



**Australian
Competition &
Consumer
Commission**

Draft Decision

Access Arrangement by East Australian Pipeline Limited for the Moomba to Sydney Pipeline System

Date: 19 December 2000

**File No:
C1999/3
Application No:
GR9903**

**Commissioners:
Fels
Shogren
Cousins
Martin
Bhojani
Jones**

Contents

Abbreviations and glossary	iv
Executive summary	vii
1. Introduction	1
1.1 Regulatory framework.....	2
1.1.1 Coverage under the Code	2
1.2 Structure of the gas industry in NSW	3
1.2.1 The MSP	3
1.2.2 The Interconnect.....	6
1.2.3 Eastern Gas Pipeline	7
1.3 The assessment process	8
1.4 Criteria for assessing an access arrangement	8
1.5 Consultative process.....	9
1.6 Draft decision	10
1.7 Final decision	11
2. Reference tariff elements	12
2.1 Reference tariff methodology.....	13
2.1.1 Code requirements.....	13
2.1.2 EAPL's proposal	13
2.1.3 Submissions by interested parties.....	15
2.1.4 Commission's considerations.....	15
2.2 The initial capital base	16
2.2.1 Code requirements.....	16
2.2.2 EAPL's proposal	17
2.2.3 Submissions by interested parties.....	21
2.2.4 Commission's considerations.....	23
2.3 New facilities investment and capital redundancy	47
2.3.1 Code requirements.....	47
2.3.2 EAPL's proposal	49
2.3.3 Submissions from interested parties	53
2.3.4 Commission's considerations.....	54
2.4 Depreciation and inflation indexation of the capital base	59
2.4.1 Code requirements.....	59
2.4.2 EAPL's proposal	60
2.4.3 Submissions from interested parties	61
2.4.4 Commission's considerations.....	62
2.5 Rate of return	67
2.5.1 Code requirements.....	67
2.5.2 EAPL's proposal	67
2.5.3 Submissions by interested parties.....	71
2.5.4 Commission's considerations.....	72
2.6 Non-capital costs	83
2.6.1 Code requirements.....	83
2.6.2 EAPL's proposal	83

2.6.3	Submissions by interested parties	85
2.6.4	Commission's considerations.....	85
2.7	Forecast revenue	88
2.7.1	Code requirements.....	88
2.7.2	EAPL's proposal	89
2.7.3	Submissions by interested parties.....	90
2.7.4	Commission's considerations.....	90
2.8	Forecast volumes	90
2.8.1	Code requirements.....	90
2.8.2	EAPL's proposal	90
2.8.3	Submissions by interested parties.....	93
2.8.4	Commission's considerations.....	93
2.9	Cost allocation and tariff setting	101
2.9.1	Code requirements.....	101
2.9.2	EAPL's proposal	101
2.9.3	Submissions by interested parties.....	105
2.9.4	Commission's considerations.....	105
2.10	Tariff path and incentive structure	110
2.10.1	Code requirements.....	110
2.10.2	EAPL's proposal	111
2.10.3	Submissions by interested parties.....	116
2.10.4	Commission's considerations.....	117
2.11	Assessment of reference tariffs and reference tariff policy	124
2.11.1	Code requirements.....	124
2.11.2	EAPL's proposal	125
2.11.3	Submissions by interested parties.....	125
2.11.4	Commission's considerations.....	126
3.	Non-tariff elements	129
3.1	Services policy	129
3.1.1	Code requirements.....	129
3.1.2	EAPL's proposal	130
3.1.3	Submissions by interested parties.....	132
3.1.4	Commission's considerations.....	132
3.2	Terms and conditions	134
3.2.1	Code requirements.....	134
3.2.2	EAPL's proposal	134
3.2.3	Submissions by interested parties.....	139
3.2.4	Commission's considerations.....	140
3.3	Capacity management policy	147
3.3.1	Code requirements.....	147
3.3.2	EAPL's proposal	147
3.3.3	Submissions by interested parties.....	147
3.3.4	Commission's considerations.....	147
3.4	Trading policy	147
3.4.1	Code requirements.....	147
3.4.2	EAPL's proposal	148
3.4.3	Submissions by interested parties.....	149
3.4.4	Commission's considerations.....	149

3.5	Queuing policy	150
3.5.1	Code requirements	150
3.5.2	EAPL's proposal	151
3.5.3	Submissions by interested parties.....	151
3.5.4	Commission's considerations	152
3.6	Extensions and expansions policy	152
3.6.1	Code requirements	152
3.6.2	EAPL's proposal	153
3.6.3	Submissions by interested parties.....	154
3.6.4	Commission's considerations.....	154
3.7	Review and expiry of the access arrangement	155
3.7.1	Code requirements	155
3.7.2	EAPL's proposal	156
3.7.3	Submissions by interested parties.....	156
3.7.4	Commission's considerations.....	156
4.	Information provision and performance indicators	158
4.1	Information provision	158
4.1.1	Code requirements	158
4.1.2	EAPL's proposal	159
4.1.3	Submissions by interested parties.....	160
4.1.4	Commission's considerations.....	160
4.2	Key performance indicators	161
4.2.1	Code requirements.....	161
4.2.2	EAPL's proposal	161
4.2.3	Submissions by interested parties.....	163
4.2.4	Commission's considerations.....	164
5.	Draft decision	166
Appendix A:	Submissions from interested parties	167
Appendix B:	Attachment A of the Code	168
Appendix C:	Description of classes of services	169
Appendix D:	Approaches to depreciation in deriving DORC from ORC	172

Abbreviations and glossary

ABARE	Australian Bureau of Agricultural and Resource Economics
ABS	Australian Bureau of Statistics
ACCC	Australian Competition and Consumer Commission
ACT	Australian Capital Territory
AGA	Australian Gas Association
Agility	Agility Management Pty Ltd
AGL	The Australian Gas Light Company
AGLGN	AGL Gas Networks Limited
AGLP	AGL Pipelines (NSW) Pty Limited
AGLWG	AGL Wholesale Gas Limited
AGUG	Australian Gas Users Group
APT	Australian Pipeline Trust
Boral	Boral Energy Holdings Limited
CAPM	Capital Asset Pricing Model
CCA	Current cost accounting
Class FT service	Firm transportation service
Class IT service	Interruptible transportation service
Class OFT service	Off-season firm transportation service
Class STP service	Small take-off point service
Class WFT service	Winter season firm transportation service
Commission	Australian Competition and Consumer Commission
CPI	Consumer Price Index
DAC	Depreciated actual cost
DEIEGP	Duke Eastern Gas Pipeline Pty Ltd, DEI Eastern Gas Pipeline Pty Ltd and Duke Australia Operations Pty Ltd (collectively)
DOE	NSW Department of Energy, now the Ministry of Utilities and Energy
DORC	Depreciated optimised replacement cost
DRC	Depreciated replacement cost
Duke Energy	Duke Energy International
EAPL	East Australian Pipeline Limited
EAPM	East Australian Pipeline Marketing

EGP	Eastern Gas Pipeline
Epic	Epic Energy South Australia Pty Ltd
FERC	Federal Energy Regulatory Commission
FFV	Full fixed variable
GJ	Gigajoule
GPU GasNet	GPU GasNet Pty Ltd
GTA	Gas Transportation Agreement
GTD	Gas Transportation Deed
ICRC	Independent Competition and Regulatory Commission
IPART	Independent Pricing and Regulatory Authority
IRR	Internal rate of return
km	kilometre
kpi	key performance indicator
LRMC	Long run marginal cost
MAPS	Moomba to Adelaide Pipeline System
MDQ	Maximum daily quantity
MHQ	Maximum hourly quantity
MMAP	Moomba to Melbourne Augmentation Project
MSP	Moomba to Sydney Pipeline System
MSPSS Act	Moomba-Sydney Pipeline System Sale Act 1994
MW	Megawatt
NCC	National Competition Council
NEMMCO	National Electricity Market Management Company
NERA	National Economic Research Associates
NIEIR	National Institute of Economic and Industry Research
NPV	Net present value
NSW	New South Wales
NTS	New Tax System
O&M	Operating and maintenance
ORC	Optimised replacement cost
ORG	Office of the Regulator-General, Victoria
PASA	Pipelines Authority of South Australia
PJ	Petajoule (equal to 1 000 000 GJ)
PNG	Papua New Guinea
PTS	Principal Transmission System

RC	Replacement cost
SCC	Stress corrosion cracking
SFV	Straight fixed variable
SRMC	Short run marginal cost
the Code	National Third Party Access Code for Natural Gas Pipeline Systems
TJ	Terajoule (equal to 1 000 GJ)
TPA	The Pipeline Authority
VIC	Victoria
WACC	Weighted average cost of capital

Executive summary

On 5 May 1999 East Australian Pipeline Limited (EAPL) submitted its proposed access arrangement and access arrangement information for the Moomba to Sydney Pipeline System (MSP) to the Australian Competition and Consumer Commission (the Commission) for approval. The application was made under the *National Third Party Access Code for Natural Gas Pipeline Systems* (the Code).

The MSP includes the 1 299 km pipeline from Moomba in South Australia to Wilton on the outskirts of Sydney, as well as pipelines from Young to Lithgow, Young to Culcairn, Junee to Griffith and Dalton to Canberra.

