OffGAR

WESTERN AUSTRALIA
OFFICE OF GAS ACCESS REGULATION

ISSUES PAPER

to assist with submissions on the

Access Arrangement

for the

Parmelia Pipeline

1. INTRODUCTION

This paper is intended as a guide to assist interested parties considering making a submission on the Access Arrangement proposed by CMS Pipelines Australia Ltd (CMS) for the Parmelia Pipeline. The paper raises issues that may be relevant in the assessment of the proposed Access Arrangement for this pipeline.

The proposed Access Arrangement and Access Arrangement Information are available at no cost from the *Off*GAR web site (www.offgar.wa.gov.au). Printed copies of the documentation are also available from *Off*GAR for $25.00 per set. Requests for the document can be made to:

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Interested parties are invited to make submissions on the issues raised in this paper and in relation to any other relevant matters.

OffGAR sent out about 300 notices to interested parties and published advertisements in the West Australian and the Weekend Australian on 15 May 1999, advising receipt of the proposed Access Arrangement and Access Arrangement Information from CMS and inviting submissions.

The Western Australian Acting Gas Access Regulator is required to issue a draft decision after considering all public submissions received by 4 pm Monday 14 June 1999. If the Acting Regulator does not approve the Access Arrangement, the draft decision must state the amendments (or nature of the amendments) which need to be made for it to be approved.

After publication of the draft decision, interested parties will be given a further opportunity to make submissions (by a specified date). After considering those submissions, the Acting Regulator will issue a final decision on the proposed Access Arrangement.

2. ISSUES FOR CONSIDERATION

Access Arrangements in Context

The National Access Code for Third Party Access to Natural Gas Pipelines (the Code), given effect by the Gas Pipelines Access (WA) Act 1998, provides for the regulation of access to gas transmission and distribution systems. Service providers of gas pipelines covered by the Code are required to submit an Access Arrangement for approval by the Acting Regulator within a specified time.

The purpose of an Access Arrangement is to provide details about the terms and conditions including price upon which an independent third party (User) can gain access to the pipeline.

The Code specifies a number of minimum requirements for the content of an Access Arrangement. The central requirement is the inclusion of one or more Reference Services (and applicable Terms and Conditions) and Reference Tariffs for those Services. This requires the description of one or more standard Services provided by the pipeline that are to be made available to Users, and the Tariffs that are applicable to those Services.

A number of other principles and procedures governing access (such as queuing policy, capacity trading, charging policies for extensions and expansions) also have to be specified. The Code requires the Regulator to assess each proposed Access Arrangement against the principles in the Code.

It is important to note that the Services (and Terms and Conditions including price) that are described in an Access Arrangement do not necessarily preclude a Service Provider and User from agreeing to the provision of a different Service at a different price. In addition, the dispute resolution provisions of section 6 of the Code are available should there be a disagreement as to the terms of supply of such other Services.

General Issues Associated with Access Arrangements

There can be adverse implications for competition and economic efficiency as a result of the Access Arrangement being either too restrictive or too liberal. The objective is to strike a balance between the interests of owners/operators, users and the broader community.

If an Access Arrangement proposes a tariff for Reference Services that is higher than appropriate it:

- may unreasonably discourage downstream uses or consumers of gas; and
- may lead to lower employment and growth opportunities for the State.

If an Access Arrangement proposes a tariff that is too low it:

- may risk the long run sustainability of the pipeline service, with revenue cash flows being insufficient to finance needed capital expenditure and maintenance;
- could deter future investment in the gas pipeline industry;
- could deter future investment in both upstream and downstream industries to the extent that both customers and producers are exposed to inadequate service reliability and capacity; and
- could result in lower employment and development opportunities for downstream industry.

These broad economic considerations may be relevant in the preparation of submissions to OffGAR. This is not an exhaustive list, and interested parties are invited to address any other issues they may consider relevant.

2.1 REFERENCE TARIFFS

One of the key objectives is to provide the Service Provider with a stream of revenue sufficient to cover the efficient cost of providing pipeline services. A second key objective is to provide the Service Provider with an incentive to be efficient.

Estimating a revenue level that meets these objectives is central to striking the appropriate balance between the interests of providers and users and in promoting competition and efficiency in upstream and downstream markets. Issues involving the revenue requirement which parties may wish to consider in preparing their submissions are considered below.

