Agility

14 March 2001

Ms Kanwaljit Kaur
General Manager Regulatory Affairs – Gas
Australian Competition and Consumer Commission
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Dear Ms Kaur

DRAFT DECISION ON ACCESS ARRANGEMENT FOR MOOMBA-SYDNEY PIPELINE

On behalf of East Australian Pipeline Limited ("EAPL"), the owner of the Moomba-Sydney Pipeline, we attach a submission responding the Commission's draft decision on the Access Arrangement proposed by EAPL.

EAPL's response to each of the particular amendments is set out in the attached submission. Additionally, we confirm that in the near future EAPL intends to lodge with the Commission a revised Access Arrangement reflecting agreed amendments from the Draft Decision and matters previously advised to the Commission.

Yours faithfully

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The submission is structured as follows:

A. INITIAL CAPITAL BASE

B. RATE OF RETURN

C. ISSUES RELATED TO CPI AND GST

D. OTHER AMENDMENTS PROPOSED IN DRAFT DECISION

1. Amendment A2.1: initial capital base
2. Amendment A2.2: treatment of redundant assets
3. Amendment A2.3: CPI for indexation of capital base in 2005
4. Amendment A2.4: treatment of GST impact on CPI
5. Amendment A2.5: alternative measure for inflation
6. Amendment A2.6: adoption of straight line depreciation
7. Amendment A2.7: basis of depreciation schedule
8. Amendment A2.8: rate of return
9. Amendment A2.9: allowance for return on working capital
10. Amendment A2.10: reference tariffs for pipeline segments
11. Amendment A2.11: phasing in of lateral tariffs
12. Amendment A2.12: setting of initial reference tariffs
13. Amendment A2.13: form of CPI-X factor
14. Amendment A2.14: impact of GST on CPI-X escalation
15. Amendment A3.1: rebatable services
16. Amendment A3.2: relationship of terms and conditions with term sheets etc
17. Amendment A3.3: clause 28.1(6) of attachment 3
18. Amendment A3.4: clause 28.1(5) of attachment 3
19. Amendment A3.5: request form
20. Amendment A3.6: review of operation and balancing provisions
21. Amendment A3.7: adoption of gas specification
22. Amendment A3.8: prudential requirements
23. Amendment A3.9: clause 27.2(6): arrangements for receipt point of gas
24. Amendment A3.10: clause 27.2(12): creditworthiness of user
25. Amendment A3.11: clause 7.5(13)(b): upstream and downstream arrangements
26. Amendment A3.12: notification of commencement of services for extensions or expansions
27. Amendment A3.13: discount rate for extensions and expansions
28. Amendment A3.14: recovery of surcharge
29. Amendment A3.15: revisions submission date

E. OTHER ISSUES RAISED IN DRAFT DECISION

1. Treatment of revenue from Gas Transportation Deed
2. NERA paper on tariff setting
3. Fuel gas

A. INITIAL CAPITAL BASE

The Initial Capital Base proposed in the Draft Decision is based on a number of mistakes, all of which have the effect of diminishing the value of the factors that the Regulator should take into account in setting the initial capital base:

1. the construction of DORC in the Draft Decision is inconsistent with the definition and interpretation of DORC in prior decisions of the Commission and the Office of the Regulator-General, Victoria and in other documents produced by the Commission (see Section 1);
2. the Draft Decision is mistaken in its assessment of the circumstances of the 1994 sale of the MSP which in turn gives rise to a mistaken view of how the sale price should be taken into account in the determination of the ICB (see Section 2);
3. the Draft Decision mistakenly dismisses the value of economic depreciation from consideration on the grounds that it is the measure of a subsidy (see Section 3); and
4. the Draft Decision has incorrectly assessed the quantum that is derived from a consideration of the reasonable expectations of EAPL under the prior regulatory regime to be the value of DORC as constructed under the Draft Decision (see Section 4).

The ICB proposed in the Draft Decision increases substantially when these mistakes are corrected.

General considerations pertaining to the establishment of the ICB, and overall conclusions are presented in Section 5.

1. Incorrect Interpretation of DORC

This section addresses the following matters:

Definition and interpretation of DORC:

- the definition and interpretation of DORC are clearly and consistently stated in a number of authoritative documents produced by the Commission and the ORG, particularly:

    - Final Decisions by the Commission and the ORG on the Access Arrangements for the Victorian gas transmission pipelines and distribution pipelines[1] in October 1998;
    - the Commission's Draft Statement of Principles for the Regulation of Transmission Revenues (May 1999) which was recently confirmed by the Commission in the Draft Decision on the Access Arrangement for the Moomba to Adelaide Pipeline (August 2000);

- the definition and interpretation of DORC in the above documents is consistent with the Code requirement that DORC be a well recognised asset valuation methodology[2] and with the position of DORC in the Code as an upper limit on valuation[3] (see Section 1.1)

- the Commission continues to be committed to the definition and interpretation of DORC which commenced with the Victorian Gas Decisions in 1998;

[1] The two Final Decisions by the Commission and the ORG are referred to together as the Victorian Gas Decisions.
[2] Code, section 8.10(c).
[3] Code, section 8.11.

- the Commission's meaning and interpretation is not qualified in any way which precludes its direct application in assessing the DORC for the MSP. Furthermore, there is nothing about the MSP, as compared to the Victorian gas assets, which would call for the construct to be changed in any way; and

- while the definition and interpretation of DORC in the Draft Decision is expressed less explicitly than in the documents referred to above, the Commission's intention in the Draft Decision appears to be consistent with those documents (see Section 1.2).

Construction of DORC from ORC:

- The Commission has indicated in the Draft Statement of Principles that it intends to produce a guideline on DORC valuations in which the depreciation aspects "will be based on the [competition depreciation] approach in [the Draft Statement of Principles]" and "will depart from the use of traditional straightline depreciation schedules"[4] (see Section 1.3);

- the NPV-based construction of DORC from ORC proposed by Agility gives effect to the definition and interpretation of DORC in the above documents (see Section 1.4); and

- the construction proposed in the Draft Decision is based on straight line depreciation of the ORC and is inconsistent with Commission's intentions as stated in the Draft Statement of Principles (see Section 1.5).

Review by Professor Stephen King:

- Professor Stephen King has reviewed the alternative approaches for the construction of DORC from ORC in the context of the definition and interpretation of DORC in the documents referred to above, and has confirmed that:

  - the construction of DORC from ORC using the Commission's "competition depreciation" approach is consistent with the definition and interpretation of DORC presented in the Victorian Gas Decisions and the Draft Statement of Principles;
  - the Agility NPV-based approach to the construction of DORC from ORC is consistent with the definition and interpretation of DORC presented in the Victorian Gas Decisions and the Draft Statement of Principles and is an expression of the Commission's competition depreciation approach;
  - the straight line adjustment to transform ORC to DORC in the Draft Decision "is arbitrary and appears to lack any economic justification" and is “clearly inconsistent with the Commission's stated economic underpinnings and justification of DORC”;
  - past actual/accounting depreciation is irrelevant to the proper construction of DORC from ORC; and
  - the depreciation implicit in the construction of DORC from ORC does not of itself place any constraint on the depreciation path of the ICB.

  (see Section 1.6)

[4] Draft Statement of Principles, page 42.

Conclusion

If the Commission is to maintain its commitment to the definition and interpretation of DORC established in the Draft Statement of Principles and the Victorian Gas Decisions, it must correct the Draft Decision by adopting the construction of DORC which is consistent with that definition and interpretation. Such a construction results in a DORC value for the MSP of approximately $940m (compared with the Draft Decision value of $539M) (see Section 1.7).

1.1 The definition and interpretation of DORC in the previous writings of the Commission and the Office of the Regulator-General, Victoria

In the Draft Statement of Principles the Commission makes the following statements in relation to the definition and interpretation of DORC:

> *"The main economic principle for assessing the economic value of any assets is that their value to investors is equal to the net present value of the expected future cash flows generated by those assets. The practical difficulty in making this assessment for regulated monopoly businesses is that the future revenue derived from the assets is itself determined by the regulator – hence the issue of circularity associated with the use of ODV as a methodology to value sunk assets.*
>
> *This potential circularity is eliminated by the use of DORC. The DORC of a network is the sum of the depreciated replacement cost of the assets that would be used if the system were notionally reconfigured so as to minimise the forward looking costs of service delivery. There are two definitions of what DORC attempts to measure:*
>
> - *One interpretation of DORC is that it is the valuation methodology that would be consistent with the price charged by an efficient new entrant into an industry, and so it is consistent with the price that would prevail in the industry in long run equilibrium.*
> - *The second interpretation is that it is the price that a firm with a certain service requirement would pay for existing assets in preference to replicating the assets."* [5]

and:

> *"Finally, another justification for DORC setting the upper limit to valuations comes from what a DORC valuation actually is attempting to measure. This is the maximum price that a firm would be prepared to pay for 'second-hand' assets with their remaining service potential, higher operating costs, and (old) technology - given the alternative of installing new assets which embody the latest technology, and which generally have lower operating costs, and which will have a greater remaining service potential. Therefore, if prices reflect a value that is in excess of DORC, then users would be better off if the existing system were scrapped and replaced by new assets. Similarly, if assets are sold for prices above the DORC valuation, then this implies that scarce investment funds are being inefficiently applied: in this case, it would have been a more efficient use of investment funds for the existing assets to be scrapped and a duplicate system installed."* [6]

[5] Page 39.
[6] Page 40.