The access arrangement and access arrangement information describe the terms and conditions on which the company will make access to its pipeline available to third parties. The Commission has assessed the access arrangement and access arrangement information against the principles in the Code, taking into consideration information provided by EAPL and interested parties.

Subsequent to the access arrangement proposed by EAPL, on 11 August and 21 September 2000, the Australian Pipeline Trust (APT), the new owner of EAPL and the MSP, submitted proposed revisions to the access arrangement. However, in some instances the revisions are of a general nature and specific details have not yet been provided. Moreover, on 18 August 2000 Agility Management Pty Ltd (Agility), on behalf of APT, submitted an alternative methodology for calculating the depreciated optimised replacement cost (DORC) of the pipeline assets.

Reference tariff elements

The Code requires an access arrangement to include a reference tariff for at least one service that is likely to be sought by a significant part of the market, and any other service that the Commission considers should be included. An access arrangement must also include a policy describing the principles that are to be used to determine reference tariffs.

Essentially EAPL is proposing a cost of service approach (based on forecast costs) whereby reference tariffs are designed to recover the efficient costs of providing reference services. Those costs include a return on the value of the assets that form the capital base, depreciation of the capital base and operating and maintenance costs. Furthermore, EAPL is proposing a smooth price path during the access arrangement period to avoid price shocks to users.

The initial capital base

The Code lists several factors that the Commission must consider in determining the value of the initial capital base for an established pipeline. Normally the value of the initial capital base should not fall outside the range defined by the depreciated actual cost (DAC) and DORC.

EAPL originally proposed a value for the initial capital base in accordance with a DORC of \$666 million based on optimised replacement costs (ORC) of \$1 058 million.

Included in EAPL's proposed ORC is a ten per cent contingency factor amounting to \$82 million. The Commission does not consider it appropriate to include such a factor when valuing the assets of an existing pipeline for regulatory purposes. Accordingly, the Commission considers that an ORC of \$976 million is more appropriate.

Because of the type of coating used and deterioration to the pipeline due to stress corrosion cracking, EAPL assumed a shorter life for the Moomba to Wilton pipeline than other pipeline segments of the MSP (60 years as opposed to 80 years). Based on a remaining life of 36 years, EAPL calculated the DORC for the Moomba to Wilton pipeline as 36/60ths (or 60 per cent) of DORC. However, the Commission does not consider that DORC calculated in this manner would adequately account for the difference in asset lives between an existing asset and a replacement asset.

Accordingly, the Commission considers that, if DORC were to be calculated in this manner, the correct figure for DORC would be the value of ORC multiplied by the ratio of the remaining life of the existing asset and the economic life of the replacement asset. On this basis DORC for the Moomba to Wilton pipeline would be calculated as 36/80ths (or 45 per cent) of ORC.

However, APT has since submitted that the life of the Moomba to Wilton section could be extended from 60 years to 80 years through refurbishment (re-coating) of some 250 km of the pipeline. The work is estimated to occur between the years 2033 and 2056 at a cost of \$560 000 per km (\$140 million in total). APT has not submitted a revised figure for DORC. However, the implication is that DORC for the Moomba to Wilton section would now be calculated on the basis of 56/80ths (or 70 per cent of ORC). In addition, under this approach the value of DORC would be reduced by the net present value (NPV) of the refurbishment costs.

The Commission's approach to assessing DORC is to examine the manner by which the assets have been depreciated in the past. The Commission is aware from information previously provided that EAPL has depreciated the assets of the MSP on the basis of an economic life of 50 years. The Commission considers that this is an appropriate basis for determining the value of DORC. For example, the mainline (Moomba to Wilton pipeline) has been in operation for 24 years. Therefore, the value for DORC is calculated as 26/50ths of ORC (where 26 years is the remaining life on the basis of an asset life of 50 years). As the average time in operation for the other pipelines is about 12 years, DORC is calculated as 38/50ths of ORC. On this basis the Commission has assessed the value of DORC at \$539.5 million.

While an asset life of 50 years has been used as the basis for determining the value of DORC, when looking forward to determine the remaining life of the assets of the MSP, the Commission has used the economic life proposed by APT, that is 80 years. Consequently, for depreciation purposes the remaining life of the Moomba to Wilton pipeline is 56 years, and the average remaining life for the other pipelines is 68 years.

Agility submitted an alternative methodology (to the more traditional straight line depreciation approach) for calculating the value of DORC from ORC. Agility's approach calculates DORC as the NPV of the future income stream from those assets, where the income is consistent with the prices that would be charged by an efficient new entrant in a contestable market. Agility's approach is forward-looking and takes no account of the manner by which the assets have been depreciated in the past. An outcome of Agility's approach is that the depreciation schedule is back-end loaded,

with little depreciation occurring in the early years of the life of the assets. On this basis, Agility estimates that the DORC for the MSP is in excess of \$900 million. The Commission does not consider this figure to be an appropriate value for the initial capital base of the MSP.

The Commission is also proposing to adjust the value of the capital base downward by the value of EAPL's accumulated deferred company tax liabilities. The deferred tax liabilities, which represent the difference between prima facie tax expenses (based on the statutory tax rate) and actual tax payable, occurs because of accelerated depreciation concessions for tax purposes.

The deferred tax liabilities represent a precompensation of future tax liabilities and as such constitute a return of capital. Therefore, the capital base should be reduced by the value of accumulated deferred tax liabilities. The Commission has calculated the adjustment to the capital base to take account of deferred tax liabilities at \$37.4 million, which includes adjustments for the value of imputation credits and changes in the statutory tax rate.

The Commission is proposing a value for the initial capital base of \$502.1 million, comprised of DORC of \$539.5 million less the value of accumulated deferred taxes of \$37.4 million. In setting the value of the initial capital base the Commission was also mindful of the 1994 sale price of \$534 million, which EAPL paid to The Pipeline Authority for the MSP and related assets. While the Commission's proposed value of the initial capital base of \$502.1 million is less than EAPL's proposal of \$666 million, it is broadly consistent with the 1994 sale price and is higher than the estimated book value at 30 June 2000 of \$459 million.

New facilities and capital redundancy

New facilities

Included in EAPL's forecast capital expenditure are the partial looping of the Canberra lateral in 2001 and the construction of a compressor at Uranquinty on the Interconnect (Wagga Wagga to Culcairn pipeline).

According to EAPL, the Canberra lateral is currently operating near full capacity and augmentation is required to cater for forecast market growth. A cost/benefit analysis undertaken by EAPL suggests that looping is preferable to compression in this instance.

Analysis by the Commission indicates that based on forecast volumes supplied by EAPL, the investment in the Canberra looping would pass the economic feasibility test under section 8.16(b) of the Code. However, a proposal by AGL to construct an interconnecting pipeline from the Eastern Gas Pipeline (EGP) to Canberra and the extent to which EAPL loses market share to that pipeline must cast some doubt on the viability of EAPL's proposed looping of the Canberra lateral. Nevertheless, the Commission is proposing to accept the inclusion of the cost of the partial looping of the Canberra lateral in EAPL's proposed capital expenditure rather than to propose an amendment to the access arrangement to exclude the facility. In the event that EAPL's forecast volumes are not realised and construction of the Canberra looping is deferred or abandoned, the loss of revenue is likely to exceed the cost of the facility, given that tariffs are based on forecast volumes. In that manner EAPL, rather than users, would bear the cost of its loss of market share.

Commissioning of the Uranquinty compressor depends on a significant increase in gas flow through the Interconnect in the last two years of the access arrangement period, in both a southward and northward direction. In the event that the facility does not proceed because of lower volumes than forecast, lower costs (the capital costs of the compressor will not be incurred) will be offset by lower revenue (due to lower volumes).

The Commission is satisfied that the Canberra looping and Uranquinty compressor station could be reasonably expected to pass the requirements of section **8.16** of the Code at the time they are forecast to occur. This does not imply, however, that those facilities will meet the requirements of section **8.16** when the Commission considers revisions to the access arrangement under section **2.28** of the Code.

Capital redundancy

While EAPL's access arrangement contains the provision that the capital base will be adjusted for redundant assets, no specific mechanism is included for determining the extent of any redundant capital. A mechanism is desirable to ensure that users do not pay for assets that have ceased, or substantially ceased, to deliver reference services. Accordingly, pursuant to section 8.27 of the Code, the Commission requires a mechanism dealing with redundant capital to be included in the reference tariff policy.

Depreciation and inflation indexation of the capital base

Current cost accounting framework

EAPL is proposing a current cost accounting (CCA) framework for establishing target revenues, under which the capital base is notionally revalued annually in line with inflation. The revalued capital base in combination with a real rate of return effectively provides the same overall return as an unadjusted capital base coupled with a nominal rate of return. The former approach, however, provides a more level tariff profile over time than alternative approaches.

Under EAPL's proposed CCA framework, tariffs and the capital base are adjusted in accordance with the March CPI. Because of the timing of the lodgment of EAPL's proposed revisions to the access arrangement for the next access arrangement period (six months prior to the revisions commencement date), by necessity the access arrangement will contain an estimate of the CPI on which the value of the capital base at the commencement of the next access arrangement period will be based. The Commission is proposing an amendment to the effect that the capital base at the commencement of the next access arrangement period will be in accordance with the actual CPI, rather than an estimate. The actual CPI adjustment will be reflected in the Commission's final decision relating to the next access arrangement period.

