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 Alinta Gas Networks Pty Ltd's (AGN) proposed revisions to the Access Arrangement for the Mid West and South West Gas Distribution Systems. 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 Economic Regulation Authority (ERA) 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.

The OOE reviewed the proposed Access Arrangement and Access Arrangement Information from the perspective of the impact on competition and on small use customers. In this regard, of particular note in this submission are the tariff basket and the interconnection service.

1. *Tariff Basket*

AGN proposes to "roll forward" the Reference Tariffs from 2004 to 2005. In the remaining years of the proposed Access Arrangement the tariffs will be set notionally as a smoothed price path. AGN would have the discretion to adjust individual tariffs and tariff components, with the whole of the tariff basket subject to a price cap. Based on AGN's proposed revisions, the smoothed price path would amount to an increase of approximately 2% over CPI per annum.

> ***AGN argues that a tariff basket approach is consistent with section 8.1 of the Code and that there are strong efficiency arguments for such an approach. While this may be so at a conceptual level, for example the approach may have benefits in terms of allowing the rebalancing of tariffs to more efficient structures and levels, there is no indication from AGN as to how it will ensure that implementation of the approach meets the Code requirements and the efficiency arguments advanced. Whilst the ERA will be notified of changes within the tariff classes, provided such changes do not exceed the tariff cap, the ERA's explicit approval may not be required. The proposed approach has the potential to create some degree of uncertainty for Users and to lack transparency without the vetting of the ERA of proposed changes to tariffs and tariff components (notwithstanding the fact that a tariff cap would apply to the tariff basket overall).***

> ***Section 8.2 of the Code provides the ERA with factors that must be satisfied to approve tariffs. One such factor is that total revenue recovered from a reference service is proportional to the usage of the reference service. The discretion for tariff variation proposed by AGN gives AGN the ability to modify individual tariffs in a manner that may not be cost reflective.***
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> ***The ERA is encouraged to closely consider the proposed tariffs and variation approach, including the components that give rise to those tariffs, particularly as they relate to and impact on the small use customer market, both residential and small business.***
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> ***Of particular note in this regard is the requirement on the ERA, under section 38(2) of the Gas Pipelines Access (Western Australia) Act 1998, that in considering the public interest the ERA is to take into account the fixing of appropriate charges as a means of extending effective competition in the small use customer market. The ERA would note that gas retail tariff caps that are escalating at CPI continue to apply in particular gas license areas of Alinta Sales.***
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> ***Unjustified and significant reduction in retail margins in the small use customer segment of the gas market as a consequence of distribution tariff increases has the potential to make this market unattractive to third party retailers and remove the possibility for effective competition in that market.***
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> ***It should also be noted that if the ERA agrees to AGN's proposal, this would effectively amount to an annual increase in individual tariff components by CPI+2%. The ERA should be satisfied that sufficient justification has been provided for the CPI+2% increase.***

2. Interconnection Service

In addition to the reference services, AGN offers an Interconnection Service as a non-reference service. This provides a right to interconnect with the AGN distribution network. The terms and conditions and prices upon which an Interconnection Service will be made available are to be negotiated by AGN and the person to whom that service is provided. AGN also provides for recovery of reasonable capital and non-capital costs incurred as a result of interconnection. Where AGN is required to incur costs relating to a heating value implementation plan, its costs are to be reimbursed by the pipeline owner or operator of the interconnected pipeline.

> ***The OOE considers that the ERA should determine whether terms and conditions in relation to the interconnection service should be included in the Services Policy of the Access Arrangement. The OOE considers that facilitation of new sources of gas supply would not only ensure demand is met but would also promote competition. This is of particular import at the current time due to issues surrounding the Dampier to Bunbury Natural Gas Pipeline.***
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> ***The OOE notes that the ERA considered this issue in its previous decision, and acknowledges that there are technical issues surrounding such service.***

However, the OOE considers that there are matters other than those in technical areas. The OOE encourages the ERA to consider the issue in a wider perspective and consider any industry concerns that may be raised during the Access Arrangement approval process.

