APA Group

APT Petroleum Pipelines Limited

Pipeline Management Agreement Termination

October 2011
PMA Termination

Treatment of the Pipeline Management Agreement Termination Payment

Background

APTPPL formerly outsourced pipeline construction, maintenance and operations services under a Pipeline Management Agreement ("PMA") with Agility Management Pty Ltd ("Agility"), including in respect of the RBP.[1] In 2007, APTPPL terminated that arrangement by way of the Contract Termination and Contract Novation Agreement ("the Agreement"). To do so, it was necessary for APTPPL to negotiate a premium to recompense Agility for the termination of the PMA ("PMA Termination Payment").

A copy of the PMA and Agreement have been provided in the package of reference document provided to the AER.

The total payment made under the Agreement was $206,226m. This included a payment of $190,099m for "Goodwill".[2] The PMA Termination Payment (also referred to as "the premium") was allocated by the APA Group to each of the different pipelines in direct proportion to the present value of the expenditure savings it anticipated would accrue to each pipeline from the premium. The regulatory valuation of the premium was derived by taking the commercial valuation and making the following adjustments:

- Removing any benefit from savings in management fees payable to Agility on the basis that the ACCC had determined that the management fee was not recoverable by the Reference Tariff[3], the asset created by mitigating that cost would not be recoverable either; and
- Discounting future cash flows by using a WACC of 8.84%, being the nominal vanilla WACC for the RBP, approved at its 2006 Access Arrangement revisions rather than APA's internal WACC.

These adjustments reduced the total value of the premium to $164.0m. The ultimate allocation to the RBP of the PMA Termination Payment was $30.1m.

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[1] The other pipelines that Agility was appointed to provide services included: the Moomba to Sydney Pipeline; Central West Pipeline; and the Carpentaria Pipeline. See: KPMG, *Regulatory Accounting Treatment of Pipeline Management Agreement Termination Payment: APA Group*, October 2011, pp 6 – 7.

[2] KPMG, *Regulatory Accounting Treatment of Pipeline Management Agreement Termination Payment: APA Group*, October 2011, p 13.

[3] ACCC, *Revised Access Arrangement by APT Petroleum Pipelines Ltd for the Roma to Brisbane Pipeline: Final Decision*, 20 December 2006, p 137; and ACCC, *Revised Access Arrangement by APT Petroleum Pipelines Ltd for the Roma to Brisbane Pipeline: Final Approval*, 28 March 2007, pp 8 – 9.

The PMA Termination Payment as Capital Expenditure

APTPPL considers that the termination of the PMA and the associated payment to Agility will deliver efficiency benefits to its operations over a prolonged period. That is, that the amount of the PMA Termination Payment will be exceeded by the present value of the benefits (costs avoided).

APTPPL considers that the PMA Termination Payment is "expenditure of a capital nature incurred to provide, or in providing, pipelines services" within the meaning of "capital expenditure" pursuant to Rule 69 of the Rules, and as such, should properly be treated as capital expenditure. In its revised access arrangement proposal APTPPL has included in the RBP capital base a portion of the PMA Termination Payment that was paid to Agility pursuant to Rules 77(2)(b) and 79(2)(a).

APTPPL sought the independent opinion of KPMG on whether, by reference to relevant accounting standards, the PMA Termination Payment paid to Agility (or part of it) is properly of a capital nature and, if so, the quantum of expenditure that would appropriately be included in the RBP capital base. This opinion has been set out by KPMG in a report entitled, *Regulatory Accounting Treatment of Pipeline Management Agreement Termination Payment* ("KPMG PMA Report").

The full text of the KPMG PMA Report, which includes KPMG's reasons and the basis for its conclusions, is attached to this submission.

Recognising that the accounting treatment of an expenditure amount is not necessarily determinative of whether expenditure is of a capital nature, APTPPL has also considered how the premium would be treated by reference to the concepts of income and capital under tax law. APTPPL considers that by reference to the criteria established in tax cases as to whether an expenditure amount is income or capital, the premium is properly characterised as being of a capital nature.

Finally, APTPPL submits that part of the PMA Termination Payment which has been allocated to the RBP is conforming capital expenditure within the meaning of Rule 79(1), and is justifiable as the overall economic value of the expenditure is positive (Rule 79(2)(a)).

PMA Termination Payment is properly of a capital nature by reference to accounting standards

The KPMG PMA Report considers the PMA Termination Payment and, taking into consideration the relevant financial accounting standards, concludes that it is reasonable that the PMA Termination Payment be treated as capital expenditure for the purposes of establishing APTPPL's opening capital base for the next regulatory period for which the revised access arrangement is to apply (2012-2017).

The KPMG PMA report notes that the premium expenditure was made to reduce future costs that the APA Group could not avoid except by making that expenditure.

The premium expenditure enabled future economic benefits to flow to the pipelines formerly subject to the PMA and therefore KPMG finds that the payment meets the key accounting criterion for the recognition of capital expenditure.[4]

The value of the PMA Termination Payment to be included in the capital base

The KPMG PMA Report also considers what proportion of the PMA Termination Payment ought to be allocated across of each of APTPPL's pipelines, and determines the appropriate value of the allocated amount to be included in the capital base, and the returns on and of capital, across each of the pipelines, including the RBP.

The KPMG PMA Report concludes that the value of $30.1m allocated by the APA Group to the RBP at October 2007 is a reasonable valuation, based on an assumption that the costs of the RBP for the five years to 30 June 2012 are, after excluding $4.3m of operational expenditure incurred in 2010/11 in connection with the Queensland floods, a reasonable indicator of future costs for the period 2012 to 2020.[5] Appendix E of the KPMG PMA Report sets out the detailed calculations undertaken by KPMG to test the capital value of the PMA Termination Payment for the RBP.[6]

PMA Termination Payment is capital in nature under Australia income tax law

APTPPL recognises that treatment of the PMA Termination Payment in accordance with the relevant financial accounting standards may not be determinative of the characterisation of the payment. APTPPL has also therefore considered how the payment should be characterised by reference to Australian income tax law. APTPPL submits that the application of the principles set out in the law to the PM Termination Payment demonstrates and confirms that the payment is properly characterised as being of a capital nature.

The approach taken in Australian law to determining whether expenditure is capital in nature, as opposed to income, is relatively well settled and largely follows the Full High Court's decision in *Sun Newspapers Ltd and Associated Newspapers Ltd v Federal Commissioner of Taxation* (1938) 61 CLR 337 ("Sun Newspapers").

The test laid down in Sun Newspapers to determine whether expenditure is income or capital in nature, involves the following three elements, although no element, in itself, is decisive:

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[4] KPMG, *Regulatory Accounting Treatment of Pipeline Management Agreement Termination Payment: APA Group*, October 2011, pp 3, 23 – 26.

[5] KPMG, *Regulatory Accounting Treatment of Pipeline Management Agreement Termination Payment: APA Group*, October 2011, p 33.

[6] KPMG, *Regulatory Accounting Treatment of Pipeline Management Agreement Termination Payment: APA Group*, October 2011, Appendix E, pp 52 – 60.

- the nature of the advantage sought, whereby expenditure is capital in nature where it is made with a view to bringing into existence an asset or an advantage (tangible or intangible) for the enduring benefit of the business;
- the way the advantage is to be used, relied upon or enjoyed, whereby the longer the length of time over which the advantage is intended to apply, the more likely the advantage is to be capital in nature; and
- the means adopted to obtain the advantage, whereby a once-off payment is more likely to be determinative of an advantage that is capital in nature than are recurrent payments over time.

In relation to each of these three criterion, APTPPL makes the following submissions:

- Nature of the advantage sought

  From an application of this criterion, it is clear that the PMA Termination Payment is capital in nature because it created an enduring benefit and the benefit related to the profit yielding structure of APTPPL, including:

  (a) the agreement related to an important capital asset of APTPPL, ie the pipeline between Brisbane and Roma;

  (b) the acquisition or enhancement of the in-house pipeline management capability was effectively an acquisition of a new business and represents an asset or advantage which was not present prior to the making of the PMA Termination Payment;

  (c) the removal of a competitor, Alinta, from providing services to the RBP is a matter which is prima facie an affair of capital[7];

  (d) APTPPL has accounted for the payment as an asset for financial accounting purposes. The accounting adopted by APTPPL is an important indicator of the capital nature of the payment. In *BP Australia Ltd v Federal Commissioner of Taxation* [1965] UKPCHCA 2; (1965) 112 CLR 386 ("BP Australia"), Lord Pearce stated at paragraph 43:

  > *One of the matters to be considered is how the sum in question should be treated on the ordinary principles of commercial accounting: see Whimster's case 12 TC 813. The sums paid to the retailers in the present case were put by BP's accountants in*

---

[7] See : *BP Australia Ltd v Federal Commissioner of Taxation* (1965) 112 CLR 386, [24], where Lord Pearce commented: "Where a trader buys out a rival in order to secure his goodwill or to suppress it and so provide or maintain a clear field for his own enterprise over a substantial period, there is a definite prima facie pointer towards a capital payment".

the profit and loss account. Had they been put in the balance sheet together with the choses in action for which they had been paid, the latter would have been inappropriate capital assets. They would necessarily have to be written down in the first and every succeeding year by one-third or one-fifth (or whatever was the figure appropriate to the length of the tie) if the balance sheet was to be honest …

- The way the advantage is to be used, relied upon or enjoyed

  This second criterion also clearly points to the payment being capital in nature. That is, the relevant benefits which were obtained were not something which continuously required expenditure to be incurred in order to derive income. Through payment of the PMA Termination Payment, the advantage to APTPPL was long-term and indefinite and not for any finite contractual period.

- The means adopted to obtain the advantage

  The PMA Termination Payment was a once-off payment and not recurrent, accordingly, this again points to the payment being capital in nature.

PMA Termination Payment is "conforming" capital expenditure

Having demonstrated that the PMA Termination Payment is capital expenditure, it is then necessary to show that the payment is "conforming" capital expenditure pursuant to Rule 79(1). Rule 79(1) provides:

> (1) Conforming capital expenditure is capital expenditure that conforms with the following criteria:
>
> (a) the capital expenditure must be such as would be incurred by a prudent service provider acting efficiently, in accordance with accepted good industry practice, to achieve the lowest sustainable cost of providing services;
>
> (b) the capital expenditure must be justifiable on a ground stated in subrule (2).

Subrule 79(2) sets out the circumstances in which capital expenditure is "justifiable". Subrule 79(2)(a) provides that capital expenditure is justifiable if the overall economic value of the expenditure is positive.

As mentioned above, Appendix E of the KPMG PMA Report sets out the detailed calculations undertaken by KPMG to test the capital value of the PMA Termination

Payment for the RBP.[8] The calculations in Appendix E test the value of the asset (being the PMA Termination Payment) against the present value of the net benefits that the APA Group procured by making the payment. The analysis performed by KPMG shows a present value of net economic benefits to 2020 of $33.2m.[9] APTPPL relies on the material set out in the KPMG PMA Report to demonstrate that the overall economic value of the expenditure is positive, and is therefore justifiable as required by Rule 79(2)(a).

In terms of quantum, that part of the PMA Termination Payment that has been allocated to the RBP is such as would be incurred by a prudent service provider acting efficiently, in accordance with accepted good industry practice, to achieve the lowest sustainable cost of providing services. This is demonstrated by the analysis set out in a confidential board paper which APTPPL has provided to the AER which indicates that Agility would have required a payment in the order of at least $190m in order to terminate the relevant arrangements.

Conclusion

In light of both the matters set out in the KPMG PMA Report as well as a review of the PMA Termination Payment against the criterion used to assess whether expenditure has the nature of capital or income as set out in relevant tax cases, APTPPL submits that the portion of the PMA Termination Payment identified by APTPPL as being attributable to the RBP is properly expenditure which is capital in nature. As such, treatment of this portion of the PMA Termination Payment as capital expenditure by APTPPL for inclusion in the opening capital asset base in its access arrangement revised proposal for the RBP is consistent with the Rules.

Further APTPPL submits that the PMA Termination Payment satisfies the requirements of Rule 79 insofar as that part of the PMA Termination Payment that has been allocated to the RBP is such as would be incurred by a prudent service provider acting efficiently, in accordance with accepted good industry practice, to achieve the lowest sustainable cost of providing services, and is justifiable as conforming capital expenditure as the overall economic value of the expenditure is positive.

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[8] KPMG, *Regulatory Accounting Treatment of Pipeline Management Agreement Termination Payment: APA Group*, October 2011, Appendix E, pp 52 – 60.

[9] KPMG, *Regulatory Accounting Treatment of Pipeline Management Agreement Termination Payment: APA Group*, October 2011, pp 31 – 32, and Appendix E, p 53.

APA Group

Regulatory accounting treatment of Pipeline Management Agreement termination payment

October 2011
This report contains 66 pages
7Oct final public

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1 Introduction

APT Petroleum Pipelines Limited (APTPPL) is a member of the APA Group (APA), an Australian infrastructure owner and operator, involved principally in the delivery of gas transmission and distribution services. As part of its operations, APTPPL formerly outsourced pipeline construction, maintenance and operations services under a Pipeline Management Agreement (PMA) that APTPPL (formerly AGL Pipelines Limited) made with Agility Management Pty Ltd (Agility) (formerly AGL Infrastructure Management Pty Limited) in April 2000.

During the period to 2007, the APA Group grew through the acquisition of various businesses, which included the acquisition of a number of businesses with substantial in house operating functions. The business model changed from a relatively small staff base to a much larger one with the resources to undertake operational and maintenance activities cost effectively. As a result, APTPPL was able to pool resources to take advantage of economies of scale. APTPPL took the view that the advantages it gained from its increased scale of operations exceeded the benefits that accrued to it from the PMA. In October 2007, APTPPL terminated the PMA and acquired the Agility asset management business.

APTPPL considered that the termination of the PMA and the associated consideration it paid (the PMA premium), would deliver efficiency benefits to its operations over a prolonged period, including efficiencies to the Roma to Brisbane Pipeline (RBP), which was formerly subject to the PMA.

The APA Group proposes to include an allocation of the premium in the Capital Base of the RBP in its forthcoming access arrangement revision for the RBP, due to take effect in 2012.

1.1 The purpose of this report

The sole purpose of this report is to provide independent evidence that may assist the Australian Energy Regulator or any relevant appellate body to consider the APA Group's proposed revisions to the access arrangement for the RBP for the period 2012 to 2017, in accordance with terms of reference provided to us by the APA Group on 26 September 2011. Those terms of reference are appended to this report at Appendix A. This report has been written to comply with the Federal Court's "*Practice Note CM 7 "Expert Witnesses in proceedings in the Federal Court of Australia"* (1 August 2011).