The Commission considers that the effect of the CPI adjustment factor should be exclusive of the impact on the CPI of the New Tax System (NTS). Failure to exclude the effect of the NTS would likely result in a windfall gain to investors over and above their expected rate of return.

EAPL is proposing that if the ABS ceases or suspends publication of the CPI, EAPL would substitute an alternative measure of consumer prices. The Commission considers that if the ABS suspends or ceases publication of, or materially alters the CPI,

an alternative independent index for measuring inflation, such as those published by the Commonwealth Treasury or the Reserve Bank, should be substituted.

Depreciation

EAPL is proposing a '5/8:3/8' kinked depreciation schedule for its pipeline assets. Under this methodology the major proportion of the assets (**62.5** per cent) is depreciated over the first half of the (remaining) economic life of the assets, while a lesser proportion (**37.5** per cent) is depreciated over the second half. In EAPL's opinion, recovery of a significant portion of the value of its pipeline assets in the early years is justified because EAPL faces significant stranded asset risk as a result of the commissioning of the Eastern Gas Pipeline.

While EAPL is forecasting a reduction in volumes during the initial access arrangement period, it is forecasting an increase in volumes during the next access arrangement period. In a situation of increasing volumes a kinked depreciation schedule seems contrary to the Code principle that the depreciation schedule should be consistent with market growth and should avoid delivering high tariffs in early years and lower tariffs in later years. Accordingly, the Commission is of the view that EAPL's proposed kinked depreciation schedule is inappropriate and proposes that straight line (in real terms) depreciation be adopted. Adoption of straight line depreciation is supported by APT.

Rate of return

The rate of return proposed by EAPL is a weighted average cost of capital (WACC), with the return on equity component based on the Capital Asset Pricing Model (CAPM) approach. EAPL submits that a feasible range for the post-tax nominal return on equity is **13.1** to **14.6** per cent.

To obtain a pre-tax real rate of return EAPL has converted the post-tax nominal rate by grossing up for the assumed taxation rate (the previous statutory tax rate of **36** per cent) to obtain a pre-tax nominal rate. **An** adjustment is then made for inflation by means of the Fisher conversion to obtain the pre-tax real rate (the 'forward transformation'). The methodology adopted by EAPL results in an equivalent range for WACC of 7.9 to 9.0 per cent, from which EAPL is proposing a pre-tax real WACC of **8.4** per cent for the initial access arrangement period.

The Commission considers that this methodology gives rise to errors and does not result in appropriate WACCs. Consequently, the Commission has adopted cash flow modelling to derive a WACC from the cost of equity determined from the CAPM.

Given the timing differences in tax payments caused by the different rates of depreciation for tax and regulatory purposes, the effective tax rate over the life of the assets is likely to be less than the statutory tax rate. The deferral of tax liabilities results in an improved cash flow, a more rapid payback of capital and a resulting internal rate of return greater than might otherwise be the case.

In establishing the cost of service revenue requirement, the Commission has 'normalised' EAPL's tax payments over the life of the assets to avoid price shocks to users when taxes become payable. The approach adopted by the Commission involves a smoothing of the revenue requirements, and hence tariffs, by allowing pre-

compensation of future tax liabilities in the form of additional depreciation. This pre-compensation of future tax liabilities removes the ‘s-bend phenomenon’ whereby future users pay a disproportionate level of the service provider’s tax liabilities.

Based on prevailing financial market conditions and the level of **risk** to EAPL in providing reference services, the Commission is proposing a post-tax nominal return on equity of 13.0 per cent. The Commission’s cash flow modelling has generated an equivalent pre-tax real WACC of 7.0 per cent and an effective tax rate of 13.6 per cent. The Commission is proposing an amendment to the access arrangement to reflect these values. EAPL’s proposed rates of returns are compared with the Commission’s proposals in Table 1.

Table 1: Comparison of proposed rates of return

	EAPL		ACCC Draft Decision (%)
	Low (%)	High (%)	
Post-tax nominal return on equity	13.1	14.6	13.0
Pre-tax nominal WACC	10.6	11.8	9.9
Pre-tax real WACC	7.9	9.0	7.0
Proposed pre-tax real WACC	8.4		7.0

Non-capital costs

The Code requires the recovery of only the operating and maintenance costs (and other non-capital costs) that would be incurred by a prudent service provider acting efficiently. EAPL has compared its operating costs with those of other Australian pipelines and submits that its costs are low in comparison with available benchmarks and represent the efficient costs of operating the MSP. The Commission proposes to accept the forecast operating and maintenance costs submitted by EAPL.

Working capital

The Commission proposes not to allow EAPL an explicit return on working capital. The rationale for this approach relates to the methodology adopted by the Commission for its modelling of cash flows. Rather than model the timing of EAPL’s cash flows throughout the year, the Commission has assumed in its model that all costs and revenue are incurred on the last day of each year. In reality, EAPL’s cash flows would occur at regular intervals throughout the year, giving EAPL a benefit above the regulated revenue equal to the time value of money on the net cash flow received throughout the year. The Commission considers that this benefit more than compensates EAPL for any gap between payments and collections during the year.

Forecast revenue

The proposed amendments in this *Draft Decision* in relation to the cost components of the MSP will reduce the target revenue on average by 34 per cent per annum of the total revenue requirements proposed by EAPL. The comparative figures are illustrated in Table 2.

Table 2: Comparison of total revenue proposals, (July 2000 %m)

Year ending 30 June	2001	2002	2003	2004	2005
Total revenue – EAPL	91.45	90.81	89.17	89.48	86.48
Total revenue – ACCC	59.31	59.87	58.34	60.19	58.96
Difference (%)	35	34	35	33	32

Forecast volumes

EAPL's volume forecasts include a loss of market share to the EGP during the initial access arrangement period. Since EAPL's proposed tariffs are determined by dividing its revenue requirements by its forecast volumes, the loss of market share to the EGP would lead to higher tariffs on the MSP than what might otherwise have occurred. In the absence of the EGP, EAPL's volume forecasts would be higher and its proposed tariffs lower. That is, the entry of a new player is leading to higher tariffs, which is contrary to the expected outcome of a competitive market.

This raises the issue of what level of volumes should be used for determining tariffs under these circumstances. Essentially the issue is one of who should bear the costs of the loss of market share, the service provider or users, or whether there should be some sharing of the costs. The Commission engaged National Economic Research Associates (NERA) as a consultant to provide advice on this issue. NERA considered several alternatives for addressing this matter:

- the service provider's expected market share (forecast volumes);
- volumes deemed at current levels;
- defined capacity; and
- back-end loaded depreciation.

In considering each of these options, NERA considered the following issues:

- which party (service provider or users) bears the costs of spare capacity;
- what incentives are implied for the service provider and users to grow the market and reduce spare capacity; and
- which party is in the best position to act on those incentives.

NERA's preferred approach is to base tariffs on defined capacity. NERA argues that the service provider is in the best position to improve utilisation of the pipeline and reduce spare capacity. By basing tariffs on defined capacity the service provider, rather than users, is bearing the cost of spare capacity. Therefore, the service provider, who is in the best position to reduce spare capacity, is also given the strongest incentive to do so.

Adoption of such an approach in Australia, however, would represent a departure from the current approach adopted by regulators. Accordingly, in this *Draft Decision* the Commission proposes that tariffs be based on forecast volumes. Nevertheless, the Commission invites comments on this issue.

Cost allocation and tariff setting

EAPL has structured its proposed reference tariffs to reflect the length of pipeline (distance) and quantity transported (service requirements). In support of a distance-based structure for reference tariffs, by which tariffs are calculated on a per kilometre basis, EAPL states that they are more directly cost reflective than zonal or postage-stamp rates and do not create artificial by-pass opportunities at zone boundaries. The Commission has no objection to this approach.

Furthermore, EAPL is proposing a two-part tariff – a capacity charge based on the level of a user’s reserved capacity; and a throughput charge based on the actual volumes transported through the pipeline. The capacity charge is designed to recover fixed costs, whereas the throughput charge has been designed to recover variable costs. EAPL has classified as fixed costs all capital costs (return on capital and depreciation) and a proportion of operating and maintenance costs, while the remaining operating and maintenance costs are regarded as variable costs. Again, the Commission has no objection to this approach.

For tariff-setting purposes, the various pipeline segments of the MSP are categorised as either mainlines or laterals:

- mainlines: Moomba to Wilton, and Young to Culcairn; and
- laterals: Young to Lithgow (with spur lines to Bathurst, Cootamundra, Oberon and Orange), Junee to Griffith, and Dalton to Canberra.

Because of different characteristics in terms of size, economies of scale and market conditions, EAPL is proposing a different, and higher, tariff structure for the laterals than the mainlines. EAPL is proposing to phase in the higher tariffs during the term of the initial access arrangement period and to apply the lateral tariffs only to the first 100 km of the lateral. The mainline tariff is applied to the rest of the lateral.

The Commission has no objection to different tariff structures applying to different pipeline segments in recognition that the segments have different economies of scale and unit costs. However, the Commission considers that a common lateral tariff for the three segments, Young to Lithgow, Junee to Griffith, and Dalton to Canberra is not efficient. This approach would lead to tariffs on the Dalton to Canberra lateral in excess of DORC plus operating costs. Accordingly, the Commission is proposing an amendment that tariffs on any pipeline should not exceed that pipeline’s DORC plus its operating costs. One feasible solution would be to apply the mainline tariffs to the Dalton to Canberra pipeline, leaving only the Young to Lithgow and Junee to Griffith laterals being charged the lateral tariff structure.

