

Economic Regulation Authority
Level 4, Albert Facey House
469 Wellington Street
Perth WA 6000

30 March 2020

Re: Wesfarmers Chemicals, Energy & Fertilisers submission on the proposed Dampier to Bunbury Natural Gas Pipeline Access Arrangement (2021-2025).

Dear Sir/Madam,

Wesfarmers Chemicals, Energy and Fertilisers (“WesCEF”) is a division of Wesfarmers Limited. Its subsidiaries, Wesfarmers Energy (Gas Sales) Limited and CSBP Limited, purchase and transport natural gas for the manufacture of LNG, LPG, Ammonia and Sodium Cyanide, and for the on-sale to commercial, industrial, small-to-medium-enterprise and residential customers in Western Australia. WesCEF holds its transportation agreements with the group of companies that own and operate the DBNGP, now collectively called Australian Gas Infrastructure Group (“AGIG”) through the following entities:

- CSBP Limited;
- Wesfarmers Gas Limited; and
- Wesfarmers Energy (Gas Sales) Limited.

In total WesCEF purchases and transports approximately 73 TJ/day for its operations.

WesCEF appreciates the opportunity to comment on the proposed Dampier to Bunbury Natural Gas Pipeline (“DBNGP”) 2021-2025 Access Arrangement (“AA5”). WesCEF notes that the Economic Regulation Authority (“ERA”) must apply the provisions of the National Gas Law (“NGL”) and National Gas Rules (“NGR”). In particular, the ERA must:

- Ensure that AA5 is consistent with the National Gas Objective¹ – ie that it promotes “efficient investment in, and efficient operation and use of, natural gas services for the long term interests of consumers of natural gas with respect

¹ Rule 100 National Gas Rules

- to price, quality, safety, reliability and security of supply of natural gas”.
- take into account the revenue and pricing principles when exercising its discretion in approving or making those parts of AA5 relating to a reference tariff². These principles include that:
 - a reference tariff should allow for a return commensurate with the regulatory and commercial risks involved in providing the reference service to which that tariff relates; and
 - the efficient provision of pipeline services.

Although WesCEF is concerned with AGIG’s proposed AA5 and the impact it has on the reference tariffs being proposed, it is understood that AGIG should achieve adequate returns but in an efficient and cost reflective manner with appropriate risk allocation.

WesCEF agrees with AGIG that the energy landscape is changing very quickly in Western Australia, but mainly as renewable electricity sources are impacting the traditional power generation mix and in turn, the way the DBNGP pipeline is being used and operated. Generally, WesCEF believes that natural gas, and therefore natural gas transmission and storage, will have a growing role to play in the long term strategic orientation of the State’s energy needs and decarbonisation targets. WesCEF’s view is supported on a number of fronts, including the ongoing development of additional gas fields whose gas is to be processed using infrastructure that is already connected to the DBNGP and also recent comments by government. As an example, on 31 January 2020, the Prime Minister of Australia stated that:

There is no credible plan to lower emissions and keep electricity price[s] down that does not involve the greater use of gas as an important transition fuel³

WesCEF also believes that these dynamics will cause more volatility in intra-day gas demand (and therefore pipeline utilisation) and are likely to reduce our ability to look at the past to determine the future, in terms of pipeline operations and costs (both operational and capital expenditure).

In these circumstances, WesCEF has structured its submission to share its views on four key issues which are that:

1. pricing the risk that the pipeline’s long term role in Western Australia’s energy landscape into the total revenue and tariff calculations in AA5 through a reduction in the standard asset lives (and therefore accelerating the depreciation schedule used in the total revenue calculation) seems premature and would not

² Section 28(2)(a) NGL

³ <https://www.pm.gov.au/media/nsw-energy-deal-reduce-power-prices-and-emissions>

- 
- appear to be consistent with the depreciation criteria required by the NGR;
2. the tariff structure for transportation should more closely reflect the variability of use of pipeline services and the variability in the costs likely to be incurred by the service provider;
 3. the future volatility will likely spark increased requirements for spot supply of transport instead of the historical reliance on firm gas transportation services; and
 4. the lowered average demand for transport services should be a driver of increased cost scrutiny.