The main components making up the required revenue are:-

- the initial Capital Base and the regulatory Rate of Return which together provide for an acceptable return on assets;
- expenditure on new capital;
- operation and maintenance requirements; and
- economic depreciation of assets (return of capital).

(a) Initial Capital Base

The Code requires the value assigned to existing assets (the initial Capital Base) to be established normally between the Depreciated Optimised Replacement Cost (DORC) and the Depreciated Actual Cost (DAC) (section 8.10 - 8.11 of the Code). Within this range, the Regulator is required to exercise judgement, having regard to a number of factors, including:

- economic efficiency;
- other well recognised methodologies for asset valuation;
- reasonable expectations of all parties;
- historical returns to the asset; and
- the price paid in a recent sale of the asset (and the circumstances of that sale).

The use of the DORC methodology involves the following steps:

- determining the optimal size and configuration of pipeline assets;
- establishing the replacement cost of each asset; and
- writing down the asset for the expired portion of its economic life.

The initial Capital Base for the pipeline is likely to be the major determinant of the revenue to the Service Provider and tariffs paid by Users for a significant period of time.

➢ **Issues for Consideration**

- Does the proposed initial Capital Base meet the requirement of the Code?
- What are the implications of the factors in section 8.10 of the Code for the valuation of the Pipeline?
- Has the asset valuation methodology been applied correctly, and is it consistent with prevailing standard industry practice (if any)?

(b) Regulatory Rate of Return

The regulatory Rate of Return is the return to be provided on the Capital Base for the purposes of determining Reference Tariffs.

The Code requires the Rate of Return to reflect an estimate of the cost of capital (as set in the market for assets) that is associated with the provision of the regulated services. The Code makes reference to recognised models from finance theory for estimating costs of capital, such as the Capital Asset Pricing Model.

➢ **Issues for Consideration**

- Does the proposed Rate of Return that has been used to derive Reference Tariffs reflect a reasonable estimate of the market-determined cost of capital for the relevant assets?
- Have any models been applied (such as from finance theory) in a logical and consistent manner; and
- Are the inputs that have been used in these models (such as estimates of the risk free rate; asset or equity betas; market risk premium; treatment of taxation and dividend imputation etc.) reasonable?

(c) New Capital Expenditure

The Code permits (sections 8.15 - 8.19) new capital expenditure to be included in the Capital Base (and hence reflected in Reference Tariffs), provided that:

- the expenditure represents efficient investment (ie reflects least-cost technologies and is necessary expenditure); and
- if the expenditure is required to meet "market growth", it is normally required to be “economically justified” (that is, to generate incremental revenues that exceed incremental costs, in present value terms).

In addition, where Reference Tariffs are based on a forecast of future capital expenditure, there needs to be a reasonable basis for such a forecast.

➢ **Issues for Consideration**

- Is the proposed expenditure for any refurbishment necessary for the maintenance of existing capacity and does it represent efficient-cost expenditure?
- Is the proposed expenditure for growth necessary to meet forecast demand and does it represent efficient-cost expenditure?
- Will the incremental revenue associated with new investment exceed the incremental costs (ie pass the economic justification test)?
- Is there a reasonable basis for the forecasts of capital expenditure?

(d) Operation and Maintenance (O&M) Expenditure

The Code permits the recovery of forecast operations and maintenance costs, provided that these costs reflect prevailing industry best-practice and that there is a reasonable basis for the forecasts.

➢ **Issues for Consideration**

- Do the forecast O&M costs represent prevailing industry best practise?
- Is there a reasonable basis for the forecasts of operating and maintenance costs?

(e) Regulatory Efficiency Incentives

The Code encourages mechanisms for providing the Service Provider with the incentive for efficient operation. One mechanism that is commonly used is for prices to be predetermined until the next review (eg. escalated by CPI-X). This permits the Service Provider to earn greater profits if it can reduce costs or increase throughput.

The strength of the incentive to reduce costs will depend (amongst other things) upon the time for which Reference Tariffs (or a formula for determining Reference Tariffs) are predetermined. It is worth noting that:

- Longer periods of time between reviews imply that the Service Provider can retain a greater benefit from cost reduction or demand growth.
- Longer periods will delay the time before the effect of cost reductions are passed on to end-users; and

- Prices may diverge from costs the longer the period between reviews (which is inefficient).