As the amendments proposed in this *Draft Decision* will reduce EAPL’s overall revenue requirements, the need to phase in the lateral tariffs over the duration of the access arrangement period is obviated. Nevertheless, the higher lateral tariffs will result in some users paying higher charges than EAPL’s current published tariffs. To limit the extent of the increase, the Commission is proposing that the 100km cap be retained.

Tariff path and incentive mechanism

Tariff path

EAPL's tariffs are based on forecast costs with a smooth price path to avoid tariff shocks. EAPL is proposing that the published tariffs applicable at the time of lodgment of its access arrangement be the reference point for reference tariffs for the initial year of the access arrangement period.

This approach may be reasonable under EAPL's proposed access arrangement, as the revenue generated from published tariffs would not be substantially different to EAPL's proposed revenue under a cost of service approach. However, as a result of the Commission's proposed amendments in this *Draft Decision*, application of published tariffs in the first year of the access arrangement would significantly over-recover total costs. Accordingly, the reference point for the initial tariffs should be the forecast costs of providing reference services rather than the published tariffs.

For the mainlines, once the initial tariff is set, tariffs in each year are indexed by a CPI-X formula to determine tariffs in subsequent years. The escalation factor proposed by EAPL for a particular year (year n) is of the form:

$$(CPI_n/CPI_{n-1}) - X$$

However, the Commission considers the following formula for indices involving an X factor to be more appropriate and proposes an amendment to the access arrangement to this effect:

$$(CPI_n/CPI_{n-1}) \cdot (1 - X)$$

As discussed earlier in relation to EAPL's current cost accounting methodology, the Commission proposes that the CPI adjustment should be exclusive of the impact of the New Tax System. The same principle applies to CPI-X adjustment to tariffs.

Backhaul

Backhaul on the MSP is applicable to the Young to Culcairn pipeline, where the predominant flow of gas may alternate between north or south. The 50 per cent backhaul rate proposed by EAPL is in the form of credits to users of firm service (rather than a service in its own right) and is dependent on the predominant flow of gas. While a 50 per cent charge might be considered appropriate under these circumstances, it may not be appropriate in other situations, for example a user shipping gas through the Eastern Gas Pipeline wishing to backhaul gas on the MSP from Wilton. The Commission is seeking comments from interested parties on this issue.

Incentive mechanisms

EAPL's proposed tariffs are based on forecast costs and volumes over the term of the access arrangement period. EAPL has sufficient incentives to reduce costs and expand the market, as any benefits arising from reduced costs and/or higher realised volumes than forecast will be retained by EAPL during the term of the access arrangement period. **An** incentive mechanism based on forecast variables (such as volumes) carries a certain degree of risk and the Commission believes that EAPL should equally **bear** both the upside and downside of that **risk**.

Services policy

EAPL is proposing two reference services, a firm transportation service (Class FT service) and a small take-off point service (Class STP service). The STP service is designed for small users where the quantity of gas does not exceed 200 TJ/year. In addition EAPL's proposed access arrangement contains three rebatable services (including an interruptible service) and a negotiable service, which are non-reference services. However, APT has since submitted that the access arrangement should be revised to delete the rebatable services in their current form.

APT argues that because of the loss of volumes to the EGP, capacity on the MSP will not be constrained during the initial access arrangement period. APT argues that under these circumstances an interruptible service would become in effect a form of fixed service and should be priced accordingly. With regard to the rebatable services in general, APT submits that the replacement of the Gas Transportation Agreement with the Gas Transportation Deed has significantly reduced the total firm capacity contracted on the MSP. According to APT, the rebatable services could produce perverse outcomes to the detriment of EAPL's revenue requirement. Of significance is the ability of AGL to vary its nomination between firm and interruptible service. APT has indicated its support for the concept of a rebate mechanism and is currently considering, but has not as yet proposed, alternatives to those contained in EAPL's access arrangement.

The Commission considers that APT's concerns have some validity and proposes to delete the rebatable services in their current form from the access arrangement. The Commission invites comments from interested parties on possible alternatives, particularly an interruptible service.

The Commission also considers that EAPL's proposed services policy satisfies those provisions of the Code that require the access arrangement to include at least one service which is likely to be sought by a significant part of the market.

Terms and conditions

Overall terms and conditions

While the proposed access arrangement contains principles for terms and conditions of access, it contains many provisions that are general in nature with little detail. It does not include the standard service agreements, which set out the terms and conditions on which EAPL will provide transportation services.

The Commission proposes an amendment to the MSP access arrangement to make it clear that, in the event that any apparent inconsistency arises, the access arrangement prevails over the standard service agreements and any other documents yet to be released.

Receipt and delivery points

A condition imposed by EAPL on users' ability to transfer receipt or delivery points is that EAPL may withhold its consent if it considers that the transfer would restrict EAPL's ability to operate the pipeline properly. NERA, on behalf of Incitec, objected to this condition on the grounds that it gave EAPL too much discretion. In its response

to submissions, EAPL agreed that this clause could be deleted. Accordingly, the Commission is proposing an amendment that this particular clause be deleted.

A further condition proposed by EAPL and imposed on users wishing to transfer their receipt or delivery points is that such a transfer must be with the consent of other users of those receipt or delivery points. The Commission is concerned that this provision may give an incumbent user, who is a potential competitor of the transferee, some commercial advantage by being forewarned of the proposed transfer. Moreover, it is difficult to envisage that users would have more knowledge than the service provider, who should be in the best position to judge whether the transfer is feasible (for example, in terms of available capacity). Accordingly, the Commission proposes that this provision be deleted.

To provide more flexibility in the transfer of receipt and delivery points, EAPL in its response to submissions put forward an amendment to the access arrangement to the effect that the Request for Transportation Services form would allow multiple receipt and delivery points. The Commission is proposing an amendment to this effect.

Overruns

EAPL is proposing overrun charges of 200 per cent of the capacity charge for authorised overruns and 350 per cent for unauthorised overruns. While these charges may appear excessive when compared with charges for some other pipelines, the Commission considers that penalties may be warranted when spare capacity exists. This is to prevent misuse of overruns by users, who might use overruns as a form of interruptible service in the knowledge that interruption is unlikely to occur because of the existence of spare capacity. Such a situation might result in an undue revenue loss to EAPL. The Commission invites comments from interested parties on this issue, particularly on the level of overrun charges proposed by EAPL.

Operational and balancing requirements

EAPL's proposed operational and balancing requirements are summarised in Attachment 4 of the proposed access arrangement. The summarised procedures are said by EAPL to be provisional only and subject to amendment as operational practices are improved and the pipeline is developed with additional users. EAPL also says it will establish a review process to consult with industry participants, users and the Commission prior to amending these procedures.

The Commission is seeking a definite commitment to the proposed review of the procedures with users, potential users and the Commission. Accordingly, the Commission proposes an amendment to the MSP access arrangement that the proposed review of operational and balancing provisions and charges will be conducted within six months of approval of the access arrangement by the Commission.

Gas quality specifications

The Australian Gas Association's Gas Specification Working Group has reached an agreement on a proposed common specification for NSW and Victoria. The Commission proposes that EAPL's access arrangement be amended to ensure that any new specification recommended by the Gas Specification Working Group and approved by the relevant jurisdictions is reflected in the access arrangement for the MSP.

Prudential requirements

EAPL is proposing that a prospective user must satisfy its prudential requirements before entering into a service agreement. EAPL does not specify what those prudential requirements are, although some of the requirements can be deduced from provisions of EAPL's proposed trading and queuing policies. The Commission is proposing an amendment that EAPL clarify its prudential requirements.

Trading policy

The Commission has some concerns that some of the conditions proposed by EAPL may be too onerous or allow EAPL too much discretion. Clause 27.2(6) of the proposed access arrangement requires an intending user to demonstrate that it has made all the necessary arrangements for the receipt of gas. The Commission has some concern that this clause could result in intending users having to provide EAPL with commercially sensitive information. Information of a general nature rather than detailed information should be sufficient for EAPL to determine the intentions and requirements of the intending user. EAPL should not obtain, or use, commercially sensitive information gathered pursuant to this clause of the access arrangement beyond that necessary to meet these requirements. Therefore, the Commission is proposing an amendment to this provision.

Clause 27.2(9) requires that a user not be in default under an existing service agreement, while clause 27.2(12) requires intending users to demonstrate that they are solvent with an appropriate level of experience in the industry. In response to concerns raised in a submission EAPL has agreed to simplify these clauses to read that an intending user must be able to demonstrate its creditworthiness. The Commission is proposing an amendment to this effect.

Queuing policy

Included in EAPL's proposed access arrangement is a queuing policy for determining the priority given to users and prospective users for obtaining access to a covered pipeline. The Commission considers that the proposed queuing policy in the main satisfies the requirements of the Code. However, the Commission has some concerns with clause 7.5(13)(b) which requires a prospective user to reasonably demonstrate that it has made appropriate arrangements for upstream and downstream transport and supply of gas. This is similar to the issue raised above with respect to 'Trading Policy' and the Commission is proposing a similar amendment.

