EAPL SUBMISSION IN RESPONSE TO ACCC FINAL DECISION ON THE MOOMBA SYDNEY PIPELINE SYSTEM ACCESS ARRANGEMENT

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EAPL SUBMISSION IN RESPONSE TO ACCC FINAL DECISION ON MOOMBA SYDNEY PIPELINE SYSTEM ACCESS ARRANGEMENT

INTRODUCTION

In its Final Decision, the Commission specified a number of amendments it required EAPL to make to its Access Arrangement in order for EAPL's Access Arrangement to be approved.

EAPL has made a number of the amendments specified by the Commission. EAPL has also made other revisions to its Access Arrangement which it considers either substantially incorporate the amendments specified by the Commission or should otherwise address, to the Commission's satisfaction, the matters the Commission identified in its Final Decision as being the reasons for requiring the amendments specified in the Final Decision.

EAPL has also made some further consequential amendments to its Access Arrangement.

SUMMARY OF EAPL's RESPONSE ON AMENDMENTS

EAPL's response	Amendments specified by Commission
EAPL has made the amendment specified or considers that the amendment it has made substantially incorporates the amendment specified by the Commission in its Final Decision	FDA 2 FDA 3 FDA 4 FDA 5 FDA 6 FDA 16 FDA 18 FDA 20 FDA 21 FDA 22 FDA 23 FDA 24 FDA 25 FDA 26 FDA 28 FDA 29 FDA 30 FDA 31 FDA 33 FDA 34 FDA 35 FDA 36 FDA 37 FDA 38 FDA 40

EAPL's response	Amendments specified by Commission
EAPL has made amendments that it considers should address, to the Commission's satisfaction, the matters the Commission identified in its Final Decision as being the reasons for requiring the amendments specified in its Final Decision	FDA 12 FDA 14 FDA 15 FDA 17 FDA 19 FDA 27 FDA 32
EAPL has not made the amendments specified by the Commission but considers that its Access Arrangement should address, to the Commission's satisfaction, the matters the Commission identified in its Final Decision as being the reasons for requiring the amendments specified in its Final Decision	FDA 1 FDA 7 FDA 8 FDA 9 FDA 10 FDA 11 FDA 13 FDA 39 FDA 41

RESPONSE ON AMENDMENTS

A. THE INITIAL CAPITAL BASE (section 2.2 Final Decision)

1. FDA 1

Amendment FDA 1 requires that, in order for EAPL's proposed access arrangement for the MSP to be approved, the value of the ICB must be set at $559.3 million (real 2002/03).

Response:

EAPL has not made the amendment specified by the Commission in its Final Decision. However, EAPL considers that its revised Access Arrangement should address, to the Commission's satisfaction, the matters the Commission identified in its Final Decision as being the reasons for requiring the amendments specified in the Final Decision.

In its further revised Access Arrangement, EAPL has adopted an ICB of $756.9[1] million (July 2000), being a value which reflects EAPL's reasonable expectations under the regulatory regime that applied to the Pipeline prior to the commencement of the Code and which, in any event, is a value that would represent a reasonable exercise of the Commission's discretion having regard to all the circumstances.

Submission:

1.1. Code Section 8.10(b)

1.1.1. The Code

Section 8.10(b) of the Code provides that when a Reference Tariff is first proposed for a Reference Service provided by a Covered Pipeline that was in existence at the commencement of the Code, the value that would result from applying the "depreciated optimised replacement cost" methodology in valuing the Covered Pipeline should be considered in establishing the initial Capital Base for that Pipeline.

1.1.2. DORC Valuation -- The Final Decision

The DORC valuation is substantively dealt with by the Commission at pages 40 to 47 of the Final Decision. The discussion on section 8.10(b) is divided into sections titled "Optimised Replacement Cost", "Depreciated optimised replacement cost methodology", "Conclusions on DORC methodology" and "DORC and remaining asset life".

In the Final Decision, the Commission states:

> "A valuation based on DORC is consistent with section 8.10(i), as a valuation in excess of DORC could potentially lead to uneconomic by-pass." (Page 60); and

[1] This value is $779 million as submitted previously, less $22.1 million reflecting exclusion of the Wagga Wagga to Culcairn Interconnect.

> "In theory, prices based on DORC represent the maximum that would be observed in a competitive market. Prices in excess of DORC would result in customers by-passing the incumbent in favour of a new entrant." (page 68)

These statements refer to the characteristics of the Hypothetical New Entrant Construct (HNEC). Application of the HNEC produces the value at which a hypothetical new entrant would be indifferent between acquiring an existing asset with its remaining service potential (and higher operating costs) and obtaining that service potential by replacing the existing asset with a new optimised asset – it represents the maximum value of the existing asset consistent with the prices a hypothetical new entrant would need to charge in order to serve the relevant market. Such a valuation also promotes economic efficiency.