➢ **Issues for Consideration**

- Does the Access Arrangement include appropriate incentives for the Service Provider to be efficient?
- Does the proposed term for the Access Arrangement represent a reasonable compromise between the competing objectives of providing incentives for efficiency on the one hand, and passing on efficiency gains to end-users and encouraging efficient pricing, on the other?

(f) Methodology for determining Total Revenue

Once the separate components listed above are calculated, the Code provides a choice of three methodologies for determining the revenue required to compensate for the efficient cost of providing the service (Total Revenue). These methodologies are:-

- the Cost of Service method;
- the Net Present Value (NPV) approach; and
- the Internal Rate of Return (IRR) approach.

Each of these methodologies delivers the same outcome if applied correctly.

➢ **Issues for Consideration**

- Is the methodology for calculating Total Revenue appropriate?
- Has the methodology for calculating Total Revenue been applied correctly?

2.2 REFERENCE SERVICES

The Code requires that at least one Reference Service is offered that is demanded by a significant part of the market (section 3.3 - 3.5).

➢ **Issue for Consideration**

- Do the Reference Services include Services that are likely to be sought by a significant part of the market?

2.3 TERMS AND CONDITIONS OTHER THAN PRICE

Access Arrangements must contain the Terms and Conditions applicable to Reference Services (section 3.6 of the Code). These will cover such matters as nominations/balancing/capacity management/penalties, as well as clauses relating to liability, contract term etc.

- **Issues for Consideration**

In assessing whether all of the Terms and Conditions are reasonable, the following issues may be relevant:

- Are the restrictions placed upon access seekers to meet legitimate pipeline operation objectives the minimum necessary to achieve this objective?
- Will the proposed Terms and Conditions facilitate competition in upstream and downstream markets?
- Is the allocation of risk between the Service Provider and Users implied by the Terms and Conditions consistent with economic efficiency?
- Is the allocation of risk implied by the Terms and Conditions consistent with proposed charges including Reference Tariffs?

2.4 OTHER REQUIREMENTS

The Code also requires Access Arrangements to include provisions (including minimum standards) dealing with a number of other issues including:-

- capacity trading;
- queuing; and
- regulation and pricing of extensions and expansions.

The Code requirements in relation to these matters are provided in sections 3.7 - 3.16 inclusive.

- **Issues for Consideration**

Are the provisions in the Access Arrangement dealing with capacity trading, queuing, extensions and expansions:

- Consistent with the minimum requirements of the Code?
- Likely to facilitate competition in upstream and downstream markets?
- Consistent with a reasonable balance of interests between the Service Provider and Users?

3. ACCESS ARRANGEMENT INFORMATION

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 (section 2.6). The term “elements” refers to Reference Tariffs, Reference Services and other minimum requirements discussed above.

Attachment A to the Code specifies a number of categories of information that must be included in the Access Arrangement Information, including pricing principles, information regarding capital, operations and maintenance costs, system capacity, volume assumptions and key performance indicators.

While there is no requirement for the Access Arrangement Information to be approved, the Service Provider can be asked to provide more information to the public if the Access Arrangement Information does not meet the purposes or minimum requirements discussed above. Any person may request the Regulator to consider whether the Access Arrangement Information is sufficient in relation to any particular matter.

Notwithstanding the above, however OffGAR cannot require the disclosure of information that the Regulator considers would be unduly harmful to the legitimate business interests of the Service Provider or a User or Prospective User (section 2.9).

4 MAKING A SUBMISSIONS

Submissions are invited from all interested parties on the proposed Access Arrangement which must be received by 4pm Monday 14 June 1999 Western Standard Time. *Off*GAR would also appreciate comments on whether the Access Arrangement Information is sufficient for its purpose described above.

Confidentiality

In general, all submissions from interested parties will be treated as in the public domain and placed on the *Off*GAR web site. Where an interested party wishes to keep part or all of the contents of a submission confidential, it should indicate these parts clearly. However, where the Acting Regulator considers that the release of this information would not be 'unduly harmful' to the legitimate business interests of any party, it will return the submission to the party making the submission and provide that party with the option of revising or withdrawing its submission.

Format for Submissions

Submissions with comments on the proposed Access Arrangement should be in both written and electronic form, preferably in Word 6.0 or 7.0 and addressed to:
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