Issues Paper on Proposed Revisions to the Dampier to Bunbury Natural Gas Pipeline Access Arrangement 2016-2020

Alinta Energy

Submission

2 June 2015

1 Introduction

Alinta Sales Pty Ltd (**Alinta**) is pleased to provide comment on the *Issues Paper on Proposed Revisions to the Dampier to Bunbury Natural Gas Pipeline Access Arrangement 2016-2020* (**Issues Paper**) prepared by the Economic Regulation Authority (**Authority**). The Issues Paper raises the key points in the proposed revised *Access Arrangement for the Dampier to Bunbury Natural Gas Pipeline* (**AA4**) offered by DBNGP (WA) Transmission Pty Limited (**DBP**) and covering the five year period from 1 January 2016 to 31 December 2020.

Alinta is a major shipper on the Dampier to Bunbury Natural Gas Pipeline (**Network**) and supplies gas to approximately 640,000 residential, business and commercial and industrial customers in Western Australia.

2 Executive Summary

Alinta has identified a number of concerns with the proposal submitted by DBP and recommends that the Authority:

- Determines whether DBP's proposed post-tax nominal rate of return of 8.36% would be commensurate with the efficient financing costs of a benchmark efficient entity with a similar degree of risk as DBP, particularly with respect to the proposed return on equity of 11.71%, in light of the recent *Draft Decision on Proposed Revisions to the Access Arrangement for the Mid-West and South-West Gas Distribution System* (**ATCO Draft Decision**);
- Assesses the impact on shippers, retailers and ultimately end use customers of any price volatility that is introduced by DBP's proposal, particularly with respect to the proposed annual updates to the return on debt and the associated new tariff variation mechanism;
- Considers allowing the debt risk premium to be fixed for a longer period to allow certainty for investors and consumers and ensure consistency with the recent ATCO Draft Decision; and
- Considers the appropriateness of including provisions for a formal gas trading market at this time.

These issues are discussed further in the sections below.

3 Background

3.1 Rate of return and importance of continuing investment in gas infrastructure

Alinta requests the Authority consider whether DBP's proposed post-tax nominal rate of return of 8.36% would be commensurate with the efficient financing costs of a benchmark entity with a similar degree of risk as DBP. In particular, Alinta recommends that the Authority considers the appropriateness of DBP's proposed return on equity in light of the recent ATCO Draft Decision.

However, in making its decision, Alinta notes the importance of the Authority achieving an appropriate balance between the price paid by end use customers in the immediate access period and the incentive for infrastructure investors to continue to invest in Western Australian gas infrastructure which benefits all current and potential gas consumers in the medium to long term.

To ensure AA4 provides appropriate incentives for ongoing investment, the Authority must provide a reasonable rate of return commensurate with similar businesses nationally and internationally, as well as ensuring all reasonable capital and operating costs are covered.

4 Pricing

4.1 The impact of price volatility on customers

In an environment where retailers are able to pass through network (transmission and distribution) cost increases, Alinta notes DBP's proposed AA4 will result in an increased price volatility which will ultimately be worn by end consumers. This is due to the proposed annual setting of the debt risk premium, resulting in price volatility year on year.

This issue is discussed in detail in section 5 below. However it is important the Authority, when considering these matters, assesses the overall impact of price volatility on end use consumers, including:

- Retailers often provide customers, particularly small business customers which tend to contract for up to 3 years, with a bundled retail price which the consumer can then rely on for budgeting purposes. If network prices are volatile the only way retailers can offer such a product is by adding a risk premium. Alternatively, contracts can have a network pass-through clause which allows retailers to pass through the impact of network cost changes – effectively passing on the volatility to customers[1]; and

- Price volatility can make it more challenging for consumers to make a choice between gas retailers. When comparing gas retail offers a consumer needs certainty about price. Where prices are changing regularly this can make it more difficult, particularly where retailers are not aligned on the pass-through of network cost changes.

Alinta therefore requests the Authority take into account the detrimental impact on customers of price volatility when assessing DBP's AA4. Alinta acknowledges that the majority of

[1] Alinta also notes that there is an added complexity with passing network costs through to customers as a result of the current tariff setting arrangements. Further details of these specific concerns are available in Alinta's submission on the Issues Paper published by the Authority for the recent ATCO access arrangement: **https://www.erawa.com.au/gas/gas-access/mid-west-and-south-west-gas-distribution-systems/access-arrangements/proposed-access-arrangement-for-period-2014-2019/public-submissions**

shippers have contracted a negotiated tariff directly with DBP, however as AA4 provides a default arrangement for accessing DBP's network to transport gas, it is appropriate that unnecessary price volatility is not introduced.