1.2 Compliance with the Federal Court's Practice Note CM 7

1.2.1 The Expert

The author of this report is:

Keith Lockey
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1.2.2 Acknowledgement

I have read, understood and complied with the Federal Court's "Practice Note CM 7 "Expert Witnesses in proceedings in the Federal Court of Australia" (1 August 2011).

1.2.3 Training and experience

My qualifications and relevant experience are set out in my CV attached at Appendix B.

1.2.4 The questions the Expert has been asked to consider

In the letter setting out terms of reference dated 26 September 2011 (See Appendix A), I was asked to address the following questions

1. Taking into consideration any relevant financial accounting standards, is it reasonable that the premium (or part thereof) paid by APTPPL to Agility be treated as capital expenditure for the purposes of establishing the opening capital base for the next regulatory period for which the revised access arrangement is to apply (2012-2017)?
2. Assuming it is reasonable that the premium (or part thereof) paid by APTPPL to Agility be treated as capital expenditure for the purposes of establishing the projected capital base for the next regulatory period for which the revised access arrangement is to apply (2012-2017), is the value of $30.1m allocated by the APA Group to the RBP at October 2007, a reasonable valuation for these purposes?

1.2.5 The documents and material the Expert has been asked to consider

Section 2.4 summarises the basis on which the APA Group has derived the PMA premium value of $30.1m as at October 2007, attributable to the RBP.

1.2.6 Source materials referenced in this report

Appendix D sets these out.

1.2.7 Factual Findings

To complete this task, I have:

- in Section 2 of this report, ascertained the factual characteristics of the premium expenditure and described how APA has accounted for it for both financial and regulatory purposes;
- in Section 3 of this report, set out the criteria that I consider to be relevant in determining whether the premium or part thereof, be treated as capital expenditure for the purposes of establishing the opening capital base of the RBP in the next regulatory period for which the revised access arrangement is to apply (2012-2017);
- in Section 4 of this report, compared the factual characteristics of the premium expenditure to those criteria and conclude that the expenditure is in the nature of capital; and
- in Section 5 of this report, tested APA's valuation of the PMA premium it has attributed to the RBP.

Sections 2 to 5 of this report and the Appendices set out the factual findings and assumptions on which my opinion is based.

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1.2.8 The Expert's opinions

In my opinion:

- it is reasonable that part of the premium paid by APTPPL to Agility for the termination of the Pipeline Management Agreement in September 2007, be treated as capital expenditure for the purposes of establishing the opening asset base (of the RBP) for the next regulatory period for which the revised access arrangement is to apply;
- the value of $30.1m allocated by the APA Group to the RBP at October 2007, is a reasonable valuation for these purposes. This opinion is predicated on an assumption that the costs of the RBP for the five years to 30 June 2012 are, after excluding $4.3m of operational expenditure incurred by APA in 2010/11 in connection with the Queensland floods, a reasonable indicator of future costs for the period 2012 to 2020. I have explained the bases for this assumption, but I do not express an opinion on APA's forecast costs. If future costs were to be different, then a different view of the value of the PMA premium attributable to the RBP could be appropriate.

1.2.9 The reasons for the Expert's opinions

The reasons for my opinions are as follows.

The premium is capital expenditure

The premium expenditure was made to reduce future costs that the APA Group could not avoid except by making that expenditure. This enabled future economic benefits to flow to the pipelines formerly subject to the PMA and thereby met the key accounting criterion for the recognition of capital expenditure. Whether the resource procured by the premium expenditure is tangible or intangible is not relevant.

It is important to note that the premium is not an avoided cost. Rather, it is a cost that has been incurred to achieve future cost savings and increases in cash flow. I explain in this report how this purpose is consistent with the Australian Government's Australian Accounting Standards Board's "Framework for the preparation and presentation of financial statements", description of what may constitute an asset.

Section 2 of this report describes how APA's regulatory accounting treatment of the premium as an asset follows the APA Group's financial accounting treatment including the allocation of part of the premium to RBP. The premium expenditure in the APA Group's balance sheet has been capitalised in accordance Accounting Standards as evidenced by successive unqualified statutory audit opinions. I conclude that it is reasonable that premium expenditure which has been capitalised under Accounting Standards, properly comprises capital expenditure, including for regulatory purposes.

My reason for this is that Accounting Standards are developed and published by the Australian Government's Australian Accounting Standards Board and compliance with them for public reporting purposes, is mandated by the *Corporations Act 2001*. Accounting Standards provide the sole framework for general purpose public financial reporting in Australia.

Accounting Standards are intended to meet the needs of a wide range of users of financial statements, explicitly including regulatory bodies. Particular users such as the Australian Energy Regulator (AER) can have specific financial information needs that extend beyond the accounting treatments and disclosures provided under Accounting Standards. However, it does

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not follow that the existence of such needs negates the truth and fairness of accounting treatments mandated by the Australian Government's Accounting Standards for general purpose reporting.

Some users of financial statements who may have special information needs and the requisite powers, may impose specific alternative frameworks on reporting entities to meet those needs. Economic regulators can issue such requirements. I have been closely involved in developing and responding to such regulatory accounting frameworks in Australia since 1995. In my experience, where regulators impose such requirements, they are invariably based on the requirements of Accounting Standards, with any exceptions to the associated accounting treatments being limited and highly specific. For example, to the best of my knowledge, the only publically canvassed regulatory accounting framework to be applied to Australian gas transmission businesses was the ACCC's Draft "Regulatory reporting guidelines for gas pipeline service providers" (May 2004), which I helped to develop. These guidelines required transmission businesses to report to the regulator using accounting policies that accorded with Accounting Standards.

Regulatory accounting treatment of the asset

I conclude that the capital nature of the premium does not necessarily mean that all of the premium expenditure should be included in a Covered Pipeline's Capital Base.

This is because I reason that the premium expenditure should only be considered as recoverable by a Reference Tariff to the extent that it reduces costs that are recoverable by a Reference Tariff. Section 2 of this report shows that the premium in part avoids a management fee payable to Agility that was not recoverable by a Reference Tariff. On this basis, the benefit that arises from avoiding this management fee should be excluded from the asset value for regulatory purposes. In Section 2, I also note that APA has taken this into account in valuing the asset.

Basis of valuation

The basis of valuation I have used is reasonable because it accords with the principle that underlies asset valuation in the "Building Block Approach" required by the National Gas Rules. Namely, I have valued the asset on the basis of net present value of the future cash flows it generates.

I have applied a discount rate that is consistent with the rate of return approved by the ACCC for the RBP current access arrangement period.

The benefits that might reasonably be expected to accrue to the RBP from the termination of the PMA include:

- avoidance of commercial profit margins otherwise payable to Agility;
- economies of scale and purchasing power from bringing services in house to a large entity; and
- acquisition and retention of intellectual capital from bringing skills and resources in house. This may have a residual value that extends beyond the avoided minimum term of the PMA. However, I have not taken this into account.

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My approach to testing APA's valuation is conservative because it does not attempt to value all benefits that might be expected to accrue to the RBP. Rather, it focuses on valuing:

- overall benefits from savings in operating expenditure; and
- savings in profit margins only on capital expenditure.

Where other operational benefits exist, they have not been taken into account.

To test APA's valuation of the PMA premium it has attributed to the RBP, I have considered only benefits that are directly attributable to the RBP and I have not considered any benefit that might accrue from the avoidance of the management fee payable to Agility under the PMA.

Where I have used benchmarks (Evans and Peck) to assess benefits arising from the termination, those benchmarks are highly specific to the PMA and are demonstrably independent of APA.

I have not valued those cash flows beyond 2020, the minimum period the APA Group would have been committed to the PMA had it not incurred expenditure to terminate the PMA. While the PMA contemplated five year renewal periods beyond 2020, the approach I have taken to valuing the PMA premium is prudent.

1.2.10 Closing statement

The statement required by paragraph 2.3 of the Federal Court's "Practice Note CM 7" is set out at Section 6 of this report.

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2 The PMA premium expenditure

2.1 Introduction

This section of the report describes:

- the scope of services and costs under the PMA;
- the termination of the PMA;
- APTPPL's expenditure under the Contract Termination and Contract Novation Agreement that terminated the PMA and a number of similar agreements;
- how the PMA premium expenditure has been accounted for in the APA Group's audited statutory financial statements, that is annual financial statements prepared in accordance with the statutory requirements of the *Corporations Act 2001* and the requirements of the Australian Stock Exchange and which have been independently audited in accordance with Australian Auditing Standards; and
- how the APA Group has derived regulatory values for the PMA premium, for each relevant pipeline.

Please note that words set out in *plain italics* below, refer to defined terms in the PMA.

2.2 Services and costs under the PMA

In April 2000, APTPPL (formerly AGL Pipelines Limited) entered into a Pipeline Management Agreement (PMA) with Agility Management Pty Ltd (Agility) (formerly AGL Infrastructure Management Pty Limited) that outsourced to Agility, pipeline construction, maintenance and operations.

The descriptions provided in the remainder of this section of the report are sourced from the PMA.

2.2.1 Term of agreement

The PMA was signed on 13 April 2000 and had an initial term of 20 years, after which it would roll forward for five year periods until one of the parties formally requested cessation of the agreement.

2.2.2 Scope of services

Agility was exclusively appointed to provide both *Specified Services* and *Additional Services* for the following *Specified Pipelines* listed at Schedule 1 of the PMA:

- Moomba-Sydney Pipeline[1];
- Central West Pipeline[2];
- Carpentaria Pipeline;

[1] Agility was not required to provide marketing services for the Moomba-Sydney Pipeline
[2] Agility was not required to provide marketing services for the Central West Pipeline

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- Roma-Brisbane Pipeline;
- MIM Lateral and Meter Station;
- Cannington Pipeline;
- Westlime Pipeline;
- Mt Todd Pipeline;
- Mataranka Pipeline; and
- Wiluna Pipeline.

2.2.3 Specified Services

Specified Services meant *Marketing Services* and *Technical Services* as they related to the *Specified Pipelines* as described in Schedule 1 of the PMA.

Marketing Services are described in Schedule 3 of the PMA and comprised:

- Marketing and Advisory Services:
  - Developing and implementing marketing strategies and programs;
  - Undertaking market analysis and long term throughput forecasting;
  - Interfacing with existing transmission shippers in relation to existing shippers' contracts and billing; and
  - Undertaking the identification of and preliminary discussions with potential new shippers; and
- Reporting:

  Furnishing to APT those reports reasonably required by APT concerning the *Marketing Services* provided by AGLIM to APT.

  Technical Services meant the services described in Schedule 2 of the PMA and in summary comprised:

Data Management Services

- Data Management:
  - Management and maintenance of SCADA master station including all hardware and software;
  - Management and maintenance of site based remote telemetry units including all hardware and software;
  - Provision and management of all communications links;
  - For the Moomba-Sydney Pipeline, provision of SCADA master station;
- Gas Control:
  - Providing operational liaison with shippers (pursuant to relevant shipper contracts);

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- Controlling pipeline operating conditions - flows, pressures, temperatures, etc to provide compliance with contractual, technical and regulatory requirements;
- Providing optimisation of pipeline operation including compression;
- Monitoring gas quality against specification, and implementing control measures in the event quality is compromised;

- Metering:

  Ensuring that all metering systems are operated in accordance with relevant standards and industry standard levels of accuracy and reliability.

Operations & Maintenance Services

- Scheduled Operations and Maintenance

  To be undertaken in accordance with a Safety and Operating Plan by APT, excluding *additional services*.

- Unscheduled Maintenance

  Unscheduled maintenance other than work of a capital nature and excluding *additional services*.

Ancillary Services

- Accounting Services

  Maintaining APT asset registers and managing spare parts inventories.

- Administration Services

  Undertaking the administration of contracts and agreements related to the provision of Technical Services, including where applicable those contracts for those Technical Services which are contestable.

- Accounts

  Preparing joint accounts for the Roma-Brisbane Pipeline joint venture and the Carpentaria Pipeline joint venture.

Transmission Services

- Providing real time metering data gathering and processing;
- Providing real time gas receipt and delivery management, including reconciliation, forecasting and nominations;
- Day to day forecasting of gas throughputs and demands;
- Preparing reconciliations and billing data in accordance with directions from APT;
- Preparing invoices for transmission for approval and issuance by APT.

Reporting

Furnishing to APT those reports reasonably required by APT, including reports required under the relevant pipeline licences and relevant statutory requirements, to the extent that those reports relate to the operational and maintenance activities of AGLIM.

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Capital expenditure

During the five year *Initial Period*, the provision of the *Specified Services* for the *Agreed Costs* was contingent on an obligation placed on APTPPL by Clause 6(a) of the PMA to approve *Capital Expenditure* of no less than the amounts set out in Schedule 8 of the PMA.

Clause 6 of the PMA also required Agility to prepare annual *Capital Expenditure* programs. Once approved by APTPPL, Agility could incur the approved amounts as an agent for APTPPL.

2.2.4 Additional Services

Additional Services meant services which were not included in the *Specified Services* and of the kind described in but not limited to, Schedule 4 of the PMA, summarised as follows:

Additional technical services

- Data management;
- Operations and maintenance;
  - Pipeline and coating repairs
  - Metal loss inspection
  - Major maintenance
- Additional asset integrity services
  - Engineering audits
  - Managing asset information using GIS
  - Fault engineering
  - Research and development
- Ancillary services
  - Accounting services
  - Administration services
  - Additional asset developments services
- Additional services on new assets

Additional marketing and advisory services

APTPPL informed us that that *Additional Services* were services generally of a similar nature to *Specified Services,* but not anticipated at the time that the *Agreed Costs* (see section 2.2.7) were set.

Given this, and for simplicity, the *Additional Charges* (see section 2.2.9) for *Additional Services* have been grouped with the *Agreed Costs* in our analyses in subsequent sections of this report.

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2.2.5 Transitional Services

The PMA required Agility to provide APTPPL with *Transitional Services* for the first two years of the term of the PMA and as may otherwise be agreed between the parties to the PMA. *Transitional Services* were described at Schedule 5 of the PMA. We were informed by APTPPL that the level of *Transitional Service* provision was not material.

2.2.6 Costs

For the services that Agility provided under the PMA, APTPPL was required to pay the following costs each year:

- *Agreed Costs* referrable for that year;
- *a Management Fee*; and
- any *Additional Charge* payable[3].

2.2.7 Agreed Costs

Agreed Costs meant the costs of the Specified Services.

The *Agreed Costs* for the five year *Initial Period* (ended 30 June 2005) of the PMA are presented in Table 2-1 below.