The definition and interpretation of DORC in the Draft Statement of Regulatory Principles is consistent with definitions contained in the Victorian Gas Decisions. In particular, the second passage above appears in essentially identical terms in both of the Victorian Gas Decisions.

The Commission confirmed its commitment to these principles in August 2000 in its Draft Decision on the Access Arrangement for the Moomba to Adelaide Pipeline:

> *"The Commission's preferred general approach to determining the value of network industry capital bases is expressed in the [Draft Statement of Principles]. The approach is one that involves optimisation using an ORC methodology and the application of 'competition depreciation'. The latter term signifies a form of economic depreciation in which asset values are depreciated in line with changes in the replacement cost of assets or in the cost of alternative technologies where they exist. Such an approach best approximates the workings of a competitive market in which service tariffs are independent of the age and residual value of assets employed in the business."*[7]

The Victorian Gas Decisions are of direct relevance to the Commission's current deliberations because they reflect the views reached by itself and another independent Regulator as to the definition and interpretation of DORC for gas assets under the Code[8].

The Code casts DORC as a maximum value. The second of the passages quoted above from the Draft Statement of Principles explains why that definition and interpretation of DORC sets an upper limit to valuations. Together, the passages cited provide a logical, internally consistent, and economically sensible construct for a value which makes sense as an upper limit to valuation as required by the Code.

1.2 The definition and interpretation of DORC in the MSP Draft Decision

While not explicit, it appears that the Commission's intention is to adopt the same definition and interpretation of DORC in the Draft Decision. The Commission explains DORC in the context of the Code as follows:

> *"In this way, it is possible to understand why the Code nominates a DORC valuation as the maximum that can be applied to existing assets and generate prices that have some correspondence with what might be observed in a competitive market."*[9]

and:

> *"DORC calculated in this manner is likely to result in a value for the capital base which is more representative of the value above which uneconomic by-pass would occur (or the price that a potential purchaser would pay for the MSP) than the methodology proposed by EAPL."*[10]

[7] Draft Decision on Access Arrangement for Moomba to Adelaide Pipeline, page 37.
[8] While the Victorian Gas Decisions were made under the Victorian Third Party Access Code for Natural Gas Pipeline Systems which applied at the time, the relevant provisions of that code (sections 8.10 and 8.11) are identical to those in the current National Access Code.
[9] Draft Decision, page 27.
[10] Draft Decision, page 33.

The references to "what might be observed in a competitive market", "more representative of the value above which uneconomic by-pass would occur", and "the price that a potential purchaser would pay for the MSP" are all elements of the definition and interpretation of DORC in the Victorian Gas Decisions and the Draft Statement of Principles.

1.3 The Commission's intention is to construct DORC from ORC using a [competition depreciation] methodology which departs from the traditional straight line approach.

The following statements are made in the Draft Statement of Principles:

> *"Given the scope for alternative approaches within the DORC methodology it is clear that in order to apply an objective methodology across different networks it is necessary to establish and publish the principles under which a DORC methodology should be conducted. The Commission intends to produce such a document by 31 December 2002. The document will address the full range of issues concerning application of the DORC methodology, but in the main the depreciation aspects will be based on the [competition depreciation] approach outlined in this section." (Page 42)*

and:

> *"Thus the Commission's guideline on DORC valuations will depart from the use of traditional straightline depreciation schedules." (Page 48)*

Not only has the Commission adopted a definition and interpretation for DORC as discussed in Section 1.1 above, but the Commission also intends to adopt a construction of DORC that gives effect to that definition and interpretation and in so doing, depart from the straight line approach.

1.4 Agility construction of DORC from ORC

Agility has proposed an approach to the construction of DORC from ORC[11] which applies the definition and interpretation in the Draft Statement of Principles. Under that approach, DORC is the NPV of the first "n" years of the hypothetical new entrant's cash flow, where "n" is the remaining economic life of the existing assets for which DORC is being evaluated. The price assumed is that price which the hypothetical new entrant would require in order to generate a NPV equal to ORC over the life of the ORC asset.

This approach is consistent in all respects with the definition of DORC in the Draft Statement of Principles and the Victorian Gas Decisions and yields a value which clearly has meaning as a maximum as required by the Code. The approach can be applied without any assumptions or knowledge about the past, and especially about past actual depreciation: DORC, being the NPV of a future cash flow, is a forward-looking concept[12]. Neither does the approach imply or impose any constraints on the form that depreciation should take in the future. The only relevant constraint is that the actual price path for the asset should not at any time exceed the assumed new entrant price path[13]. This applies irrespective of whether the ICB is set at DORC or something less.

[11] Submission to ACCC, August 2000.

[12] This conclusion in relation to the irrelevance of past actual depreciation is also consistent with the observations of the ORG in its October 1998 Final Decision as follows:

"There are two equivalent definitions of what DORC attempts to measure:

The only structural assumption that must be made in order to apply the Agility approach is the price that would be charged by an efficient new entrant into the industry. In its August 2000 submission, Agility adopted the competition price profile proposed in the Draft Statement of Principles. However, that profile is but one of a number of alternatives. If, as the Commission suggests in the Draft Decision, straight line depreciation is the norm for the gas industry, then the new entrant's price path can readily be modelled on that basis. The effect of making this change is discussed in Attachment 1.

When the Agility approach is applied to the MSP, the result is a DORC value of approximately $940m compared with the Draft Decision value of $539m.

1.5 The Draft Decision construction of DORC from ORC

The Draft Decision's general approach to the construction of DORC from ORC is described as follows:

> *"To reflect such potential competitive pressures in pricing, the Code recognises that the relevant benchmark for valuing existing assets must be the Optimised Replacement Cost (ORC) and this is the maximum benchmark that should be considered. Of course, allowance must still be made for the fact that existing assets are old and may not last as long as the replacement assets. Therefore, the code suggests the use of DORC, which applies depreciation to the hypothesised ORC on the basis that the pattern of depreciation follows that of the existing asset. In this way, it is possible to understand why the Code nominates a DORC valuation as the maximum that can be applied to existing assets and generate prices that have some correspondence with what might be observed in a competitive market."*[14]

The Draft Decision then interprets the pattern of depreciation to be applied to the ORC by assuming:

> *"that the asset depreciates uniformly in real terms over the life of the asset. This leads to a relatively simple calculation so that the DORC is equated to a percentage of the ORC with the percentage equal to the expected remaining life of the existing asset expressed as a proportion of the expected life of an (sic) replacement asset"*[15]

- the asset value that is consistent with the prices that would prevail in a competitive market (that is prices which reflect the cost structure of an efficient new entrant); and
- the price that a firm with a certain service requirement would pay for existing assets in preference to replicating the assets."

and:

"**Depreciation is implied** - the value of an asset in a competitive market is the net present value of future income from that asset, which will be lower for an asset that is part of the way through its life. Similarly, assets which have a lower remaining life will need to be replaced earlier than new assets, implying that a buyer would pay less for older assets." (Page 58).

[13] According to the hypothesis upon which the DORC calculation is made, the assumed new entrant price path defines the price above which entry by the new entrant would become viable. In practice this would not occur unless prices were to be at that level for some foreseeable time, so the constraint as stated is unnecessarily restrictive. It is nevertheless acceptable.

[14] Draft Decision, page 27.

[15] Draft Decision, page 28.

This approach amounts to straight line depreciation of the ORC, and can be contrasted with the definition in the Draft Statement of Principles and in the Victorian Gas Decisions:

(i) it does not determine a valuation based on the NPV of a future revenue stream;
(ii) it makes no reference to the prices that would be charged by a new entrant;
(iii) it has no connection to the behaviour of a new entrant; and
(iv) it relies explicitly on the assumed historical treatment of depreciation.

