

Our Ref: 99/1006

Dr Ken Michael
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Dear Ken

OFFICE OF ENERGY SUBMISSION - DRAFT DECISION ON THE ACCESS ARRANGEMENT FOR THE MID-WEST AND SOUTH-WEST GAS DISTRIBUTION SYSTEMS

Thank you for notifying me of your Draft Decision in respect of the proposed Access Arrangement lodged by AlintaGas for the Mid-West and South-West Gas Distribution Systems on 30 June 1999, and for allowing interested parties to respond to that Draft Decision.

As part of your Draft Decision you have not approved the Access Arrangement in its current form and have required AlintaGas to make amendments as detailed in the Draft Decision.

It is my view that in making your Draft Decision you have endeavoured to give proper consideration to the interests of various stakeholders, and to the investment and market risks faced by AlintaGas.

I note that each of the specific comments made by the Office of Energy (OOE) in its submission of 5 August 1999 appear to have been either directly or indirectly addressed in making the Draft Decision. The majority of issues raised by the OOE have been adequately addressed by the amendments you have required AlintaGas to make to the proposed Access Arrangement.

The OOE submits the following specific comments in respect of your Draft Decision in the order of your required amendments:

1. Duration of Reference Services (Amendment 2)

As part of your Draft Decision you required that Clause 1 of Schedule 6 of the Access Arrangement be amended so that a Haulage Contract for Reference Service B2 or Reference Service B3 can have a duration of more than one year and is not constrained to a duration of exactly one year, as proposed by AlintaGas.

The Access Arrangement offers Reference Service A and B1 on the basis of a contract duration of no less than 2 and no longer than 5 years. In the light of the required amendment regarding the contract duration for Reference Service B2 or B3, it may be appropriate, in the interest of making services to users available on a more flexible basis, to also require that the contract duration for Reference Service A and B1 be amended to a minimum contract duration of one year instead of the two years proposed by AlintaGas. This will also be consistent with the duration of comparable Reference Services offered in the Access Arrangements for distribution networks submitted in other States (ref. page 30, Part B of the Draft Decision).

2. Interconnection Service

In its first submission of 5 August 1999 on the proposed Access Arrangement, the OOE considered 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 AlintaGas distribution systems.

You responded to that comment by stating that interconnection between AlintaGas' network and other transmission or distribution systems is likely to be sought relatively infrequently and will require some extremely complex technical issues to be resolved. Given this, and that interconnection is not offered as a Reference Service in other Access Arrangements for distribution systems in other States, you considered that interconnection is best offered on the basis of a negotiated service by AlintaGas and did not consider that an Interconnection Service should be a Reference Service for the purposes of the Access Arrangement.

Although the OOE notes your observation that interconnection is not an issue in some Eastern States, the OOE does consider that the relevant concerns in Western Australia need to be addressed. The OOE agrees with your observation that in this State interconnection between AlintaGas' network and other distribution systems would require some complex technical issues to be resolved. Addressing such issues was the prime objective of the OOE when late last year it convened a specific working group to deal with the issues related to interconnections with the AlintaGas distribution systems.

As the Western Australian gas industry opens up to competition, it is likely that new network owners will wish to set up discrete distribution networks that are adjacent to and potentially facilitated by connection to existing networks. As there is no legislation or code presently available in this State to provide guidelines on interconnection issues between networks owned by different parties, the OOE convened the above-mentioned working group which in February 2000 published guidelines on the matter. These guidelines have been developed to

assist new network owners in planning, operating and obtaining a connection to an existing network.

The OOE notes your view that interconnection of third party distribution systems is likely to be sought relatively infrequently. However, it is suggested that the likelihood of such events would be able to be determined as the small use consumer end of the gas market opens to competition, which will take place during the Access Arrangement period. It would therefore be appropriate to revisit the issue at the end of this Access Arrangement period.

It is also noted that connection between the AlintaGas system and the Parmelia pipeline is proceeding and connection is due to occur before the middle of the year at Harrow St. The OOE has given an agreement to CMS for a 12 month trial based on a fixed gas mixing rate.

3. Listed Ancillary Services

In its 5 August 1999 submission on the proposed Access Arrangement the OOE considered that as the four listed ancillary services would be utilised by a significant part of the market, the prevailing standard terms and conditions for those listed ancillary services should be approved by the Regulator.

You responded to that comment by stating that the ancillary services are relatively simple in nature and are presently offered to Users without specific terms and conditions. The imposition of a requirement for terms and conditions to be available would impose an additional administrative burden, which would not necessarily provide additional benefits to Users. In your Draft Decision you have therefore not required AlintaGas to offer its listed ancillary services as Reference Services, or for terms and conditions for the provision of such services to be included in the Access Arrangement.