Table 2-1: Agreed Costs of the PMA

Pipeline	Year 1 $'000	Year 2 $'000	Year 3 $'000	Year 4 $'000	Year 5 $'000
Moomba-Sydney pipeline	11,800	12,200	12,600	13,240	13,500
Central West pipeline	525	540	550	565	580
Carpentaria pipeline	3,780	3,880	3,970	4,080	4,180
Roma-Brisbane pipeline	4,300	4,410	4,520	4,630	4,750
MIM Lateral and Meter Station	500	520	530	540	560
Cannington pipeline	220	230	235	240	245
Westlime pipeline	59	60	62	63	65
Mt Todd pipeline	46	47	48	49	50
Mataranka pipeline	102	105	107	110	112
Wiluna pipeline	72	74	76	78	80
Total	**21,404**	**22,066**	**22,698**	**23,595**	**24,122**

Source: Schedule 7 of the PMA contract

[3] Transitional service charges were also mentioned in the contract however, APA informed KPMG that the transitional services were relatively small and are included in the Agreed Costs for analysis in this report.

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Following the end of the *Initial Period* on 30 June 2005, *Agreed Costs* were determined over a rolling three year process in accordance with Clause 5.2 of the PMA. At the time of renewal, Agility was required to prepare a proposal containing for a period of three years:

- a *Capital Expenditure* program; and
- *Agreed Costs* after taking into account the *Capital Expenditure* program.

Until each party agreed with the proposal, current *Agreed Costs* applied and once agreement was reached, any necessary adjustments were made with adjustment payments accruing interest at the *Agreed Rate*.

Once the *Capital Expenditure* program and *Agreed Costs* were approved, Agility could undertake the approved capital expenditure. Additionally, Agility was permitted to make monthly cash calls in advance for capital expenses, however such amounts were only able to be applied in accordance with the approved expenditure program.

2.2.8 Management Fee

The *Management Fee* was initially set at $6 million per annum and was subject to quarterly increases in accordance with 75 percent of the quarterly increase in the CPI. If any quarterly percentage increase in CPI was more than two percent, then Agility's *Management Fee* increased as follows:

Rate of increase = 1.5% + 0.4 x (CPI – 2%)[4]

2.2.9 Additional Charge

Additional Charges were:

- charges agreed between APTPPL and Agility for Additional Services; and
- recharges back to APTPPL for any charges levied on Agility by APTPPL or its group entities of any equipment data or facilities owned, leased or licensed by, that were necessary for Agility to perform services under the PMA.

2.2.10 Other matters

Emergency expenditure

Clause 5.4 of the PMA allowed Agility to be reimbursed for expenditure including capital expenditure incurred in an *Emergency* without the prior approval of APTPPL, that was outside the scope of the *Specified Services,* if the *Emergency* was not caused or exacerbated by Agility.

Spare parts

Clause 7.4 of the PMA had the effect of APTPPL not Agility, bearing the cost of all inventory or spare parts.

[4] Clause 5.1(c), PMA

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2.3 Termination of the PMA

In October 2007, APTPPL and Agility agreed:

- to terminate the PMA and other agreements for the management of other APTPPL assets; and
- for APTPPL to acquire the resources, assets and liabilities within the Alinta group (Agility's parent) that served those agreements.

This is evidenced by:

- a Contract Termination and Contract Novation Agreement dated 14 September 2007 between APT Pipelines Limited and Alinta Limited, Alinta Asset Management (3) Pty Limited and Alinta Asset Management (4) Pty Limited; and
- the following Deeds of Termination between various members of the APA Group and Alinta Group for the following Agreements.

Table 2-2: Agreements between APTPPL and Agility in October 2007

APA Group Entity	Alinta Group Entity	Agreements
APT Pipelines Ltd	Alinta Asset Management (3) Pty Ltd, Alinta LGA Ltd	Pipeline Management Agreement
Australian Pipeline Ltd	Alinta LGA Ltd	Pipeline Development Agreement
APT Pipelines (WA) Pty Ltd	Alinta Asset Management (3) Pty Ltd	GGTP Operating Sub-Contract and Westlime Association Gas Supply Lateral-Asset Delivery Agreement
Origin Energy Pipelines Pty Ltd	Alinta Asset Management (3) Pty Ltd	Murrin Murrin Lateral-Pipeline Services Agreement
APT Petroleum Pipelines Holdings Pty Ltd	Alinta Asset Management (3) Pty Ltd	Kogan North CSM Plant Operation and Maintenance Agreement
APT Parmelia Pty Ltd	Alinta Asset Management (3) Pty Ltd	Parmelia Operating Agreement, APT Parmelia Facilities Agreement, Transfer of the Westlime Lateral Agreement, Alcoa Relocation Works Asset Delivery and Works Agreement

- The following statement is contained in the Director's Report in the APA Group's 2008 Annual Report:

  "The arrangements between APA, Alinta and the Babcock & Brown/Singapore Power Consortium to terminate or transfer to APA the operating and maintenance services previously provided by Alinta for many of APA's gas transmission pipelines were completed on 2 October 2007. APA paid $206.2 million, resulting in the elimination of all fees and

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margins that were paid to Alinta and the transfer to APA of associated property, plant and equipment and Alinta personnel involved in the provision of services."[5]

- The APA Group's audited statutory financial statements for the year ended 30 June 2008 which accounted for the Alinta Contract Termination and Contract Nomination are as follows.

Table 2-3: Net assets acquired[6]

	$'000	Note
Non-current assets		
Property, plant and equipment	4,565	
Deferred tax asset	1,705	
Intangible assets	15,544	1
Other non-current assets	582	
Non-current provisions		
Employee entitlements	(5,671)	2
Current provisions		
Employee entitlements	(593)	2
Goodwill		
Goodwill on acquisition ("the premium")	190,094	3
Total acquisition consideration	**$206,226**	

Notes

1 Intangible assets have been explained by APTPPL as:

- representing the value derived from 13 third party operating and maintenance contracts novated to the APA Group by Agility as part of this transaction; and
- relating mainly to the Ethane Pipeline at the Goldfields Gas Transmission Pipeline.

Because neither of these pipelines were subject to the PMA, these intangible assets do not relate to the PMA and are not relevant to the premium.

2 The APA Group has explained that the non current and current liabilities disclosed in Note 41 to the 2008 audited statutory financial statements represent liabilities for the entitlement of employees transferred from the Alinta Group.

3 The APA Group accounted for the excess of purchase consideration over the other net assets set out in Table 2-3, as an asset (goodwill) in its 2008 audited statutory financial statements (and subsequent years). Note 41 to the 2008 financial statements indicates that:

"For. . .the operating and maintenance services previously provided by Alinta, the Consolidated Entity has paid a premium for the acquiree as it believes the acquisitions will create synergistic benefits to the existing operations."

I have termed this "the premium". The basis of this accounting treatment is considered in Section 4 of this report.

[5] APA Annual Report, 2008, p. 26
[6] APA Annual Report 2008, Note 41 to the Financial Statements, p. 102

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Table 2-4 shows the figure of $190,094,000 of goodwill arising on the Alinta Contract Termination and Contract Novation reconciles to the total asset value for goodwill carried in the APA Group's 2008 balance sheet in its audited statutory financial statements.

Table 2-4: Reconciliation of goodwill arising on Alinta Contract Termination and Novation to APA Group balance sheet assets

	$'000	**APA Group 2008 Annual Report Ref.**
Goodwill arising during the year		
• On Alinta Contract Termination and Contract Novation (Table 2-3)	190,094	Note 41, p 102
• On Origin Energy Network's acquisition	37,823	Note 41, p 102
Total goodwill arising	227,917	Note 41, p 102
Finalisation of provision purchase price accounting (prior year determination)	(4,888)	Note 19, p 74
Goodwill at beginning of financial year	297,745	Note 19, p 74
Goodwill asset on balance sheet at end of year	$520,774	Note 19, p 74 and Balance Sheet p 43

The APA Group indicated that the purchase consideration stated in the 2008 audited statutory financial statements was a provisional figure using best available information at the time. When the 2009 audited financial statements were prepared, the purchase consideration was known with certainty.

Consequently:

- an additional $5,000 of purchase consideration was accounted for in 2008/09; and
- the goodwill (being the balance of purchase consideration and separate assets and liabilities) was increased by $5,000[7] to give a final figure for goodwill arising on the Alinta Contract Termination and Contract Novation of $190,099,000.

APA allocated the premium to the pipelines that benefited from it as follows:

Table 2-5: Allocation of premium to pipelines

	$'000
[illegible]	[illegible]
[illegible]	[illegible]
[illegible]	[illegible]
[illegible]	[illegible]
[illegible]	[illegible]
[illegible]	[illegible]
[illegible]	[illegible]
[illegible]	[illegible]

[7] Ibid

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I have inspected a spreadsheet[9] prepared by the APA Group which shows that the APA Group allocated the premium to the different pipelines in direct proportion to the present value of the expenditure savings it anticipated would accrue to each pipeline from the premium. This spreadsheet also disclosed that the APA Group anticipated that the present value of the future benefits would exceed █████ an amount in excess of the $190.1m that the APA Group accounted for on its balance sheet.

2.4 APA's regulatory valuation of the premium

The APA Group derived its regulatory valuation of the premium by taking the commercial valuation and making the following adjustments:

- removing any benefit from savings in management fees payable to Agility (refer to Section 2.2.8), on the basis that because the management fee was not recoverable by a Reference Tariff, the asset created by mitigating that cost would not be recoverable either; and
- discounting future cash flows by using a WACC of 8.84%, being the nominal vanilla WACC for the RBP, approved at its 2006 Access Arrangement revision rather than APA's internal WACC.

These adjustments reduced the total value of the premium by ██████████████. The adjustments (and hence the resulting regulatory valuation) were apportioned by APA to the different pipelines in the proportion of the sum of avoided *Agreed Cost, Additional Charges* and *Capital Expenditure* amounts for each pipeline.

On this basis, the resulting attribution of the premium is set out in Table 2-6 below.

Table 2-6: APA 2007 regulatory values of PMA premium

	2007 $m
███████████████	███
█████████████	███
███████████████	███
███████████████	███
█████████████	████
██████████████████████████████ ████████████	███
	█████

Source: APA

9 APA Group, PMA Cost Allocation Final Sep-08 (PLD).xls

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2.5 Findings

Because the PMA was terminated, the *Agreed Costs, Management Fee* and *Additional Charges* otherwise payable by APTPPL to Agility under the PMA, have been avoided.

The APA Group has accounted for the premium that APTPPL paid to terminate the PMA and other agreements, as an asset in the balance sheet of its audited annual financial statements prepared under the requirements of the *Corporations Act 2001.*

The APA Group has accounted for and valued the PMA premiums for regulatory purposes on a basis consistent with the amounts accounted for under Accounting Standards, except that the values have been reduced for regulatory purposes by excluding any benefit from reduced management fees savings and have been stated on the basis of discounting future benefits using a WACC consistent with the 2006 RBP access arrangement revision.

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3 The criteria that are relevant to determining whether the premium or part thereof, should be treated as capital expenditure.

I consider that the criteria that are relevant in determining whether the premium or part thereof, should be treated as capital expenditure are contained within:

- fundamental accounting concepts;
- statutory accounting requirements and associated Accounting Standards; and
- regulatory precedents.

I describe these criteria and their bases, below.

3.1 Fundamental accounting concepts

As a general principle, expenditure is either debited in the year of expenditure, to:

- the profit and loss account and recorded as an expense; or
- the balance sheet and accounted for as an asset or less commonly, as a reduction in shareholder capital or reserves.

The National Gas Rules require expenditure that may be recoverable by a Reference Tariff to be categorised as either capital or non-capital expenditure.

Definition of an asset

The Australian Government's Australian Accounting Standards Board defines an "asset" as:

> *"A resource:*
>
> *a) controlled by an entity as a result of past events; and*
>
> *b) from which future economic benefits are expected to flow."*[10]

The authority of the Australian Government's Australian Accounting Standards Board over accounting policies is described at Section 3.2.2 below.

I observe that this definition hinges on the economic effect of the expenditure, not the physical characteristics of the asset procured by the expenditure. Therefore assets may be tangible or intangible.

Two fundamental general accounting concepts, which I describe below, are also relevant.

The matching or accruals concept

This concept matches the period in which costs are recognised with the period in which the benefits that relate to or are facilitated by those costs, are recognised.

Accordingly, expenditure may be accounted for as an asset which is carried forward on a company's balance sheet into future periods and subsequently written back, amortised or

[10] AASB, Glossary of defined terms, May 2011, p. 3

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depreciated to match the recognition of those costs in the profit and loss account with periods in which associated revenue is recognised.

For example, a business may make expenditure on an asset that it anticipates it will utilise in subsequent periods to generate profits by increasing revenues or reducing costs. That expenditure would typically be:

- capitalised and accounted for as an asset; and
- depreciated over the periods in which it delivers benefits, with a depreciation charge or expense being recognised in the profit and loss accounts of each of those periods.

In general terms, the application of the matching concept should be considered concurrently with the application of the prudence concept.

The prudence concept

The prudence concept requires:

- losses, expense and liabilities to be recognised as soon as they are known even where the amounts may not be certain; but
- revenues and assets are only to be recognised when it is certain that they will be realised.

The intention of the prudence concept is to avoid the risks of assets and revenues being overstated and of liabilities and costs being understated.

These concepts provide well established, generally accepted principles that underpin the more specific requirements of Accounting Standards.

The Australian Government's Australian Accounting Standards Board (AASB) has published a "Framework for the Preparation and Presentation of Financial Statements" (July 2004) (the Framework).

The purposes of the Framework include assisting:

- preparers of financial reports in applying Australian Accounting Standards and in dealing with topics that have yet to form the subject of an Australian Accounting Standard;
- auditors in forming an opinion as to whether financial reports conform with Australian Accounting Standards; and
- users of financial reports in interpreting the information contained in financial reports prepared in conformity with Australian Accounting Standards.[11]

The Framework "sets out concepts that underline the preparation and presentation of financial reports for external users".[12]

The Framework:

- includes an underlying assumption that financial reports are prepared on an accruals basis[13]; and

[11] Ibid.
[12] AASB, Framework for the preparation and presentation of financial statements, July 2004, p. 10
[13] Ibid, p. 16

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- stipulates that to be useful, information must be reliable.[14] This includes the exercise of prudence, which is described as "*the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated. . . .*"[15]

3.2 Corporations Act requirements and Australian Accounting Standards

3.2.1 Introduction

In this subsection of the report, I establish the authority and relevance of Australian Accounting Standards to determining the questions that have been asked of me.

In Section 4, I consider the specific requirements of Australian Accounting Standards that are relevant to determining whether the premium or part thereof is in the nature of capital expenditure.