1.6 Review by Professor Stephen King of the Agility and Draft Decision approaches to the construction of DORC from ORC

Agility has sought advice from Professor Stephen P King, Professor of Economics, The University of Melbourne, on a number of matters relevant to the construction of DORC from ORC. In summary, the questions put to Professor King and his responses are:

A. *Is the Agility NPV-based approach to the construction of DORC from ORC consistent with the definition and interpretation of DORC in the Draft Statement of Principles and the Victorian Gas Decisions?*

"The above discussion shows that … the Agility NPV approach to the construction of DORC from ORC as set out in the Agility submission of August 2000, is consistent with the interpretation of DORC presented by the ACCC and the ORG. In fact, it can be argued that the Agility approach is the *only* form of adjustment of ORC to DORC that is consistent with these interpretations."

B. *Is the approach to the construction of DORC from ORC adopted by the Commission in the Draft Decision consistent with the definition and interpretation of DORC in the Draft Statement of Principles and the Victorian Gas Decisions?*

"It is not obvious what this valuation means". The straight-line adjustment to transform ORC to DORC adopted by the ACCC in the Draft Decision "is arbitrary and appears to lack any economic justification"; and "is clearly inconsistent with the Commission's stated economic underpinnings and justification of DORC."

C. *What relevance if any does past actual/accounting depreciation have to the construction of DORC from ORC if that construction is performed in a manner which is consistent with the definition and interpretation of DORC in the Draft Statement of Principles and the Victorian Gas Decisions?*[16]

"if the adjustment of ORC to DORC is made consistent with the interpretations of DORC presented by the ACCC and the ORG, then past accounting depreciation is completely irrelevant to that adjustment."

[16] This, and the succeeding question D, address the first of the Commission's "two main reasons" for rejecting the Agility methodology i.e. that "[the methodology] is inconsistent with the depreciation proposed in the regulatory framework and the historical treatment of depreciation for the purpose of setting tariffs … " (Draft Decision, Page 30).

D. *Given that the Gas Code provides for the ICB to be set at a value which may be less than DORC, is it necessary for the regulatory asset base to be depreciated according to the same depreciation scheme as that assumed in the DORC calculation?*

No. "One way to formalise the use of DORC and consistent depreciation as a price or revenue cap is provided by the following rule. *'Irrespective of whether the ICB is set at DORC or something less, the actual price path for the asset should not at any time exceed the new entrant competition depreciation price path assumed in the calculation of DORC. This constraint does not of itself impose any limitation on the form of on-going depreciation.'* Such a rule maintains consistency of the DORC valuation over time and, in my opinion, is a legitimate approach under the Gas Code."

E. *Comment on the relationship between the DORC valuation established by the Agility NPV approach and the written down value calculated under the ACCC's competition depreciation scheme.*

"the Agility approach based on contestability is an economically meaningful case of competitive depreciation. In particular, under the assumption that revenue flows must equal perfectly contestable revenues, the two approaches are identical."

"Neither approach is limited by the specific examples presented … by the ACCC. Either approach can be used to generate or value any consistent set of revenues."

Professor King's detailed advice is attached (Attachment 2).

1.7 Conclusion

The DORC for the MSP is not $539.5m as proposed in the Draft Decision. When calculated in accordance with the definition and interpretation of DORC established by the Commission in the Draft Statement of Principles and by the Commission and by the ORG in the Victorian Gas Decisions, the value of DORC is of the order of $940m.

2. Misunderstanding of the circumstances of the 1994 sale and purchase of the MSP leads to a mistaken view of how the sale price should be taken into account in determining the ICB

Section 8.10(j) of the Code provides for consideration to be given to the price paid for any asset recently purchased by the service provider and the circumstances of that purchase.

The Draft Decision places significant emphasis on the circumstances of the 1994 sale and purchase of the MSP. Clearly this is important to give context to the price so that conclusions can be drawn as to how the price should be taken into account in establishing the ICB.

The Draft Decision describes these circumstances in terms of an implied but deliberate decision by the Commonwealth Government to perpetuate a subsidy to gas users in New South Wales. Under these circumstances, the Draft Decision concludes that "the privatisation price of assets in this case must be a fundamental lynchpin of any initial capital base assessment" on the basis (among others) that an ICB set above the sale price would have the effect of "appropriating some of the subsidy ostensibly intended for industry development [in New South Wales]".

If the actual circumstances differed from those described in the Draft Decision, then the relationship between the ICB and the sale price must be assessed differently. Accordingly, the question is, what were the circumstances of the 1994 sale and purchase and in particular, what support is there for the Commission's contention that there was an implied but deliberate decision by the Commonwealth Government to perpetuate a subsidy to gas users in New South Wales?

As far back as 1983, Senator Peter Walsh, the then-responsible Minister, wrote to the Chairman of AGL in the following terms:

> *"During our discussion of 15th April 1983 I explained that the Government wanted to get back to the original intention of carrying AGL's gas at cost and so was looking for a solution that would not only avoid future losses but also ensure that the Authority will recoup its past losses by the end of the contract period. The Government cannot accept that there is a case for continuing to subsidise AGL or the gas consumers of New South Wales from the public purse and therefore its aim is to put beyond doubt a break even result for the Authority over the life of the 1974 Haulage Agreement, as originally intended."*[17]

The Government's clear intention was to avoid any subsidy to New South Wales gas consumers, and an arrangement was subsequently negotiated between the parties which provided for the Government to break even in the recovery of all its capital and operating costs by the end of the contract period (2006).

In 1990 the Government sought to increase tariffs by a further 25 per cent from 1 January 1991 and 25 per cent again from 1 January 1992 – a total increase of 56 per cent. This was stated to be "the first step in the implementation of the Government's decision to commercialise and sell the Moomba-Sydney gas pipeline system"[18] . The Pipeline Authority (Charges) Bill 1990 which would have imposed the tariff increases, was ultimately defeated in the Senate and the increases were not implemented.

It is clear from this that it was not the intention of the Government to provide a subsidy to the natural gas industry in New South Wales. If it had been the intention of the Government to perpetuate a subsidy it would have been open to it to do so. The fact is that it did not. Far from seeking to entrench a subsidy, the Government which ultimately conducted the sale had sought tariff increases to underpin a maximum sale price.

Given these circumstances, the Commission is wrong in concluding that "If the initial capital base [for the MSP] is set above the sale price, the new owner gets a windfall gain by effectively appropriating some of the subsidy ostensibly intended for industry development"[19].

[17] Letter of 15 August 1983.This excerpt from the Minister's letter is reproduced in Pipelines, privatisation and pricing: natural gas and The Pipeline Authority, prepared for the Australian Gas Light Company, Centre for International Economics, September 1990.

[18] Hansard, House of Representatives, 8 November, 1990, page 3633.

[19] Draft Decision, page 40.

The fact is that the sale and purchase of the MSP in 1994 was negotiated on a commercial basis in an environment where each party was seeking to maximise its position. In such circumstances a rational buyer would seek to pay as little as possible and certainly no more than its assessment of the NPV of future cash flows obtainable from the purchase. Where the buyer succeeds in negotiating a purchase price which is less than the NPV of future cash flows, the difference is value over and above the purchase price which the buyer has won in the negotiation, and setting the asset value at the purchase price in those circumstances would amount to a confiscation of value from the buyer.

In considering the relevance of the purchase price to setting the ICB, the Draft Decision concludes that, if the ICB were set at the sale price:

> *"Firstly, users are not disadvantaged since they will not be required to support a double-up on depreciation or repay past government subsidies. Secondly, the service provider is not disadvantaged since the valuation roughly reflects the funds it expended in purchasing the assets. Thirdly, the intended Government policy objectives are preserved since the value of the implied gas industry subsidies have not been transferred to any significant extent from one party to another."*[20]

Each of these grounds is based on an incorrect understanding of the circumstances surrounding the sale.

- ***Users***

The statement that if the ICB is set at the purchase price, users will not be required to repay past government subsidies, assumes that such subsidies existed.

The clear evidence is that the Government never intended that there be subsidies. The renegotiation of the contracts in the mid-1980s provided for the Government to recover all its capital and operating costs by the end of the contract period (2006).

The statement that if the ICB is set at the purchase price, users will not be required to support a double-up on depreciation also shows a misunderstanding of the true position. It is noted in Section 3 that the ICB could be as high as the residual economic value (estimated to be $1,700m as at June 2000) without there being a double-up on depreciation.

- ***EAPL***

The second ground in the Draft Decision for establishing an ICB at the purchase price is that the service provider is not disadvantaged since the valuation roughly reflects the funds it expended in purchasing the assets. This assumes that the value to EAPL of the pipeline is equal to the purchase price. If EAPL paid less than the amount at which it valued the asset, then it would be disadvantaged by an ICB set at the purchase price since the benefit of the deal it negotiated would be effectively confiscated.

