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Dear Mr Pullella

**EPIC ENERGY ACCESS ARRANGEMENT FOR THE DBNGP
WESTERN POWER'S SUBMISSION NUMBER 3
REFERENCE TARIFF**

Western Power submits for review by the Office of Gas Access Regulation (OffGAR), Western Power's present concerns on the Reference Tariff proposed by Epic Energy in their Access Arrangement for the DBNGP.

This third submission by Western Power, addresses specific matters concerning the calculation of a Reference Tariff, and identifies areas where there is insufficient supporting information provided to understand the derivation of the elements used.

Western Power wishes to acknowledge the invaluable assistance of Australian Energy Advisors in the compilation of this submission.

BACKGROUND

As a foundation shipper on the DBNGP, Western Power was assigned and now has reserved capacity and interruptible transport entitlements which in aggregate terms, lie between 143TJ/d (summer) and 116TJ/d (winter), covering part haul and full haul requirements to delivery points in the Pilbara, Gascoyne, Mid West and to the South West. In addition, Western Power has a share of the transport capacity reserved for the Worsley Cogeneration Plant. The terms and conditions of Western Power's transport contracts are in accordance with the Gas Transmission Regulations (GTR) circa 1996-98 (i.e. the "grandfathered" Prior Contracts referred to in Epic Energy's proposed Access Arrangement).

It is currently not settled between Western Power and Epic Energy, whether an offer under section 20 of the Dampier to Bunbury Pipeline Act 1997 ("section 20 offer") has been made and accepted in respect of Western Power's GTR contracts. If the section 20 offer

has been (or is) made and accepted, the future costs to Western Power of these contracts could be substantially impacted by any future statutory price established as a result of OffGAR's determination of the Reference Tariff for the proposed Firm Service. Western Power is also likely to be a future acquirer of incremental or replacement capacity under the Access Arrangement.

Western Power was a foundation shipper on the DBNGP. It has previously been led to believe that costs would decrease as reservation charges were discharged and delivery quantities increased. To the extent that costs do decrease, Western Power believes that it (with other foundation shippers on the DBNGP) has a right to expect an opportunity to participate in that decrease.

Furthermore, while the Regulator is of course obliged to consider the Access Arrangement in accordance with the Code, Western Power submits that the Regulator can and should take into account the historical background to the development of the Western Australian gas industry, and the construction of the DBNGP which played such a role in that development. Western Power submits that, taking into account that history, it would be an inappropriate outcome if Western Power or other foundation shippers were to be left in a "stranded" position as a result of the introduction of the reforms embodied in the National Access Code.

REFERENCE TARIFF CALCULATION

Total Revenue

The Total Revenue is said to be calculated using the 'cost of service' method described in the National Access Code (Cl 8.4). This requires that the Total Revenue equal the costs derived for all services, not just the Reference Service. However this is difficult to reconcile based on Epic Energy's assumption that all shippers will be using the Reference Service. In fact, in the initial years, Reference Service shippers will occupy at most a negligible proportion of DBNGP capacity. For this reason alone, the Total Revenue does not appear to have been calculated in accord with the Code.

Rebate Sharing

The Access Contract Terms and Conditions state that any new Firm Service contract could be a Rebate Sharing Contract and therefore contributes Rebate Sharing Revenue. It appears that shippers with Prior Contracts will not be Rebate Sharing Contracts. As a foundation shipper, Western Power contracted on the understanding that its access would be regulated on an equitable basis.

To participate in Rebateable Revenue, Epic Energy requires a shipper to have contributed to Rebate Sharing Revenue, and Epic Energy has indicated that shippers with Prior Contracts do not share in any Distributable Revenue. Prior Contract shippers will be the major users of services providing Rebateable Revenue. The equity of the Rebate Sharing proposal is not obvious, and there needs to be an explanation for the approach adopted by Epic Energy.

Distributable Revenue

The Distributable Revenue also requires further information and explanation as to the basis of its derivation and application. The principle of the Distributable Revenue would appear to be that to the extent that Prior Contracts over-recover or under-recover revenue that would have been derived if they were Reference Services, then Rebateable Revenue will be applied to:

- make-up any shortfall, and therefore be retained by Epic Energy, or
- distributed with any excess recovery amongst shippers using the Firm Service and Epic Energy.