Extensions and expansions policy

EAPL's extensions and expansions policy allows it the discretion to decide which extensions and expansions should be included in the access arrangement (subject to the Commission's approval). However, in the event that EAPL decides not to submit an extension or expansion for inclusion in the access arrangement, there is no mechanism in the access arrangement to provide for the Commission to be notified. The Commission is proposing an amendment that EAPL must notify the Commission in advance of the commencement of services provided through expansions and extensions to the MSP.

EAPL is also proposing that a surcharge may be levied on new facilities if the NPV of revenue is less than the NPV of costs. However, no discount rate is mentioned. The Commission is proposing an amendment that the vanilla WACC should be used as the discount rate for calculating the NPV.

A further provision of EAPL's extensions and expansions policy is the subsequent inclusion in the capital base of part of any speculative investment fund. The Commission is proposing an amendment that this would be subject to the Commission's approval.

Review and expiry of the access arrangement

EAPL is proposing that it will submit revisions to the access arrangement on or before 1 January 2005 with the revisions to commence from the later of the 1 July 2005 or the date on which the Commission's approval of the revisions to the access arrangement takes effect. The Commission is proposing an amendment that the revisions commencement date will be four years **and** six months after the commencement date of the initial access arrangement period.

Draft decision

Pursuant to section 2.13(b) of the Code, the Commission proposes not to approve EAPL's access arrangement for the Moomba to Sydney Pipeline System in its present form. This *Draft Decision* states the amendments (or nature of amendments, as appropriate) that would have to be made in order for the Commission to approve the proposed access arrangement.

Proposed amendments

The Commission proposes the following amendments to the access arrangement.

Proposed amendment A2.1

In order for EAPL's access arrangement for the MSP to be approved, the value of the initial capital base is to be set at \$502.081 million.

Proposed amendment A2.2

In order for EAPL's access arrangement for the MSP to be approved, the reference tariff policy must be amended to allow the Commission, at the commencement of the subsequent access arrangement period, to review and, if necessary, adjust the capital base for wholly or partially redundant assets.

Proposed amendment A2.3

In order for EAPL's access arrangement for the MSP to be approved, the relevant index for determining the value of the initial capital base at the commencement of the next access arrangement period is the actual 2005 CPI.

Proposed amendment A2.4

In order for EAPL's access arrangement for the MSP to be approved, the CPI index used in EAPL's current cost accounting methodology must be exclusive of the impact of the New Tax System.

Proposed amendment A2.5

In order for EAPL's access arrangement for the MSP to be approved, EAPL must amend its access arrangement so that, in the event that the ABS suspends or ceases publication of or materially alters the CPI, a well recognised alternative index for measuring inflation, such as one published by the Commonwealth Treasury or the Reserve Bank, will be substituted.

Proposed amendment A2.6

In order for EAPL's access arrangement for the MSP to be approved, EAPL should adopt a straight line method of depreciation (in real terms) in place of its proposed kinked depreciation schedule.

Proposed amendment A2.7

In order for EAPL's access arrangement for the MSP to be approved, the basis of the depreciation schedule for the initial capital base should be the value of the initial capital base as proposed by the Commission in this *Draft Decision*.

Proposed amendment A2.8

In order for EAPL's access arrangement for the MSP to be approved, the WACC estimates and associated parameters must be amended to more accurately reflect current market conditions. In particular, the post-tax nominal return on equity should be set at 13.0 per cent, the pre-tax real WACC should be set at 7.0 per cent and the associated inflation assumption set at **2.9** per cent.

Proposed amendment A2.9

In order for EAPL's access arrangement for the MSP to be approved, **an** allowance for a return on working capital should not be included in EAPL's revenue requirements.

Proposed amendment A2.10

In order for EAPL's access arrangement for the MSP to be approved, the reference tariffs applicable to any pipeline segment of the MSP should be no higher than tariffs consistent with that segment's costs based on DORC (plus operating and maintenance costs).

Proposed amendment A2.11

In order for EAPL's access arrangement for the MSP to be approved, EAPL should introduce a more cost-reflective tariff structure by dispensing with the phasing in of the lateral tariffs.

Proposed amendment A2.12

In order for EAPL's access arrangement for the MSP to be approved, the initial reference tariffs must be set in relation to the efficient forecast costs of providing reference services in accordance with the amendments proposed in this *Draft Decision*, rather than current published tariffs.

amendment A2.13

In order for EAPL's access arrangement for the MSP to be approved, the CPI-X escalation factor must be of the form $(CPI_n/CPI_{n-1}) \cdot (1 - X)$.

In order for EAPL's access arrangement for the MSP to be approved, EAPL must include in the access arrangement a provision that the proposed review of operational and balancing provisions and charges will be conducted within six months of approval of the access arrangement by the Commission.

Proposed amendment A3.6

In order for EAPL's access arrangement for the MSP to be approved, the *Request for Transportation Services – Request Sheet* must be amended to include the option of multiple receipt and delivery points.

Proposed amendment A3.5

In order for EAPL's access arrangement for the MSP to be approved, EAPL must delete Clause 28.1(5) of Attachment 3.

Proposed amendment A3.4

In order for EAPL's access arrangement for the MSP to be approved, EAPL must delete clause 28.1(6) of Attachment 3 to the proposed access arrangement.

Proposed amendment A3.3

In order for EAPL's access arrangement for the MSP to be approved, the access arrangement must clearly specify that the access arrangement provisions in general, and specifically, attachments 3 and 4 of the access arrangement prevail over the term sheets, standard service agreements, EAPL's nominations and balancing procedures and any other existing or future documents relating to the provision of access.

Proposed amendment A3.2

In order for EAPL's access arrangement for the MSP to be approved, EAPL must remove the three rebatable services known as class WFT, OFT and IT services currently included in the access arrangement.

Proposed amendment A3.1

In order for EAPL's access arrangement for the MSP to be approved, the CPI-X formula must be exclusive of the impact of the New Tax System.

Proposed amendment A2.14

Proposed amendment A3.7

In order for EAPL's access arrangement for the MSP to be approved, EAPL must amend the access arrangement to state that EAPL will, if recommendations by the AGA Gas Specification Working Group to adopt more flexible gas specifications in south-eastern Australia are approved, substitute that specification for the specification currently set out in Table A7.1 of Attachment 7 of the access arrangement, subject to obligations under existing service agreements.

Proposed amendment A3.8

In order for EAPL's access arrangement for the MSP to be approved, EAPL must clarify the prudential requirements for users and prospective users.

Proposed amendment A3.9

In order for EAPL's access arrangement for the MSP to be approved, clause 27.2(6) must be amended to state that written confirmation to EAPL's satisfaction is required from the intending user that the appropriate arrangements have been made. EAPL should not be able to obtain commercially sensitive information from intending users beyond the scope of this criterion.

Proposed amendment A3.10

In order for EAPL's access arrangement for the MSP to be approved, EAPL must delete clause 27.2(12) of Attachment A to the access arrangement and amend clause 27.2(9) of Attachment A to the access arrangement to read: 'The Intending User is able to demonstrate its creditworthiness to EAPL's reasonable satisfaction'.

Proposed amendment A3.11

In order for EAPL's access arrangement for the MSP to be approved, clause 7.5(13)(b) must be amended to state that written confirmation to EAPL's satisfaction is required from the prospective user that the appropriate arrangements have been made. EAPL should not be able to obtain commercially sensitive information from intending users beyond the scope of this criterion.

Proposed amendment A3.12

In order for EAPL's access arrangement for the MSP to be approved, EAPL must specify in the access arrangement that it will notify the Commission of the commencement of services provided through expansions and extensions to the MSP and that notification must be given prior to commencement of operation of the facility.

Proposed amendment A3.13

In order for EAPL’s access arrangement for the MSP to be approved, EAPL must amend clause 16.6 to define the discount rate to be applied in the NPV analysis as the vanilla WACC determined in accordance with the Commission’s *Final Decision*.

Proposed amendment A3.14

In order for EAPL’s access arrangement for the MSP to be approved, EAPL must amend clause 16.7 to include ‘with the approval of the Commission’ following the phrase ‘to the Capital Base’.

Proposed amendment A3.15

In order for EAPL’s access arrangement for the MSP to be approved, EAPL must change the revisions submission date so that it is four years and six months after the commencement date of the initial access arrangement period.

1. Introduction

On 5 May 1999, East Australian Pipeline Limited (EAPL)¹ submitted a proposed access arrangement and access arrangement information for the Moomba to Sydney Pipeline System (MSP) to the Australian Competition and Consumer Commission (the Commission). Approval was sought under the *National Third Party Access Code for Natural Gas Pipeline Systems* (the Code). The MSP extends from Moomba (South Australia) to Wilton (Sydney, NSW) and includes laterals to Canberra and regional centres including Lithgow and Griffith.

The access arrangement and access arrangement information describe the terms and conditions on which the company will make access to its pipeline available to third parties. The Commission's assessment of the access arrangement is being conducted in accordance with the requirements set out in the Code and is based on information and comments provided by EAPL and interested parties.

This document sets out the Commission's draft decision and related proposed amendments under section 2.13 of the Code for EAPL's access arrangement.

This introduction includes:

- a description of the regulatory framework;
- a description of the NSW gas industry structure;
- a description of the MSP;
- a description of the current assessment process; and
- the Commission's draft decision, and an outline of the path to the Commission's final decision.

