ODV is calculated may be sensitive. Therefore, it is considered that the Regulator should verify the application of the selected method and confirm the capital base value resulting from that application.***
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> ***The Regulator would need to be satisfied that AlintaGas has provided enough information to allow third parties to understand the derivation of the Optimised Deprival Values for the capital base which are used as the basis to determine the final tariff structure.***
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> ***The Regulator would also need to be satisfied of the reasonableness of the retail prices expected to prevail in the market during the period of the Access Arrangement. These are a key factor used in establishing what AlintaGas considers is the ODV.***
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> ***The OOE considers that more justification is needed for the assumption made in the Access Arrangement Information that the technical life is equivalent to the economic life of the assets making up the distribution network. This is***

relevant in the context of the (argued) risk factors such as bypass, which is more likely to occur on high pressure distribution assets serving larger customers, which have the longest technical asset life, but these factors would otherwise alter the determination of the economic asset life.

The economic asset life for establishing the Initial Capital Base of the existing distribution network becomes more important with the age of the assets. With a longer asset life assumed, the value of the Initial Capital Base increases for the same level of depreciated life. For the cost of service tariff determination methodology and the rate of return used, the resultant tariffs would be higher with longer asset lives.

7. Incentive Mechanism

The adoption of the "price path" approach proposed in the Access Arrangement is intended to provide an incentive to AlintaGas to improve efficiency and to promote efficient growth of the gas market by allowing AlintaGas to retain all returns from the sale of reference services during the Access Arrangement period that exceed the level of returns expected at the commencement of the Access Arrangement period.

The escalation of the initial reference tariffs using the proposed CPI-X methodology may not be appropriate. The total revenue has been calculated using the cost of service method as the sum of the return on the capital base, the depreciation, and the non-capital costs. The Code requires that an Incentive Mechanism should be designed to provide the operator with an incentive to minimise the overall costs and an incentive to undertake only prudent New Facilities Investment and to incur only prudent Non Capital Costs.

Therefore, it should be considered whether or not the incentive mechanism should apply to the initial capital base, given the associated costs cannot be "minimised", or it should only apply to non-capital costs and costs associated with New Facilities Investment. However, the Regulator would need to be also satisfied whether the CPI-X incentive mechanism should be applied to the New Facilities Investment cost. This would need to be determined in the perspective of future capital expenditure having been already incorporated into the tariff structure.

In addition to reviewing the forecast capital expenditure with a view to establishing that the new facilities investment met the requirements of the Code, the Regulator would need to be satisfied that the forecast non-capital costs are limited to costs that would be incurred by a prudent service provider acting efficiently and in accordance with good industry practice.

8. Inputs to the Weighted Average Cost of capital (WACC)

Capital Structure, Debt and Equity

AlintaGas considers that the de facto standard for the financing structure of going concerns in the electricity and gas industries in Australia is between 50% and 60% debt. KPMG Corporate Finance has also advised AlintaGas that a financing structure comprising 50% to 60% debt was appropriate.

A financing structure comprising 60% debt and 40 % equity was adopted by AlintaGas for determination of the weighted average cost of capital used in setting prices under the access regime of the *Gas Corporation Act 1994* and the *Gas Distribution Regulations 1996*.

In consequence, a financing structure comprising 55 per cent debt and 45 per cent equity was assumed for determination of the WACC for calculation of the return on the capital base in this instance.

> ***The standard debt to equity ratio for the gas transportation industry is considered to be 60/40, as has been considered reasonable in past tariff determinations for AlintaGas. The OOE does not believe that AlintaGas has adequately substantiated changing the debt to equity ratio to 55/45. A number of the businesses whose financing structure is used by AlintaGas in determining a range of debt to equity ratio values are "stapled" businesses incorporating both distribution and retail. The average debt to equity ratio for those businesses would be lower than that expected to apply only to the distribution part of the business.***
>
> ***The OOE considers that the existing financial structure of AlintaGas should not impact on the WACC and that a standard debt to equity ratio for this industry of 60/40 should be adopted.***
>
> ***The WACC is moderately sensitive to changes in the debt equity ratio parameter. If it is increased from 55% to 60% then the WACC is reduced by approximately 0.4 percentage points.***

The risk free rate of return used by AlintaGas in calculating a return on equity for the purpose of determining the WACC was 5.65%, based on an average bond rate over the last 12 months.