3.2.2 The authority of Australian Accounting Standards

Australian Accounting Standards provide the regulatory framework that governs accounting policies and disclosures in Australian financial reports or statements that are intended to provide a true and fair view of a business's financial performance and position to general users of those reports or statements.

Australian Accounting Standards are developed and published by the Australian Government's Accounting Standards Board.

The APA Group publishes public annual and half year financial reports that accord with the requirements of the *Corporations Act 2001*.

Section 296 of the *Corporations Act 2001* requires financial reports to comply with Australian Accounting Standards.[16]

Section 297 of the *Corporations Act 2001* requires financial statements[17] and notes to give a true and fair view of the reporting entities' financial performance and financial position. Further, Section 297:

- *has an overarching requirement for a financial report to comply with Australian Accounting Standards; and*
- *requires the notes to financial statements to provide additional information if the financial statements and notes prepared in accordance with Australian Accounting Standards do not give a true and fair view."*

[14] Ibid, p. 18
[15] Ibid, p. 19
[16] Section 296 allows certain exemptions for small proprietary companies and small companies limited by guarantee. These exemptions do not apply to the APA Group.
[17] The Glossary to this report explains the relationships between financial reports and financial statements.

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3.2.3 The relevance of financial reports and statements prepared under Australian Accounting Standards

Australian Accounting Standards have an objective of enabling general purpose financial reports to provide a true and fair view of the financial performance and position of a reporting entity.

The Framework explains that it (and hence Accounting Standards) is concerned with general purpose financial reports. This is reiterated in the "Application" section at the front of each Accounting Standard.

The Framework states that:

> *"The objective of financial reports is to provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions."*[18]

The Framework also explains with specific reference to general purpose financial reports, that:

> *"Such financial reports are prepared and presented at least annually and are directed toward the common information needs of a wide range of users. . . . . Many users, however, have to rely on the financial report as their major source of financial information and such financial reports should, therefore, be prepared and presented with their needs in view."*[19]

The AASB's glossary of defined terms further supports this explanation. It defines general purpose financial statements as:

> *"Financial statements that are intended to meet the needs of users who are not in a position to require an entity to prepare reports tailored to their particular information needs."*[20]

This means that Accounting Standards are required to enable financial statements to meet the needs of a wide variety of users for a true and fair view.

The Framework also emphasises the importance of neutrality to financial reports. For example, it states:

> *"To be reliable, the information contained in financial reports must be neutral, that is, free from bias. Financial reports are not neutral if, by the selection or presentation of information, they influence the making of a decision or judgement in order to achieve a predetermined result or outcome."*[21]

The Australian Government's Australian Accounting Standards Board has recognised the range of users whose needs general purpose financial statements are required to meet, including:[22]

- investors;
- employees;
- lenders;
- suppliers and other trade creditors;

---

[18] AASB, Framework for the preparation and presentation of financial statements, July 2004, p. 13.
[19] Ibid, p. 11.
[20] AASB, Glossary of defined terms, May 2011, p. 27.
[21] AASB, Framework for the preparation and presentation of financial statements, July 2004, p. 19.
[22] Ibid, p. 12-13

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- customers;
- governments and their agencies; and
- the public.

In particular, the Australian Government's Australian Accounting Standards Board requires that:

> *"Governments and their agencies are interested in the allocation of resources and, therefore, the activities of entities.* ***They also require information to regulate the activities of entities****. . . ."*[23] (Author's emphasis)

The Australian Government Australian Accounting Standards Board also affirms that:

> *"While all of the information needs of these users cannot be met by financial reports, there are needs which are common to all users. As investors are providers of risk capital to the entity, the provision of financial reports that meet their needs will also meet most of the needs of other users that financial reports can satisfy."*[24]

Conclusion

The information I have set out above in this Section 3.2 leads me to conclude that the Australian Government's Australian Accounting Standards have an objective of implementing accounting policies and disclosures that are relevant to providing an impartial, true and fair view of a business's financial performance and position to a wide range of users including APA's customers, the Government, the Australian Energy Regulator and other regulatory stakeholders. While the information disclosed under Australian Standards may not necessarily meet all possible needs of all stakeholders, that factor does not diminish the truth and fairness of information disclosed under Accounting Standards.

Accordingly, I conclude that the requirements of Australian Accounting Standards are highly relevant to a consideration of whether the expenditure on the PMA premium or part thereof, should be treated as capital expenditure.

3.3 Relevant Australian Accounting Standards

The following Accounting Standards are particularly relevant to the capitalisation of the PMA premium expenditure:

- AASB 3, Business Combinations, November 2010;
- AASB 136, Impairment of Assets, December 2009; and
- AASB 138, Intangible Assets, October 2009.

The specific application of their criteria to the PMA premium is considered in Section 4.

[23] Ibid
[24] Ibid, p. 13

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3.4 Regulatory precedents

I have assisted Australian access regulators to develop guidelines that implement reports to regulators of regulated businesses' financial performance, assets and liabilities, since 1995[25] and most recently, in 2010[26].

In my experience, these requirements invariably require the business to base its reports on its audited general purpose financial reports, which accord with Corporations Law and Accounting Standards. The regulator typically requires the business to follow accounting policies under Accounting Standards except where the regulator may specify a substitute policy to meet a special purpose of the regulator.

My experience includes assisting the ACCC to develop *"Regulatory reporting guidelines for gas pipeline service providers"* (May 2004). The ACCC (and subsequently the AER) chose not to implement this guideline, although it was published for consultation.[27]

That Guideline also followed the general approach of requiring the financial reports to the regulator to be based on general purpose financial statements prepared under Accounting Standards. To the best of my knowledge, this is the only public regulatory accounting guideline provided by the AER or the ACCC, to gas transmission businesses.

Also, to the best of my knowledge, the Essential Services Commission of Victoria (formerly the Office of the Regulator-General, Victoria (ORG)) has been the only Australian access regulator to specifically require an adjustment to accounting policies under Accounting Standards, to exclude goodwill, in its regulatory accounting guidelines for electricity and gas distribution businesses. I was seconded to the ORG and drafted Issues 1 and 2 of its Electricity Industry Guideline No 3 that originated this requirement. My understanding was that the regulator wished to exclude goodwill on the acquisition of a distribution by its owner, because it was not an asset of the regulated business itself. This was a different situation to that described in Section 2 of this report where expenditure on goodwill has been made by and on behalf of the regulated business for the purposes of the regulated business.

The ORG's adjustment therefore aimed to exclude assets that were outside of the scope of the regulated business, rather than to adjust an accounting policy on goodwill that complied with Accounting Standards. The ORG precedent is not therefore relevant to consideration of whether the PMA premium should be capitalised in the capital base of a Covered Pipeline.

[25] Office of the Regulator-General, Victoria, Electricity Industry Guideline No 3, Regulatory Accounting Information Requirements
[26] Queensland Competition Authority – Water price monitoring
[27] http://www.aer.gov.au/content/index.phtml/itemId/683187

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4 Comparison of the factual characteristics of the premium expenditure to the criteria that are relevant to determining whether the premium or part thereof, should be treated as capital expenditure

4.1 Explanation

Section 2.3 of this report describes how the PMA premium has been accounted for as an asset in the APA Group's audited financial statements that have been prepared in accordance with Australian Accounting Standards.

Because these financial statements are subject to unqualified auditor opinions[28], there is no reason to suggest that within the framework provided by Accounting Standards and the *Corporations Act 2001* the treatment of the expenditure as an asset and its unimpaired carrying value, are not fairly stated.

Nonetheless, I set out in this section additional analysis to explain the rationale for this treatment.

The Australian Government Australian Accounting Standards Board defines an "asset" as:

> *"A resource:*
>
> *a) Controlled by an entity as a result of past events; and*
>
> *b) From which future economic benefits are expected to flow."*[29]

The capitalised PMA premium meets both legs of this definition because:

- the APA Group controls the resource. That is to say that in accordance with the description of control set out in AASB 138 Intangible Assets[30], the APA Group has the power to obtain the future economic benefits flowing from the resource and access to those benefits (i.e. the expenditure savings) are restricted to the APA Group;
- it arose from a past event, the execution of the Contract Termination and Contract Novation Agreement dated September 2007, explained in Section 2.3 of this report;
- that Agreement relieved APTPPL from its obligations under the PMA; and
- future economic benefits were and are expected to flow to the APA Group as a consequence of the Contract Termination and Contract Novation Agreement.

The expectation of those benefits is evidenced by the following Board paper: Australian Pipeline Limited, Item for approval No 6 Board Meeting 26/02/07, '*Acquisition of Alinta's Pipeline Operation Agreements for APG's Assets and Associated Assets (All States)*'.

The paper stated:

> *"To arrive at a price that APG may be willing to pay to effect this transaction, a discounted cash flow analysis has been undertaken to assess the present value of the future margins*

[28] APA Group Annual Reports, 2008, 2009 and 2010
[29] AASB, Glossary of defined terms, May 2011, p. 3
[30] AASB 138 Intangible Assets, October 2009, p. 16

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payable under the PMA and GGT contracts plus the margin achievable under the third party contracts.

The four key sources of value to the contracts are:

- *the margins and fees disclosed in the PMA (including the Pipeline Management Fee);*
- *additional undisclosed margins achieved;*
- *operational cost savings available to APG; and*
- *margins through third party contracts."*

The Australian Government's Australian Accounting Standards Board Framework document which I describe in Section 3 of this report, further supports a conclusion that the PMA premium is capital expenditure. For example, it states:

"The future economic benefit embodied in an asset is the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the entity. The potential may be a productive one that is part of the operating activities of the entity. It may also take the form of convertibility into cash or cash equivalents ***or a capability to reduce cash outflows****. . . ."*[31] (Author's emphasis)

I also note that on a first principles basis, the expenditure is appropriately treated under the matching concept described at Section 3.1 as an asset, because it delivers economic benefits over a period of no less than the minimum term of the contract, not just in the year of expenditure. If it were not treated as an asset then there would be a significant mismatch between the timing of the delivery of benefits and the recognition of the costs that enable those benefits to be realised.

The APA Group has accounted for the PMA premium as capitalised "goodwill" rather than another form of intangible asset. This is a matter of classification. It does not question the status of the expenditure as an asset.

The Australian Government's Australian Accounting Standards Board defines "goodwill" as:

"An asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognised."[32]

This means that future economic benefits are recognised as an asset which is not separable from other assets.

In this context, "not separable" means that the asset is not capable of being separated or divested from the APA Group and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, identifiable asset or liability regardless of whether the APA Group intends to do so.[33]

Accordingly, in accordance with AASB 3, Business Combinations[34], the acquisition cost of the PMA premium asset has been established by assessing the difference between the total purchase consideration under the Contract Termination and Contract Novation Agreement, and the

[31] AASB, Framework for the Preparation and Presentation of Financial Statements, July 2004, p. 23
[32] AASB, Glossary of defined terms, May 2011, p. 27
[33] AASB 138 Intangible Assets, October 2009, p. 15
[34] AASB 3, Business Combinations, November 2010, p. 18

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separable or identifiable assets acquired under that Agreement. This calculation is disclosed at Table 2-3 of this report.

For the avoidance of doubt, I also make the following clarification that I believe is pertinent.

The PMA premium was a payment made that allowed APTPPL to make savings and reduce costs in its business, that it would otherwise have been obliged to incur. This does not mean that the capitalised PMA premium results in the capitalisation of an avoided cost because the premium was actual expenditure incurred, not an avoided cost.

A consequence of the PMA premium being accounted for as goodwill is that Australian Accounting Standard AASB 136, Impairment of Assets, requires it to be tested for impairment annually.[35][36]

The impairment test requires the APA Group to allocate goodwill to each of the cash generating units or groups of cash generating units expected to benefit from synergies of the business combination (i.e. the Alinta acquisition)[37]. Table 4-1 discloses how the APA Group allocated the goodwill identified in Section 2.3 to the pipelines subject to the PMA premium.

Table 4-1: Allocation of premium to pipelines

	$'000

Source: APA [39]

Impairment testing requires the APA Group to consider for each cash generating unit whether its carrying value exceeds its recoverable amount, where:

- *carrying value* is the amount at which the asset is recognised after deducting any accumulated depreciation, amortisation and improvement losses;[40] and
- *recoverable amount* is the higher of its fair value less costs to sell and its *value in use* which is in turn defined as the present value of the future cash flow, expected to be generated from the cash generating unit.[41]

---

[35] AASB 136, Impairment of Assets, December 2009, p. 15
[36] We understand that as an ASX listed entity the APA Group also tests for impairment half yearly
[37] Ibid, p. 33
[38] Agrees to Table 2-3 with additional $5,000 of consideration described in Section 2.3.
[39] APA, PMA Cost Allocation Final Sep-08 (PLD)_PS(2).xls
[40] Ibid, p. 12
[41] Ibid, p. 13

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I note that the APA Group's audited statutory financial statements for the years ending 30 June 2008, 2009, 2010 and 2011 (the most recent available at the time of writing) do not record any impairments of goodwill. Therefore and because impairment testing was conducted on a pipeline by pipeline basis, it is reasonable to conclude from this that both the directors of the APA Group and the auditor were satisfied that there was no material impairment of the premium attributable to any pipeline formerly subject to the PMA. That is to say that the present value of the future cash flows attributable to the premium for each pipeline is greater than the stated carrying value. I have referred only to the present values of future cash flows as being synonymous with the '*recoverable amount*' because I believe that it is reasonable to assume that the PMA premium allocated to each pipeline would not be separable and because of this would have no fair value to anyone other than the owner of each pipeline.

4.2 Findings

This section of my report demonstrates on both a first principles basis and under the statutory framework provided by the Australian Accounting Standards, that it is reasonable to capitalise the PMA premium or a part thereof as an asset principally because the expenditure enables future economic benefits to flow to the APA Group.

I also refer to the precedents provided by the AER for costs to be accounted for in accordance with Accounting Standards.

I am unaware of any alternative to the accounting framework provided by Australian Accounting Standards, that the AER has directed to apply to gas transmission businesses. In the absence of any alternative accounting framework, and taking into account the authority given to Australian Accounting Standards over general purpose financial reports by the *Corporations Act 2001*, I conclude that Australian Accounting Standards provide an appropriate framework for determining that the PMA premium was expenditure of a capital nature.

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5 Testing APA's valuation of the premium it has attributed to the RBP

5.1 Introduction

Section 4 of this report establishes that it is reasonable that the premium, or part thereof paid by APTPPL to Agility, be treated as capital expenditure. This section of the report sets out:

- how I have independently tested APA's valuation of the premium it has allocated to the RBP; and
- the results of that test.