Economic life of the pipeline (Issue 2)

- a) WesCEF believes there is too much uncertainty to consider changing the standard asset lives (and therefore accelerating the depreciation schedule used in the total revenue calculation) in AA5. AGIG has fairly described a future where renewables and hydrogen take a growing share of supply of the State's energy requirements. WesCEF recognises that AGIG has adequately assessed cases of slower or faster penetration of these technologies. Equally though, and simply by way of an example, an outlook of WA's energy landscape could include other prevailing technologies or simply sharing with those technologies suggested by AGIG such as the large-scale development of carbon capture and storage capability which would, in this case, have the effect of significantly altering AGIG's view of the DBNGP's economic life. Furthermore, there is nothing to suggest that the DBNGP would not be a key asset involved in a future state involving hydrogen.

Any proposal to shorten the economic life of the DBNGP and therefore reduce the standard asset lives to be used in deriving the depreciation schedule such that the lives are shorter than the intended technical lives of the assets, rests substantially on forecasts as to likely future outcomes. In this regard, the NGR requires that forecasts or estimates "must be arrived at on a reasonable basis and must represent the best forecast or estimate possible"⁴.

In WesCEF's view, the above reasonable, but contrasting, future scenarios highlights the degree of uncertainty about AGIG's forecast and estimate of the remaining economic life of the DBNGP and therefore of the asset lives to be used in determining the depreciation schedule.

WesCEF considers that this shows there is insufficient evidence to reasonably

⁴ Rule 36A(2)(c) NGR

conclude that these issues will, or are reasonably likely to, result in the utilisation of the DBNGP declining significantly such that it will cease being utilized before the technical lives of the assets that make up the DBNGP. The assumption that the above issues have reduced the expected economic life of the DBNGP is therefore, at best, speculative at this point in time and has not been adequately established by evidence-based forecasts.

Furthermore, the cost to users and AGIG of delaying such a decision to shorten asset lives for depreciation purposes to 2026-30 (ie in AA6) or beyond to make a more informed decision has not been considered by AGIG.

It is also important to note that the NGR requires the depreciation schedule to lead to tariffs varying, over time, in a way that promotes efficient growth in the market for reference services⁵. WesCEF has not been able to find any evidence in AGIG's proposal or its supporting submissions to the effect that the acceleration of depreciation resulting from the proposed shorter standard asset lives and the consequent increase in reference tariffs that would occur would result in reference tariffs for the DBNGP being set in a way that promotes the efficient growth in the market for pipeline services during AA5. To the extent that the asset lives being proposed do not reflect the expected economic life of the DBNGP (which is WesCEF's view as highlighted above), the resultant reference tariffs are being set at a level that is above the efficient cost for providing reference tariffs in the access arrangement period. It follows therefore that these inefficient tariffs could potentially result in inefficient utilisation, investment and asset management incentives.

In light of the above, WesCEF is currently of the view that AGIG's proposed asset lives and therefore its proposed depreciation schedule used to determine the total revenue in AA5 would result in a depreciation schedule which does not meet the depreciation criteria required by the NGR⁶ nor could it be said that it complies with the National Gas Objective.

- b) Even if AGIG is able to provide evidence based forecasts that lead to a conclusion that there is likely to be a shorter economic life for the DBNGP and therefore a shortening of asset lives used in the depreciation schedule for AA5 such that the reference tariffs in AA5 are set at an efficient level, WesCEF questions AGIG's submission that the depreciation schedule should be set such that the pipeline should be *fully* depreciated in anticipation of (indirect) competition. Private

⁵ Rule 89(1)(a) NGR

⁶ Rule 89(1)(a)-(c) NGR

industry is commonly making investment decisions on a horizon of 20, if not 40, years in the case of the oil and gas industry. WesCEF does not believe that it is reasonable to aim for a full depreciation of the pipeline when determining the economic life of the asset as it causes an unfair contribution by users towards the de-risking of this asset.

It is not the case that the NGL or NGR require that the total revenue and reference tariffs be set so as to guarantee the service provider a return on and return of its capital investment. To the contrary, the NGL provides that the “service provider should [only] be provided with a reasonable opportunity to recover at least the efficient costs the service provider incurs in providing reference services”.⁷ Consistent with this, rule 85(3) also notes that, in the case of capital redundancy, costs may be shared with, not transferred to, the users.