> ***If the inflation rate is 2.5% then the real risk free rate is only 3.07% where the nominal risk free rate is assumed to be 5.65%. This is less than the real risk free rates assumed in other access regimes.***
>
> ***AlintaGas has not substantiated the method of averaging past bond yields over 12 months in calculating the risk free rate that it proposes. The Capital Asset Pricing Model is a forward looking model and as such it is considered acceptable practice to use a point estimate for the ten year Commonwealth***

bond or to use an average over a shorter period such as 20 business days as used recently by IPART.

Recently (4 August 1999) the 10 year bond rate has increased slightly to 6.7%. If this rate is used as the nominal risk free rate then the real risk free rate is 3.68%.

The WACC is moderately sensitive to changes in the real risk free rate. If it is increased from 3.07% to 3.68% then the WACC is increased by approximately 0.7 percentage points.

AlintaGas have estimated the returns on equity (K_e) and debt (K_d) using the Capital Asset Pricing Model:

$$K_e = R_f + \beta_e \times \text{MRP}$$
$$K_d = R_f + \beta_d \times \text{MRP}$$

R_f is a risk free rate of return, β_e is the equity beta, β_d is the debt beta, and MRP is the equity market risk premium.

The debt premium or risk free rate is estimated by $\beta_d \times$ MRP, resulting in the debt premium of 1.55%.

An equity market risk premium (MRP) of 6.5% was used in applying the Capital Asset Pricing Model in calculating the return on equity for the purpose of determining the WACC for the AlintaGas network. Financial market research has produced ranges of possible values for the market risk premium (with different ranges applying for different measures of the risk free rate of return). With the risk free rate of return measured using the 10 year Treasury Bond yield, the estimates of the equity market risk premium are in the range 6% - 7%. The value used for the risk premium is the midpoint of this range.

The assumed typical market risk premium of 6.5% appears to be consistent with accepted industry values though higher than regulatory decisions for the Victorian gas transmission and distribution arrangements. Regulator needs to be satisfied that there is wide acceptance of 6.5% as used by AlintaGas.

The debt premium or risk margin used by AlintaGas of 1.55% is substantially higher in comparison to that used in the determination of the Victorian gas access arrangements by the ACCC and ORG of 1.2%. The OOE considers that further substantiation by AlintaGas is required. Regulator should undertake a further review of the proposed debt premium and its components of the debt beta (β_d) and the equity market risk premium (MRP) to ensure they are reasonable values.

It is noted that this parameter does not have much effect on the WACC calculation. If the risk margin on debt is decreased to 1.2% the resulting WACC is only reduced by approximately 0.2 percentage point.

Dividend Imputation

AlintaGas has used dividend imputation which is considered standard industry methodology in Australia. The franking credit value (γ or gamma) for the value of imputation credits is 0.3 or 30%.

> ***The OOE does not believe that AlintaGas has provided adequate substantiation of the gamma value used for dividend imputation of 30%. The Office considers that a more appropriate value is 50%. This has been the recommended approach for past gas distribution access arrangements in Western Australia and is consistent with the ACCC's and ORG's recent determination for the Victorian gas transmission and distribution access arrangements. In light of these determinations, Regulator would need to be satisfied that the γ or gamma value used by AlintaGas is in fact a reasonable value.***
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> ***The WACC is moderately sensitive to changes in the assumed imputation parameter. If it is increased from 30% to 50% then the WACC is reduced by approximately 0.6 percentage points.***

Beta Value

For unlisted entities, like the business unit within AlintaGas responsible for provision of reference services using the AlintaGas distribution network, equity betas must be estimated from the betas of listed companies engaged in comparable business activities. Beta estimation therefore involves a degree of subjectivity.

Examination of the equity betas for a sample of comparable listed companies, and the betas estimated for the Victorian gas distributors, indicated a figure in the range of 0.77 to 1.01 for AlintaGas. A beta of 0.85 was subsequently used in the calculation of the WACC. This value is consistent with the figure used in determining the WACC for the Victorian gas distributors. However, it could underestimate the true equity beta if the risk of by-pass of the AlintaGas distribution network is greater than the risk of by-pass in Victoria.