My approach compares observed and forecast operating and maintenance expenditure and applies specific independent benchmark margins to determine the capital expenditure costs that the APA Group avoided by terminating the PMA.

5.2 My approach to testing APA's valuation

My approach is based on the premise that the value of the asset should not exceed the net present value of the future benefits attributable to the RBP that have been procured by the expenditure on the PMA premium. This is consistent with:

- the "building block approach" used to determine revenue requirements under Division 3 of the National Gas Rules[42]; and
- the accounting definition of an asset explained at Section 3.1 of this report.

These benefits principally comprise reductions in expenditure on the RBP, subsequent to the termination of the PMA, that can be attributed to the termination of the PMA. My approach has sought to identify these expenditure reductions where they can be reasonably quantified. Where benefits cannot be reasonably quantified, I have excluded them from consideration and to that extent, my testing of APA's valuation will be conservative.

The potential benefits secured by the PMA premium include:

- the avoidance of profit and overhead margins that would otherwise have been payable to Agility under the PMA;
- synergies and the benefits of increased scale and purchasing power from bringing the activities formerly contracted to Agility under the PMA, in house;
- the value of intellectual capital and know-how acquired by the APA Group by bringing former Agility employees in house as a direct consequence of the PMA termination; and
- the benefits that arise from advancing taxation deductions by making the capital PMA premium payment in place of operating expenditure over the period to 2020.

These benefits would be most completely measured by comparing expenditure on the RBP had the PMA continued, with RBP expenditure after the PMA's termination.

[42] See National Gas Rules, Version 10. p. 52.

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To make this assessment, I considered non-capital or operating expenditure capital expenditure and accelerated tax deductions, separately. I explain why below

5.2.1 Benefits reflected in non-capital expenditure

Non-capital expenditure on the RBP delivers a constant output, namely the continued operations and maintenance of the RBP. A ready benchmark for the efficient level of this expenditure under the PMA is provided by the non-capital expenditure for the RBP for the period, approved by the ACCC, as part of the 2006 access arrangement revision for the RBP. This expenditure was approved in December 2006, on the basis that the RBP would continue to be subject to the PMA. The PMA was not terminated until October 2007. My approach to measuring the benefits of reduced operating expenditure was therefore to:

- compare the actual non-capital expenditure for the RBP for the period 2007/08 to 2010/11 with the corresponding efficient expenditure approved in the 2006 RBP access arrangement revision;
- test for the comparability of the actual expenditure with the amounts approved by the ACCC for that period by testing for evidence of deferral of RBP non-capital expenditure. (To the extent that RBP non-capital expenditure may have been advanced, this would diminish the benefits used to test the APA valuation and produce a conservative result. Hence I did not test for possible advancement of RBP non-capital expenditure);
- estimate annual savings for the period 2011/12 to 2020 on the basis of the average annual differential between benchmarked non-capital expenditure (provided by the 2006 access arrangement revision) and actual non-capital expenditure for the period 2007/08 to 2010/11. It is possible that after 2011, actual expenditure would increase beyond the average levels for 2007/08 to 2010/11 if the scale of operations were to increase. However, if this were to be so, it is also reasonable to assume that an increasing scale of operations would cause expenditure that would have been incurred under the PMA to increase too and by a greater amount if the proportional saving were to remain constant. Therefore the use of a constant amount for assumed savings after 2011, is conservative.

5.2.2 Benefits reflected in capital expenditure

In principle, the approach described above could also be used to assess the benefits accruing to capital expenditure. However, in practice capital expenditure has a greater non-recurrent element and may be more sensitive than non-capital expenditure to uncertainty about whether a comparison of forecast and actual expenditure reflects efficiencies derived from termination of the PMA rather than differences in scale of expenditure.

To avoid this uncertainty, I took an approach that captures only avoided profit margins and overheads that would otherwise have been payable under the PMA. My approach is therefore conservative in that it does not reflect any benefits of direct capital expenditure efficiency savings.

I applied benchmark profit and overhead margins that were highly specific to the PMA and to known and planned capital expenditure for the RBP.

I assumed that average capital expenditure for the period 2007/08 to 2011/12 will be indicative of capital expenditure for the period 2012/13 to 2020/21. I explain this assumption further, below Table 5-1.

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It is realistic to assume that:

- Agility like any commercial business, would seek to recover in its pricing, overheads and a profit margin in order to deliver services, including services under the PMA. This principle has been accepted by the AER.[43]; and
- APA would avoid margins and overheads payable to Agility if it no longer procured services under the PMA.

To determine the margins for overhead and profit on capital expenditure that the APA Group avoids, I referred to an independent report commissioned by both Agility and APA (then APT) from Evans and Peck in 2003[44]. Agility and APA (then APT) commissioned Evans and Peck to *provide "an independent opinion as to what overhead and profit margins should be applied to arrive at an 'additional charge'"* that is *"consistent with reasonable competitive costs"*[45]. The purpose of the study was to assist APA and Agility to agree amounts of profit and overhead to be costed into works conducted by Agility for APA. Evans and Peck conducted a benchmarking study on a sample of firms operating within comparable industries with similar market characteristics. Evans and Peck also made use of the capital asset pricing model (CAPM) to derive average industry returns based on relative market risk, as a secondary comparison.

Evans and Peck's opinion was that "*an overhead component in the vicinity of 10 percent base cost was commensurate with current competitive industry practice"*. Furthermore, *"an appropriate return (profit) to Agility for the provision of services to APA would be within the range of 8 percent to 10 percent*".[46]

Accordingly, I applied a 9% profit margin and a 10% overhead margin to identify the margins on direct costs that the APA Group avoids by having terminated the PMA. The Evans and Peck report is the most relevant available source of information for determining these values. Furthermore, given that this report was jointly commissioned by the principal counterparties to the PMA to assist them reach agreement on costs, I have no reason to believe that the margins it presents are not derived on an independent basis.

Because my approach takes into account actual non-capital expenditure including overheads attributable to the RBP, my approach takes into account the possibility that bringing capital expenditure management in house may have caused APA's overheads to increase. I explain why below.

---

[43] See AER (2010) "Victorian electricity distribution network service providers' distribution determination 2011-2015", October 2010. Specifically, the AER recognises the legitimate economic reasons for the inclusion of a margin in outsourcing arrangements to compensate for a share of the contractor's corporate and other indirect costs and to retain the benefit of historical efficiencies for a period of time (page 153). The AER defines the term 'margin' as "used to reflect any difference between a contract price and a contractor's actual direct costs (that is, 'margins' may include corporate and other indirect costs, and profit margins)" (page 149). The other legitimate economic justification for a margin is to compensate for the return on and return of capital invested in assets utilised by the related party contractors, where those assets are not already in the service provider's regulatory asset base (RAB) (page 153).

[44] See Evans and Peck (2003), "Industry standard margins", prepared for Agility Management Pty Ltd and Australian Pipeline Trust on the Pipeline Management Agreement.

[45] See Evans and Peck (2003), "Industry standard margins", prepared for Agility Management Pty Ltd and Australian Pipeline Trust on the Pipeline Management Agreement, p. 2.

[46] See Evans & Peck (2003), "Industry standard margins", prepared for Agility Management Pty Ltd and Australian Pipeline Trust on the Pipeline Management Agreement, p. 11.

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APA has informed me that it does not capitalise any material overheads it incurs. This is consistent with its internal accounting policy.[47] I also observed the relevant line item for capital related overheads in APA's Oracle accounting records and have observed that no overhead costs were capitalised during the period 2007/2008 to 2010/11.

Businesses necessarily incur overheads. Where overheads are not capitalised, it follows that they are accounted for as non-capital costs. Therefore because APA does not capitalise overheads, it follows that these costs:

- are accounted for by the APA Group as non-capital costs. APA has confirmed to me that attributable overheads are accounted for in the non-capital costs incurred that it reported for the RBP for the period 2007/2008 to 2010/11; and
- therefore have been taken into account in the comparison of non-capital costs described above, diminishing the non-capital savings calculated above.

The Evans and Peck Report accounts for efficient levels of overheads on the Base Costs (direct costs) that were subject to the PMA. The approach I have taken is consistent with the Evans and Peck Report because it applies the Evans and Peck margins to APA capital expenditure that excludes overheads.

5.2.3 Benefit of advanced taxation deductions

My approach takes into account the fact that the expenditure on the premium enables APA to access tax deductions more quickly than would have been the case had it continued with the PMA and accessed tax deductions on expenditure with the same present value, over a longer period.

5.2.4 Summary

The approach I have taken methodically tests APA's valuation by applying the generally accepted approach of net present value assessment to quantify future benefits only where there is a basis for doing so. In this regard, my approach is conservative and may understate the value of the RBP PMA premium. The principal potential benefits that I have not taken into account in testing APA's valuation are any efficiencies in direct capital expenditure and any value that may accrue to intellectual property and know-how acquired by APA from Agility that may have continuing benefit to APA after 2020. I also have not ascribed any value to savings in management fees.

5.3 Other assumptions

In testing APA's valuation, I have made the following assumptions:

- the asset has been valued at October 2007, the date the asset was acquired;
- benefits have been assessed over a 13 year period to 2020, the date at which the term of the PMA would have expired, subject to any mutually agreed extension for five year terms. (Section 2.2.1 of this report explains this.) At 2020, APTPPL would have had the opportunity to terminate the PMA if it so wished. I have assumed that the termination benefits procured by the termination payment in 2007 do not extend beyond those that

[47] APA "Accounting Policy: Capitalisation of Labour Costs", 2010.

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would have been obtainable by APPTL without a termination payment, at 2020. It is possible that by terminating the Agreement and bring the intellectual property and skills of Agility's former work force in house, APA acquired a benefit that has value that extends beyond 2020, thereby resulting in the PMA premium having a terminal value at 2020. However, to be conservative in my test of APA's valuation I have not ascribed a terminal value to the PMA premium at 2020.

- present values have been calculated using a real vanilla discount rate of 5.45%. This is consistent with the weighted average cost of capital approved by the regulator for the access arrangement revision for the period 2006 to 2011 for the Roma to Brisbane Pipeline[48], the most recent access arrangement concerning a pipeline that was covered by the PMA. I have assumed that this is the most relevant rate. Appendix F outlines the reason for choice of the WACC;
- all historic costs have been inflated or deflated by CPI to 2007/2008 dollars;
- a simplifying assumption has been made that all tax cash flows arise in the years to which they relate;
- the tax benefit on the termination payment arises over five years;[49]
- the capital expenditure savings arising as a result of the termination payment, are assumed to be tax deducted over 20 years from the date of expenditure; and
- Section 2.2.8 explains that a management fee was payable to Agility under the PMA. I understand that this was not considered by the AER and predecessor regulators to be recoverable by a Reference Tariff. On this basis, savings accruing to the avoidance of the management fee have been excluded from my calculations.

5.4 Valuation test result

My approach values the PMA premium attributable to the RBP at October 2007 at $33.2m. The basis of this valuation is summarised in Table 5-1 below. Appendix E details the calculations and assumptions on which it is based.

Table 5-1: Estimated value of the RBP portion of the PMA

Cash flow	13 year PV at 2007 $m	Comment
Operational cost savings	7.7	Estimated difference between expected operational costs under the PMA, based on costs approved by the ACCC, and actual expected post termination operational costs of APA
Margins on capital works savings	10.5	Estimated margins no longer paid to Agility on capital expenditure.

[48] See ACCC "Final decision – Roma to Brisbane Pipeline – revised access arrangement" Date 20 December 2006 p 120.
[49] Letter of advice from KPMG to APA, 21 August 2007.

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Cash flow	13 year PV at 2007 $m	Comment
Overheads on capital works savings	11.6	Estimated overhead costs no longer paid to Agility on capital expenditure.
NPV before tax	**$29.8m**	Total estimated savings from the purchase of the PMA before tax.
Tax deductions forgone	(4.3)	Tax deductions foregone on all cost savings.
Tax benefit from purchase	7.6	Tax deduction benefit from payment of the premium for the PMA.
Present value of net economic benefits	**$33.2m**	

These components of the valuation are summarised below. Appendix E.1 describes in more detail the detailed assumptions and calculations.

Non-capital costs

From 2007/08 until 2009/10 APA's actual non-capital costs (converted to real 2007/08 dollars) are compared to the costs approved in the RBP access arrangement revision.

For 2010/11 APA's actual non-capital RBP costs were adjusted to exclude $4.366 million of abnormal flood related costs[50]. This represents abnormal expenditure not anticipated at the time of the 2006 access arrangement revision and therefore does not a basis for comparison between pre and post PMA expenditure.

The average of the savings achieved between 2007/08 and 2010/11 is used as a proxy for the expected annual savings that may be achieved each year for the remainder of the period to 2020. I have used this differential figure because:

- the use of a constant differential is conservative because it in effect reduces the proportional savings where pipeline operations and maintenance activity may increase with future upgrades to pipelines; and
- using the average differential provided a lower and more conservative savings estimate than the difference provided by an alternative of the difference of the final year (2010/11) for which actual cost data is available.

I encountered no evidence to suggest that the savings are overstated because non-capital expenditure may have been deferred or reduced post termination. In response to my enquiries on this matter, APA referred me to independent *"Safety and operating plan compliance reports*" on the Queensland PMA pipelines (including RBP) from 2008 to 2011.

These provide independent reports on whether relevant outcome standards for the operational and maintenance activities have been. For example in 2011 for the RBP and Carpentaria pipelines, the report stated that:

[50] This amount was evidenced by an extract from the APA Group's accounting records for 2010/11 which summarised operating costs classified under account headings "RBP Flood damage".

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- *"The objective of the audit process was to verify implementation of the Safety and Operating Plans developed by the APA Group with evidence of understanding of requirements and implementation of the defined systems."*
- *"In undertaking the audit there was also an overview of the effectiveness of the undertakings and the implementation of the requirements under the governing code AS2885 Part 3:2001."*
- *The Audit also reviewed compliance with the Safety and Operating Plan Compliance with Section 675 of the Queensland Petroleum and Gas (Production and Safety) Act 2004*[51]*."*

I observe that the Safety and Operating Plans appear to be analogous to the requirements under the PMA, for Agility to undertake operations and maintenance in accordance with a *Safety and Operating Plan* as described in Section 2.2.3 of this report.

The recent report for the Queensland pipelines indicated that while there were a few minor areas for improvement:

- *"The above issues cannot be considered to be impacting on the integrity of the operational processes used for the pipeline; however they reflect the need to fine tune the management systems applied to the overall pipeline operation"*[52]*.*

This suggests that post PMA termination operating and maintenance meets operating and safety standards for the RBP and Carpentaria in 2011.