It is Alinta's preference that AA4 ensures a smooth price path for DBP to limit any price volatility.

5 DBP's Total Revenue Proposal

5.1 Price volatility caused by annual changes to the debt risk premium

In its accompanying Access Arrangement Information, DBP explains[2] that it has departed from the Authority's *Rate of Return Guidelines* (**Guidelines**) in relation to the estimation of the cost of debt. DBP notes that this departure is almost identical to that made recently by the Authority in its recent ATCO Draft Decision. The key difference appears to be the adoption of a ten-year term for debt rather than a five-year return. DBP considers that the Authority's use of a five-year risk-free rate is inappropriate because standard regulatory and commercial practice is to use a ten-year rate.

DBP also departs from the Authority's annual updating approach for ease of practical implementation. Instead, DBP generally[3] adopts an annual updating approach based on that outlined by the Australian Economic Regulator (**AER**) in its *Rate of Return Guideline* published in 2013. Overall, the DBP considers this approach better aligns with the efficiency criteria than the Authority's approach.

Alinta believes it is important to consider the impact on customers of regulated assets when determining the rate of return to apply during an access period. Network customers such as Alinta require price certainty to minimise financial risks when entering into energy contracts with end use customers. In addition, end use customers benefit from price certainty.

Greater volatility in the debt risk premium will flow through to end use customers via higher and potentially more volatile prices. It is not in the best interests of end use customers to be subject to tariffs that vary significantly year on year. Without certainty, the only way to manage this risk is by passing it on to end use customers via higher overall energy prices as outlined in section 4 above.

Given the significant value that investors and end use customers place on price certainty, Alinta considers that the Authority should allow the debt risk premium to be fixed for a longer period than outlined in the Guidelines to allow certainty for investors and end use customers and ensure continual investment in gas infrastructure. Alinta notes that this would ensure consistency with the Authority's decision to allow the debt risk premium to be fixed for ten years in the ATCO Draft Decision.

Alinta is concerned that DBP's proposed approach of annually updating the return on debt within the access period, which is based on the approach recommended by the AER[4], may result in volatility for end use customers. Any great volatility that is caused by enabling

[2] Access Arrangement Information, Page 20
[3] The only variant is to adopt a weighted trailing average approach to the treatment of each block of capital (resulting in essentially a ten year transition period applying to each block of capital). This is marginally more complex than that adopted by the AER but is easily implemented by a spread sheet model.
[4] Alinta notes that under the AER's trailing average approach one tenth of the return on debt is rolled over every year. This differs to the Authority's approach where no updating is completed within the access period.

annual updates to the return on debt will ultimately flow through to end use customers via higher and potentially more volatile prices.

Alinta supports the Authority in considering whether DBP's proposed annual update of the return on debt within the access period would ensure volatility is not inappropriately imported into prices while maintaining sufficient incentives for DBP to invest on the basis of a chosen prudent debt risk management strategy.

6 Reference Tariffs

6.1 Tariff variation mechanism

Related to the DBP's proposed approach of annually updating the return on debt is the proposed introduction of an additional tariff variation mechanism - the Trailing Average Cost of Debt Annual Update Variation (**Variation**). In particular, Alinta understands that the intention of this new variation mechanism is to provide the means by which any changes in the return on debt can be passed through to end use customers within the access period.

Alinta notes that the appropriateness of the proposed Variation will be ultimately dependent on the Authority's decision regarding the inclusion of an annual update of the return on debt within the access period. As stated above, Alinta does not support annual variations which create price uncertainty and risk for retailers and therefore customers.

7 Other Access Arrangement Provisions

7.1 Amendments to capacity trading requirements

Alinta does not support provisions being made in AA4 for a formal gas capacity trading market. There are no known plans for the implementation of a formal compulsory trading market in the near term and so the proposed provisions are purely speculative at this time. Alinta considers it would be more appropriate to use the cost pass through mechanism contained within AA4 if a market is implemented in the future.