The 1994 sale and purchase of the MSP was negotiated on a commercial basis in an environment where each party was seeking to maximise its position. The value of the revenue stream from the foundation contract alone is assessed to be $586m ($1994) which exceeds the purchase price of the pipeline ($534m). The purchase price is not the determinant of the pipeline's value to EAPL. The difference between the purchase price and the assessed value of the future cash flows acquired in the purchase must be viewed as value which rightfully accrues to the owner: it must not be confiscated.

[20] Draft Decision, page 43.

- ***Government***

The third ground on which the Commission decided that the ICB should equal the purchase price was that the intended Government policy objectives are preserved since the value of the implied gas industry subsidies have not been transferred to any significant extent from one party to another.

The circumstances surrounding the purchase set out above clearly establish that no such Government policy existed.

3. Value based on economic depreciation wrongly dismissed

Section 8.10(f) of the Code requires the Commission to take into account the basis on which tariffs have been (or appear to have been) set in the past, the economic depreciation of the pipeline, and the historical returns to the Service Provider from the pipeline.

Having estimated the residual economic value of the MSP to be $1,291m as at June 1994, the Draft Decision goes on to observe that:

- *"it would appear that the book depreciation values were not fully reflected in tariffs in addition to a commercial rate of return. … The residual value at 30 June 1994 from this analysis is $1 291 million, well above the 1994 sale price and the various DORC estimates. This would suggest that, if one of the DORC values were applied to the regulatory asset value moving forward from that point in time, there would be a windfall benefit to users and a possible windfall loss to the service provider."*[21]
- *"the relatively high residual value confirms that monopoly rents had not been achieved in operating the natural monopoly pipeline, at least until 1994."*[22]
- *"Calculating the residual value of the MSP pipeline based on economic depreciation applying a normal commercial rate of return gives a value even above the current ORC valuation. The fact that very little allowance has been made for depreciation in the past suggests that the maximum valuation permitted under the Code (that is, DORC) should be used to set the initial capital base."*[23]

The Draft Decision concludes that:

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[21] Draft Decision, pages 37-38.
[22] Draft Decision, page 38.
[23] Draft Decision, page 39. There is an implication here, and in other places throughout section 2.2 of the Draft Decision, that the Commission's approach is to apply the range limit for the ICB specified by 8.11 to each of the quantitative factors of 8.10 in turn and then weigh the resultant "constrained" values together to arrive at the ICB. If that is the case, we would say that the Commission's approach is inconsistent with the Code. On a proper reading, the Code requires that each of the 8.10 factors be determined separately and then all of them weighed together. It is only at that point that the constraint in 8.11 should be considered and applied to the resultant weighted value. For example, if all of the quantitative factors in 8.10, other than DAC and DORC itself, were to exceed DORC when evaluated separately, the "unconstrained" weighting of all factors is likely to exceed DORC and the resultant ICB, after applying 8.11, would be DORC. On the other hand if the approach which appears to have been taken in the Draft Decision were adopted, the constraint in 8.11 would be applied at the factor level resulting in a number of values equal to DORC to be weighed against a single value (DAC) less than DORC (assuming a spread between DAC and DORC). The result would inevitably be an ICB less than DORC. In EAPL's view it is the former approach which is required by the Code.

> *"This difference [between the purchase price and the residual economic value] can be interpreted correctly as the value of the subsidy provided by the Government in establishing the pipeline up to that point including losses associated with changing market expectations."*[24]

with the result that the residual economic value is effectively dismissed from further consideration.

Given the actual circumstances of the 1994 sale and purchase i.e. that it was not the intention of the Government to extend a subsidy to gas users and that the terms of the sale were the result of a commercial negotiation in which both parties sought to maximise their positions, the only reasonable conclusion to be drawn about the residual economic value is that customers would not be disadvantaged if the ICB were set as high as $1,700m[25] as, over its lifetime, they would be paying no more than the full value of the pipeline.

4. Recognition given to EAPL's expectations under prior regulatory regime

Section 8.10(g) of the Code requires the Commission to take into account the reasonable expectations of persons under the regulatory regime that applied to the Pipeline prior to the commencement of the Code.

It should be noted at the outset that DORC was not a factor in the regulatory regime that applied to the MSP prior to the commencement of the Code, and so no person could have had an expectation of DORC, as such, under that regime.

The Draft Decision makes the following observation:

> *"Underpinning EAPL's purchase price of the MSP were the cash flows generated by the GTA, (recently replaced by the GTD). Contained in the GTA was an escalating tariff path for the duration of the agreement. EAPL has stated that the NPV of the cash flows inherent in its current long term contractual arrangements would yield an asset valuation in excess of the upper limit of DORC imposed by the Code. Accordingly, it may seem reasonable for EAPL to expect that the value of the initial capital base would be equivalent to DORC rather than to some lower valuation."*[26]

In its Access Arrangement Information (section 3.2.3), EAPL expressed its expectation by reference to the value of DORC. However, it is wrong to construe EAPL's statement to mean that its expectation under the prior regulatory regime is the value of DORC proposed in the Draft Decision i.e. $539m. The value of EAPL's expectation under the prior regulatory regime is at least $666m, which happened to be EAPL's assessment of DORC at the time it submitted the Access Arrangement Information under the current regime.

It follows that the value which comes out of section 8.10(g) for consideration in setting the ICB is $666m at least.

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[24] Draft Decision, page 40.

[25] If the estimated residual economic value as at June 1994 ($1,291m) were brought up to its June 2000 equivalent, the unrecovered residual amount would exceed $1,700m.

[26] Page 47.

5. Initial Capital Base – overall conclusion

The Draft Decision describes "a significant conclusion drawn from the Commission's interpretation of the Code" in relation to the setting of the ICB, i.e.:

> *"that the value assigned to the initial capital base should be a fair value to both the service provider and users of the pipeline system. That is, where the service provider has sought in the past to recover an allowance for depreciation of the assets in past tariff charges the initial capital base should be based on a residual value reflecting that extent of accumulated depreciation. If the initial capital base were set below the residual value then the service provider would suffer a windfall loss equal to the difference between the initial capital base and the residual value. If the value of the initial capital base were set above this residual value the users would be paying a second time for depreciation of a portion of the assets delivering what is a windfall gain to the service provider above a reasonable commercial rate of return. For the initial capital base value of the existing assets to be fair to both the service provider and users it needs to reflect a residual value based on the historic depreciation which has been recovered by the owners. The illustrative model in Appendix D of this* Draft Decision *demonstrates this proposition."*[27]

The Commission has not given reasons for reaching this conclusion except that "[it has been developed] in such a way as to be consistent with the regulatory and economic principles developed elsewhere in the Code as well as preserving the intent of the Code." EAPL can find no evidence in the Code to support the Commission's conclusion.

Section 8.10 lists 11 factors that must be taken into account in setting the ICB, but the Commission's conclusion appears to constitute a pre-determination of the result inasmuch as it foreshadows an outcome linked closely to a residual value based on the historic depreciation which has been recovered by the owners. The Code makes no reference to 'windfall gains' (or their avoidance) and it imposes no requirement that the ICB be established so that the actual cost of pre-existing assets is depreciated only once.[28]

The initial capital base must be determined by reference to all of the factors in section 8.10 of the Code: it is not open to the Commission to proceed on a basis which would have the effect of excluding any of those factors from consideration. In particular, the Code requires, in sections 8.10(b) and 8.10(c), that the Commission take into account a DORC valuation and other well recognised asset valuation methodologies, many of which are economic based and forward looking with no particular linkage to actual accumulated depreciation. Other section 8.10 factors are similarly unrelated to actual accumulated depreciation.

[27] Draft Decision, page 25.

[28] Code section 8.33(d) requires that "the Depreciation Schedule should be designed … so that the sum of the Depreciation that is attributable to any asset or group of assets over the life of those assets is equivalent to the value of the asset or group of assets at the time at which the value of that asset or group of assets was first included in the Capital Base". This requirement applies only to the value of the ICB once it has been determined, and to subsequent capital expenditure: it does not govern the determination of the ICB itself.

As the result of mistakes of methodology and the fact that incorrect values were attributed to a number of the quantitative factors to be considered under section 8.10 of the Code, the ICB in the Draft Decision is understated and must be revised. The following table compares the values attributed to those factors in the Draft Decision[29] with the corrected values:

Code Ref	Description	Draft Decision	Corrected Values
8.10(b)	DORC	$539.5m	Correct value is ≈$940m. Draft Decision inconsistent with established definition and interpretation.
8.10(f)	Economic WDV	$1,291m in 1994. Draft Decision says not relevant because the calculated value is a measure of subsidy.	$1,291m in 1994 (which uplifts to ≈ $1,700m in 2000). No subsidy. Economic WDV is a factor to be considered on its merits. Users not disadvantaged if ICB set at that level.
8.10(g)	Reasonable expectations under the prior regulatory regime	$539.5m (DORC)	>$666m.
8.10(j)	Purchase price and its surrounding circumstances	$459m to $567.6m as at June 2000. Circumstances suggest an ICB value no greater than the 1994 purchase price adjusted for additions and depreciation.	$586m ($1994) is minimum. Conclusions in the Draft Decision about circumstances of 1994 sale are incorrect. Value of the cash flows from foundation contract alone is assessed to be $586m ($1994) which is significantly greater than the purchase price. To set the ICB on the basis of the purchase price would amount to a confiscation of value.

