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Dear Dr Michael

**DRAFT DECISION: ACCESS ARRANGEMENT FOR THE ALINTAGAS MID  
AND SOUTH WEST DISTRIBUTION NETWORK**

Western Power offers the following comments on the Draft Decision for the above Access Arrangements.

**1. AMENDMENT 12 – FIXED CHARGES WAIVED IN FORCE MAJEURE**

Amendment 12 requires that for the duration of a force majeure event, Reference Tariff fixed charges relating to a Reference Service must be waived. This requirement could be considered to be unduly harsh and does not appear to recognise the nature of the Service Provider's cost structure.

It is evident that the majority of costs, incurred by a Service Provider in supplying a given level of service capacity to meet Users' requirements, are fixed. These costs must be met irrespective of the actual level of capacity utilisation. During a force majeure event, which by definition is outside of a party's control, the level of capacity utilisation will tend to towards zero. However, there is no corresponding reduction in capacity costs – they must still be met by the Service Provider.

In force majeure circumstances where Reference Tariff fixed charges paid by Users are waived, there is a potential for a mismatch to occur between a Service Provider's revenues and expenditures. In effect, under these conditions force majeure risk relating to the distribution networks has been allocated to the Service Provider, presumably on the basis that the Service Provider is better able to manage that risk. However, this assumption is difficult to sustain in practice and its intuitive underpinning is also open to debate.

Disallowing a Service Provider from recovering fixed charges during force majeure events also gives rise to questions of equity. On this basis, and in view of the issues raised above, there is an argument that distribution network force majeure risk should be allocated to Users as well as to the Service Provider. In terms of fixed costs recovery, this suggests that a percentage of the fixed charges inherent in a Reference Service should be paid by Users for the duration of a force majeure event. Ultimately, the quantum of the percentage is a matter of judgement. In Western Power's view, a percentage value of 50% is reasonable.

## **2. AMENDMENT 43 - IMPLEMENT PRICE CAP MECHANISM AND REMOVE REFERENCE TARIFF REBALANCING PROVISIONS**

### **2.1 *Tariff Re-balancing***

The Draft Decision acknowledges the benefits of Average Revenue Yield regulation. It also concludes, on balance, that these benefits are outweighed by the potential for AlintaGas to pursue strategic pricing (ie. “game”) of distribution services that may impede the introduction and maintenance of competition into the retail gas market.

Opportunities to engage in strategic pricing can occur either when distribution tariffs are determined at the start of the regulatory period or annually through the tariff re-balancing process.

In Western Power's view, the ability to game the initial tariffs has been effectively prevented by the Draft Decision requirement to set distribution reference tariffs to allow for a 2% retail margin in all customer classes across all consumption blocks. Further, the capacity to game tariffs through annual tariff re-balancing is limited by the side constraints on price movements (ie. Y control), threat of bypass and asset write-downs. Moreover, the side constraints can be set to allow any desired level of flexibility in this re-balancing.

In the Draft Decision, it is suggested that the opportunity to engage in tariff gaming would be reduced by dropping Average Revenue Yield regulation in favour of Tariff Basket/Price Cap regulation. Under the latter regulatory regime, the Regulator would oversee any tariff re-balancing. However, the significant benefits of Average Revenue Yield regulation would be lost.

In Western Power's view, the most important feature of Average Revenue Yield regulation is the incentive to improve network utilisation resulting in the long-term benefit of lower network prices for all customers. Further, it is suggested that the issue of tariff re-balancing, and the extent to which it is desirable, can be separated from the question of which regulatory approach delivers the best outcomes for all industry participants. For example, an Average Revenue Yield regime could be implemented with no re-balancing (by setting Y equal to negative X) or unlimited re-balancing (Y uncapped) or anything in between.

However, if there is a resolute view that the Service Provider may engage in gaming and set inefficient prices, then there is scope to retain Average Revenue Yield regulation by restricting the application of the re-balancing mechanism or removing it altogether. This could include the requirement, as suggested in the Draft Decision, that any tariff re-balancing be fully scrutinised by the Regulator. This option would allow some of the benefits of Average Revenue Regulation to be retained, while meeting the Regulator's concerns regarding tariff re-balancing.

Overall, in Western Power's view there does not appear to be a strong case, based on tariff re-balancing considerations, that would favour Price Cap/Tariff Basket over Average Revenue Yield.

## **2.2     *Advantages of Average Revenue Yield***

Western Power submits that the key distinguishing feature of Average Revenue Yield, as opposed to Tariff Basket/Price Cap, is the incentive for the Service Provider to improve returns to the business through the efficient use and growth of the distribution network (and not the ability to re-balance tariffs without regulatory oversight). For example, under Price Cap/Tariff Basket, incremental revenue is related to the average cost of supply of each tariff class whereas, under Average Revenue Yield, incremental revenue is related to the average cost of supply for all tariff classes. This means that in comparison with Price Cap/Tariff Basket, Average Revenue Yield incorporates a stronger incentive to grow off-peak throughput and a weaker incentive to grow peak load.

More specifically, Price Cap/Tariff Basket provides a relatively homogenous incentive to grow load across all tariff classes that will likely result in the Service Provider adding more capacity to meet peak load growth. In contrast, Average Revenue Yield encourages the Service Provider to develop alternative and innovative solutions to meet peak load growth. In effect, under Revenue Yield, Service Providers have stronger incentives to improve asset utilisation.

Another concern about Price Cap/Tariff Basket regulation relates to the requirement for setting efficient incentive levels on a tariff basis. In Western Power's view, because network business costs are characterised by a high degree of common costs it is difficult to determine the actual cost of supply of a tariff class. It follows that it would also be difficult to assess what level incentives are efficient and equitable for each tariff class. This issue does not arise under Average Revenue Yield regulation.

Western Power urges the Regulator to reconsider the decision to drop Average Revenue Yield in favour of Price Cap/Tariff Basket. Western Power believes that Average Revenue Yield provides simple, well understood (by Service Provider, Regulator and Government) incentives, namely to maximise off-peak throughput and so improve asset utilisation which will benefit all customers through lower prices in the longer term.

## **3.     **AMENDMENT 44 - X FACTOR EFFICIENCY GAINS****

The Draft Decision notes that the X factor calculation methodology, used by AlintaGas, reflects efficiency gains and falling unit costs that are already incorporated into the cost forecasts underpinning the tariff calculations. It is also stated that the Regulator, prior to issuing the Final Decision on the AlintaGas Access Arrangement, will consider whether an additional incentive for efficiency gains is warranted.

In order to objectively assess the potential for efficiency improvements in the distribution networks, Western Power suggests that there may be merit in benchmarking performance levels. In particular, it may be useful to review recent trends in productivity performance levels and establish the current level of productivity for the distribution networks. This data could then be matched up with an assessment of best practice productivity levels to determine the potential for efficiency improvement, given the characteristics of the AlintaGas distribution networks.

One way to assess productivity performance is through undertaking a review of total factor productivity for the distribution networks. Data Envelope Analysis, based on performance data for networks with reasonably similar characteristics, could be used to establish best practice levels.

In Western Power's view, this type of information would provide both a rigorous and defensible basis on which to consider the quantum of any additional efficiency incentives that could be included in setting the X factor.

I trust these comments are useful in OffGAR's deliberation process.

Yours sincerely

**N NINKOV**  
**GENERAL MANAGER**  
**CORPORATE STRATEGY**