



12 April 2010

Economic Regulation Authority
PO Box 8469
Perth BC WA 6849

Attention: Jennifer Hughes

SUBMISSION – WA GAS NETWORKS PTY LTD PROPOSED REVISIONS TO THE ACCESS ARRANGEMENT FOR MID WEST AND SOUTH WEST GAS DISTRIBUTION SYSTEMS

I refer to the invitation by the Economic Regulation Authority (the Authority) for public submissions on the revised access arrangement for the Mid-West and South-West Gas Distribution System.

The Office of Energy (the Office) has reviewed the WAGN proposed revised Access Arrangement and comments are attached for your consideration.

The Office supports the independence of the Authority in assessing the merits of the WAGN submission. Therefore, the Office has limited its discussion to a number of key points that it wishes for the Authority to consider, rather than on specifics concerning the proposed amount of revenue sought by WAGN.

The main areas that the Office of Energy wishes the Authority to consider are:

- The short term impact of increasing the revenue collected from the fixed charge relative to the variable charge;
- The impact of the proposed tariff increases on small use customers;
- The lack of an incentive mechanism despite escalating operating expenditure;
- The tariff variation methodology proposed by WAGN.

Finally, the Office is supportive of any transition that results in more efficient gas distribution tariffs for consumers in Western Australia.

Thank you for the opportunity to provide a submission on this matter

ANNE HILL
A/ COORDINATOR ENERGY

**SUBMISSION TO THE ECONOMIC REGULATION AUTHORITY:
WA GAS NETWORKS PTY LTD PROPOSED REVISIONS TO THE ACCESS
ARRANGEMENT FOR THE MID WEST AND SOUTH WEST GAS
DISTRIBUTION SYSTEMS**

The Office of Energy's comments to the Economic Regulation Authority (the Authority) are provided below on the revisions proposed by WA GAS Networks Pty Ltd (WAGN) to the access arrangement for the Mid-West and South-West Gas Distribution System.

The proposed increase in the portion of revenue to be recovered from the standing charge for each tariff class

- The Office of Energy supports any transition of tariffs and their components towards more efficient pricing. In fact, any re-weighting of the portion of revenue to be recovered from the standing charge for each tariff that is more efficient than the current situation is consistent with the efficiency objective of the National Gas Law (NGL). Ultimately, assessing the efficiency of the relative levels of each tariff class is a decision to be determined by the Authority.
- The Office of Energy would however ask that the Authority consider price shock applicable to consumers (particularly small use customers) in terms of movements of their relative fixed and variable tariff components. It is acknowledged that regulation of monopoly assets ensures that regulated entities can invest with the knowledge that assets, once sunk, are still able to earn a commercial return on their investment. Regulated networks make substantial investments in long lived assets that have little alternative use, therefore in order to prevent restricting investment, networks need relative certainty as to receiving future cash flows to support capital investments. Consumers also make sunk investments relative to the network and the provision of gas services. In the case of the gas distribution network, these include the location of housing and the mix of appliances used within the home. Those consumers who have already made sunk investment do so with the understanding that the regulatory regime will protect service quality, and provide for fair and consistent prices.
- The Office of Energy also understands that the WAGN proposal results in a large increase in the annual total regulated revenue. The Office of Energy's position is that the consideration of price shocks should not impact upon the level of the revenue requirement determined by the Authority.
- The Office of Energy is concerned that the tariff structures proposed by WAGN, and specifically the increase in the portion of revenue to be collected by the fixed charge relative to the variable charge, is inconsistent with the customer expecting consistent prices. WAGN has argued that efficient pricing for network users requires a re-weighting of the fixed and variable components. The Office of Energy does not necessarily disagree with this premise. It does however support a more gradual transition of individual tariff components from current levels, within the boundaries of the revenue requirement.