[29] As noted in footnote 23, there is an implication throughout Section 2.2 of the Draft Decision, that the Commission may have applied the range limit for the ICB specified by Code 8.11 to each of the quantitative factors in 8.10 separately then weighed the resultant "constrained" values to arrive at the ICB equal to its assessed value of DORC. If that is the case, then the Commission's approach is inconsistent with the Code. In the interests of transparency, it would be helpful if the Commission were to do as other Regulators have done – most notably IPART in New South Wales – and tabulate the values it has attributed to the quantitative factors in 8.10.

This submission has focused on four significant mistakes in the Draft Decision. When these mistakes are corrected, key quantitative factors in the evaluation of the ICB are increased materially and the value of the ICB must increase accordingly. There are compelling economic arguments for setting the ICB at the correctly calculated value of DORC i.e. $940m. Alternatively, if $539m was considered to be the appropriate value for the ICB on the basis of the mistaken values assumed for key factors in the Draft Decision, then a value of at least $740m would be expected when the corrected values are taken into account.[30]

[30] ICB values referred to here are before any adjustment for taxation effects.

B. RATE OF RETURN

1. Introduction

The Draft Decision proposes a post-tax nominal return on equity of 13.0% and an equivalent pre-tax real WACC of 7.0%. [31] This contrasts with EAPL's proposal for a pre-tax real WACC of 8.4%.

Due to errors regarding several variables in the calculation of the cost of equity and the WACC, the proposed rate of return is not consistent with the Code which requires that the return be commensurate with the prevailing market conditions for funds and the risks involved in delivering the reference service[32]. Additionally, EAPL believes that setting the cost of capital at such a low level has the potential to affect detrimentally the interests of users in the longer term.

Low returns on regulated investments will jeopardise plans for further pipeline construction and interconnection. This will be detrimental to the public benefit as further development is needed to:

- fully develop the potential of Australia's natural gas reserves;
- promote upstream competition;
- allow regional economies to benefit from access to natural gas as a competitive energy source.

These objectives will only be achieved if the regulatory environment is such as to encourage the construction of new pipelines and the upgrading or enhancement of existing pipelines.

Any assessment of the cost of capital, including the WACC approach, provides a framework for identifying the cost of capital, and produces a range of values rather than a precise answer. If returns are set below the market cost of capital, the investment necessary for development and innovation will be discouraged. Accordingly, once the possible range for the cost of capital is identified, the Commission should establish a return at the higher, rather than the lower, end of that range to ensure that its decision does not deter necessary investment.

2. Variables adopted in Cost of Capital

The Draft Decision uses the CAPM and WACC approaches to determine the cost of capital. EAPL regards these approaches as generally acceptable and notes that the use of these approaches is consistent with current regulatory practice. However, the Draft Decision contains errors in the assumptions concerning several variables in deriving the cost of equity and WACC. The result of these errors is that the proposed rate of return does not meet the requirements of the Code.

There are several other matters on which EAPL differs from the Draft Decision, including the appropriate bond rate to be adopted in establishing the return for long term assets, which have previously been the subject of submissions to the Commission. This submission does not revisit these matters.

[31] The Commission has advised in discussion that the proposed pre-tax real WACC is in fact 6.89%.
[32] Code, section 8.30.

Debt Margin

EAPL believes that the debt margin of 1.2% used in the Draft Decision is incorrect as it is not based on capital market information. The use of a debt margin which is not based on capital market information will not be reflective of market conditions for funds, contrary to the requirements of the Code[33].

While a debt margin of 1.2% was used in the Final Decision on the Central West Pipeline Access Arrangement, this margin was determined on the basis of a particular transaction rather than on the basis of capital market information[34].

In its decision on the electricity distribution price review, the Office of the Regulator General in Victoria used a debt margin of 1.5% based on "current information from capital markets"[35]. Given that similar capital market conditions are likely to exist for capital funding of gas pipelines, a similar debt margin should be used in the Final Decision.

Given changes in the market since the Draft Decision, a debt margin determined on the basis of capital market information would be approximately 1.35%.

Market Risk Premium

While the Draft Decision assumes a market risk premium of 6%, it indicates that the Commission could consider a lower value to be appropriate (5.5% as opposed to 6%)[36].

Studies indicate that the long term arithmetic mean of the historically observed market risk premium exceeds 6%. Accordingly, EAPL believes a market risk premium of less than 6% cannot be justified.

Effective Tax Rate

The Draft Decision models tax cost in cash flows rather than directly into the WACC.

This approach is not preferred because

- it suggests that decisions as to corporate structuring and tax planning are matters for control by the regulator, rather than management of the company;
- the consequence of this approach is that the allowed rate of return relies on assumptions made by the Commission as to the consequences for the regulated business of the application of complex and often contentious tax legislation; and
- it introduces additional complexities thereby increasing the potential for error.

However, EAPL would not object to the adoption of this approach provided that the tax modelling is correct.

Imputation Credit Utilisation Rate (Gamma)

[33] Code, section 8.30 requires the return to be commensurate with market conditions for funds.
[34] ACCC Final Decision on Central West Pipeline Access Arrangement, page 21.
[35] Electricity Distribution Price Determination 2001-2005, page 301.
[36] Draft Decision, page 75.

The Draft Decision largely accepts a value for gamma in the range put forward by EAPL in the proposed Access Arrangement. However, the Draft Decision indicates that the Commission could consider a higher value for gamma to be appropriate (close to 100% as opposed to 50%)[37].

The Draft Decision proposes to adopt a value of 50% on the basis of consistency between regulatory decisions and uncertainty as to the appropriate value to be used.

No move should be made to increase the value of gamma without extensive further study and consultation.

Betas

The Draft Decision assumes an asset beta of 0.5 and an equity beta of 1.16.

These figures are similar to the asset and equity betas proposed by the Commission in the Draft Decision on the Moomba Adelaide pipeline[38], which is fully contracted. Additionally, in the Final Decision relating to Victorian gas transmission assets the Commission allowed an asset beta of 0.55.

EAPL believes that the proposed asset beta of 0.5 is incorrect and that the asset beta of 0.55 to 0.6 proposed by EAPL in the Access Arrangement is appropriate because:

- the MSP is not fully contracted;
- the market served by the MSP is smaller and not as deep as the market served by the Victorian gas transmission assets; and
- the MSP is not the only pipeline transporting natural gas to the market served by it.

For the purposes of the analysis in section 3 below an asset beta of 0.55 is used.

3. Proper range of WACC

Given the matters above, EAPL believes the following should apply to the calculation of WACC and cost of equity:

- a market risk premium of at least 6%;
- asset beta of 0.55 to 0.6; and
- cost of debt of 1.35%.

Recalculation of Moomba Sydney Pipeline WACC

Variable	Draft Decision WACC position	EAPL WACC position
Debt / Equity	60/40	60/40
Inflation	2.9%	2.9%
Effective Tax Rate[39]	13.6%	13.6 %
Imputation Credit Utilisation Rate (Gamma)	50%	50%
Bond Rate	6.0%	6.0%
Debt Premium	1.20%	1.35%

[37] Draft Decision, page 80.
[38] Draft Decision on Access Arrangement for Moomba Adelaide Pipeline, pages 69-72.
[39] As per modelling by the Commission

Cost of Debt	7.20%	7.35%
Market Risk Premium	6.0%	6.0%
Asset Beta	0.50	0.55
Equity Beta	1.16	1.28
Simple Nominal Cost Of Equity	**13.0%**	**13.67%**

Adjusting for the matters discussed above, and otherwise adopting the variables in the Draft Decision, EAPL believes a return on equity of 13.67% is appropriate for the pipeline.

This figure can be converted into a pre tax real WACC via adjustments for inflation and the modelling of tax in the cash flows. This gives EAPL an estimates of pre tax real WACC of 7.17%.

Accordingly, EAPL does not accept the proposed post-tax nominal return of 13.0% or the pre-tax WACC of 7.0%.