The formulae proposed do not appear to achieve this objective and there is no stated basis as to the proposed distribution of any excess recovery between the Firm Service participants. Furthermore there is insufficient information for shippers to be able to assess the likelihood of a distribution at any time.

Initial Capital Base

The Initial Capital Base once set is not subject to further review. In these circumstances shippers must be confident conditions set by the Code as a basis for consideration of the Initial Capital Base have been adhered to.

The Code is quite explicit when dealing with the factors that should be considered in establishing the Initial Capital Base. Cl 8.11 of the Code essentially requires consideration of at least two methodologies of establishing the Initial Capital Base by indicating to the Regulator that the value should lie within the values provided by the Depreciated Actual Cost (DAC) and Depreciated Optimised Replacement Cost (DORC) as described in Cl 8.10. It is also a requirement of Cl 2.7 of the Code that matters included in Attachment A such as asset valuation methodologies must be included in the information provided. This has not been done.

Given the information supplied, Western Power does not consider that the proposition of using the acquisition price is supported nor is there sufficient information to establish that the selected Initial Capital Base conforms with the Code. In fact the Access Arrangement Information indicates that Epic Energy considers the proposed Initial Capital Base to be in excess of both the DAC and DORC evaluations.

In Western Power's opinion, this section of Epic Energy's proposal is deficient and that the selected value is not supportable in relation to the requirements of the Code.

Western Power requests the Regulator to require that Epic Energy submit DAC and DORC valuations, together with adequate supporting information in their Access Arrangement. Western Power fully endorses the AlintaGas submission (Submission No. 1 of 11 January 2000) to OffGAR, including their request that the time for submissions be extended until shippers and other interested parties have has an opportunity to consider the DAC and DORC information to be provided by Epic Energy.

Regulatory Rate of Return

The rate of return sought by Epic Energy is above that provided in recent decisions by other regulators in respect of gas transportation and distribution assets. For example, the Regulator-General in Victoria determined that the rates of return for similar assets should be no greater than 7.75% on a real pre-tax basis.

Advisors to Western Power have indicated concerns with parameters and the approach adopted by the Brattle Group in their estimation of a suitable rate of return for the DBNGP.

Western Power requests the Regulator to appoint an expert to examine the reasonableness of the assumptions, database and computational methodology prepared by the Brattle Group for the Epic Energy Access Arrangement.

Economic Depreciation of Assets

The manner of dealing with depreciation is inadequately detailed particularly in respect of depreciation applied to the physical asset account. While the Access Arrangement provides a table of economic lives over which the physical assets will be depreciated (Table 3.2 of the Access Arrangement Information) there is inadequate detail to identify how the depreciation schedule in Table 3.3 has been derived.

Epic Energy acknowledge that the proposed Reference Tariff cannot recover the now claimed capital and operating charges attributed to the pipeline with the current and projected level of utilisation. This comment causes serious concern as the Reference Tariff is proposed to reduce in real terms.

The principle applied is that to the extent that current revenue fails to recover the costs then that portion not recovered will be provided for as 'economic depreciation' to be recovered at a future time when utilisation increases. In Western Power's view, this is not in conformity with the intention of the Code. This 'economic depreciation' is added to the capital base each year and is computed to earn a return (compounded for each year it remains unrecovered). As shown by the Deferred Recovery Account in Table 3.3, the total of under-recovery rapidly escalates.

Epic Energy has given no indication of how it envisages load growth enabling recovery of the deferred capital base.

Western Power considers that no significant increased utilisation can be obtained (excepting contributions from Non-Reference Services) without expansion of the pipeline. Even if no capital was added to the physical asset account (which is entirely unrealistic) it is estimated that by year 10 a doubling of the revenue from the Reference Service would be required to prevent further increases in the Deferred Recovery Account. In any event, if efficiencies in operation result in substantial load growth without capital investment, the principles of the Code are that the benefit should be shared between the Service Provider and the users. Typically, the Service Provider enjoys the benefit of the increased revenue until the next Access Arrangement review, after which it is factored into tariffs. The code certainly does not envisage such efficiencies being used solely to the benefit on the Service Provider, to allow it to draw down notionally "deferred" capital expenditure caused by an initially inflated Capital Base.