Under section 16 of proposed Access Arrangement, however, the terms and conditions upon which AlintaGas will make a listed ancillary service available to a user will be “the standard terms and conditions for that service as determined, amended or substituted by AlintaGas from time to time”. AlintaGas will when requested make available a copy of its prevailing standard terms and conditions for a listed ancillary service.

The comment in the OOE’s 5 August 1999 submission reflected an expectation that the listed ancillary services are likely to be sought by all users of the Reference Service B2 and Reference Service B3 and thus effectively form part of these Reference Services. As such, the comment also reflected a concern that the standard terms and conditions for the listed ancillary services were proposed by AlintaGas to be determined, amended or substituted by AlintaGas without the consent of the Regulator. The OOE continues to consider that it is in the interest of Users that at least the tariffs for the listed ancillary services, together with an appropriate escalation mechanism, should continue to be approved by the Regulator.

It is noted that AGL Gas Networks’ revisions to its Access Arrangement, which were based on IPART’s Draft Decision and were submitted in February 2000, contain charges for five ancillary services as part of the Reference Tariffs proposed by AGL. Those charges include charges for Request for Service, Special meter read, Charge payable on transfer of Delivery Point from one User to another User (payable by the new User), Disconnection Fee, and Charge payable for provision of End User Information as defined under the Code.

In order to facilitate the development of retail competition, the National Gas Pipelines Advisory Committee is considering recommending to Ministers that a new provision be included in the Code placing an obligation on Service Providers to disclose End User Information at the request of an End User. It is relevant to note that it is also contemplated to allow the Service Provider to require the End User to pay a fee to compensate the Service Provider for its reasonable costs of providing the End User Information, provided that fee has been approved in writing by the Regulator. Western Australia is supportive of these proposed inclusions in the Code. It is noted that in the above mentioned Access Arrangement AGL has proposed that fee to provide End User Information be \$10 per request and AGL has included that service as part of its ancillary services.

4. Gas Quality Specification (Amendment 3)

As part of your Draft Decision you required that Clause 20 of Chapter 2 of the Access Arrangement be amended to clarify that, for each gas quality component listed, the most stringent specification contained in the *Gas Standards (Natural Gas) Regulations 1999* and the broadest specification as defined in the Access Arrangement and currently specified in the *Dampier to Bunbury Pipeline Regulations 1998* will prevail.

You would be aware that the broadest specification currently specified in the *Dampier to Bunbury Gas Pipeline Regulations 1998* will cease to exist with the repeal of those Regulations, ie on the day the Access Arrangement for the Dampier to Bunbury Natural Gas Pipeline (DBNGP) is approved by the Regulator. As a consequence there will be no regulatory control over the DBNGP gas quality specification except as provided for under the DBNGP Access Arrangement. In contrast, the gas quality requirements contained in the *Gas Standards (Natural Gas) Regulations 1999* will continue to apply to gas distribution systems in Western Australia, including to AlintaGas' distribution systems subject to this Access Arrangement. Given that the latter are legal requirements it may be appropriate, for consistency reasons, for the Access Arrangement to specify that the specification contained in the *Gas Standards (Natural Gas) Regulations 1999* will prevail for the components specified in those Regulations. For the remaining components, not specified in the Regulations, AlintaGas may wish to propose, and the Regulator may wish to approve, the broadest specification as currently specified in the *Dampier to Bunbury Pipeline Regulations 1998*.

5. Contractual Rights (Amendment 5)

As part of your Draft Decision you required that Clause 19(1)(b) of Chapter 2 of the Access Arrangement be amended to state that AlintaGas will only enter into a service agreement if it would not deprive any person of a contractual right that existed prior to 30 June 1999, other than an exclusivity right which arose on or after 30 March 1995.

It is understood that the amendment was required because under Section 2.25 of the Code the Regulator must not approve an Access Arrangement which would deprive any person of a contractual right in existence prior to *the date the proposed Access Arrangement was submitted (or required to be submitted)*, other than an exclusivity right which arose on or after 30 March 1995.

Guidance in this respect is also provided under section 6.18 of the Code, which contains the restriction on the Arbitrator in making a decision in relation to an access dispute. Under that section the Arbitrator must not make a decision that would impede the existing right of a User

to obtain Services or would deprive any person of a contractual right that existed prior to the notification of the dispute, other than an Exclusivity Right which arose on or after 30 March 1995.