C. ISSUES RELATING TO CPI AND GST

The Draft Decision discusses the need to adjust the CPI indexation of EAPL's tariffs for the effects of the New Tax System, particularly the Goods and Services Tax. Proposed amendments A2.4 and A2.14 respectively require EAPL to:

(a) exclude the GST component from CPI indexation of the capital base throughout the regulatory period;
(b) exclude the GST component from CPI indexation of Reference Tariffs throughout the regulatory period.

The rationale in the Draft Decision for requiring adjustment of CPI is that failure to exclude this effect of the NTS would result in a "windfall gain to investors" over and above their expected rate of return.

EAPL has adopted a real Cost of Service methodology in setting a Total Revenue requirement in accordance with section 8 of the Code. CPI indexation is an integral part of this framework and consequently any adjustment to CPI indexation must meet the Code's requirement that total costs must be matched with total revenue over the regulatory period.

EAPL considers that the proposed amendments are not consistent with the Code because the effect of the amendments will be a mismatching of costs and revenue, and that an alternative approach to adjusting the CPI needs to be developed.

D. OTHER AMENDMENTS PROPOSED IN DRAFT DECISION

1. Amendment A2.1: value of initial capital base

This amendment is discussed in section A above.

2. Amendment A2.2: treatment of redundant assets

The Commission has proposed that the reference tariff policy be amended to allow the Commission to adjust the capital base for wholly or partially redundant assets.

EAPL does not object to the proposed amendment.

3. Amendment A2.3: CPI for indexation of capital base in 2005

The Draft Decision exhibits a concern with the possibility that when proposed revisions to the Access Arrangement are lodged at the expiry of the first access arrangement period, the proposed capital base to apply from approval of those revisions will have been based on an estimate of CPI. To address this, the Draft Decision proposes that the capital base at the commencement of the next access arrangement period will be adjusted using the actual CPI rather than an estimate.

EAPL does not object to the concept that the CPI used in determining tariffs and the capital base should generally be based on the latest CPI available at the time of the decision, rather than an estimate. EAPL understands that this has been the practice to date of regulators, including the Commission, in considering and approving access arrangements under the Code. EAPL believes that it is not necessary to include this matter in the Final Decision as it merely asserts what would generally be understood to be the position – that on approval of the initial access arrangement and revisions to an access arrangement, the capital base in the approved revised access arrangement would be based on the most up to date information on CPI available at the time.

Issues in relation to the impact of GST on the roll-forward of the capital base on the review of the access arrangement are addressed in section C above.

4. Amendment A2.4: treatment of GST impact on CPI

The Draft Decision proposes that the CPI used in the current cost accounting methodology adopted by EAPL must be exclusive of the impact of the New Tax System.

This amendment is addressed in section C above.

5. Amendment A2.5: alternative measure for inflation

The Draft Decision proposes that if the ABS suspends or ceases publication of or materially alters the CPI, an alternative index such as one published by the Commonwealth Treasury or the Reserve Bank should be substituted.

EAPL does not object to this proposed amendment.

6. Amendment A2.6: adoption of straight line depreciation

The Draft Decision proposes that straight line depreciation be adopted in lieu of the kinked depreciation used in the proposed Access Arrangement.

EAPL does not object to the adoption of straight line depreciation during this Access Arrangement period.

7. Amendment A2.7: basis of depreciation schedule

The Draft Decision proposes that the basis of the depreciation schedule should be the value of the initial capital base proposed in the Draft Decision.

EAPL assumes that the intent of this proposed amendment is that the value of the ICB determined under the Final Decision will form the basis of the depreciation schedule and does not object to this approach. However, EAPL does not consider it necessary to specify this given section 8.33 of the Code and the fact that this approach has been accepted in processes to date as the intent of the Code.

8. Amendment A2.8: rate of return

This amendment is addressed in section B above.

9. Amendment A2.9: allowance for return on working capital

The Draft Decision proposes that there should be no allowance made for a return on working capital.

EAPL concurs that working capital can be regarded as being a non-capital cost of the pipeline. Regardless of whether working capital represents the gap between the first expenses and revenues, or the gap between monthly expenses and revenues, the gap must be financed.

Allowing a return on working capital is consistent with the Code which allows for recovery of all non-capital costs except those which would not be incurred by a prudent service provider in accordance with good industry practice[40]. As there is no reason to suggest that the costs of working capital are not efficient or consistent with good industry practice, an allowance should be made as proposed in the access arrangement.

Accordingly, EAPL does not agree to the proposed amendment.

10. Amendment A2.10: reference tariffs for pipeline segments

The proposed access arrangement derived tariffs based on a number of features including:

- the tariffs have a “two-part” structure with users paying both a capacity and a throughput charge

[40] Code, section 8.37.

- different tariffs were proposed for the mainline and for each of the laterals
- costs were allocated to the mainline and tariffs on the basis of ORC (capital costs) and on the basis of pipeline length and asset value (O&M costs), with some “re-allocation” of costs (3.7%) from the laterals to the mainline.

The Draft Decision recognises that a cross-subsidy does not exist where the tariffs are between the avoidable costs and stand-alone costs, with stand-alone costs being the costs above which a user will be inclined to by-pass a segment of the pipeline[41].

The Draft Decision proposes that the reference tariffs applicable to any pipeline segment “should be no higher than tariffs consistent with that segment’s costs based on DORC (plus operating and maintenance costs).”

EAPL concurs with the view and does not object to the proposed amendment.

11. Amendment A2.11: phasing in of lateral tariffs

The Draft Decision proposes dispensing with the phasing-in of the lateral tariffs.

EAPL does not object to this amendment as it believes that the proposed new single, distance-based tariff structure which has been developed since the acquisition of EAPL by APT does not lead to tariffs which will lead to price shocks for any customers.

EAPL welcomes the Commission’s recognition that it may be appropriate to accept a cap on lateral tariffs where the effect of the cap is to retain users such that users overall experience lower tariffs.

12. Amendment A2.12: setting of initial reference tariffs

The Draft Decision requires that the initial reference tariffs are to be set in relation to the efficient forecast costs of providing reference services in accordance with the amendments proposed in the Draft Decision.

On the assumption that the intent of this proposed amendment is that the initial reference tariffs are to reflect the Final Decision, EAPL does not object to the amendment.

13. Amendment A2.13: form of CPI-X factor

The proposed access arrangement includes an adjustment to tariffs by reference to a CPI-X factor, which is designed to establish a smooth price path over the access arrangement period. The Draft Decision supports the approach but requires that the formula be specified in a different manner.

While EAPL does not agree that the formula specified in the Draft Decision is any more accurate or appropriate than the formula in the proposed access arrangement, EAPL does not object to the proposed amendment.

14. Amendment A2.14: impact of GST on CPI-X escalation

[41] Draft Decision, page 112.

This amendment is addressed in section 3 above.

15. Amendment A3.1: rebatable services

The Draft Decision proposes that the three rebatable services included in the proposed access arrangement (WFT, OFT and IT) must be removed.

EAPL no longer believes that it is appropriate to include these services in the access arrangement and therefore agrees with the amendment.

In relation to the IT service, EAPL: notes that traditionally, an interruptible service is provided when the pipeline is at or near capacity and there is a real likelihood that the service provider will have to interrupt the service to ensure that it is able to satisfy obligations to other users under firm transportation services. Given the current expected levels of capacity available in the MSP, there is no rationale for a service of this type to be offered.

While a service with some of the features consistent with the proposed IT service may be sought by users of the pipeline, EAPL believes it is not necessary to offer a specific interruptible service. These features are the availability of the service for a term of less than one year, and a low load factor. EAPL believes that these features are more properly addressed through adjustment to the tariffs for the firm reference service where the term of the service is less than one year.

EAPL also proposes to remove the Small Take-Off Point Service (STP Service) from the access arrangement as it is not likely that the service will be sought by any user.

16. Amendment A3.2: relationship of terms and conditions with term sheets etc

The Draft Decision proposes that the access arrangement must clearly specify that the access arrangement provisions in general, and attachments 3 and 4 specifically, prevail over the term sheet, standard agreements, nominations and balancing procedures and other "existing or future documents relating to the provision of access".

EAPL does not object to an amendment to clarify that reference services will be provided on the terms and conditions of the access arrangement, and to clarify the priority of the attachments 3 and 4 over documents which are not part of the access arrangement.

However, given that EAPL and a user may negotiate different terms of access (as contemplated by the Code), it is not appropriate that the access arrangement mandate that attachments 3 and 4 must prevail over any other agreements.

Additionally, it is not appropriate that the Commission should require an amendment which would have the effect of requiring EAPL to act inconsistently with its rights and obligations under existing transportation agreements.

Accordingly, EAPL does not agree to the proposed amendment.