Chapter 2 of this *Draft Decision* considers major issues associated with the regulatory rate of return and the capital base valuation which are required to determine reference tariffs for third party access. The reference tariff principles in section 8 of the Code are examined.

Chapter 3 provides an assessment of the access arrangements in terms of the non-tariff mandatory elements in the Code.

Chapter 4 examines information provision and performance indicators.

Chapter 5 sets out the Commission's draft decision. The Commission has identified amendments that would need to be made to the access arrangement in order for it to be approved. These proposed amendments are set out in the relevant sections of the *Draft Decision* and are brought together in the Executive Summary.

¹ The ownership of EAPL was transferred to the Australian Pipeline Trust in June 2000. For consistency, all references to the service provider made throughout this document will be to EAPL as the applicant.

1.1 Regulatory framework

The main legislation and relevant documents regulating access to gas transmission pipelines in NSW are:

- the Code, under which transmission service providers are required to submit access arrangements to the Commission for approval;²
- the *Gas Pipelines Access (South Australia) Act 1997*;³ and
- the *Gas Pipelines Access (New South Wales) Act 1998*.⁴

Code and appeal bodies in NSW with respect to transmission pipelines are:

- the Commission – regulator and arbitrator;
- the National Competition Council – Code advisory body;
- the Commonwealth Minister – coverage decision maker;
- the Federal Court – judicial review; and
- the Australian Competition Tribunal – administrative appeal.

The Independent Pricing and Regulatory Tribunal (IPART) is the regulator for gas distribution systems in NSW and has recently assessed AGLGN's access arrangement for its NSW distribution system. The Independent Competition and Regulatory Commission (ICRC) is the regulator for the gas distribution system in the ACT, Queanbeyan and Yarralumla.

1.1.1 Coverage under the Code

All of the pipelines included in the MSP are covered under the Code with the exception of the section from Wagga Wagga to Culcairn which has been treated as an extension to the covered pipeline and is included as part of this access arrangement.

On 28 April 2000, EAPL submitted an application to the National Competition Council (NCC) to revoke coverage of three transmission pipelines within the MSP under the Code.

In its Final Recommendation to the Minister on 8 September 2000, the NCC stated that coverage under the Code of the Moomba to Wilton pipeline, the Young to Culcairn pipeline and the Dalton to Canberra pipeline should not be revoked. The Minister for Industry, Science and Resources, Senator Minchin, subsequently accepted the NCC recommendation on 16 October 2000 to not revoke coverage of the MSP.

² The Independent Pricing and Regulatory Tribunal (IPART) is the relevant regulator for gas distribution pipelines in NSW and the Independent Competition and Regulatory Commission (ICRC) is the relevant regulator in the ACT.

³ South Australia acted as lead legislator for the national gas access legislation.

⁴ NSW subsequently enacted legislation applying the SA legislation in NSW. The NSW legislation commenced on 14 August 1998.

1.2 Structure of the gas industry in NSW

Briefly, the overall structure of the gas industry in NSW has the following key characteristics:

- the total volume of gas sold in NSW was 106.6PJ to 753 190 customers generating total revenue of \$722.5 million in 1997-98;⁵
- the MSP transmits gas from Moomba to the Sydney city gate at Wilton, with laterals and spur lines to Canberra and regional centres such as Lithgow and Yass;
- the Eastern Gas Pipeline (EGP), a transmission pipeline from Longford (Victoria) to Horsley Park (NSW), was commissioned in September 2000 to supply Gippsland Basin gas into NSW;
- prior to the commencement of the EGP, almost all of the natural gas demand in NSW was supplied solely by the Cooper Basin Production Unit in South Australia, which has supplied natural gas to NSW since 1976;
- AGL Gas Networks Limited (AGLGN) operates the natural gas distribution system to most regional centres in NSW, including Sydney, Newcastle and Wollongong;
- the Albury Gas Company Ltd operates the natural gas distribution system in Albury, and Great Southern Energy Gas Networks Pty Ltd distributes natural gas in Wagga Wagga;
- all gas customers are to become contestable by 1 July 2001 under the NSW Government's timetable for the introduction of competition in the NSW retail gas market; and
- the Interconnect, a pipeline between Barnawartha (Victoria) and Wagga Wagga (NSW), was completed in August 1998 linking the NSW and Victorian natural gas systems. This was initially the only link between the NSW and Victorian gas pipeline systems and now provides an alternative supply route for Gippsland Basin gas into NSW since the commencement of the EGP.

1.2.1 The MSP

The MSP was built in the mid 1970s to supply Cooper Basin gas to Sydney. It extends from Moomba in South Australia to Wilton on the outskirts of Sydney, where it connects with AGLGN's distribution networks. The Moomba to Wilton pipeline is 1 299 km in length with a diameter of 864 mm and has compressors located at Bulla Park and Young to augment capacity. Mainline offtakes are located at Marsden, Young and Dalton.

The MSP also includes the following pipelines:

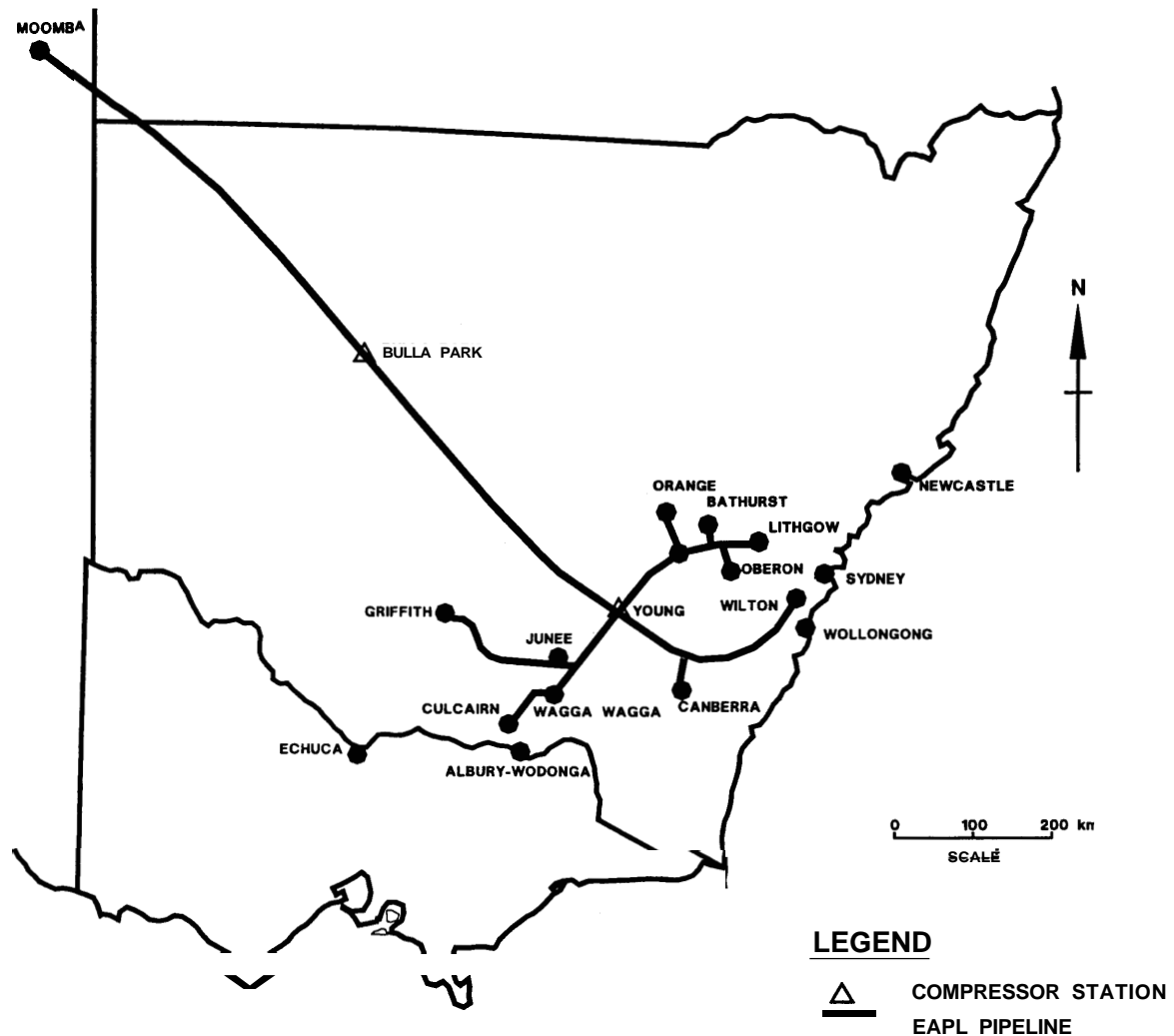
- Young to Wagga Wagga: commissioned in 1981, this pipeline is 131 km in length;
- Dalton to Canberra: commissioned in 1981, 58 km;
- Young to Lithgow: commissioned in 1987, 270 km;
- Junee to Griffith: commissioned in 1993, 179 km;

⁵ Ministry of Energy and Utilities, *Energy in New South Wales 1999*, p. 8.

- Wagga Wagga to Culcairn: commissioned in 1998, 88 km.⁶

The location of the MSP is illustrated in Figure 1.1 below.