It is therefore suggested that in practice AlintaGas would only enter into a service agreement if it would not deprive any person of a contractual right that existed prior to the date of entering that service agreement, other than an Exclusivity Right which arose on or after 30 March 1995.

6. Force Majeure (Amendment 12)

As part of your Draft Decision you required that the Access Arrangement be amended to provide for the waiving of the fixed charges of a Reference Tariff for any period in which provision of a Reference Service is interrupted or reduced by a force majeure event.

This amendment will reverse AlintaGas' proposed allocation of risk between AlintaGas and Users. It may be more equitable to establish a mechanism whereby force majeure risks are shared between the parties to the Haulage Contract.

7. Extensions/Expansions Policy

An Extensions/Expansions Policy is provided by AlintaGas in Chapter 7 of the Access Arrangement. Under the general provisions of the Extensions/Expansions Policy any extension or expansion which is part of, or directly connected with, an existing sub-network will be treated as part of the AlintaGas network for all purposes under the Code unless AlintaGas, with the prior consent of the Regulator, declares that a proposed extension or expansion is to be an excluded extension. (Clauses 55 and 57 of the Access Arrangement). Unless an excluded extension becomes a Covered Pipeline under the Code, access to it will be a matter for negotiation between AlintaGas and the prospective user.

The Government proposes to make Retail Tariff Regulations under the Energy Coordination Act, which will have the effect of capping gas tariffs for all small use customers (using below 1 TJ/annum). The Regulations will apply in those areas of the State, which are the subject of distribution licences granted to AlintaGas under the Energy Coordination Act. It is also likely that the approved distribution licence areas will extend beyond the current distribution systems of AlintaGas as defined in the Access Arrangement, although the extent of the areas is yet to be determined. The capping of gas retail tariffs within those areas would effectively mean that extensions to the current distribution system for the supply of gas to small use customers would only be viable if the relevant distribution tariffs allow sufficient retail margin below the cap. There may also be concern by users of the system (eg retailers supplying small use customers) that the ability of AlintaGas to exclude some of the extensions from the Access Arrangement could enable the AlintaGas Distribution Business to discriminate in favour of its Trading Business.

The Code requires that an Access Arrangement include an Extensions/Expansions Policy which sets out the method to be applied to determine whether any extension to, or expansion of the capacity of, a covered pipeline should or should not be treated as part of the covered pipeline for the purposes under the Code. It is arguable that even relatively minor low/medium pressure extensions would technically comprise extensions to the AlintaGas network. It is suggested however that given the Code was originally developed to cover only transmission pipelines, the ability to exclude minor extensions to established distribution

systems may have not been intended by the creators of the Code. Related provisions in similar Access Arrangements covering distribution systems in the other States should also be noted. For example, under AGL's Access Arrangement for the NSW distribution system any extension or expansion carried out by AGL will be part of the covered network and no extension or expansion will effect the respective Reference Tariff.

Notwithstanding the above, it is considered that should you approve the Extension/Expansion policy as proposed by AlintaGas your consent for AlintaGas to declare a proposed extension as an excluded extension should be granted subject to a public consultation process, limited to the proposal, being conducted prior to that consent. Public consultation is considered particularly appropriate in situations where the extension, which is proposed to be excluded, would be used, or would be part of interconnected system which would be used, to supply gas to small use customers.

8. Trigger Mechanisms (Amendment 25)

In your Draft Decision you required that Chapter 8 of the Access Arrangement (Review Date) be amended to include trigger mechanisms enabling the Regulator, if the Regulator wishes, to initiate a review of the Access Arrangement in response to, amongst other triggers, increases in quantities of gas distributed above forecast increases by an amount of more than 50 percent of the forecast increases.

You considered that the Access Arrangement should provide for a significant difference between forecast and actual values used in the determination of Reference Tariffs to trigger a review of the Access Arrangement. Given the implicit uncertainty involved in forecasting throughput over the Access Arrangement period, you considered that a trigger mechanism based on actual throughput is appropriate, provided the trigger mechanism does not have an adverse effect on AlintaGas' incentives to increase network usage.

In view of the significantly different markets serviced by the various Reference Services and the likelihood of forecast growth in gas quantities varying significantly between those Reference Services, it may be appropriate that in addition a review is triggered in response to increases in quantities for specific Reference Services. Given that the market growth for Reference Service B3 can reasonably be expected to be proportionately greater than other Reference Services, Reference Service B3 appears to be one service for which an individual trigger may be appropriate. It is considered, however, that the proposed trigger of 50% of the forecast increase could be easily achieved in the case of Reference Service B3, which may create a disincentive for AlintaGas' to grow that part of the market. A trigger substantially higher than the general trigger may need to be set for the Reference Service B3 if this approach is accepted.