For example, AGN refers to heating value management costs in its proposed Access Arrangement. It would be prudent for the ERA to consider what cost allocation would be fair and reasonable and consistent with the Code. This can be done without having to consider the details of what the actual costs will be but rather the broad principles of allocation. For instance, the allocation of all costs related to heating value management solely to a single or select group of Users (particularly if benefits would accrue in time to all or additional Users) would have the potential to hinder access to the AGN distribution system and represent a barrier to entry.

In addition to the main issues outlined above, the OOE also provides the following comments:

3. Services Policy

AGN may allocate a replacement reference service if it reasonably anticipates that the requirements for the service will fall within a different reference service. The User may provide evidence as to why the change should not occur. However, AGN may issue written notice to the User which automatically takes effect as a variation of the haulage contract. There is no provision inhibiting the issuance of the notice should the User and AGN dispute the matter.

The ERA should consider whether it is appropriate for AGN to have the ability to give notice of a replacement reference service, which takes place regardless of whether the User agrees to the terms of the notice.

AGN proposes that it may require Users or Prospective Users to hold contractual rights to Firm Capacity on an Interconnected Pipeline sufficient for delivery to meet their Contracted Peak Rate.

The ERA is asked to seek clarification of the need for this pre-condition and consider its reasonableness given that Users in meeting supply commitments to their customers could be using a combination of firm, interruptible and spot transmission pipeline capacities, as well as other services that may be available through the distribution system and operation of the retail market. Development of competition will not be served if this becomes a barrier to entry.

4. Reference Tariffs

a) Capital Base

The value of AGN's initial capital base in the current arrangement was $535.9 million at 31 December 1999. AGN proposes a capital base at 1 January 2005 of $634.4 million, adjusted for inflation to 30 June 2003 and reflecting capital expenditure undertaken during the current Access Arrangement period. AGN suggests in its Access Arrangement Information that the Authority should infer that all capital expended, and projected to be expended in the current period is New Facilities Investment and meets the Code's requirements as set out in section 8.16. In addition, AGN proposes that there is no redundant capital.

> ***While AGN's arguments that it is reasonable for the ERA to infer that past capital expenditure meets the requirements of the Code are noted, OOE suggests that, as a minimum, the ERA is required by the Code to assure itself of the prudency and efficiency of the capital expenditure undertaken, and forecast to be undertaken, by AGN. The ERA's assessment of past/actual capital expenditure in part will contribute to the ERA's consideration of forecast capital expenditures and whether these meet the requirement of the Code.***

b) Regulatory Rate of Return

AGN proposed a rate of return, based on the CAPM pricing model, expressed as a pre-tax weighted average costs of capital of 8.5%, compared to 7.5% in the current period. AGN supports this WACC of 8.5% with information and a recommendation from KPMG. KPMG provides a number of parameters supporting the recommendation, which is derived from a range of 8.0% to 8.7%.

> ***While the OOE makes no particular comment on the justification advanced to arrive at the proposed WACC, the proposed change in WACC is considered substantial. The ERA should closely consider the parameters and data used to arrive at the WACC range and to provide its views in order to facilitate debate on the issue. This should include consideration of the sources of data used in the report in comparison to a range of other sources of data, including comparison to the WACC parameters applied by other energy regulators in Australia.***

5. Prudent Discount

AGN is requesting adjustment to reference tariffs to pass on amounts incurred from prudent discounts. AGN has not provided information in relation to the discounts.

> ***As a minimum, even on a confidential basis, the ERA will need to be provided with detailed information from AGN on the discounts given to Users and how these meet the requirements of the Code. It will then be a requirement on the ERA to assess whether these discounts meet the Code's conditions for prudent discounts.***

Office of Energy
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