Known and planned capital expenditure for the RBP to 2012 has been used. APA has indicated that future capital expenditure comprises Stay in Business Capital Expenditure and capital expenditure in response to customer demand which can be reasonably expected as is evidenced by historical expenditure, but is not agreed beyond 2012. On this basis the average post PMA capital expenditure of $13.1m pa incurred from 2007/08 to 20011/12 has been used as the basis for capital expenditure from 2012/13 to 2020/21. A multi year average avoids distortions arising from the lumpy nature of capital expenditure. This has also been checked against average capital expenditure on the RBP from 2002 to 2012, which amounts to $12m pa. My sensitivity testing indicates that if the lower figure of $12m pa is substituted for the capital expenditure assumed for 2013 to 2020, the results of my testing would support a valuation of $32.1m rather than $33.1m. This is still in excess of APA's valuation of $30.1m and therefore the use of this potential alternative reasonable assumption would not lead me to change my findings.

Tax deductions forgone.

This is the present value of the tax deductions that APA would have received had it paid Agility for the saved operational and capital costs identified in Table 5-1.

Tax deduction savings on pre tax premium.

I understand that the PMA termination payment is tax deductible over five years[53]. I have tax amortised the net present value of $29.8m (see Table 5-1), that I have calculated prior to

[51] See AQUAS (2011) "Audit report, Work package: RBP & CGP Gas pipelines, Scope of Audit: Safety and operating plan compliance", Audit reference AQ689.25, p.4.
[52] See AQUAS (2011) "Audit report, Work package: RBP & CGP Gas pipelines, Scope of Audit: Safety and operating plan compliance", Audit reference AQ689.25, p.3.
[53] Letter of advice from KPMG to APA, 21 August 2007.

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consideration of this benefit, rather than the premium paid, to ensure that the benefit of advanced tax deductions is not overstated.

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6 Expert's statement

I have read the Federal Court's "Practice Note CM 7 "Expert Witnesses in proceedings in the Federal Court of Australia" (1 August 2011) and prepared this report in a form consistent with Practice Note CM 7.

I have prepared this report for the purpose set out in Section 1.2 of this report and it is not to be used for any other purpose without my prior written consent. Accordingly, KPMG accepts no responsibility in any way whatsoever for the use of this report for any purpose other than that for which it has been prepared.

I have made all inquiries that I believe are desirable and appropriate and no matters of significance which I regard as relevant have, to my knowledge, been withheld from the material set out in this report.

Nothing in this report should be taken to imply that I have verified any information supplied to me, or have in any way carried out an audit of any information supplied to me other than as expressly stated in this report.

My opinion is based solely on the information set out in this report. If I amend any conclusion on further information, I will amend the report.

Keith Lockey

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Dear Mr Lockey

Roma to Brisbane Pipeline access arrangements 2012 – 2017: Regulatory treatment of Pipeline Management Agreement termination payment

Background

APT Petroleum Pipelines Ltd (**APTPPL**) owns the Roma to Brisbane Pipeline (**RBP**) which transports natural gas from the gas hub near Roma to the markets of Brisbane and the regional centres along the pipeline route. The mainline was constructed in 1969, is 438km long and runs from Roma (Wallumbilla) to Brisbane. The Peat lateral was constructed in 2001, is 121km long and runs from the Peat and Scotia gas fields to Arubial.

Pursuant to the National Gas Rules (**Rules**), APTPPL is required to submit an access arrangement revision proposal to the Australian Energy Regulator (**AER**) by 12 October 2011. The access arrangement revision proposal must, amongst other things, set out the amendments to the access arrangement that the service provider proposes for the following access arrangement period.

The reference service provided by the RBP is a non-interruptible service for the receipt, transportation and delivery of gas through any length of the pipeline in the direction from Wallumbilla or Peat to Brisbane.

Under the Rules, total revenue for a relevant service provider is determined for each regulatory year of the access arrangement using a "building blocks" methodology (rule 76). The building blocks include, amongst other things:

- a return on the projected capital base for the year (rule 76(a));
- depreciation on the projected capital base for the year (rule 76(b)); and

The return on the projected capital base for the year and the depreciation on the capital for the year are both a function of the projected capital base for a particular period (rule 78). The projected capital base for a particular period takes into account, amongst other things, the forecast conforming capital expenditure for the period (rule 78(b)) and the forecast depreciation for the period (rule 78(c)).

The criteria governing the inclusion of new capital expenditure in the projected capital base for a particular period is set out in rule 79. Rule 79 includes the following requirements:

> "**New capital expenditure criteria**
>
> (1) Conforming capital expenditure is capital expenditure that conforms with the following criteria:
>
> (a) the capital expenditure must be such as would be incurred by a prudent service provider acting efficiently, in accordance with accepted good industry practice, to achieve the lowest sustainable cost of providing services;

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(b) the capital expenditure must be justifiable on a ground stated in subrule (2).

(2) Capital expenditure is justifiable if:

(a) the overall economic value of the expenditure is positive; or

(b) the present value of the expected incremental revenue to be generated as a result of the expenditure exceeds the present value of the capital expenditure; or

(c) the capital expenditure is necessary:

(i) to maintain and improve the safety of services; or

(ii) to maintain the integrity of services; or

(iii) to comply with a regulatory obligation or requirement; or

(iv) to maintain the service provider's capacity to meet levels of demand for services existing at the time the capital expenditure is incurred (as distinct from projected demand that is dependent on an expansion of pipeline capacity); or

(d) the capital expenditure is an aggregate amount divisible into 2 parts, one referable to incremental services and the other referable to a purpose referred to in paragraph (c), and the former is justifiable under paragraph (b) and the latter under paragraph (c).

(3) In deciding whether the overall economic value of capital expenditure is positive, consideration is to be given only to economic value directly accruing to the service provider, gas producers, users and end users.

...

(6) The AER's discretion under this rule is limited."

Rule 74, which applies generally to forecasts and estimates (including those used in determining the return on capital), provides:

"(1) Information in the nature of a forecast or estimate must be supported by a statement of the basis of the forecast or estimate.

(2) A forecast or estimate:

(a) must be arrived at on a reasonable basis; and

(b) must represent the best forecast or estimate possible in the circumstances."

Pursuant to section 28 of the National Gas Law (**Law**), in making a decision on whether to approve an access arrangement proposal, the AER must have regard to the National Gas Objective (in section 23 of the National Gas Law), which is:

"...to promote efficient investment in, and efficient operation and use of, natural gas services for the long term interests of consumers of natural gas with respect to price, quality, safety, reliability and security of supply of natural gas."

The AER must also take into account the revenue and pricing principles in section 24 of the Law when exercising a discretion in approving or making those parts of an access arrangement relating to a reference tariff. The AER may take into account the revenue and pricing principles when performing or exercising any other AER economic regulatory function or power (which is defined to include an applicable access arrangement decision), if the AER considers it appropriate to do so. The revenue and pricing principles in section 24 of the Law include the following:

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"(2) A service provider should be provided with a reasonable opportunity to recover at least the efficient costs the service provider incurs in—

(a) providing reference services; and

(b) complying with a regulatory obligation or requirement or making a regulatory payment.

...

(5) A reference tariff should allow for a return commensurate with the regulatory and commercial risks involved in providing the reference service to which that tariff relates.

(6) Regard should be had to the economic costs and risks of the potential for under and over investment by a service provider in a pipeline with which the service provider provides pipeline services."

Pipeline Management Agreement termination payment

APTPPL formerly outsourced pipeline construction, maintenance and operations services under a Pipeline Management Agreement (**PMA**) with Agility Management Pty Ltd (**Agility**). In 2006, APTPPL terminated that arrangement. To do so, it was necessary for APTPPL to negotiate a premium to recompense Agility for the termination of the PMA.

APTPPL considers that the termination of the PMA and the associated premium will deliver efficiency benefits to its operations over a prolonged period. That is, that the amount of the premium will be exceeded by the present value of the benefits (costs avoided).

In its access arrangement revision proposal APTPPL proposes to include in the RBP capital base a portion of the premium that was paid to Agility. In this context, APTPPL is seeking the opinion of a recognised independent expert on whether, by reference to relevant accounting standards, the premium paid to Agility (or part of it) is properly of a capital nature and, if so, the quantum of expenditure that would appropriately be included in the RBP capital base.

Scope of Work

You are briefed to provide an expert opinion report for use by APTPPL in its access arrangement revision proposal that addresses the following questions:

1 Taking into consideration any relevant financial accounting standards, is it reasonable that the premium (or part thereof) paid by APTPPL to Agility be treated as capital expenditure for the purposes of establishing the opening capital base for the next regulatory period for which the revised access arrangement is to apply (2012 – 2017)?

2 Assuming it is reasonable that the premium (or part thereof) paid by APTPPL to Agility be treated as capital expenditure for the purposes of establishing the projected capital base for the next regulatory period for which the revised access arrangement is to apply (2012 – 2017), is the value of $30.1m allocated by the AAP Group to the RBT at October 2007, a reasonable valuation for these purposes?

Information to be relied on

In providing your report, you are expected to draw upon the following information:

- the Law and the Rules in relation to the economic regulation of gas networks;
- relevant financial accounting standards;

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- relevant regulatory precedents on the use of financial accounting standards in regulatory decision making; and
- such information that, in expert's opinion, should be taken into account to address the questions outlined above.

Guidelines in preparing your report

The Guidelines for Expert Witness in the Federal Court of Australia are attached to this letter. Although this brief is not in the context of litigation, APTPPL is seeking a rigorously prepared independent view for use in the context of regulatory decision making and you are requested to follow the Guidelines to the extent reasonably possible in this context.

In particular, within your report you are requested to:

(e) identify all persons contributing to the report, their relevant area of expertise and provide a curriculum vitae for each person setting out the details of their expertise (to be attached to your report);

(f) only address matters that are within your expertise;

(g) where you have used factual or data inputs please identify those inputs and the sources;

(h) if you make assumptions, please identify them as such and confirm that they are in your opinion reasonable assumptions to make;

(i) if you undertake empirical work, please identify and explain the methods used by you in a manner that is accessible to a person not expert in your field;

(j) confirm that you have made all the inquiries that you believe are desirable and appropriate and that no matters of significance that you regard as relevant have, to your knowledge, been withheld from your report; and

(k) please do not provide legal advocacy or argument and please do not use an argumentative tone.

All key source materials referenced by you in your report should be provided to APTPPL with your report.

Confidentiality

Please ensure that any confidential information provided to you by APTPPL for the purposes of drafting your report is kept confidential, and that any confidential information is not disclosed to any person without the consent of APTPPL.

Your report, and potentially all key source material, will be provided to the AER as part of APTPPL's revised proposal. All non-confidential material will be published by the AER on its website, including your report. As such, should your report contain any information which is confidential, this material must be clearly identified by you as confidential at the time your report is finalised.

Timing

APTPPL requires a final report no later than 3 October 2011 and a draft report no later than 28 September 2011. Please let us know if you anticipate that you may not be able to meet these deadlines.

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Yours sincerely

Peter Bolding
General Manager Regulatory and Strategy

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ATTACHMENT: FEDERAL COURT GUIDELINES

FEDERAL COURT OF AUSTRALIA

EXPERT WITNESSES IN PROCEEDINGS IN THE FEDERAL COURT OF AUSTRALIA

Guidelines

1. General Duty to the Court[1]

1.1 An expert witness has an overriding duty to assist the Court on matters relevant to the expert's area of expertise.

1.2 An expert witness is not an advocate for a party even when giving testimony that is necessarily evaluative rather than inferential.

1.3 An expert witness's paramount duty is to the Court and not to the person retaining the expert.

2. The Form of the Expert's Report[2]

2.1 An expert's written report must comply with Rule 23.13 and therefore must

(a) be signed by the expert who prepared the report; and

(b) contain an acknowledgement at the beginning of the report that the expert has read, understood and complied with the Practice Note; and

(c) contain particulars of the training, study or experience by which the expert has acquired specialised knowledge; and

(d) identify the questions that the expert was asked to address; and

(e) set out separately each of the factual findings or assumptions on which the expert's opinion is based; and

(f) set out separately from the factual findings or assumptions each of the expert's opinions; and

(g) set out the reasons for each of the expert's opinions; and

(h) comply with the Practice Note.

2.2 The expert must also state that each of the expert's opinions is wholly or substantially based upon the expert's specialised knowledge[3].

2.3 At the end of the report the expert should declare that "[the expert] has *made all the inquiries that* [the expert] *believes are desirable and appropriate and that no matters of significance that* [the expert] *regards as relevant have, to* [the expert's] *knowledge, been withheld from the Court.*"

[1] The "*Ikarian Reefer*" (1993) 20 FSR 563 at 565-566.

[2] Rule 23.13.

[3] *Dasreef Pty Limited v Nawaf Hawchar* [2011] HCA 21.

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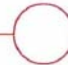

2.4 There should be included in or attached to the report the documents and other materials that the expert has been instructed to consider.

2.5 If, after exchange of reports or at any other stage, an expert witness changes the expert's opinion, having read another expert's report or for any other reason, the change should be communicated as soon as practicable (through the party's lawyers) to each party to whom the expert witness's report has been provided and, when appropriate, to the Court[4].

2.6 If an expert's opinion is not fully researched because the expert considers that insufficient data are available, or for any other reason, this must be stated with an indication that the opinion is no more than a provisional one. Where an expert witness who has prepared a report believes that it may be incomplete or inaccurate without some qualification, that qualification must be stated in the report.

2.7 The expert should make it clear if a particular question or issue falls outside the relevant field of expertise.

2.8 Where an expert's report refers to photographs, plans, calculations, analyses, measurements, survey reports or other extrinsic matter, these must be provided to the opposite party at the same time as the exchange of reports[5].

3. Experts' Conference

3.1 If experts retained by the parties meet at the direction of the Court, it would be improper for an expert to be given, or to accept, instructions not to reach agreement. If, at a meeting directed by the Court, the experts cannot reach agreement about matters of expert opinion, they should specify their reasons for being unable to do so.

PA KEANE
Chief Justice
1 August 2011

[4] The *"Ikarian Reefer"* [1993] 20 FSR 563 at 565.

[5] The *"Ikarian Reefer"* [1993] 20 FSR 563 at 565-566. See also Ormrod *"Scientific Evidence in Court"* [1968] Crim LR 240.

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B Keith Lockey's curriculum vitae

Keith Lockey

Executive Director

Economics, Infrastructure and Policy Group

Location	Melbourne
Education	BSc (Hons) (Environmental Sciences), University of Lancaster
Professional qualifications	Associate Chartered Accountant. Institute of Chartered Accountants in England and Wales
Country experience	Australia, 17 years UK, 11 years USA, Europe, Middle East, NZ, Asia - project based

Background

Keith co-leads KPMG's specialist group that advises governments and participants in utility and other economically regulated industries on matters of industry reform, economic regulation and pricing and funding arrangements.