In addition you may wish to consider whether the general trigger - 50% of the forecast increase, is set at a level sufficiently high to retain AlintaGas' incentives to grow the throughput of the distribution system for the long-term benefits of its customers.

The OOE notes that both the ACCC (in its Draft Decision on the Central West Pipeline (NSW)) and IPART (in its Draft Decision on the AGL's gas network (NSW)) have required trigger mechanisms based on throughput volumes. Both regulators have required the respective Access Arrangements to be reviewed, if, in any one year, contract market volume forecasts on which reference tariffs are based proved to be more than 25% inaccurate. The

IPART considers that this mechanism leaves sufficient incentive for AGL to grow the NSW gas market in the Access Arrangement period.

9. Quantity Forecast

In its 5 August 1999 submission on the Access Arrangement the OOE considered that the Regulator would need to be satisfied as to the validity of the volume forecasts. It may be that the decrease in volume indicates customers being lost to by-pass. One reason for this happening could lie in inefficient distribution pricing.

The Draft Decision states that you did not undertake a detailed review of quantity forecasts. While the absence of growth for the services may arise from practices of distribution pricing and consequent by-pass, you regarded this to be a commercial matter for AlintaGas and not of direct relevance to the assessment of the Access Arrangement.

In relation to this matter I would like to draw to your attention some of the factors that the Regulator needs to consider in assessing a proposed Access Arrangement. Firstly, one of the factors about which the Regulator must be satisfied in determining to approve a Reference Tariff and Reference Tariff Policy is that any forecasts required in setting the Reference Tariff represent best estimates arrived at on a reasonable basis. Secondly, one of the factors that should be considered in establishing the Initial Capital Base for a pipeline is the comparability with the cost structure of new pipelines that may compete with the pipeline in question (for example, a pipeline that may by-pass some or all of the pipeline in question). In addition, for example, the Code requires that the Depreciation Schedule should be designed so as to result in the Reference Tariff changing over time in a manner that is consistent with the efficient growth of the market for the Services provided by the pipeline. It is requested that you give further consideration to the matter of volume forecasts and efficient distribution pricing in respect of Reference Services A and B1.

10. Retail Margins for Reference Services B2 and B3 (Amendment 39)

In its 5 August 1999 submission on the proposed Access Arrangement the OOE alerted you to the Western Australian Government's policy of allowing a limited increase in the delivered residential tariffs as being aimed at ensuring that all residential customers become and stay profitable, and therefore at ensuring that retail competition is viable in respect to those customers.

That submission also referred to section 38 of the *Gas Pipelines Access (WA) Act 1998* (the Act) which 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.

You have interpreted the obligations of section 38 of the Act as requiring that the level and structure of distribution tariffs for Reference Services B2 and B3 are consistent with a retail margin in the supply of gas that is sufficiently large to enable gas traders to enter the market for gas supply to small-business and residential customers. The OOE considers that this is consistent with the original intent of section 38.

Further, you have concluded that the level and structure of the distribution tariffs proposed by AlintaGas would have the effect of reducing retail margins. In reducing some retail margins,

AlintaGas has implicitly assumed a shift in revenue from the AlintaGas retail business to the AlintaGas distribution business. You regarded the extent of this shift in revenue, and the consequent decline in retail margins, to be unreasonable.

Given the above, you have revised the assumptions as to retail margins to provide for minimum retail margins of 2.0 percent for each service, consistent with ranges of observed retail margins in gas and electricity distribution businesses in NSW.

As part of your Draft Decision you required that Clause 24 of the Access Arrangement be amended to provide a tariff structure for Reference Service B3 that makes provision for reasonable retail margins for a User providing gas to residential end users of gas, both in total for any residential end user and for any gas-quantity block. You also noted that whilst regulated retail prices for gas remain in force, the retail margins and consequences for contestability and competition in the retail gas markets will be an ongoing matter of concern in the regulation of distribution tariffs, and in any reviews of the Access Arrangement.

It is understood that you required that the above amendment be based on the consideration that the low and/or negative retail margins for certain gas-quantity blocks in the supply of gas to residential customers under Reference Service B3 would impede the development and continuation of effective competition in the supply of natural gas to these customers, particularly for large residential customers consuming more than 45 GJ/year.

The Draft Decision discussed retail margins in terms of net and gross retail margins, defined as follows:

- *Gross retail margin* – the margin on gas sales before interest, tax and retail costs, but after all other costs.
- *Net retail margin* – the margin on gas sales before interest and tax, but after all other costs (including retail costs) have been accounted for.