Tariff structure (Issues 2 and 4)

- a) WesCEF notes the rising concern of AGIG to meet increasingly volatile gas transport requirements of the power generation industry as a result of the fast and large penetration of renewable electricity generation in the SWIS and other electricity networks of Western Australia. AGIG notes in its proposed AA5 that “peaks and troughs in renewable electricity supplies are already affecting the way [AGIG] operates the pipeline with a growing divergence between nominations and actual use of [AGIG’s] services”. AGIG’s lowering demand forecast has prompted the ERA to question: “should a mechanism be added to the Access Arrangement to provide for the redundancy of assets in the future if demand falls away?”

In WesCEF’s view, this gives rise to two additional distinct issues relating to the tariff structure.

Firstly, whether the reference tariffs are compliant with Rule 95 of the NGR and secondly, whether all of the total revenue and therefore costs, should continue to be recovered solely from the reference service tariffs. In WesCEF’s view, the evidence suggests that AGIG has not adequately demonstrated either issue such that its proposal in AA5 complies with the requirements of the NGL and NGR.

WesCEF understands that whilst demand has continued to reduce, the pipeline’s current capacity remains necessary to meet gas transportation requirements (covering full haul, back haul and part haul) on some days. Indeed, AGIG notes that, “while all of the physical assets associated with the pipeline are still required,

⁷ Section 24(2)(a) NGL



they are not required for as long as they were previously”. WesCEF is concerned with the growing inadequacy of the current pipeline tariff structure (and that being proposed in AA5) to meet the requirements of the NGR in relation to both the allocation of total revenue and costs (Rule 93) and the setting of tariffs for transmission pipelines (Rule 95).

Turning to the first issue raised above, traditional industrial, commercial and residential users of gas have not changed the nature nor the profile of their consumption. Therefore the costs involved in the provision of each service to this class of user has not changed. However, a new class of user has evolved for each type of service over recent years – the user involved in the generation of electricity. Given the level of contracted capacity has reduced significantly, but the cost base of the DBNGP is not proposed to be reduced, it would appear that significantly more costs are required to provide a service to this distinct class of user.

Yet, based on the way in which total revenue (and costs) are proposed to be allocated under AA5 and also the structure of the reference tariffs being proposed, the same tariff structure is being proposed for two distinctly different classes of users of the services. The class of users who use the service for electricity generation have, and are continuing to use the service in a way that gives rise to costs that would not be incurred by the service provider were all users of the class of industrial, commercial and residential users. But, according to AGIG under its proposal, this class of users is now expected to contribute to the costs associated with changes to the electricity sector. WesCEF believes that the cost of this increased need for gas flexibility should at least be differentiated amongst the different classes of users of the service on the pipeline.

To adopt this approach would be consistent with the requirements of Rule 95 of the NGR. WesCEF trusts that the ERA and the appropriate electricity market operator would recognise this cost and allow for it to be efficiently passed through into downstream electricity markets or tariffication, where appropriate.

Turning to the second issue raised above, WesCEF also encourages the ERA to investigate further whether the tariff structure is consistent with Rule 93 of the NGR. This is because in the proposed AA5, AGIG is seeking to recover all of the total revenue from reference services in circumstances where the pipeline’s capacity utilisation for AA5 is forecast to be significantly less than what it has been in the past. Rule 93(1) of the NGR requires total revenue to be allocated between reference and other services in the ratio in which costs are allocated between such services. Rule 93(2) then provides that costs are to be allocated so that costs directly attributable to reference services are allocated to those services. It is not

clear to WesCEF how, with capacity utilisation for AA5 being forecast to be much less, all of AGIG's costs should continue to be allocated to the reference services.

Furthermore, AGIG itself has recognised non-reference service revenues of two to five per cent of its total revenues in the last three years. ERA's AA4 decision reported that non-reference services represented four per cent of the service provider's revenues in FY2014/15⁸. WesCEF holds the view that the non-reference revenues have consistently been considered to be variable or uncertain in nature but that these revenues have nonetheless appeared to exist across the last two Access Arrangements. In these circumstances, WesCEF believes costs should be allocated to these services under Rule 93(2) of the NGR, or that a rebate mechanism applies to these services in accordance with Rule 93(3) of the NGR⁹.

Further issues about cost allocation between services arise in relation to WesCEF's position below, with regard to the use of the Spot Service. This is the case regardless of whether the Spot Service should or should not be a reference service.