> ***The value AlintaGas uses as an equity beta of 0.85 is consistent with past Western Australian gas transmission and distribution access arrangements. However, as a comparison this value is significantly lower than 1.2 used in the determination of the Victorian gas transmission and distribution access arrangements. Regulator would need to review and assess the equity beta being used and whether or not it adequately reflects the risk of the business with regard to:***
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> - ***the growth being experienced in and increased marketing opportunities resulting from full deregulation of the gas market in Western Australia over the next five years,***
> - ***the proposal to sell AlintaGas distribution/retail as a stapled business; and***

- ***the reduced risk of by-pass for the AlintaGas distribution pipeline from the likelihood of an interconnection of the distribution system with the Parmelia pipeline.***

The WACC is very sensitive to changes in this input parameter and therefore should be considered carefully by the Regulator. Increasing the input parameter from 0.85 to 1.2 increases the WACC by approximately 1.3 percentage points.

Inflation Rate

AlintaGas have assumed an expected inflation rate (π_e) of 2.5%.

The inflation rate assumed by AlintaGas of 2.5% differs from the recent Commonwealth Treasury forecast, contained in the budget, of 2.25%. The WACC is moderately sensitive to changes in this parameter. Decreasing the input parameter from 2.5% to 2.25% increases the WACC by approximately 0.3 percentage points.

Calculation of the WACC Value

As described in subsection 3.4 of the Access Arrangement Information, the return on the capital base in each year of the Access Arrangement is the product of the rate of return and the CCA cost base (adjusted for additions) for that year. AlintaGas has used, as the rate of return to be applied to the cost base, a weighted average of the returns applicable to the equity and debt used to finance the assets which form the AlintaGas distribution network.

The values used to estimate the rate of return are given in the table below:

Return parameter		**Range**	**Value used to determine Rate of Return**
Risk free rate of return	R_f	5.20% - 5.90%	5.65%
Market risk premium	MRP	6.0% - 7.0%	6.5%
Equity beta	β_e	0.77 - 1.01	0.85
Debt beta	β_d	0.23 - 0.24	0.235
Corporate tax rate	T	36%	36%
Franking credit value	γ	0.20 - 0.40	0.30
Debt to total assets ratio	D/V	50% - 60%	55%
Equity to total assets ratio	E/V	40% - 50%	45%
Pre-tax cost of debt	K_d	6.6% - 7.6%	7.2%
Post-tax cost of debt	$K_d(1 - T(1 - \gamma)$	4.7% - 5.9%	5.4%
Post-tax cost of equity	$R_f + \beta_e \times MRP$	9.8% - 13.0%	11.2%
Expected inflation	π_e	2.5%	2.5%
Post-tax nominal WACC		7.25%- 8.75%	8.0%
Pre-tax nominal WACC		10.7% - 11.2%	10.7%
Pre-tax real WACC		7.5% - 8.5%	8.0%

> ***The WACC estimate can be validated by a deterministic model using the typical input parameters quoted by AlintaGas.***

9. Unaccounted for Gas

Unaccounted for gas is defined as the difference between the measurement of the quantity of gas delivered into the AlintaGas distribution network in a given period, and the measurement of the quantity of gas delivered from the AlintaGas distribution network during that period. AlintaGas lists a number of reasons for the difference including system line pack variations.

AlintaGas argues that the *non-capital costs*, including “unaccounted for gas” are *fixed* costs given these do not vary materially with the throughput of the AlintaGas distribution network.

The OOE considers that "system line pack variation" should not contribute to the "unaccounted for gas".

AlintaGas purchases, and transports via the Dampier to Bunbury Natural Gas Pipeline, gas for replacing gas lost as "unaccounted for gas". Forecasts of the costs of the gas purchased and transported are included in the non-capital costs for recovery through the reference tariffs. Given "unaccounted for gas" for all purposes is calculated as a percentage of throughput it would not be appropriate to be considered a fixed cost.

10. Overheads and Marketing Costs

The expected corporate level and overhead costs are shown in Table 5.1. These costs include $7.5 (with $4.2M allocated to distribution) for Corporate Overheads in 2000 which declines to $5.9M ($3.4M allocated to distribution) in 2001 and $5.1M ($2.9M allocated to distribution) in 2002.