Western Power submits that the treatment of the proposed “economic depreciation” is primarily a symptom of the over-stated Initial Capital Base, and that it would be more appropriate to review the method of depreciation after Epic Energy has complied with the Code in terms of deriving the Initial Capital Base.

The inappropriateness of Epic Energy’s proposed “economic depreciation” deferral of the surplus Initial Capital Base can best be illustrated by considering Table 3-3 of Epic Energy’s Access Arrangement Information. Taking its contents at face value, that table indicates that at the time of the next Access Arrangement review, the Regulator will be confronted by an apparent regulated Capital Base for the DBNGP, after just \$59.3m of projected expenditure during the period, which has ballooned to \$3.37 billion. Western Power submits that on any asset valuation methodology, this will be an absurd regulatory valuation for the DBNGP. Such a Capital Base would also pose difficulties under the National Access Code when setting tariffs for the 2005-2010 and subsequent Access Arrangement Periods.

For this reason, Western Power submits that the Initial Capital Base for the DBNGP should be constrained to a range between DAC and DORC, and that the deferred “economic depreciation” model be abandoned. Western Power requests the Regulator to require Epic Energy to propose a Reference Tariff on this basis.

Incentive Mechanisms

Epic Energy has elected to use the form of regulation based on a pre-determined price path as provided for in the Code.

Key outcomes from this approach are that increased utilisation and savings in costs are attributable to Epic Energy for the full period of the Access Arrangement. However, both costs and utilisation are based on forecasts for that period. Therefore there is a substantial onus on shippers and the Regulator to ensure that cost and volume forecasts are reasonable. Shippers therefore would be foregoing any benefits of cost savings and increased utilisation at least until the commencement of the next Access Arrangement period.

Nevertheless the approach does ensure that transportation costs will decline in real terms. However it would appear to be a prudent requirement of this initial Access Arrangement, that Epic Energy, in its subsequent applications for review, provide a summary of actual costs against the forecasts made so that the Regulator and shippers have better information on the effectiveness of the incentive at future reviews.

Western Power notes that under tariff setting methodology in effect since 1995 for the DBNGP, there was de facto sharing of efficiencies built into the 3-year tariff redetermination mechanism. The current proposed Access Arrangement is a move away from the principles established in Prior Contracts that have been grandfathered.

The second element of structure claimed to provide an incentive is the offering of Rebateable Services. In principle this is correct as at least a portion of the revenue from Rebateable Services is to be applied to reducing the Reference Tariff now and in the future. However there is a threshold level of revenue required before this occurs, and the Access Arrangement does not state the basis of assessing at what point rebateable revenue may be distributed to shippers. Furthermore, there is no discussion as to the appropriateness of the shares distributed to the various recipients.

Therefore there is no basis upon which to make a judgement as to whether the Rebateable Services provide for a reasonable sharing of any efficiency gains.

Determination of Reference Tariff

As mentioned previously, Epic Energy has not provided the details of the calculation of the Total Revenue to be derived to meet the 'cost of service'.

The Total Revenue to be derived from services is not defined but may be deduced as arising from:

- a) revenue to be derived from the Reference Service, which initially will be zero or very small
- b) revenue to be derived from Prior Contracts, and which are defined as Non-Reference Services, which will be the major proportion of revenue
- c) revenue derived from other Non-Reference Services, which are rebateable, and
- d) revenue derived from surcharges, fees and other payments.

The imputed Total Revenue has been calculated on an assumption that all grandfathered contracts are Reference Service contracts, when in fact revenue will almost exclusively be derived from Prior Contracts and their existing tariffs. This does not conform to the Code.

The derivation of the 'cost of service' for the Reference Service proceeds on the basis that the Prior Contracts (being Non-Reference Services) are in fact Reference Services. If it were otherwise there would be effectively no costs associated with the Reference Service, as there are no projected Reference Service shippers in the Access Arrangement period.

In this context, the determination of Reference Tariffs could not be said to conform to the Code.