- b) WesCEF observes AGIG's assumption that System Usage Gas ("SUG") is the only variable cost attributable to the Commodity portion of the tariff. This assertion should be tested including whether or not there are rotating equipment costs, both capex and opex, that are determined as a function of the throughput in the pipeline. WesCEF has identified the following variability in AGIG's costs:
- ***Turbine and GEA overhauls:*** AGIG notes that these costs are a function of unit run hours. These costs were predicted to be \$33 million in AA4. They will actually result in a total of \$24 million on the basis of lower run hours, themselves, a function of the throughput in the DBNGP.
 - ***Compressor stations:*** AGIG notes that these assets are "run based on the requirements of our customers and must be ramped up or down quickly to meet these needs". The ERA had concluded in its technical paper on short run marginal costs in the electricity industry¹⁰ that "where output causes a costly deterioration of equipment, wear and tear can be thought of as a productive input, and thus can be described by an input-output curve similar to that of fuel."

⁸ Final Decision on Proposed Revisions to the Access Arrangement for the Dampier to Bunbury Natural Gas Pipeline 2016-2020, page 245.

⁹ WesCEF notes that the ERA had considered the rebate mechanism in AA3 to accommodate the uncertainty of DBP's future non-reference revenues in its Draft Decision. The ERA had proposed at the time, that these services be provided at the commodity charge, representative of an efficient cost, and that 80% of the value of the revenue be rebated.

¹⁰ Portfolio Short Run Marginal Cost of Electricity Supply in Half Hour Trading Intervals Technical Paper Author: Adam McHugh, 11 January 2008.

WesCEF believes the large deviation between actual and forecasted costs of maintenance of the items listed above highlights the need to reflect this variable cost back to AGIG's customers.

Regulation of the Spot Capacity Service (Issues 4, 9 and 12)

- a) WesCEF understands that shippers use the Spot Capacity Service as a way to adjust their daily gas transport requirements and/or hedge against the risk that their actual gas demand deviates from their forecast. AGIG has tested this service against the reference service factors in the NGR to conclude that this service was (a) in low demand in the current period, and (b) substitutable to the extent that capacity swaps may be entered into between the shippers. WesCEF believes that the forecast presented in its plan is likely to change the conclusions of this assessment.
- **Increased future demand:** WesCEF has observed a significant increase in bidding activity on this service in the past twelve months and in parallel, a reduced availability of this service. Going forward, WesCEF notes that AGIG plans a strong reduction in the difference between the contracted capacity and the expected throughput and believes that, as the volatility of gas demand will continue to increase, the demand for Spot Capacity Service will increase accordingly.
 - **Reduced capacity swaps:** Capacity swaps have been the shippers' preferred way of optimising short term capacity requirements as AGIG's Spot Capacity Service has been set at a floor price largely exceeding shippers' opportunity cost of trading excess short term capacity. However, as shippers' excess capacity holding is expected to reduce in AA5, the market for short term transport capacity will be essentially the Spot Capacity Service.

Therefore, WesCEF believes that, looking forward, this service will satisfy more criteria of the reference service factors. WesCEF believes that converting this service into a Reference Service will improve the transparency of the floor price determination as well as the daily availability of this service.

- b) In this context, WesCEF also believes that AGIG should be in a position to model the expected daily and hourly usage of its customers and derive an understanding of this variability on its Spot Capacity and Over-run services in the context of lower subscribed capacity. Such an exercise may expose a growth in demand for these services which would warrant that service being included as a reference service in AA5. In such a case, it would be reasonable to assume that the revenue forecast to be earned by AGIG from the sale of such a service should reflect the portion of

total revenue and costs that should be allocated to this service (regardless of whether it is a reference or nonreference service)¹¹.

Totex Efficiency (Issues 5, 6 and 7)

WesCEF believes that under times of significant average under-utilisation of the pipeline, the highest level of cost scrutiny should be maintained. In the following paragraphs, WesCEF points to its concerns in that respect:

- a) ***Service level assessment:*** WesCEF recognises the importance of preventive maintenance and regular inspection, and believes AGIG has provided transparency in its plan with respect to the maintenance and replacement options identified for its largest assets (turbines and GEAs more specifically). However, WesCEF notes that AGIG has not tested the benefit of maintaining an *underutilised* pipeline to 100% reliability. WesCEF notes that the NGR point to capital expenditure being allowed where this is “to maintain the service provider's capacity to meet levels of demand for services existing at the time the capital expenditure is incurred” (NGR Rule 79 (2)). WesCEF suggests AGIG provides further clarification to help understand the impact on maintaining the underutilised portion of the pipeline and related compressor and meter stations 100% reliable. WesCEF supports a 100% service level and feels it is important to understand the cost of maintaining redundant equipment; and whether the service level is to address throughput, contracted capacity or pipeline capacity.
- b) ***Capitalisation of expenditure:*** WesCEF notes that AGIG considers as operational expenditure, costs relating to works which will deliver benefits over a period that exceeds the accounting period. As per AASB 116 Property, Plant and Equipment, WesCEF would expect such expenditure be capitalised. Such costs include GEA and turbine overhauls which are dependent on run hours in excess of a year and asset inspections which are required on a regular basis (4, 5 or 8 years). WesCEF does not understand the rationale for such accounting changes (those requested for GEAs and turbine overhauls in AA4 and those requested for inspection and maintenance works in AA5). WesCEF believes capitalisation of such costs would reflect more accurately the costs to its customers through the regulated tariff determination. By way of an example, WesCEF notes that AGIG’s AA4 forecasted a cost of \$32.5 million for GEA and turbine overhauls were over-estimated (actual cost was \$24.0 million) as a result of lower running hours postponing this

¹¹ More generally, WesCEF would expect that such an allocation of costs would also generally apply to those other non-reference services for which AGIG recognizes an average revenue of 2-5% per annum.

maintenance into AA5 (planned for \$29.7 million). Should these have been capitalised instead, AGIG customers would have shared the benefits of reduced works as a result of reduced flows.

- c) ***Asset reclassification and its impact on the regulatory asset base:*** WesCEF welcomes initiatives that aim at higher standards of financial reporting. AGIG's proposed re-categorisation of assets into more precise asset classes is a fair and equitable suggestion so long as it is more reflective of the technical life of these assets. The approach proposed by AGIG lacks transparency and WesCEF struggles to understand how such an exercise can result in an unchanged regulated asset base at the start of AA5. In its report¹², Incenta highlights concerns on the classification of large generators and inlet scrubbers in the "Other" category in respect of which AGIG is proposing a shortened life from 30 to 10 years. Incenta also explains that the re-categorisation may result in a "price shock" due to the new alignment of physical assets and the regulated asset base and that instead, AGIG has opted for a transitional arrangement to be implemented. However, AGIG's customers and the ERA have not been informed of the quantum of this transitional arrangement. WesCEF also notes that the ERA commented in item 159 that AGIG could not trace back to individual assets, amongst other due to the fact that depreciation of assets was calculated on the basis of AGIG's forecast expenditure rather than actual expenditure. How may AGIG propose conforming capital approval for past access arrangements if not from tracking its ***actual*** expenditure? WesCEF believes that good industry practice requires the establishment of a detailed asset register. This register should, in its view, support precise accounting of regulatory depreciation.
- d) ***Overhead costs and cost allocation between services:*** WesCEF suggests that the ERA explore how overhead costs (e.g. nominations, billings, technical services) between reference services and non-reference services are shared to ensure that costs are allocated proportionally:
- The broader AGIG group which includes entities other than the AGIG entities that own and operate the DBNGP, has expanded its range of activities in the recent years to engineering (DBP Development Group) and storage services (Tubridgi) while also incorporating East Coast activities. While there may be some increased costs to the overall AGIG group as a result of these additional assets, there is still only one head office in Perth and one management team. It would therefore appear logical to have seen more synergies being achieved with increasing unregulated revenue being earned (particularly by the DBP

¹² Review of Asset Recategorisation – January 2020. Attachment 9.4

Development Group). Insufficient transparency has been provided to demonstrate that the users of the reference services on the DBNGP are not being asked to subsidise (or double contribute to) the costs that should be recovered from unregulated assets. WesCEF would seek clarity on the exact allocation of AGIG's central costs to these activities in order for the ERA to be satisfied that there is compliance with Rule 93 of the NGR.