AlintaGas has provided no reason for the decrease in these costs over the period of the access arrangement. The Regulator would need to be satisfied that $7.5 (with $4.2M allocated to distribution) for Corporate Overheads in 2000 is not an indication of inefficiency.

11. Forecast Volumes

Table 6.4 indicates a 2% decrease in the Reference Service A forecast volume and 1% decrease in the Reference Service B1 forecast volume.

The Regulator would need to be satisfied as to the validity of the forecasts. It may be that the decrease in volume indicates customers being lost to by-pass. One reason for inability to prevent by-pass could lie in inefficient distribution pricing.

12. Gas Standards

Under the proposed Access Arrangement, it is a term of every service agreement that gas entering and being transported through the AlintaGas Network must at all times comply with the standards detailed in the *Gas Standards (Natural Gas) Regulations 1999* and the requirements for the current broadest specification for the DBNGP.

The gas quality relevant to the Parmelia Pipeline would need to be carefully considered in the context of the proposed interconnection between the two systems.

13. Reference Tariff Principles and Price Path Approach

Under section 38 of the proposed Access Arrangement, in accordance with sections 8.47 and 8.48 of the Code, a number of Reference Tariff principles are fixed principles for a fixed period of 10 years commencing on the commencement date.

> ***Under section 8.47 of the Code, the Reference Tariff Policy may provide that certain principles are fixed for a specified period and not subject to change when a Service Provider submits reviews to an Access Arrangement without the agreement of the Service Provider. However, under section 8.48, in assessing whether any Structural Element may be a Fixed Principle, regard must be had to the interests of the Service Provider and the interests of Users and Prospective Users. A Market Variable Element cannot be a Fixed Principle. The OOE considers that maintaining some of the principles listed in section 38 of the Access Arrangement fixed for a period of 10 years may not be in the interest of Users and Prospective Users.***
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> ***One such principle is the financing structure that has been assumed for the purposes of determining the rate of return. Given the proposed privatisation of AlintaGas, expected to take place shortly after the period of the currently proposed Access Arrangement commences, and the likely different financing structure that may be attributable to the private business, it is not considered appropriate for this principle to remain fixed but rather reviewed at the first review of the Access Arrangement.***
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> ***The allocation of revenue between services is another such principle. Given that the allocation of revenue between services has in part been based on forecasts, it is considered appropriate for this to be reviewed at the time of the first review of the Access Arrangement when forecasts for the next review period would need to be developed.***
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> ***Section 38 also proposes to fix "the structure of the Reference Tariffs". It is understood that this refers to the type of components that comprise each reference tariff and not the actual charges that apply for each component. The Regulator may also wish to consider maintaining the ability to review the proposed "price path" approach, if accepted, at the time of the first review of the Access Arrangement when more information on the workability of that approach would be available. It should also be noted that if the Regulator agrees to fix the "price path" approach in its current form for 10 years as proposed, this would effectively fix the ability of AlintaGas to annually increase individual tariff components by CPI+2%.***

The average revenue, or revenue yield, control proposed in the Access Arrangement constrains average revenue to a $CPI - X$ path while allowing individual reference tariffs to be varied. The proposed approach would allow AlintaGas to annually increase any component of any reference tariff with CPI+2% for as long as the average revenue increase remains CPI-X.

No information has been provided to justify the need for CPI+2% annual increase in any reference tariff component. The consequence, however, could be that, for example, both components of Reference Tariff B3 are increased by CPI+2%. The Regulator would be aware that the Government intends to regulate for a nil retail tariff increase in 1999/2000 and 2000/01 and no more than a CPI tariff increase in 2001/02. In addition, increases in any standard tariffs to residential users beyond the full opening of the market to competition between retailers in July 2002, will be capped at no more than CPI+2% in any year and that on average, it is expected residential tariff increases in any year would not exceed CPI. This Government's policy of allowing a limited increase in the <u>delivered</u> residential tariffs is aimed at ensuring that all residential customers become and stay profitable, and therefore ensure that retail competition is viable in respect to those customers.