The Commission observes that:

> "The uncertainty surrounding [the inputs to the cost-based formulation of the NPV HNEC methodology proposed by NERA] makes it difficult to estimate a DORC based on this methodology with any degree of confidence. The same conclusion is reached whether this methodology is considered as a method of determining DORC for the purposes of section 8.10(b) or as a 'well recognised asset valuation methodology' under section 8.10(c)." (page 46)

and concludes that:

> "Hence, for the purposes of the MSP the Commission has used straight line depreciation to determine a value for DORC, which could be considered a proxy for the true economic value of DORC." (page 46)

1.1.3. Depreciation of ORC – EAPL's response

Since August 2000 EAPL, its associates, and its regulatory advisers, have made numerous submissions to the Commission on the subject of the correct calculation of DORC in the context of the Code, recommending that the value of DORC be determined in a manner that is consistent with the Hypothetical New Entrant Construct (HNEC) first enunciated by the Commission in 1998 and referred to by the Commission since then in a number of regulatory contexts, including the current review of the MSP Access Arrangement. The HNEC defines a maximum value and so a DORC calculated by reference to the HNEC is consistent with the position of DORC in the Code as the (normal) upper limit of the ICB. It is arguable and accepted by reputable economists that application of the HNEC requires that DORC be calculated from ORC using a NPV methodology.

It is apparent from the Final Decision that the Commission accepts, in principle, that "the true economic value of DORC" (page 46) is defined by reference to the HNEC. However, it has rejected the corollary to the HNEC that DORC must be calculated from ORC using a NPV methodology on the grounds that the uncertainty surrounding the estimation of inputs to the calculation (at least on one formulation) makes it difficult to estimate such a value with confidence. The Commission has instead "used straight line depreciation to determine a value for DORC, which could be considered to be a proxy for the true economic value of DORC" (page 46)

Given the material difference between the two values, the straight line value ($715 million) cannot be regarded as a proxy for the NPV-based HNEC value ($1,045 million) – it is a different value altogether. Accordingly, EAPL submits that it is an unreasonable and unsustainable exercise of discretion for the Commission to adopt the straight line value as a "proxy for the true economic value of DORC" simply because assessment of the value may be difficult or involve dealing with uncertainty. Application of the NPV-based HNEC value is just another instance in the Access Arrangement approval process where the Commission must deal with uncertainty. In that regard, EAPL draws the Commission's attention to a recent statement by NERA:

> "The [New Zealand Commerce] Commission has stated that it considers an ODRC approach with tilted annuity depreciation may provide an upper bound for current asset values or a crosscheck on asset values "otherwise considered" (presumably historical cost valuations). The main reason the [New Zealand Commerce] Commission has not decided to use an ODRC valuation exclusively appears to be due to practical difficulties associated with identifying the appropriate "tilt". …
>
> In our view, the difficulties associated with determining an appropriate level of depreciation for the purposes of determining an ODRC valuation – addressed explicitly by the Commission in questions 30 through 33 - are likely to be much more manageable than the difficulties associated with undertaking an historic cost valuation." (NERA; A*sset Valuation for the Gas Control Inquiry -- A Report for NGC Holdings;* August 2003, p18)

EAPL notes that the "tilted annuity depreciation" approach referred to here is consistent with the Agility revenue based formulation of the NPV DORC methodology. NERA appear to accept the revenue formulation and that any difficulties involved in determining depreciation under the methodology are manageable.

1.1.4. Depreciation of ORC – Conclusion

It is apparent that the Commission accepts that the "true economic value of DORC" is defined by reference to the methodology propounded by NERA which is in turn "based on the premise that DORC represents the price that a new entrant with a certain service requirement would pay for existing assets in preference to replacing them" (page 44) i.e. the HNEC. The value calculated by the Commission under section 8.10(b) is inconsistent with the application of that construct.

EAPL submits that it is unreasonable and unsustainable to adopt the straight line value as a "proxy for the true economic value DORC" simply because assessment of the value may be difficult or involve dealing with uncertainty.

The value of DORC that is consistent with the HNEC is $972[2] million (June 2000) which translates to a 2003 value of $1,045 million.

[2] This DORC value of $972 million as submitted was based on an ORC value of $1,058.2 million. Assets were disposed of at the time APT was formed in 2000 which reduced the ORC to $1,042.1 million. The corresponding DORC value would be $954 million and this would reduce further to $925 million when the Wagga Wagga to Culcairn Interconnect is removed. This submission will continue to refer to the 2000 value of $972 million and the corresponding estimated equivalent 2003 value of $1,045 million, recognising that a refined estimate will be required.

1.1.5. Optimised Replacement Cost – the Final Decision

Under the section titled "Optimised Replacement Cost", the Commission deals substantively with the "contingency factor" (pages 41 and 42 of the Final Decision).