He has worked exclusively in this area since the inception of National Competition Policy in Australia and has wide-ranging experience of advising on and managing utility reform and its consequences.

Keith has over 12 years experience and has advised regulators and businesses on regulatory accounting and cost allocation and efficiency issues in the utilities sector. He has a detailed knowledge of Australian regulatory accounting requirements for utilities, including drafting many of the original principles which regulators have subsequently adopted and developed.

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Experience

Regulatory reporting of cost allocations and efficiencies

Legal advisors to Envestra – Independent report on a management fee claimed as a recoverable cost under the Gas Code. Keith was engaged as an expert witness to report on the efficiency of the business's cost structures. This included benchmarking, examining and explaining how operational requirements for organisational structures led to costs, and benchmarking those costs to demonstrate their efficiency. An Appeal Tribunal accepted the report and agreed that the management fee was a recoverable cost.

Legal advisors to Multinet - Independent report on a management fee claimed as a recoverable cost under the Gas Code. Keith was engaged as an expert witness to report on the efficiency of the business's cost structures. Keith used benchmarks, cost modelling of staffing structures and referred to corporate legal and regulatory obligations to provide an independent assessment of the efficient non-capital costs of a distribution business where management and governance services are provided to the business by other entities. Following the submission of this report, the regulator's Final Decision substantially increased the amount of recoverable non-capital cost.

Electricity Transmission Network Owners Forum (ETNOF) - Transmission Cost Allocation Guidelines 2007 -Keith assisted ETNOF to critique and draft a submission on Cost Allocation Guidelines published by the Australian Energy Regulator.

Transend Networks Ltd - Keith led a KPMG team that drafted a "Cost Allocation Methodology" required by the Australian Energy Regulator, and for Transend, an accompanying cost allocation and regulatory reporting procedures and process manual.

Related party transactions. Keith advised a network business on the business risks and regulatory implications of regulatory requirements for related party disclosures, that were inconsistent with Accounting Standards.

Electricity industry regulatory accounting guidelines. Keith was engaged by industry to critique the *Queensland Competition Authority's Guidelines* (2005). He demonstrated its significant practical limitations and inconsistencies with Accounting Standards.

Electricity industry ring-fencing guidelines. Keith provided an electricity utility with a draft submission on the jurisdictional regulator's draft guideline. He demonstrated significant practical difficulties that also would not have assisted the regulator to achieve his objectives.

Independent Pricing and Regulatory Tribunal of NSW – Review of audit requirements for electricity industry price cap variables. Keith was engaged by IPART to provide an independent critique of criticism of the audit regime recommended changes to the audit regime to make it more light-handed and consistent with Auditing Standards.

Independent Competition and Regulatory Commission, ACT – Licensed electricity, gas, water and sewerage utilities Performance reports 2003-04, 2004-05 and 2006-07. Keith led small KPMG teams that provided the ICRC with substantial assistance to compile these comparative performance reports and commentaries.

Accounting Information for Office of the Regulator-General, Victoria. Keith surveyed the accounting and management information capabilities of regulated business to help the regulator to determine appropriate information requirements.

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AER/Australian Competition and Consumer Commission – Accounting Ring Fencing Guidelines for Gas Transmission Businesses. Keith critiqued a jurisdictional regulator's guideline as a basis for accounting ring fencing for gas transmission pipeline service providers, and subsequently drafted a guideline for the Commission.

Major New Zealand gas distribution and transmission business – Advice on regulatory accounting requirements. Keith assisted a major gas network business to comply with the New Zealand Commerce Commission's Avoided Cost Accounting Method ("ACAM") for regulatory financial reporting.

Office of the Tasmanian Electricity Regulator – Electricity Industry Regulatory Accounting Guidelines. Keith developed regulatory accounting guidelines for distribution and transmission businesses.

Review of regulatory accounting submission. Keith has been engaged by different electricity networks to review regulatory accounts for compliance with regulatory requirements, prior to submission.

ACCC – Review of Airport Regulatory Accounts. Keith undertook a high level review of the first airport regulatory accounts submitted to the ACCC. The objective was to also assess airport operator compliance with the guidelines issued by the ACCC.

*Australian Competition and Consumer Commission – Review of Electricity Transmission Business Co Regulatory Information Guideline*s. Keith reviewed and provided advice to the ACCC on proposed regulatory information guidelines and subsequently drafted revised Guidelines that were published in 2001.

Office of Regulator-General, Victoria ("ORG"). Shortly after its establishment, Keith was seconded to the ORG for a 15 month period to manage and implement the process of acquiring and analysing regulatory accounts from electricity distribution businesses. He also provided the ORG with day-to-day advice on regulatory financial and accounting issues.

ACCC. Keith organised and participated as a key speaker at a one-day workshop held with the ACCC on regulatory accounting, that explored both issues of principle and practice.

Office of the Regulator-General, Victoria. Keith initiated the first practical steps to obtain regulatory accounting information from electricity distribution businesses in Victoria.

Electricity

Transpower New Zealand – Network operating cost benchmarking. Keith advised on the robustness of its approach to benchmarking network operating costs for regulatory purposes.

Electricity industry disaggregation and reform in Korea Keith led KPMG teams that:

- reviewed the draft pool rules for the Korean electricity market and advised the vertically integrated Korea Electric Power Corporation (KEPCO) on the practical implications for the disaggregation of distribution and retail businesses;
- developed demand side management strategies for the disaggregated businesses; and
- assisted with development of a pool price risk management strategy ("vesting contracts") for KEPCO.

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Network revenue submission. Keith advised the Northern Territory's Power and Water Corporation on its submission.

Assessment of potential for cross-subsidies in a vertically integrated energy utility. Keith reviewed the potential for economic cross- subsidies both within the utility and with other parties.

NEM Entry Costs. Keith advised a utility on how the capital and operating costs associated with NEM entry might be recovered through regulatory pricing mechanisms.

Independent Pricing and Regulatory Tribunal of NSW – Review of electricity industry regulatory model. Keith led a team that provided an independent review of the robustness of its electricity network pricing model.

Business Analysis Modelling in the Electricity Industry. Keith was involved in designing a financial model of the Victorian electricity distribution businesses.

Department of Treasury and Finance Victoria – Review of Distribution Business ("DB") Submissions to the 2001 Electricity Price Review. Keith advised on the implications of the DB submissions.

Electricity Industry Enquiry Panel – New Zealand Regulatory Information Requirements. Keith compared regulatory information and reporting requirements between regimes in Australia and the UK, in the context of the New Zealand regulatory environment.

Energy retailing

Electricity retailer gross margin benchmarking. Keith has undertaken a range of benchmarking studies for retailers (and network businesses) to establish benchmarks of operating costs and margins. This involved both empirical and analytical comparisons, the latter building up cost models based on benchmarked inputs.

Assessment of a gross retail margin for franchise electricity retailers. Keith led a KPMG team that was engaged by Queensland Treasury to assess a benchmark efficient gross margin.

Assessment of cost allocations and the bases of CSO payments for electricity supply. Keith advised the NT Power and Water Authority on appropriate responses to government guidelines on and a regulator's review of, these issues.

Gas

Gas industry licensing and code regime in South Australia. Keith worked with the Essential Services Commission of South Australia to develop the industry licensing and code regime and associated regulatory requirements.

Cost allocation in the gas industry. Keith has worked with gas pipeline operators in Australia and New Zealand to develop and explain regulatory models to attribute costs to pipeline businesses.

Development of a cost allocation model for gas businesses. To assist a gas business gain regulatory approval for access arrangements, Keith led a KPMG team that developed a cost allocation model.

Gas Access Arrangements - Independent Pricing and Regulatory Tribunal New South Wales ("IPART"). Keith helped to analyse pricing proposals included in a major pipeline operator's Access Arrangement proposals. This work included the development of a financial model and

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options for cost allocation. Keith has also reviewed for IPART pricing and cost allocation models.

Gas & Fuel Corp. Keith conducted a benchmarking review.

Water

Utility – Assessment of efficient overhead and indirect costs for regulatory purposes. Keith advised a major utility on the potential for efficiency improvements in indirect and overhead costs. This included reviewing cost accounting and allocation processes, and staffing structures.

Other

Financial Modelling – Forecasting. Keith has completed numerous assignments which required the production of cost forecasting models to help analyse the financial implications of proposed transactions. Financial modelling assignments include assessing significant transactions for Crown Casino, Wool International, Gold Mines of Kalgoorlie, Bell Resources and ACI.

Benchmarking training – University of Melbourne and Council of Capital City Lord Mayors. In these engagements, Keith provided both benchmarking training and advice on its practical implementation.

Legal advisors to BHP Billiton (BHPB) - Options for providing access to the Mt Newman railway. Keith provided an independent report on the commercial and regulatory options for providing access, in connection with an access dispute.

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C Glossary

Financial Report Section 291(1) of the *Corporations Act 2001* provide that a financial report comprises:

a) financial statements;

b) notes to financial statements; and

c) a director's declaration about the statements and notes.

The director's declaration is specified in Section 295 and is required to include among other things, a declaration that the financial statements and notes comply with the Act and Australian Accounting Standards.

Financial statements Section 295 of the *Corporations Act 2001* defines financial statements as meaning financial statements required by Australian Accounting Standards.

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D Sources of information

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- Australian Pipeline Limited, Item for Approval No 6 Board Meeting 26/02/07, Acquisition of Alinta's Pipeline Operation Agreements for APG's Assets and Associated Assets
- Commonwealth of Australia, Corporations Act, 2001
- Evans & Peck, Agility Management Pty Ltd, Australian Pipeline Trust, Pipeline Management Agreement, Industry Standard Margins, 18 June 2003
- KPMG (2007) Taxation treatment and recommendations in relation to the draft Contract Termination and Novation Agreement.
- National Gas Rules, Version 10.
- Pipeline Management Agreement dated 13 April 2000 between AGL Pipelines Limited and AGL Infrastructure Management Pty Limited

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E Detailed calculations used to test the capital value of the PMA termination premium for the RBP

These calculations test the value the asset on against the present value of the net benefits that APA procured by making the termination payment. The basis of valuation and assumptions are set out in Section 5 of this report.

E.1 A comparison of non–capital costs before and after the termination of the PMA and an assessment of margins and overheads saved on future capital expenditure

Table E- 1 provides the results up to 2020.

- The cash flows have been discounted using a real vanilla WACC of 5.45% as observed in the most recent access arrangement revision for the RBP[54].
- Net Present Value (NPV) calculations are presented in the final column of the table. Sub-totals have been presented to provide an analysis of the different components of the NPV.
- Supporting explanations follow Table E- 1.

[54] See ACCC "Final decision – Roma to Brisbane Pipeline – revised access arrangement" Date 20 December 2006 p.120.

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Table E- 1: Valuation results, Real 2007/2008 $M

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	PV Total to 2020	Ref
Opex differential savings	$1.2	$0.5	$0.3	$1.3	$0.8	$0.8	$0.8	$0.8	$0.8	$0.8	$0.8	$0.8	$0.8	$7.7	Table E-4
Tax deduction foregone	$(0.4)	$(0.2)	$(0.1)	$(0.4)	$(0.3)	$(0.3)	$(0.3)	$(0.3)	$(0.3)	$(0.3)	$(0.3)	$(0.3)	$(0.3)	$(2.3)	Table E-8
Margins saved on capex	$0.2	$0.3	$0.9	$0.8	$3.7	$1.2	$1.2	$1.2	$1.2	$1.2	$1.2	$1.2	$1.2	$10.5	Table E-6
Tax deduction foregone	$(0.0)	$(0.0)	$(0.0)	$(0.0)	$(0.1)	$(0.1)	$(0.1)	$(0.2)	$(0.2)	$(0.2)	$(0.2)	$(0.2)	$(0.2)	$(0.9)	Table E-8
Overheads saved on capex	$0.2	$0.3	$1.0	$0.9	$4.2	$1.3	$1.3	$1.3	$1.3	$1.3	$1.3	$1.3	$1.3	$11.6	Table E-7
Tax deduction foregone	$(0.0)	$(0.0)	$(0.0)	$(0.0)	$(0.1)	$(0.1)	$(0.2)	$(0.2)	$(0.2)	$(0.2)	$(0.2)	$(0.2)	$(0.3)	$(1.0)	Table E-8
Subtotal	$1.1	$0.6	$1.1	$1.7	$4.2	$1.7	1.6	1.6	1.6	1.6	1.6	1.6	1.6	$15.0	
Tax benefit of deductibility of PMA Termination value	$1.8	$1.8	$1.8	$1.8	$1.8	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$7.6	
														$33.2m	

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E.1.1 Operational cost differential savings

As described in Section 5, this operational cost difference is based on a comparison of non-capital costs relevant to the PMA that were allowed by the ACCC under the access arrangement revision for the period 2006 to 2011 for the RBP, with APA's equivalent actual costs adjusted to exclude unregulated costs and abnormal costs of flood repair, explained below.

These operational costs are presented below in Tables E-2 and E-3.

Table E-2 presents ACCC approved costs in $2005/06 dollars. I have observed APA's regulatory model that tests out the RBP approved access arrangement and have observed that the figures in Table E-2 match the relevant lines items in the model.

The costs in $2005/06 have been converted into nominal costs for ease of comparison with APA's costs, before converting the difference back into $2007/08 dollars, consistent with the rest of this report.

Table E- 2: RBP allowed operational costs $M (Nominal)

Cost item	2008	2009	2010	2011
ACCC approved costs ($2005/06)	$5.8	$5.7	$5.7	$5.6
CPI change from previous year[55]	5%	1.5%	3.1%	3.6%
Cumulative CPI adjustment $2005/06 start date	1.07	1.08	1.12	1.16
ACCC approved costs ($ Nominal)	$6.2	$6.2	$6.3	$6.5

Table E-3 presents APA's equivalent costs for the RBP from 2008 to 2011. These are the actual equivalent costs that the APA Group has occurred post the termination of the PMA. I have observed the nominal costs in printed extracts of APA consolidated financial accounts from its Oracle accounting records. I have also observed how these costs make up a part of APA's profit and loss statement for each year and have observed that the profit recorded in APA's consolidated financial accounting record matches that of APA's published annual report.

In order to make an appropriate comparison between the ACCC approved costs and APA's actual costs I have excluded an amount of approximately $0.2 million per year from APA's actual costs because these costs related to unregulated pipeline costs under 3rd party contracts. These equivalent costs are not included in the approved ACCC costs, thus if they are not excluded it would not be a consistent comparison. I have observed this cost in APA's consolidated Oracle accounting records which makes the distinction between regulated and unregulated costs.