17. Amendment A3.3: clause 28.1(6) of attachment 3

Clause 28.1 of Attachment 3 sets out the circumstances in which a user may change the Receipt Point or Delivery Point for a service, and the circumstances in which EAPL may withhold consent or give consent subject to conditions. Clause 28.1(6) specifies that one of the grounds on which EAPL could withhold consent or give conditional consent is if the transfer would affect EAPL's ability to operate the pipeline properly.

The Draft Decision proposes that clause 28.1(6) be deleted and indicates that EAPL had (prior to its acquisition by APT) agreed to this proposal. It is understood that this is because clause 28.1(4) provides that EAPL must have sufficient Capacity to provide the transferred Service.

In considering an access arrangement, the Commission must have regard to the impact of the access arrangement on the service provider's ability to operate the pipeline safely and in accordance with good practice. The Code specifically recognises that users' rights under a trading policy are subject to the service provider's reasonable technical requirements[42]. Additionally, the ability of the service provider to operate the pipeline properly is recognised in the matters to be taken into account by the Commission in approving the access arrangement[43] and in the provisions relating to the arbitrator's powers[44].

The retention of clause 28.1(6) in the access arrangement is reasonable and is consistent with the Code. Accordingly, EAPL does not agree to the proposed amendment.

18. Amendment A3.4: clause 28.1(5) of attachment 3

The Draft Decision also proposes that Clause 28.1(5) should be deleted. This clause provides that the user must have arranged with other users for the sharing of facilities at the Receipt Point or Delivery Point, at no cost to EAPL.

The proposed deletion of this clause arises from a concern that this requirement could give an existing user of a Receipt Point or Delivery Point a commercial advantage by being forewarned of the transfer. Additionally, the Draft Decision suggests that the provision is unnecessary as EAPL can be expected to have better knowledge of whether the transfer is feasible.

EAPL does not agree with either of these arguments.

The need for clause 28.1(5) arises from the fact that EAPL requires access to certain facilities to be able to operate the pipeline and provide the services. For example, if EAPL does not own facilities at a delivery point, but relies on those facilities to provide a service, it is necessary that a user wishing to have a service to that delivery point make the arrangements necessary for EAPL to be able to provide the service.

[42] Code, section 3.10.
[43] Code, section 2.24(c).
[44] Code, section 6.21.

As a general matter, it is appropriate that where EAPL does not own or operate facilities at a receipt point or delivery point (including meter sets and data sources), EAPL will not be able to provide a service from/to that receipt point or delivery point unless arrangements have been made with the owner or operator of the facility to ensure that EAPL has access to facilities necessary for the proper operation of the pipeline and the provision of services. The intent of the clause is to ensure that EAPL's access to the facilities is unaffected by another user using the receipt point or delivery point.

EAPL would not object to an amendment which better reflected the intent of the clause.

19. Amendment A3.5: request form

The Draft Decision requires that the Request for Transportation form must be amended to specifically include the option of multiple receipt points and delivery points.

The access arrangement specifically provides in clause 9.1(2)(e) that the reference service is available to one or more receipt points and delivery points. EAPL does not believe that the format of the Request for Transportation Service limits this specific right.

EAPL will include on the Request a statement that the user may specify one or more receipt points and delivery points.

20. Amendment A3.6: review of operational and balancing provisions

The proposed access arrangement includes in Attachment 4 an outline of the requirements and arrangements for nominations, allocations and balancing of quantities of gas. It is recognised that the arrangements are subject to amendment after discussion with users.

The Draft Decision proposes that the access arrangement include a provision requiring that a review of the operational and balancing provisions and charges be undertaken within six months of approval of the access arrangement.

This amendment is not necessary for the access arrangement to comply with the Code. Attachment 4 provides sufficient detail in relation to the current arrangements for balancing, nominations and other operational matters for users to understand the terms of the reference service. Requiring completion of a review of these procedures is not necessary for the access arrangement to comply with the Code. Additionally, given the statutory obligation to comply with an access arrangement, and the potential sanctions for breach of that obligation, it is not appropriate that completion of the review within a certain period be mandated in the access arrangement.

Accordingly, EAPL does not agree to the proposed amendment.

In relation to the wording of Attachment 2 section 6 (balancing charges), EAPL recognises that the wording is not clear and will address this in the revised access arrangement.

21. Amendment A3.7: adoption of gas specification

The Draft Decision proposes that the access arrangement be amended to provide for adoption of a wider gas specification subject to recognition of existing contractual arrangements.

EAPL would not object to providing for adoption of the wider AGA approved specification once the legislation necessary to facilitate the change in specification is in place in the jurisdictions in which gas will be delivered through the pipeline (currently NSW, ACT and Victoria).

22. Amendment A3.8: prudential requirements

The Draft Decision proposes that the prudential requirements for users and prospective users should be clarified with a view to ensuring that different requirements are not applied to different users and/or transactions.

EAPL does not object to the proposed amendment.

23. Amendment A3.9: clause 27.2(6): arrangements for receipt point of gas

Clause 27 of Attachment 3 sets out the arrangements for transfer of MDQ by a user to another party, and the criteria which are to be satisfied prior to EAPL giving consent to the transfer.

Clause 27.2(6) provides that the incoming user is to establish that it has made appropriate arrangements with producers, purchasers and other parties involved in the provision of the Service to the incoming user.

The Draft Decision expresses a concern that this could provide EAPL with access to an unnecessary level of commercially sensitive information, and proposes that the clause be amended to provide that written confirmation from the intending user will be sufficient evidence of these matters.

The ringfencing obligations under section 4 of the Code would prevent EAPL from disclosing or improperly using such information. Additionally, it was EAPL's intention that the user would have complied with the clause by providing written confirmation as proposed in the Draft Decision.

Accordingly, EAPL does not object to the proposed amendment.

24. Amendment A3.10: clause 27.2(12): creditworthiness of user

In relation to a transfer of MDQ to an incoming user, Clause 27.2(12) also provides for EAPL to be satisfied as to the incoming user's solvency and experience. Clause 27.2(9) requires the existing user not to be in default under the existing Service Agreement.

The Draft Decision proposes that these requirements be combined into a single requirement that the incoming user be able to demonstrate its creditworthiness to EAPL's reasonable satisfaction.

EAPL does not object to the proposed amendment.

25. Amendment A3.11: clause 7.5(13)(b): upstream and downstream arrangements

As part of the queuing policy, section 7.5(13)(b) requires the user to demonstrate that it has made appropriate arrangements for upstream and downstream supply and transportation of gas.

The Draft Decision notes that this may provide EAPL with access to an unnecessary level of commercially sensitive information, and proposes that the clause be amended to provide that written confirmation by the user is sufficient evidence of these matters.

The ringfencing obligations under section 4 of the Code would prevent EAPL from disclosing or improperly using such information. Additionally, it was EAPL's intention that the user would have complied with the clause by providing written confirmation as proposed in the Draft Decision.

Accordingly, EAPL does not object to the proposed amendment.

26. Amendment A3.12: notification of commencement of services for extensions or expansions

The Draft Decision proposes that EAPL should be required to notify the Commission of the commencement of services through any extension or expansion, and that notification must be given prior to commencement of operation of the facility.

The Commission suggests that the amendment is desirable to "aid its role as transmission access regulator". While the Commission will be interested in the commencement of services provided through new facilities, the Commission does not need to have been notified of the commencement of services to be able to fulfil its function as regulator under the Code. Additionally, inclusion of such an obligation is not necessary for the access arrangement to comply with the Code.

The Code does not require a service provider to obtain the consent or concurrence of the regulator to the extension or expansion of the pipeline, and the regulator is entitled to review the prudency of the capital expenditure for the facility on the review of the access arrangement. The Draft Decision notes that the Code provides for a suitable degree of transparency in assessment of any proposed roll-in of capital expenditure, and EAPL does not know of any other matter which would require the Commission to be notified as suggested.

Further, inclusion of such a requirement will be an unnecessary intrusion of regulatory oversight into the operations and commercial management of the pipeline.

EAPL does not agree to the proposed amendment.

27. Amendment A3.13: discount rate for extensions and expansions

The Draft Decision proposes that for extensions or expansions the rate of return to be used in determining the charges for any expansion of capacity[45] is to be the vanilla WACC determined under the Final Decision.

[45] Access Arrangement clause 16.6.

The effect of this amendment is that EAPL would receive for potentially higher risk new facilities a return determined by the Commission as reasonable for an established pipeline. This amendment indicates a simplistic view to valuing investment in new facilities and in particular overlooks the Code requirement that the rate of return earned by a service provider should reflect the underlying risks of the investment.