Figure 1.1: Geographic location of the MSP



Source: Access arrangement information, p. 3.

For tariff setting purposes, EAPL has segregated the MSP into two pipeline groups. These are:

- Mainlines: Moomba to Young, Young to Wilton and Young to Culcairn; and
- Laterals: the remaining pipelines of Young to Lithgow (with spur lines to Bathurst, Cootamundra, Oberon and Orange), Dalton to Canberra, and Junee to Griffith.

⁶ This is EAPL's portion of the Interconnect which connects the Victorian and NSW transmission systems. See section 1.2.3 for further details.

The service provider

Section 2 of the Code specifies that the service provider is required to submit a proposed access arrangement (and associated access arrangement information) to the regulator for approval. The service provider is defined as ‘a person who owns (whether legally or equitably) or operates the whole or any part of a Pipeline’. EAPL currently owns the MSP. The access arrangement provides for ownership of the MSP to change over time.⁷ The Commission expects that it will receive notification of any change in ownership or operation of the MSP as those changes occur in the future.

EAPL purchased the MSP from The Pipeline Authority (TPA), a Commonwealth Government owned entity, in June 1994. At the time, and until December 1999, EAPL was owned by AGL (51 per cent) and Gasinvest Australia Pty Ltd (49 per cent).⁸ Maintenance and operational activities were carried out by EAP Operations Pty Limited while marketing activities were conducted by East Australian Pipeline Marketing Pty Limited. These companies were owned by AGL and Gasinvest Australia.

In December 1999 AGL increased its interest in EAPL to approximately 76 per cent through the acquisition of TransCanada Pipelines Limited’s interest. Ownership of the MSP (and other transmission pipelines wholly or partly owned by AGL) was subsequently transferred to the Australian Pipeline Trust (APT). Trading of units of the APT on the Australian Stock Exchange commenced on 13 June 2000. AGL is understood to hold a 30 per cent share in APT and Petronas a ten per cent share.

Historical background to the MSP

The MSP was initially proposed by AGL in the early 1970s following the discovery of natural gas in the Cooper Basin. The Commonwealth Government established the TPA as part of a plan to facilitate the establishment of an interconnected national gas pipeline system and assumed control of the project in 1974. TPA subsequently transported gas on behalf of AGL consistent with contractual commitments AGL had already entered into with the Cooper Basin producers.

As part of its long term restructuring of the Australian economy in the 1980s, the Commonwealth Government embarked on a broad range of micro and macro economic reforms, including a National Gas Strategy in November 1991. The sale of the MSP was part of this strategy. The *Interstate Gas Pipelines Bill* introduced in 1993 was designed to establish an appropriate regulatory environment following the sale of the pipeline. More specifically, the regulatory framework was designed to promote the development of a competitive pipeline industry structure by providing, among other things, for transparency of pricing and open access to third parties.

The *Moomba-Sydney Pipeline System Sale Act 1994* (MSPSS Act) enabled the sale of the MSP to EAPL. The sale of the pipeline system and related assets to EAPL for \$534 million was completed on 30 June 1994.⁹

⁷ Access arrangement, Definitions for Principles for Terms & Conditions, clause 35.

⁸ Gasinvest Australia was in turn owned by the TransCanada Pipelines Limited (formally NOVA Gas Australia Pty Ltd) and Malaysian owned Petronas Australia Pty Ltd.

⁹ The Pipeline Authority, 1993-94 annual report, pp. 30-31.

Under the provisions of the MSPSS Act the Commission's predecessors (the Trade Practices Commission and the Prices Surveillance Authority) had regulatory responsibility regarding third party access disputes and the monitoring of haulage charges and transactions that were not conducted at arm's length.

The legislative framework underpinning the MSPSS Act was seen as a temporary measure pending the implementation of the current uniform framework applying to third party access to gas transmission pipelines and distribution networks in Australia under the Code.

Gas Transportation Agreement

Between 30 June 1994 and 30 June 2000, AGL Wholesale Gas Limited (AGLWG) acquired most of its haulage services through the MSP under the Gas Transportation Agreement (GTA) with EAPL. Under the GTA, the terms and conditions for the transmission haulage of gas were established between EAPL and AGLWG to supply customers in NSW and the ACT. The terms and conditions of this agreement were separate to those established for third party access under the MSPSS Act. Although the GTA was scheduled to conclude on 31 December 2016, it was terminated and replaced by the Gas Transportation Deed (GTD) between AGLWG and EAPL on 30 June 2000.

The GTD is a framework agreement setting out the broad relationship between EAPL and AGLWG until 31 December 2016. Haulage services provided to AGLWG are in accordance with the minimum published reference tariffs¹⁰ for comparable haulage services under this access arrangement.

The GTD also specifies a minimum level of monthly payments that AGLWG must make to EAPL until 1 January 2007. AGLWG is entitled to deduct from these payments the tariffs payable by AGLWG for services provided in that period. However, if, at 1 January 2007, the amounts AGLWG is entitled to deduct were less than the total of the payments, EAPL will retain the difference. That is, the payments would be non-refundable.

If, in any year between 1 July 2000 and 1 January 2003, EAPL receives revenues from third parties that exceed the third party revenues received in the year 1 January 1999 to 1 January 2000, AGLWG is entitled to have 50 per cent of the excess deducted from the minimum payments.

On 4 January 2000 the Commission received an application from EAPL seeking approval for the GTD with AGLWG as an associate contract under section 7.1 of the Code. The Commission approved the revised GTD as submitted by EAPL on 3 April 2000.¹¹

1.2.2 The Interconnect

The Interconnect, which was completed in July 1998, is a 151 km pipeline of 450 mm diameter linking the NSW and Victorian pipeline systems. EAPL owns the 88 km

¹⁰ These tariff charges may be varied in certain events as defined in the GTD.

¹¹ ACCC, Statement of reasons for decision: East Australian Pipeline Limited proposed Gas Transportation Deed, 3 March 2000.

northern section (from Wagga Wagga to Culcairn) while GPU GasNet Pty Ltd owns the 62 km southern section (from Barnawatha (near Wodonga) to Culcairn).

The Interconnect is able to provide northern or southern gas flows thereby enabling customers in both NSW and Victoria to potentially enjoy a competing source of gas. Following the Longford processing plant explosion in 1998, the capacity of the Interconnect to deliver gas into Victoria was increased from 35TJ/day to 92TJ/day.¹²

EAPL has included its portion of the Interconnect in the current proposed access arrangement. In contrast, GPU GasNet did not include the Barnawatha to Culcairn leg in the access arrangement relating to the Victorian Principal Transmission System (PTS) prior to approval by the Commission in December 1998. The Commission subsequently approved an application by GPU GasNet to roll-in the capital cost of its portion of the Interconnect (and associated compressor and valves) to the PTS access arrangement in April 2000.¹³

1.2.3 Eastern Gas Pipeline

The EGP is owned by Duke Eastern Gas Pipeline Pty Ltd, DEI Eastern Gas Pipeline Pty Ltd and Duke Australia Operations Pty Ltd (collectively known as DEIEGP). The 792 km pipeline extends between Longford (Victoria) and Horsley Park (NSW). The pipeline provides an alternative source of gas for consumers in Sydney as well as providing the possibility for natural gas supply for the first time to towns on the eastern seaboard of Australia south of Wollongong.

The EGP has an initial capacity of 55 PJ of gas per year, which is equal to approximately half the current NSW gas demand that has been supplied by the MSP. DEIEGP proposes to install additional compressors to the EGP to match demand growth up to a maximum capacity of 110PJ/year. The EGP was completed on 17 August 2000.

DEIEGP sought approval from the Commission of an undertaking submitted under Part IIIA of the *Trade Practices Act* 1974 to cover third party access on the pipeline. The Commission made a final decision on the application on 28 August 2000 to not accept the undertaking on the basis that the information supplied by Duke was inadequate to allow a proper assessment of the undertaking

On 7 January 2000 the National Competition Council (NCC) received an application from AGL Energy Sales and Marketing Ltd for the EGP to be covered under the Code. On 8 May 2000 the NCC released its *Draft Recommendation* on the application for coverage in which it recommended coverage of the pipeline south of the off-take for the ACT. With regard to the rest of the pipeline the NCC was undecided whether to recommend coverage or not. On 3 July 2000 the NCC released its *Final Recommendation* in which it recommended coverage of the whole pipeline.

¹² ACCC, Final Decision: Access arrangement for the Principal Transmission System, application for revision by GPU GasNet Pty Ltd, 28 April 2000, p. 21.

¹³ ACCC, Final Decision: Access arrangement for the Principal Transmission System, application for revision by GPU GasNet Pty Ltd, 28 April 2000.

On 16 October 2000, the Minister for Industry, Science and Resources, Senator Minchin, accepted the NCC recommendation and announced that the EGP would be a covered pipeline for the purposes of the Code. On 27 October 2000 DEIEGP filed with the Australian Competition Tribunal an Application for Review of the decision for coverage of the EGP.

1.3 The assessment process

The proposed access arrangement and access arrangement information describe the terms and conditions on which EAPL will make access to the MSP available to third parties during the initial access arrangement period which EAPL proposes will last approximately five years. However, under the provisions of the Code, EAPL has the discretion to submit revisions earlier than the scheduled review.