ACCESS ARRANGEMENT INFORMATION

Access and Pricing Principles

The tariff determination information is deficient in a number of respects:

- There is no explicit description of the manner in which existing contracts are to be phased into the proposed Access Arrangements.
- There is no detail as to whether there are any costs associated with providing the Reference Service, that is, all costs arise from existing contracts. It is indirectly acknowledged in Section 6.4 of the Information that there are no costs associated with the Reference Service.
- There is no information on how the pro-rata adjustment of tariffs computed from the cost base is applied to derive the Tariff Schedule.
- There is no detail on the basis of the total revenue to be derived, which will largely be from existing contracts.

- Consequently it is not possible to determine whether actual revenue is likely to result in over recovery or under recovery.
- It is not possible to identify when the Reference Tariff will have a meaningful effect on revenue, and therefore its relevance in establishing the “Regulatory Asset Accounting” proposed.
- It is not possible to verify the Delivery Point charges from the information supplied.
- The return on the capital base appears to have been miscalculated as the application of WACC as determined by the Brattle report adjusted to a nominal base gives lower required returns than shown in Table 2.2: Forecast Total Costs of Providing Services, page 9, Access Arrangement Information.

The definition of zones requires examination and explanation. Additional work would be required to identify whether there are sufficient zones defined particularly in the region of zone 1 and zones 9 and 10, and whether the proposed zones provide an equitable allocation of costs.

The double-length zone 1 in particular requires a considerably clearer justification: it is difficult to see a user-pays justification for a shipper delivering gas into the DBNGP say 500m downstream of CS2 having to pay for the 270km of pipe between Dampier and CS2.

Epic Energy should also be required to demonstrate technical or operation reasons for ending zones 1km downstream from Compressor Stations.

There is no information to support zone selection and demonstrate that it results in an equitable allocation of costs.

Capital Costs

Assumptions regarding the economic life of the assets for depreciation purposes are provided in the Access Arrangement Information, however, no supporting documentation is made available.

Depreciation and accumulated depreciation are provided for the proposed Access Arrangement period, but there are insufficient supporting calculations to properly identify the treatment of asset depreciation and its impacts on the Reference Tariff beyond the proposed Access Arrangement period.

As noted there is little by way of justification for the planned capital expenditure. This is required under the conditions of Prior Contracts.

Overheads and Marketing

The approach taken in dealing with overheads and marketing are deficient in two respects. On the assumption that these costs have been previously allocated on the basis stated then under Access Arrangements or contracts in place, the Epic Energy business units in South Australia and Queensland will be recovering costs on a different basis than this allocation would now provide. To that extent, the proposed allocation will result in an over-recovery in this Access Arrangement period.

Secondly there is no breakdown of the costs and therefore it is not possible to identify components, but it would be reasonable to have marketing costs identified separately and justified.

System Capacity and Volume Assumptions

The data on volumes delivered requires some further explanation, sufficient to allow the identification of the appropriate data to be used in calculation of revenue. The uncertainties arise from:

- For year ended 31 December 1998, the quantity of energy delivered in zone 9 was generally between 80 and 100 TJ/d, and the maximum daily quantities between 130 and 160 TJ/d. Comparable figures for zone 10 were between 380 and 400 TJ/d delivered and 450 and 475 TJ/d as maximum daily quantities.
- For the all forecast periods, the annual quantity forecast for zone 9 exceeds the annual capacity forecast – inferring shippers will exceed their MDQs consistently or an alternative delivery system is to be used that was not used in 1998.
- Nevertheless the sum of quantities forecast in zones 9 and 10 are less in the future than for 1998.

Generally there is insufficient detail on how the capacity and quantity data has been applied to derive Total Revenue.

CONCLUSION

The Regulator will be aware of the considerable attention by the media concerning the tariffs proposed by Epic Energy, which have been linked to the acquisition price paid for the DBNGP.

Western Power is aware that AlintaGas has recently made available to the Regulator, key information relating to the privatisation of the DBNGP and the status of representations made at the time regarding tariffs.

Western Power requests that the Regulator disclose this information to prospective shippers and other parties, who may have an interest in this matter. As a shipper under existing regulations, Western Power contends that this information is a key factor in the determination of a Reference Tariff for the DBNGP.

Western Power intends to make further submissions to OffGAR concerning other aspects of the proposed Access Arrangement for the DBNGP.

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