- **System Use Gas:** From its calculations¹³, WesCEF infers that AGIG is estimating its SUG requirements to average 8.2TJ/d in AA5, down from 9.9TJ/d in 2020, and that the unit cost of gas reduces from \$8.40/GJ in 2020 to an average of \$7.20/GJ in AA5. WesCEF believes this price is far in excess of current gas prices and expected gas prices in the AA5 period and does not reflect efficient pricing.
- **Incentive mechanism basis:** WesCEF remains neutral on the concept of an incentive mechanism on opex. WesCEF observes that AGIG has somewhat had the incentive to outperform in AA4 its opex allowance (excl. SUG) in 2019, the penultimate year of the current Access Arrangement, without an incentive scheme in place. In all cases, WesCEF believes such a system must be calibrated properly, and in this respect queries the following:
 - **Baseline reference and basis of cost estimates:** WesCEF would suggest that AGIG's base year 2019 assumption is benchmarked to the expenditure targeted in the acquisition model of its new shareholders for the AA5 period. WesCEF is concerned about using this single year as a reference when AGIG points to an update of its actuals through the end of September 2019 from its Draft plan assessment to cause the single largest impact to its AA5 opex. WesCEF, like the ERA, is concerned about an unexplained increase in excess of 30 per cent of its estimates of government charges in AA5. Finally, WesCEF would seek clarification on the profile of its opex estimate (excl. SUG), as this points to a year-on-year increase of \$5-7 million in 2021 and a slow decline of \$5 million across AA5 (in real terms).
 - **Exclusions:** WesCEF understands the necessity to exclude from an incentive mechanism the costs which may be out of AGIG's control. According to AGIG, these include Turbine and GEA overhauls. WesCEF notes AGIG's comment in its OPEX business case review that it has

¹³ Combining the information provided by AGIG in its plan, relating to SUG efficiency with ERA's summary of 2020 and AA5 throughput estimates.

efficiently managed its cost of turbine overhauls throughout AA4, reporting that “a number of assets were additionally “swapped out”, moving gas turbines which had lower run hours to compressor stations with higher utilisation, in order to extend the useful life of all assets and prudently defer overhaul”. In WesCEF’s view, this comment shows cost control in this matter, of which AGIG’s customers would be pleased to share the upside in AA5.

- WesCEF would also seek clarification where AGIG has included internal labour costs to specific maintenance expenditure (see attachment 8.7, paragraph 1.1) which is understood to form part of “Field Expenses”. How do these internal labour costs marry with the “Wages & salaries” cost category advised by AGIG in its plan?

Other matters

WesCEF notes that the ERA has raised further issues which WesCEF has not provided comments on in this submission.

Amongst these issues, the ERA has requested feedback on AGIG’s demand forecast (Issue 8). Regrettably, WesCEF believes it has received far too little information to form an opinion on this estimate. WesCEF simply notes:

- AGIG justifies the reduction in capacity subscription from the competition from another pipeline which can bring gas to Perth, namely, the Parmelia Gas Pipeline (PGP). WesCEF does note that, from latest information publicly available, this pipeline will have reduced throughput of gas from the Perth Basin to Perth as the Xyris processing plant is being connected away from the PGP into the DBNGP from July 2020 onwards.
- WesCEF cannot observe the impact of a shutdown of Muja C from October 2022 on AGIG’s estimated throughput. It is WesCEF’s expectation that the closure of a coal-fired power generator would lead to an increased consumption of gas from replacement gas-fired generation.

With regard to the stakeholder consultation process (Issue 1), WesCEF found the approach beneficial and commends AGIG’s efforts. The opportunity to share different point of views highlights the challenges in forming a consensus on a broad range of issues.

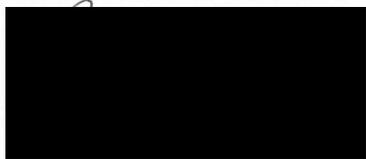
Finally, WesCEF has commented only on certain issues arising from the ERA Issues Paper, and the absence of a comment on any specific issue should not be taken to indicate that WesCEF supports, or does not support, that particular issue. It is important to note that the comments above have been provided in good faith and reflect



WesCEF's broad view on the proposed DBNGP AA5. They are not intended to be used as expert technical advice; but to provide comments for consideration by the ERA in reviewing the proposal.

Should you wish to discuss any points raised in this submission please contact Vincent Blondeau on [REDACTED] or Hans Niklasson on [REDACTED].

Yours sincerely,



Ian Hansen
Chief Executive Officer
Wesfarmers Chemicals, Energy and Fertilisers