The Commission's current assessment process relates to the initial access arrangement period. However, it will also impact on subsequent access arrangement periods.

Section 2 of the Code sets out the assessment process to be undertaken by the Commission which involves the following:

- inform interested parties that it has received the access arrangement and access arrangement information from EAPL;
- publish a notice in a national daily newspaper which describes the covered pipeline to which the access arrangement relates and states how copies of the documents may be obtained. A date by which submissions are to be lodged must also be specified in the notice;
- after considering submissions received, issue a draft decision which proposes either to approve the access arrangement or not to approve the access arrangement and states the amendments (or nature of the amendments) which have to be made to the access arrangement in order for the Commission to approve it. Submissions will be sought again following the release of the Commission's draft decision;
- after considering any additional submissions and a revised access arrangement (if submitted), issue a final decision that either approves or does not approve the access arrangement (or revised access arrangement) and states the amendments (or nature of the amendments) which have to be made to the access arrangement (or revised access arrangement) in order for the Commission to approve it; and
- if the amendments are satisfactorily incorporated in a revised access arrangement, issue a final approval. If not, the Commission must draft and approve its own access arrangement.

1.4 Criteria for assessing an access arrangement

The Commission may approve a proposed access arrangement only if it is satisfied that it contains the elements and satisfies the principles set out in sections 3.1 to 3.20 of the Code, which are summarised below. **An** access arrangement cannot be rejected by a regulator solely on the basis that it does not address a matter that section 3 of the Code does not require it to address. Subject to this, the Commission has a broad discretion in accepting or opposing an access arrangement.

An access arrangement must include a policy on the service or services to be offered which includes a description of the service(s) to be offered. The policy must include one or more services that are likely to be sought by a significant part of the market and any service(s), which in the Commission's opinion should be included in the policy. To the extent practicable and reasonable, users and prospective users must be able to obtain those portions of the service(s) that they require, and the policy must allow for a separate tariff for an element of a service if requested.

An access arrangement must also contain one or more reference tariffs. A reference tariff operates as a benchmark tariff for a particular service and provides users with a right of access to the specific service at the specific tariff. Tariffs must be determined according to the reference tariff principles in section 8 of the Code.

An access arrangement must also include the following elements:

- terms and conditions on which the service provider will supply each reference service;
- a statement of whether a contract carriage or market carriage capacity management policy is applicable;
- a trading policy that enables a user to trade its right to obtain a service (on a contract carriage pipeline) to another person;
- a queuing policy to determine users' priorities in obtaining access to spare and developable capacity on a pipeline;
- an extensions and expansions policy to determine the treatment of extensions and expansions of a pipeline under the Code;
- a date by which revisions to the arrangement must be submitted; and
- a date by which the revisions are intended to commence.

In considering whether **an** access arrangement complies with the Code, the Commission must (pursuant to section 2 of the Code) take into account:

- the legitimate business interests and investment of the service provider;
- **firm** and binding contractual obligations of the service provider or other persons (or both) already using the covered pipeline;
- the operational and technical requirements necessary for the safe and reliable operation of the covered pipeline;
- the economically efficient operation of the covered pipeline;
- the public interest, including the public interest in having competition in markets (whether or not in Australia);
- the interests of users and prospective users; and
- any other matters that the Commission considers are relevant.

1.5 Consultative process

Pursuant to the requirements of section 2 of the Code, the Commission **has** sought input from interested parties during the assessment process of the access arrangement. It

published a public notice in the *Australian Financial Review* on 19 May 1999 to inform interested parties that it received the access arrangement and access arrangement information from EAPL. The Commission released an *Issues Paper* on 4 June 1999 and invited submissions on the proposed access arrangement.

The Commission has received written submissions from seven interested parties regarding the proposed access arrangement (see Appendix A).

The major issues raised by interested parties in the submissions have included:

- valuation of the initial capital base;
- rate of return;
- depreciation;
- reference tariffs;
- terms and conditions, such as operational and balancing requirements; and
- other non-tariff elements such as extensions and expansions policy, trading policy and services policy.

In response to concerns regarding the adequacy of information available to interested parties raised by the Commission, EAPL provided additional access arrangement information on 28 October 1999. Moreover, on 17 August 2000 EAPL provided a response to submissions from interested parties.

Also in August 2000, APT raised some concerns with the access arrangement as proposed originally by EAPL and submitted proposed revisions to the access arrangement. The revisions relate to the issues of asset valuation, depreciation, rebatable services and gas fuel. In some instances APT has not provided full details of its proposed revisions.

APT initially wished its proposals to be raised as revisions to the access arrangement after the Commission released its *Draft Decision*. However, the Commission considered that such an approach would require a further round of public consultation and would delay the decision-making process. Therefore the Commission has raised APT's proposals for discussion in this *Draft Decision* in the appropriate section and invites comments from interested parties.

Also in August 2000, Agility, on behalf of APT, submitted an alternative proposal for determining the value of DORC. Agility's approach is forward looking and calculates DORC in accordance with the future revenue stream of a new entrant in a hypothetical competitive market and takes into account the remaining life of the existing asset. It differs from the more traditional approach of calculating DORC on the basis of straight line depreciation. Agility's proposal is discussed in section 2.2 of this *Draft Decision*.

1.6 Draft decision

The Commission has now made a draft decision under section 2.13(b) of the Code that it proposes not to approve the access arrangement submitted by EAPL in its current form. It has identified amendments to the proposed access arrangement that must be

satisfactorily incorporated in a revised access arrangement in order for it to be approved (under section 2.16(c)). These proposed amendments are set out in the relevant sections in this *Draft Decision* and in the Executive Summary.

The Commission is now seeking submissions from interested parties on the Commission's draft decision on the proposed access arrangement. All submissions must be delivered to the Commission by 9 February 2001 and should be addressed to:

Ms Kanwaljit Kaur
General Manager
Regulatory Affairs – Gas
Australian Competition and Consumer Commission
PO Box 1199
Dickson ACT 2602
Fax: (02) 6243 1260

All submissions must be in writing, and preferably should also be supplied in electronic format compatible with Microsoft Word 97 for Windows. They may also be e-mailed to the Project Manager, John Bastick, at 'john.bastick@acc.gov.au'.

1.7 Final decision

After considering submissions and any revised access arrangement submitted by the service provider, the Commission must issue a final decision (pursuant to section 2.16 of the Code) which:

- (a) approves the access arrangement; or
- (b) does not approve the access arrangement or revised access arrangement and provides reasons why it does not approve the (revised) access arrangement and states the amendments (or nature of the amendments) which would have to be made to the (revised) access arrangement in order for the Commission to approve it and the date by which a revised access arrangement must be submitted; or
- (c) approves a revised access arrangement.

In the event that the Commission issues a final decision (pursuant to section 2.16(b) of the Code) which does not approve the access arrangement, the Code (sections 2.18-2.19) requires the service provider to submit a revised access arrangement to the Commission for consideration. However, if the service provider does not submit a revised access arrangement by the required date, or does so but the Commission is not satisfied it incorporates amendments specified in the final decision, the Commission must draft and approve its own access arrangement (section 2.20 of the Code). Such a decision is subject to merits review by the Australian Competition Tribunal under the Gas Pipelines Access Law.

The Commission proposes to issue its final decision on the MSP access arrangement by 17 June 2001. Based on this timetable, the proposed date of effect for the access arrangement is 1 July 2001 (or a date at least 14 days after the release of the final decision, whichever is the latter).

2. Reference tariff elements

The Code specifies a set of mandatory elements with which an access arrangement must comply. This chapter examines matters relating to reference tariffs including the WACC, depreciation and asset value. Chapter 3 considers EAPL's compliance with the non-tariff elements of the Code.

Sections 3.3 to 3.5 of the Code require an access arrangement to include a reference tariff for at least one service that is likely to be sought by a significant part of the market and other services for which the Commission considers a reference tariff should be included. An access arrangement must also include a policy describing the principles that are to be used to determine a reference tariff (a reference tariff policy). The reference tariff and reference tariff policy must comply with the reference tariff principles in section 8 of the Code.

In addition to the respective access arrangement and access arrangement information, EAPL has provided the Commission with several spreadsheet files which contain the model for construction of the tariff from forecasts of volumes and cost data. Following a request by the Commission,¹⁴ EAPL has made publicly available a supplementary access arrangement information package¹⁵ to assist users and prospective users to understand the derivation of elements of the access arrangement and to form their own views as to compliance of the access arrangement with the provisions of the Code.

This chapter assesses compliance of the proposed reference tariff for the access arrangement using the structure below, taking into account specific requirements of the Code, proposals by EAPL, and submissions from interested parties:

- 2.1 Overall reference tariff methodology
- 2.2 The initial capital base
- 2.3** New facilities investment and capital redundancy
- 2.4 Depreciation and inflation
- 2.5 Rate of return
- 2.6 Operations costs and working capital
- 2.7 Forecast revenue
- 2.8 Forecast volumes
- 2.9 Cost allocation and tariff setting
- 2.10 Tariff path and incentive structure
- 2.11 Assessment of reference tariffs and reference tariff policy.

The Commission's proposed amendments relating to reference tariffs are located in the relevant sections of this chapter and in the Executive Summary.

¹⁴ Commission letter to EAPL, 24 August 1999.

¹⁵ Supplementary access arrangement information, 28 October 1999.