Section 38 of the Gas Pipelines Access (WA) Act 1998 requires the Regulator, when considering whether a proposed Access Arrangement should be approved, to take into account the fixing of appropriate charges as a means of extending effective competition in the supply of gas to small customers. Allowing the distribution Reference Tariff B3 to annually grow at CPI+2% has the potential to severely reduce retail margins in the residential segment of the market and to make the expectation that average increases will be limited to CPI unrealistic. It also has the potential to make the residential market unattractive to third party retailers and remove the possibility for effective competition in that market.

The OOE considers that in addition to requesting information on the basis for the necessity for CPI+2% increases in individual tariff components, the Regulator must assess those possible increases when taking into account the public interest as required under section 2.24 of the Code, including the public interest referred to in section 38 of the Act.

If the Regulator does not approve the proposed reference tariffs in a variation proposal, as revised on the basis of the proposed "price path" approach, AlintaGas may seek review of that decision not to approve as though it was a decision to which section 38 of Schedule 1 to the Gas Pipelines Access (Western Australia) Act 1998 applies. In addition, AlintaGas may seek review of a decision by the Regulator in relation to pass through of taxation and regulatory changes (as proposed in Schedule 3 of the Access Arrangement) as though it was a decision to which section 38 of Schedule 1 to the Act applies.

Section 38 of the Act provides that a person adversely affected by the following decision may apply to the Review Board for a review of the decision:

- ***a decision that a pipeline or proposed pipeline is or ceases to be a Code pipeline;***
- ***a decision to add to, or waive, a ring-fencing requirement under the Code;***
- ***a decision not to approve a contract, arrangement or understanding between a service provider and an associate of a service provider;***

- ***a decision of the Regulator to draft and approve an access arrangement or to draft and approve revisions of an access arrangement; and***
- ***a decision relating to any other matter that under the Code is a decision to which there is an appeal.***

Decisions to not approve the proposed reference tariffs in a variation proposal or the pass through of taxation and regulatory changes, as described in the Access Arrangement, would not in isolation be decisions for which a review by the Review Board is contemplated under the Act including the Code. It is not considered appropriate for AlintaGas' Access Arrangement to attempt to modify the law and create additional "prescribed" decisions subject to the appeals mechanism of the Act. This becomes even more important for decisions such as those proposed in the Access Arrangement, which do not follow the procedures prescribed by the Code, including the employment of a public consultation process. Under the Act in reviewing a decision the Review Board is generally restricted to considering only a limited number of matters including public submissions before and in relation to the decision.

14. Tax or Regulatory Changes

Schedule 3 to the Access Arrangement provides for a pass through of taxation and regulatory changes. Regulatory changes contemplated by the Access Arrangement include amongst other things community service obligations, uniform tariff obligations or any other restrictions on the level of tariffs, licensing requirements, etc. If the Regulator receives a change statement, the Regulator must decide whether to accept the pass through amount AlintaGas proposes in relation to a taxation or regulatory change. Thirty days are given to the Regulator to notify AlintaGas of his decision.

If the taxation and regulatory changes contemplated in Schedule 3 of the Access Arrangement are identified by AlintaGas to be specific major events that trigger an obligation on AlintaGas to submit revisions prior to the revisions submission date then those revisions should be treated following the procedures prescribed in the Code. Under the Code, changes to an Access Arrangement may be made before a review date if the Regulator and the Service Provider agree. In the event revisions to the Access Arrangement are proposed, a process of public consultation and approval by the Regulator, similar to that followed for approving a compulsory Access Arrangement, must be followed. It is noted, however, that the Regulator may dispense with public consultation if changes proposed between reviews are sufficiently minor. In either case, the process for introducing and approving revisions contemplated by Schedule 3 of the Access Arrangement would not at present allow for the proper Code procedures to be followed. The Regulator must request an amendment to Schedule 3 to align the proposal and approval of the revisions described in that Schedule with the processes prescribed by the Code.

Section 7 of Schedule 3 to the Access Arrangement provides for any pass through amount applied under that Schedule to apply as a variation to any Haulage Contract, set by reference to a Reference Tariff. A Haulage Contract may however exclude or vary the effect of this provision.