[55] ABS 6401.0 Consumer Price Index, Australia, Tables 3 and 4. CPI: Groups, Weighted Average of Eight Capital Cities, Index Numbers and Percentage Changes, latest figures at June 2011.

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Table E- 3: RBP actual non-capital costs post the termination of the PMA, $M

Cost item	2008	2009	2010	2011
Nominal costs	$5.2	$5.9	$6.2	$5.2[56]
Third party uncovered costs	$(0.3)	$(0.2)	$(0.2)	$(0.1)
Adjusted nominal	$4.9	$5.7	$5.9	$5.1

To determine the non-capital cost savings I have:

a) Subtracted APA's non-capital expenditure from the ACCC approved non-capital expenditure for each year from 2008 to 2011.

b) Converted the differences estimated above into real 2007/08 dollars.

c) Averaged the estimated non-capital expenditure between 2008 to 2011 and assumed that this average value remains constant for the rest of the period to 2020. I have not used the estimated difference for 2011 as representative of 2012 onwards because the estimated differences using this method provides a lumpy profile between 2008 and 2011 with 2011 not being the lowest figure. Thus to be conservative I have used the average of the differences in each year, for 2012 onwards.

d) This is demonstrated in Table E-4.

Table E- 4: Operational cost savings estimates, $M

Cost item	2008	2009	2010	2011	2012 onwards	Comment
RBP ACCC approved costs ($ Nominal)	$6.2	$6.2	$6.3	$6.5		Operational costs under the PMA, based on the ACCC approved costs, inflated to nominal terms
RBP operational cost post PMA termination ($ Nominal)	$4.9	$5.7	$5.9	$5.1		APA actual operational costs for RBP post the termination of the PMA (Table E-3)
Operational cost savings in nominal terms	$1.2	$0.5	$0.4	$1.4		Difference between ACCC approved costs and APA actual costs for the RBP
CPI change from previous year[57]	5%	1.5%	3.1%	3.6%		CPI change from previous year[58]

[56] This amount is stated after deducting $4.366m for flood related costs. These costs are evidenced by an extract from the APA Group's accounting records for 2010/11 which summarised operating costs classified under account headings "RBP Flood damage".

[57] ABS 6401.0 Consumer Price Index, Australia, Tables 3 and 4. CPI: Groups, Weighted Average of Eight Capital Cities, Index Numbers and Percentage Changes, latest figures at June 2011.

[58] ABS 6401.0 Consumer Price Index, Australia, Tables 3 and 4. CPI: Groups, Weighted Average of Eight Capital Cities, Index Numbers and Percentage Changes, latest figures at June 2011.

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Cost item	2008	2009	2010	2011	2012 onwards	Comment
Cumulative CPI adjustment $2007/08 start date	1	1.02	1.05	1.08		Cumulative CPI adjustment
Real operational cost savings ($2007/08) = Nominal costs/cumulative CPI adjustment	$1.2	$0.5	$0.3	$1.3	$0.8	Difference between forecast operational costs under the PMA and APA forecast operational costs. See Table E-1.

As can be seen, these figures match those in the Operational savings line of Table E-1.

E.1.2 Profit margins on capital works

The margin is sourced from Evan and Peck[59] as discussed in Section 5. This is 9% of the value of the direct cost of capital works.

The capital cost amount for RBP is presented in Table E-5. I have observed the nominal costs from 2008 to 2011 in printed extracts of APA consolidated financial accounting records from its Oracle accounting records. I have also observed how these costs form a part of APA's total capital expenditure that it announces to the ASX.

In particular, for 2012 I observed how additional capital works APA forecast for the RBP in 2012 formed part of a total capital expenditure initiative of $50m announced by APA to the ASX[60]. All of the capital costs have been converted into 2008 dollars in order to make comparisons in real terms.

For 2013 onwards I have calculated an average amount based on the 2008 to 2012 figures.

Table E- 5: RBP capital cost and forecasts post the PMA termination, $M

Cost item	2008	2009	2010	2011	2012	2013 onwards
Nominal capital costs	$2.3	$3.2	$10.4	$9.4	$45[61]	
CPI change from previous year[62]	5%	1.5%	3.1%	3.6%		
Cumulative CPI adjustment	1	1.02	1.05	1.08		

[59] See Evans and Peck (2003), p.11
[60] APA Group, ASX release, APA expanding capacity of the Roma Brisbane Pipeline, 28 April, 2011.
[61] This figure is a nominal 2011 figure, hence it has been deflated by the 2011 cumulative CPI adjustment figure.
[62] ABS 6401.0 Consumer Price Index, Australia, Tables 3 and 4. CPI: Groups, Weighted Average of Eight Capital Cities, Index Numbers and Percentage Changes, latest figures at June 2011.

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Cost item	2008	2009	2010	2011	2012	2013 onwards
Real costs ($2008) = Nominal costs/cumulative CPI adjustment	$2.3	$3.2	9.9	$8.7	$41.5	$13.1

To determine the profit margin savings I have:

a) averaged the real costs in Table E-4;

b) assumed this figure will be representative of real capital expenditure for the period 2012/13 to 2019/20; and

c) applied the Evans and Peck margin of 9% to the actual real capital expenditure and the assumed real expenditure for future years. This is demonstrated in Table E-6.

Table E- 6: Profit margin savings on capital expenditure estimate, real 2007/2008 $M

Cost item	2008	2009	2010	2011	2012	2013 onwards	Comment
Real capital costs	$2.3	$3.2	9.9	$8.7	$41.5	$13.1	Assumed real capital costs as per Table E-5.
Evans and Peck Capital margin	9%	9%	9%	9%	9%	9%	Percentage margin on capital works from Evans and Peck.
Capital margin cost savings	$0.2	$0.3	$0.9	$0.8	$3.7	$1.2	Forecast margin savings from the termination of the PMA. See Tables E-1 and E-10.

As can be seen, these figures match those in the margin savings line of Table E-1.

I have used the average figure, rather than the 2012 figure for the assumed future capex because capital works can have some volatility year to year, hence using a single year figure may bias the result up or down.

E.1.3 Overheads on capital works

The overhead is sourced from Evan and Peck[63] as discussed in Section 5. This is 10% of the value of any capital works.

The capital cost amounts as above.

Specifically, to determine the overhead capital savings I have:

a) taken the real capital costs presented in Tables E-5 and E-6; and

[63] See Evans and Peck (2003), p.11

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b) multiplied the Evans and Peck overhead percentage of 10% to the actual real capital expenditure and the forecast real expenditure for each year. This is demonstrated in Table E-7.

Table E- 7: Capital overhead savings estimate, Real 2007/2008 $M

Cost item	2008	2009	2010	2011	2012	2013 onwards	Comment
Real capital costs	$2.3	$3.2	9.9	$8.7	$41.5	$13.1	Forecast real capital costs as per Table E-5.
Evans and Peck overhead component	10%	10%	10%	10%	10%	10%	Percentage overhead on capital works from Evans and Peck.
Capital overhead cost savings	$0.2	$0.3	$1.0	$0.9	$4.2	$1.3	Forecast overhead savings on capital costs from the termination of the PMA. See Table E-1.

As can be seen, these figures match those in the overhead capital savings line of Table E-1.

E.1.4 Foregone tax deduction

The forgone tax deduction, is the tax deduction that APA would have received had it paid Agility for the cost items discussed above, and hence not received these savings. These payments would have been recorded as operating costs or for capital related savings, depreciation in APA’s profit and loss statement. This would have had the effect of reducing the profit that APA could have earned and hence the tax which it would have had to have paid on this profit.

To determine the foregone tax deduction I have:

a) taken the savings identified above;

b) for the operational related savings I have multiplied these by the current Australian corporate tax rate of 30%;

c) for the capital related savings I have depreciated these over an assumed 20 year period and then multiplied the depreciation amounts by the current Australian corporate tax rate of 30%.

d) Each forgone tax deduction figure is presented in Table E-8.

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Table E- 8: Foregone tax deduction, Real 2007/2008 $M

Cost item	2008	2009	2010	2011	2012	2013 onwards	Comment
Operational cost savings	$1.2	$0.5	$0.3	$1.3	$0.8	$1.2	Forecast operational cost savings as per Table E-1.
Tax deduction on operational cost savings	**($0.4)**	**($0.2**	**($0.1)**	**($0.4)**	**($0.3)**	**($0.3)**	**30% corporate tax rate multiplied by operational savings. See Table E-1.**
Capital margin cost savings	$0.2	$0.3	$0.9	$0.8	$3.7	$1.2	Forecast capital margin savings as per Table E-16.
Depreciation	0.01	0.01	0.04	0.04	0.19	0.06	Capital margin cost savings per year divided by 20.
Total depreciation expense per year	0.01	0.02	0.07	0.11	0.30	0.35*	Sum of current year depreciation and previous ear total depreciation expenses
Tax deduction on capital margin savings	**($0.0)**	**($0.01)**	**($0.02)**	**($0.03)**	**($0.09**	**($0.11)***	**30% corporate tax rate multiplied by total depreciation expense. See Tables E-1 and E-10.**
Capital overhead cost savings	$0.2	$0.3	$1.0	$0.9	$4.2	$1.3	Forecast overhead savings as per Table E-7.
Depreciation	0.01	0.02	0.05	0.04	0.21	0.07	Capital margin cost savings per year divided by 20.
Total depreciation expense per year	0.01	0.03	0.08	0.12	0.33	0.39*	Sum of current year depreciation and previous ear total depreciation expenses
Tax deduction on capital overhead savings	**($0.0)**	**($0.01)**	**($0.02)**	**($0.04)**	**($0.10**	**($0.12)***	30% corporate tax rate multiplied by capital overhead cost savings. See Table E-1.
Total tax deduction forgone	**($0.37)**	**($0.17)**	**($0.15)**	**($0.46)**	**($0.44)**	**($0.48)***	**Sum of total tax deduction savings forgone.**

* Note that these values continue to grow over time, consistent with the methodology discussed.

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As can be seen, these figures match those in the respective tax deduction lines of Table E-1. For simplicity, the total tax deduction forgone is presented within the report.

E.1.5 Tax deduction savings on termination payment

To determine the tax deduction savings I have:

a) taken the estimated pre-tax asset value of $29.8 million (see Table 5-1); and

b) divided it by 5 to determine a yearly depreciable value over the allowable 5 year depreciation period[64]; and

c) multiplied the result by the Australian corporate tax rate of 30%.

d) presented result in Table E-9.

Table E- 9: Tax deduction savings on the PMA purchase price, Real 2007/2008 $M

Cost item	2008	2009	2010	2011	2012	Comment
PMA value pre-tax	$29.8					The estimated value of the PMA premium pre-tax.
Depreciable value	$6.0	$6.0	$6.0	$6.0	$6.0	PMA purchase price divided by 5, tax depreciation of 5 years.
Tax deduction savings	$1.8	$1.8	$1.8	$1.8	$1.8	Depreciable value multiplied by the corporate tax rate of 30%. See Table E-1.

As can be seen, these figures match those in tax benefit line in Table E-1.

[64] Letter of advice from KPMG to APA, 21 August 2007.

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F WACC

The value of the asset being valued is made up of three core components:

- The avoided opex and capex costs resulting from termination of the PMA;
- The tax deduction due to depreciation of payment for termination of the PMA; and
- The reduced tax deductions available as a result of reduced payments under the PMA.

The purpose of providing a discount rate is to determine a net present value of the asset (the net impact of the above components) that reflects the real cost of capital including any risk premium.

I have used a real vanilla WACC (Officer 3) to discount all cashflows in this report.

$$\textit{Real WACC (vanilla)} = d/(e+d) \times Rd + e/(e+d) \times Re$$

The net tax benefit being valued in this report is effectively an asset (or capital investment, as demonstrated earlier in this report). Tax shields and credits with respect to recovering the discounted NPV of this asset (i.e. the avoided costs and tax impacts over time) are not relevant; while these factors have been used to derive a value for the asset, the asset itself will not be impacted by on-going taxation considerations.

Importantly, the WACC employed by regulators in determining, for example, appropriate cost recovery, reflects a required rate of return on the investment, rather than a discount rate per se.

I have not directly used a pre or post tax WACC. This is because the choice of a post-tax or pre-tax WACC depends on the manner in which a regulator decides to compensate a regulated entity for needing to pay company tax on its profits. Such compensation is not relevant to the current analysis.

On this basis, I have used the real vanilla WACC.

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G APA's synergy benefits

The lower cost of insourcing services may appear unusual as many regulated entities have argued that outsourcing of their operational and maintenance practices is more efficient. However evidence suggests that this will not necessarily be the case for all regulated entities and in this case, APA.

At the time that the PMA contract was signed, KPMG understands that the APA effectively had 15 staff members and did not have the capacity to undertake its own operational and maintenance practices cost effectively. As such, at the time of the PMA, it was clear that outsourcing the operational and maintenance activity to a service provider that was capable of providing such a service cost effectively was viewed as a prudent decision, "in accordance with accepted good industry practice, to achieve the lowest sustainable cost of providing services."

However, during the period 2000 to 2007, APA began acquiring several business entities. These include:

- GasNet Australia Group ("GasNet")
- Allgas gas distribution business
- Directlink electricity transmission asset
- Origin Energy Networks assets comprising Origin Energy Asset Management which provides management and operations services to Envestra Ltd ("Envestra"), a 17% stake in Envestra, and a one-third interest in the SEAGas Pipeline
- Murraylink assets.

As a result, the APA business model changed from a relatively small staff base to one a much larger one with the resources to undertake operational and maintenance activities cost effectively. As a result, APA was able to pool resources to take advantage of economies of scale.

This means that APA was able to take advantage of the typical benefits that one may expect to witness form outsourcing arrangements. These include:

- greater economies of scale;
- direct management and greater control of required services; and
- flexibility in the services provided;

Other benefits noted by APA included:

- ensuring APA pipelines are operated with APA's ownership interests in mind;
- allowing APA to optimise the long term management of its key assets in an economic and operational manner; and
- provides additional internal skills necessary to undertake future Greenfield and Brownfield developments.[65]

[65] APA, *Item for Board Approval: Acquisition of Alinta's pipeline operation agreements for APG's Assets and Associated assets,* 26/02/2007.

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This is evidenced by the fact that other regulated entities in the energy sector, such as Envestra, have recognised APA's ability to provide a cost effective service and engage APA to provide them with operational and maintenance services. As a result, APA transformed from a business entity that outsourced operational and maintenance practices to one that operates operational and maintenance outsourcing activities of other businesses.

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