- The Office of Energy notes that other recent regulatory decisions using a tariff basket approach generally apply a side constraint to annual increases to both the standing and usage charge. While the Office of Energy notes that WAGN has not proposed a tariff basket approach, nor is the Office of Energy advocating a tariff basket approach, the side constraint mechanism adopted in other regulatory regimes may provide a useful guide for the Authority.
- The side constraint restricts movements in tariffs, and the relative components of tariffs, to a fixed percentage annually. The Office of Energy would like the Authority to consider a similar approach when considering the merits of transitioning from the current tariff components to more cost reflective components. This will allow customers time to adapt to changing price structures, and alternatively alter their consumption patterns over time. Consumers of domestic gas have very little ability to respond to changing price signals in the short term.
- WAGN has proposed an increase in the annual revenue requirement of approximately 36%. Should the Authority determine that an increase of this magnitude is required, the Office of Energy considers that this increase should be applied to the current tariff structure and classes, rather than the proposed structure. The tariff structure alignment, and the split between fixed and variable charges, could then be adjusted over the term of the access arrangement, subject to the determined side constraint.
- Depending on the efficient level of the usage charge, consideration should also be given to smoothing alterations in this charge as well.

The proposal to not have a declining block tariff for most tariff classes

- The Office of Energy seeks further clarification on the reasoning for this approach. Once again, the Office of Energy supports pricing that delivers efficient signals to consumers. The Office of Energy considers that there is potential for significantly increased gas bills for some customers. This needs to be fully assessed for efficiency against the pricing proposal put forward by WAGN.

The proposed application of the Western Australian regulations in relation to the proposed reference tariffs

- The Western Australia specific regulations are intended to guide the regulator on the impact of reference tariff changes on small use customers. Part 2 – Reference tariffs for supply to small customers of the *National Gas Access (WA) (Local Provisions) Regulations 2009* requires that when exercising a discretion in approving or making an access arrangement for a distribution pipeline the Authority must take into account the possible impact of proposed reference tariffs, tariff determination methods and tariff variation mechanisms on small use customers and retailers.
- As discussed, the WAGN proposal increases the value of the fixed charge relative to the variable charge faced by small use customers. The Office of Energy considers that this can potentially impact on small customers consumption decisions. Small customers should be given the opportunity to adjust to this re-weighting over time. Therefore the Office of Energy would like the Authority to consider a tariff transition path, should the Authority agree with

the WAGN proposal that the new tariff structure moves towards an efficient pricing structure.

- WAGN's proposed pricing structure, including a higher fixed charge and the removal of the declining block tariff, will have greatest impact amongst customers using less than 10GJ per year and consumers on the B3 tariff using greater than 45GJ per year in absolute terms. The Office of Energy notes that the Western Australian Regulations require the Authority to consider the impacts of this proposed pricing structure upon small use customers.

The proposed reference tariff variation mechanism

- The Office of Energy has concerns with the proposed reference tariff variation mechanism for unanticipated capital and operating expenditure, While it is recognised that such an approach will reduce the business risk to WAGN and encourage it to invest in the network and gate station infrastructure, it reduces the discipline on the organisation to manage its risks and to accurately forecast its costs.
- The Office of Energy is however of the view that unaccounted for gas is a risk generally outside of the control of network providers and could be considered as part of the reference tariff variation mechanism. There is however scope for the Authority to require detailed and verified forecasts from WAGN surrounding the price and quantity of unaccounted for gas.
- There is also concern that the proposed reference tariff variation mechanism appears to only contemplate tariff increases but does not cater for reference tariff adjustments that reduce tariffs. An equitable mechanism would cater for decreases as well as increases.
- The Office of Energy would like the Authority to consider whether there is a need to go as far as including unexpected capital and operating expenditure in an annual tariff adjustment in order to encourage network investment. There may be more efficient and effective mechanisms than this risk averse approach, for example by pre-approval by the Authority of investment proposals.

Weighted Average Cost of Capital

- The Office of Energy notes that the Weighted Average Cost of Capital (WACC), and the return on capital component of the building blocks, is a significant driver in the increased costs faced by gas distribution consumers.

The Incentive Mechanism

- Under the NGL, the Authority must approve any proposed incentive mechanism. The Office of Energy notes that WAGN has not proposed an incentive mechanism in its Access Arrangement. The Office of Energy also notes an increase in operating expenditure, both in the final year of the current access arrangement and throughout the proposed access arrangement.
- The Office of Energy asks that that the merits of an incentive mechanism that would apply to the operating expenditure of WAGN be considered. This potentially delivers benefits to all users of the Network, as well as allowing WAGN to retain revenue should it out-perform its approved forecasts. The Office of

Energy notes that regulatory regimes that minimise inputs relative to outputs deliver benefits across the network, resulting in lower prices in the long term.

Office of Energy

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