> ***Under section 4 of Schedule 3 of the Access Arrangement the Regulator must ensure that the financial effect on AlintaGas associated with the tax change or regulatory change concerned is economically neutral. Given that Regulator would have to verify whether section 7 of Schedule 3 effectively gives discounts to some haulage contracts and if so consider whether these are prudent discounts for the purposes of the Code and are to be passed on to other Users. Under the Code, where a User is receiving a discount (which implies the Service Provider is receiving less revenue from that User than that assumed in the calculation of Reference Tariffs), and such a discount is 'prudent', the Regulator has the discretion (when Reference Tariffs are set initially or reviewed) to permit the Service Provider to recover some or all of that shortfall in revenue by raising Reference Tariffs to other Users (if the discount is prudent, the Reference Tariff would be lower for all Users).***

15. Arbitration

Section 44 of Schedule 7 to the Access Arrangement provides that if a dispute between the parties is not of a kind that the Arbitrator may hear and determine, then the dispute must be referred to arbitration under section 45 of that Schedule. Section 45 enables a dispute to be heard and determined by a person other than the Gas Disputes Arbitrator under the *Commercial Arbitration Act 1985* and not the *Gas Pipelines Access (WA) Act 1998.*

> ***The Western Australian Gas Disputes Arbitrator (the Arbitrator) was established by the Gas Pipelines Access (WA) Act 1998 (the Act) to hear and determine disputes in addition to the disputes provided for under the National Access Code and the Gas Pipelines Access Law. For example, the Arbitrator also has the functions conferred on him by the Gas Referee Regulations in relation to the AlintaGas' distribution systems and the Dampier to Bunbury Natural Gas Pipeline. In addition, section 74 of the Act provides for the making of regulations enabling the Arbitrator to hear and determine disputes in addition to the disputes provided for under the National Access Code. For example, such disputes may be in relation to contracts signed under the provisions of the Gas Corporation Act 1994, existing at the time when the Code came into operation in Western Australia, and were "grandfathered" under the Code and therefore not covered by the arbitration provisions in the Code and the Gas Pipelines Access Law.***
>
> ***The OOE considers that it is appropriate and convenient for the independent Arbitrator, established in Western Australia for the purposes of the Code, to hear all access disputes in relation to covered gas pipelines and distribution systems. This will provide for consistency in dispute resolution and enable***

information to flow back to the Regulator. It would be useful if AlintaGas provides examples of what kind of disputes it considers may not be heard and determined by the Arbitrator. This may also provide a useful guidance to the parties in the event the Regulator determines that some disputes may still need to be heard by an arbitrator that is not the independent Arbitrator established under the Act.

16. Damages

Under section 47 of Schedule 7 to the Access Arrangement, AlintaGas will not be liable to pay compensation for, or in respect of, or make good any damage done to the land or premises of the user or the user's gas customer by AlintaGas, its officers, servants or agents in the reasonable course of installing the user specific delivery facilities or the standard delivery facilities whether that damage is of a temporary character or a permanent character.

It may be appropriate for the Access Arrangement to state that AlintaGas, its officers, servants, or agents would use best endeavours to minimise damage in the course of performing their duties.

17. Confidentiality Arrangements

Under section 52 of Schedule 7 to the Access Arrangement both parties must keep confidential the contents of a Haulage Contract and any information of a confidential nature provided to it during the course of negotiations for, or during the duration of, a Haulage Contract. The obligation of confidentiality however does not prevent the disclosure of information, which is required under any law. Recognising that information to which the obligation of confidentiality relates may also come within the definition of **"Confidential Information"** in section 10.8 of the Code, the Access Arrangement deems that the definition of **"Confidential Information"** in section 10.8 of the Code does not apply to the confidentiality provisions of the Access Arrangement.

It is understood that the obligation of confidentiality imposed by the Access Arrangement does not prevent the disclosure of information, which is required under any law including the Gas Pipelines Access (WA) Act 1998 and the Code. Therefore it is not considered appropriate for the Access Arrangement to attempt to modify that Act and the Code by excluding the Access Arrangement confidentiality provisions from the application of any part of the Act and the Code. If the purpose of the exclusion is to allow disclosure of information in the course of any restructuring or sale of AlintaGas then it should be stated that the exclusion is only for that limited purpose and for the duration of any sale or restructuring process.