It is noted from your Draft Decision that while [gross] retail margins are relatively high for the first 15 GJ per annum delivered to a Reference Service B3 customer (gross retail margin of 22 percent), lower [gross] retail margins apply to subsequent gas quantity blocks. The total gross retail margin for a customer declines with increasing gas consumption by that customer, becoming negative for gas consumption of greater than 100 GJ/year.

The analysis presented in the Draft Decision in respect of the gross retail margins may be relevant in providing a useful indication whether retail margins for the customers consuming a reasonable quantity of gas per annum are reasonable. However, it is considered that the analysis does not sufficiently address the reasonableness of the retail margins for customers with a relatively low annual gas consumption. An analysis conducted by the OOE indicates that while gross retail margins are relatively high for this group of customers, net retail margins are negative for customers using less than around 11 GJ per annum. The OOE analysis assumed fixed annual retail costs of \$50 per customer, which is considered conservative compared with the \$80 for such costs quoted elsewhere in relation to utilities similar to AlintaGas. The retail costs would need to be as low as \$25 per customer in order for the net retail margin for 5 GJ per annum customers to be zero and not negative.

In the light of the above analysis it may not be practicable to restructure the Reference Tariff B3 in a way that provides for the very low usage customers to have positive net retail margins.

However, the OOE supports the creation of positive net retail margins for, and making viable retail competition to, as many Reference Service B3 customers as is practicable. It is expected that AlintaGas should be able to restructure its Reference Tariff B3 in a manner which produces equitable and reasonable retail margins for as wide a group of such customers as is practicable. This should be able to be achieved without further affecting the financial position of AlintaGas ie in a manner which has a neutral effect on AlintaGas' Initial Capital Base or total distribution revenue.

11. Regulatory Approval of Changes to Reference Tariffs (Amendment 40)

As part of your Draft Decision you required that Clause 1 of Schedule 2 and Clause 2 of Schedule 3 of the Access Arrangement be amended to make variations to Reference Tariffs and the pass through of changes in taxation and regulation subject to the approval of the Regulator.

Consistent with related comments in the OOE's 5 August 1999 submission the OOE agrees that variations to Reference Tariffs (or "re-balancing" of Reference Tariffs) and the pass through of changes in taxation and regulation should be subject to the approval of the Regulator. The OOE also considers that the required amendment is consistent with the intent of the Code.

When read in isolation the above amendment may be taken to read that Regulator's approval would also need to be obtained before each annual CPI-X change of Reference Tariffs. It is suggested that the above amendment should be read in conjunction with Amendment 43 in the Draft Decision removing provisions in the Access Arrangement for re-balancing of Reference Tariffs and implementing a price-cap mechanism for the variation of Reference Tariffs.

A concern with Amendment 40 may be that it could give the Regulator considerable discretion to trigger a full review of the Access Arrangement and bring the current Access Arrangement Period to a premature end. The currently proposed Access Arrangement Period of approximately 5 years appears to balance the interests of AlintaGas in regulatory and business certainty with the interests of users in ensuring appropriate regulatory oversight.

It is noted however that you consider that Schedule 3 should make provision for the Regulator to seek public submissions on any proposed change statement submitted by AlintaGas, where the Regulator believes it is necessary to do so. The OOE considers that it is possible to conduct limited reviews (with limited public consultation) of the Access Arrangement solely for the purpose of variations to Reference Tariffs or the pass through of changes in taxation and regulation. Restricting the reviews to those specific matters would reduce regulatory risk and increase business certainty. It would also help restrain regulatory cost to an efficient level.

12. Ring Fencing

You Draft Decision notes that once AlintaGas becomes subject to the ring fencing provisions of the Code, contractual arrangements between the distribution and trading businesses of

AlintaGas for gas distribution in the AlintaGas network will comprise Associate Contracts within the meaning of part 7 of the Code. The Regulator's approval of an Associate Contract is required before such a contract comes into effect.

It is noted that it is possible for contractual arrangements between the distribution and trading businesses of AlintaGas to comprise Associate Contracts within the meaning of part 7 of the Code before AlintaGas becomes subject to the ring fencing provisions of the Code by virtue of the amendments to the *Gas Pipelines Access (WA) Act 1998* implemented through the *Gas Corporation (Business Disposal) Act 1999*. Therefore, a Regulatory approval of such arrangements may be required before that time.

Yours sincerely

VINCE WALSH
ACTING COORDINATOR OF ENERGY

5 May 2000

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