The risks faced by a service provider in undertaking new facilities investment are not homogenous as would appear to have been assumed in the Draft Decision. In fact, the risks involved in any investment will reflect the strength or otherwise of the underlying risk of the project requiring the new investment and the prudential strength of the proponent advancing the project. By way of example, some time ago Force Energy was vocal in promoting expansive plans for the development of gas fields in the Narrabri region which were going to be linked into the Central West Pipeline and possibly the EAPL system. Subsequently Force Energy appears to have withdrawn from these ventures. In that case, a return appropriate to an established pipeline with a number of users would clearly have failed to reflect the conditions in the market for funds, and the risks of providing the service.

The Draft Decision may have also proposed the “vanilla” WACC approach on the assumption that such investment is minor relative to the existing pipeline, and therefore the risk (in terms of money actually exposed) is minimal. While this may be the case in scenarios such as adding a small delivery station, it is clearly incorrect for major delivery stations or laterals.

In light of the above, EAPL does not agree to the proposed amendment.

In submitting a revised access arrangement to the Commission, EAPL will take into account the matters discussed in the Draft Decision in relation to extensions/expansions of the pipeline.

28. Amendment A3.14: recovery of surcharge

The Draft Decision proposes that clause 16.7 be amended to specifically provide for the Commission to approve the surcharge. As the Commission notes, this matter is already provided for in the Code and EAPL therefore submits that the amendment is not necessary.

29. Amendment A3.15: revisions submission date

The Draft Decision proposes that the revisions submission date should be four years and six months from commencement of the initial access arrangement.

EAPL does not object to this amendment.

E. OTHER ISSUES RAISED IN DRAFT DECISION

1. Treatment of revenue under Gas Transportation Deed

The Draft Decision proposes to disregard the revenue earned under the Gas Transportation Deed. EAPL concurs with this approach as it recognises that the Deed is in effect a replacement for the Gas Transportation Agreement which predated the Code and the submission of the access arrangement. Accordingly, it is consistent with the intent of the Code.

2. NERA paper on setting of tariffs

The Commission has made reference in the Draft Decision to a NERA report titled "Regulation of tariffs for gas transportation in a case of "competing" pipelines: evaluation of five scenarios". EAPL notes that the NERA paper was commissioned by the Commission.

The basis of this report and in particular its relevance to the Commission's consideration of the access arrangement for the MSP are unclear.

The thrust of the report is that the Commission should be focussing its efforts on regulating pipelines on the basis of the "defined capacity" approach. However, the report appears to be a relatively simplistic generalisation of possible regulatory methodologies, and contains very little of substance to support its conclusions.

In relation to the apparently overly simplistic nature of the report, two observations can be made:

Firstly, the report appears to be proffering the view that because the "defined capacity" approach is adopted by FERC in the US that that is sufficient reason for it to be adopted in Australia. In the report, there is no support for the benefits or otherwise of this approach apart from an example involving an El Paso pipeline which highlighted the risks that service providers face from new entrants. Indeed even the report notes FERC's recognition (in footnote 34 of the report) that "some cost sharing may be appropriate when a large, historic customer leaves a system that was originally designed to meet its needs".

Secondly, there is the view that pervades the report that if a new entrant (pipeline) enters the market previously served by an incumbent pipeline which was operating at capacity, the loss of say 50% of the incumbent pipeliner's market (ie throughput) to the new entrant, will create an incentive for the incumbent to recover its throughput by selling its now spare capacity. EAPL agrees with the proposition, however disagrees with the consequences. In order for the incumbent to recover any throughput there must be gas available at competitive prices and demand for gas, and the incumbent will have to discount its prices to attract new business.

Rather than the incentive for the incumbent to simply sell the now spare capacity, the commercial reality is that the need to discount to sell the capacity is likely to place a significant financial burden on the incumbent. This financial burden would be further magnified under the "defined capacity" approach where the incumbent will only earn its allowed costs if it can sell all its capacity at the regulated rate. The "defined capacity" approach gives no recognition to the fact that if the pipeline has to discount below the regulated rate, it will not earn the amount which has been accepted as its costs of operating the pipeline.

This commercial reality is dismissed by NERA which appears to suggest that little or no financial burden will be faced by the incumbent in this scenario and that any financial pressure can be simply mitigated by selling any spare capacity – with only passing reference made to the fact that the actual revenue earned by the pipeline for this capacity may be well short of either the regulated return or indeed the cost to the service provider of providing the capacity.

EAPL concurs with the position in the Draft Decision to maintain the previous regulatory approach of setting tariffs on the basis of forecasts rather than capacity and in particular believes that the NERA report falls far short of the level of analysis which would be required before any change to the application of the Code were adopted.

3. Fuel cost

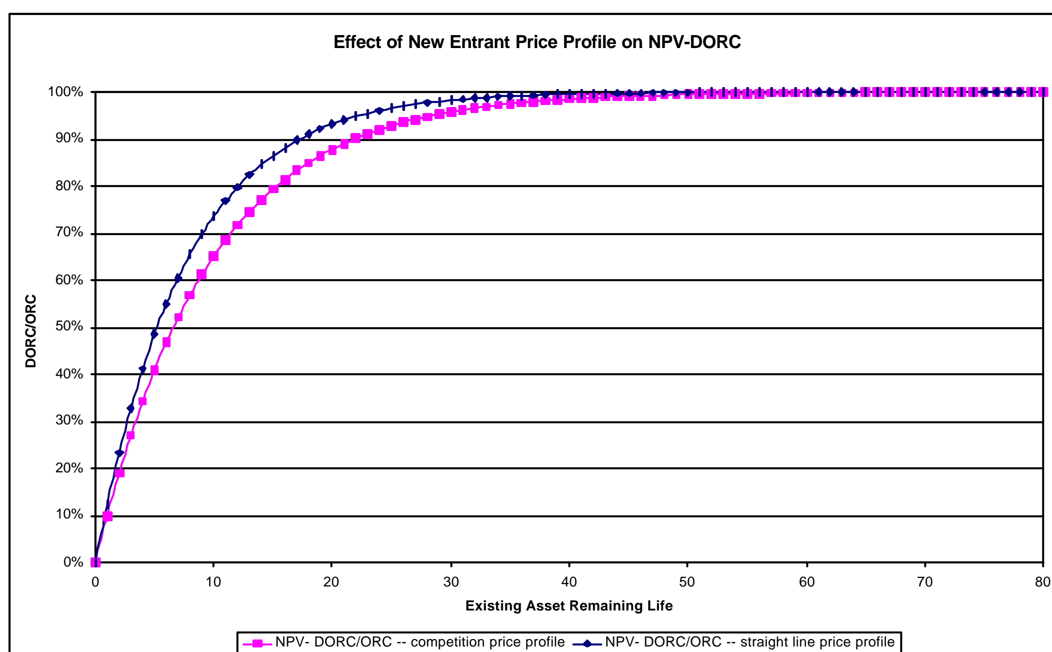
The proposed access arrangement included an amount for fuel gas as part of the non-capital cost. This was consistent with arrangements which applied between EAPL and users at that time. However, users have accepted a new policy under which users provide fuel gas. Accordingly, the non-capital costs should be reduced for each year of the access arrangement period by forecast levels of fuel costs.

ATTACHMENT 1

THE AGILITY NPV-BASED APPROACH TO CONSTRUCTION OF DORC FROM ORC: NEW ENTRANT PRICE PROFILE

In its August 2000 submission on the Construction of DORC from ORC, Agility has adopted the competition price path espoused by the Commission in the Draft Statement of Principles as a rational basis for defining the price path that a new entrant would adopt. In essence, new entrant prices are assumed to vary at the rate of asset price inflation ("g") which recognises that the real cost of replacement assets will decline with time as the result of productivity improvements and new technology.[46] Real prices should decline accordingly. The initial level for the new entrant price is set such that the NPV of cash flows over the life of the "replacement" (ORC) asset will equal the ORC i.e. assuming that prices will move over time at the rate of asset price inflation, it is the minimum initial price that would be acceptable to a rational new entrant. If the initial price were set below this level then the net present value of the expected future cash flows would be less than the initial investment (ORC), and a rational new entrant would not proceed with the investment.

Of course, the competition price path proposed in the Draft Statement of Principles is but one of an infinite number of alternatives. If, as the Commission suggests in the Draft Decision, straight line depreciation is the norm for the gas industry, then the new entrant's price path can readily be modelled on that basis. The effect of this change on the DORC/ORC ratio is shown in the following graph:



[46] The ACCC defines the rate of asset price inflation (Draft Statement of Principles, page 66) as follows:

g = estimated rate of asset price inflation;
  = $(1+f) \times (1-p) - 1$, where:
f = inflation rate; and
p = trend productivity growth

The straight line profile results in higher front end prices and lower back end prices than the competition profile with the result that the straight line DORC is higher at any remaining life.

ATTACHMENT 2

REPORT ON THE CONSTRUCTION OF DORC FROM ORC
Professor Stephen P King, February 14, 2001.