At page 41, the Commission states that it:

> "affirms its *Draft Decision* proposal to exclude the contingency factor of 10% proposed by EAPL and its consultants, Venton and Associates. In its review of the Venton report, Kinhill concluded that Venton's estimates were reasonable, although on the high side of an acceptable range. The exclusion of the contingency factor still results in a value for ORC within the 20 per cent tolerance level described in the Venton report."

At pages 41-42, the Commission states:

> "The purpose of determining an estimate of ORC under the Code is to assist the regulator in establishing a value for the ICB for an existing pipeline. The Commission does not consider it necessary to replicate the cost estimations of a firm that is planning to construct a new pipeline. To make allowance for all contingencies that may occur and which produces a cost estimation at the high end of a feasible range is, in the Commission's view, contrary to the objectives in sections 8.1(a) (efficient costs) and 8.1(b) (replicating the outcomes of a competitive market) of the Code. A firm that is planning to construct a new asset may well include an allowance for contingencies that could increase the cost of construction. However, this does not mean that those contingencies will occur or that those costs will be incurred. It is equally likely that the project may cost less than was forecast. An ORC valuation seeks to estimate the actual cost of replacing the existing asset. To include in such a valuation an allowance for contingencies assumes that the replacement project would always suffer from the planned contingencies and would cost more than was forecast. This assumption is not justified.
>
> Furthermore, one of the reasons given in the Venton report for the contingency factor was that the 'attention of Government and Landowner/Landowner/Land Claimant Groups' may increase costs significantly. This argument assumed that the estimate of ORC was based on considerations of a greenfields pipeline. By implication, these particular costs would be less if consideration of the ORC estimate was based on a brownfields project.
>
> Finally, EAPL has provided little evidence to justify a level of 10 per cent for the contingency factor as opposed to some other value. The indicative nature of the 10 per cent level is demonstrated in Venton report of 20 May 2003 in which Venton stated that a more detailed analysis may produce a level of contingency lower than 10 per cent."

1.1.6. Optimised Replacement cost – EAPL's response

As is apparent from the passages quoted above, the Commission provides four reasons for excluding the contingency factor, namely:

- The exclusion of the contingency factor still results in a value for ORC within the 20 per cent tolerance level described in the Venton report;
- The assumption that the replacement project would always suffer from contingencies and would cost more than is forecast is not justified;
- Particular costs would be less if consideration of the ORC estimate was based on a brownfields project;
- EAPL has provided little evidence to justify a level of 10 per cent for the contingency factor as opposed to some other value.

EAPL considers each of these matters in turn.

Exclusion of contingency factor still results in a value for ORC within 20% tolerance level described in the Venton report

EAPL considers that the Commission's justification of its approach on the basis that the result is still within the tolerance of the estimate, is arbitrary and unreasonable in that it is inconsistent with the approach taken by the Commission in relation to the gas throughput forecast. Amendment FDA 10 in effect requires that forecast annual gas throughput be increased by 0.54 PJ on 95.2 PJ (FD p176) – an increase of less than 0.6%, which is well within the range of uncertainty of the forecast.

Unjustified assumption that a replacement project would always suffer from contingencies and would cost more than is forecast

EAPL does not agree with the Commission's assessment. EAPL considers that the Commission has misunderstood the nature of the contingency estimate which was explained in detail in a letter from Venton and Associates dated 12 May 2003 (the Venton Report)

It is clear from the Venton Report that the 10% "contingency" might better have been referred to as an allowance for unspecified items which are anticipated but not itemised. Accordingly, EAPL considers that it is appropriate to allow this contingency estimate.

Brownfields

The Commission has stated that the costs relating to the attention of Government and Landowner/Landholder/Land Claimants would be less if consideration of the ORC estimate was based on a brownfields project.

In the context of this observation, EAPL assumes that by "brownfield" the Commission means that the hypothetical pipeline would be constructed within existing easements. Even if that were the case, there will be issues with Governments on environmental matters, and Landowners and Native Title holders will require and be entitled to compensation for the inconvenience caused by the construction. In today's climate, those parties are increasingly aware of the strength of their position, and there is potential for disputes. Costs in this category are tending to increase and cannot be disregarded.

Little evidence from EAPL to justify a level of 10 percent

The Commission has stated that EAPL has provided little evidence to justify a level of 10 per cent for the contingency factor as opposed to some other value. The Commission noted that "the indicative nature of the 10 per cent level is demonstrated in Venton report of 20 May 2003 in which Venton stated that a more detailed analysis may produce a level of contingency lower than 10 per cent."

EAPL considers that the Commission has misunderstood or failed to have regard to the Venton Report. While the Venton Report does acknowledge that a detailed analysis of the estimate was not undertaken at the time of the report and that the 10% figure could be high, a figure of 7.5% might, on a more detailed analysis, be a more appropriate allowance. Venton makes it clear that it is most unlikely to find that 0% was an appropriate allowance.

Accordingly, EAPL submits that whatever methodology is adopted to depreciate the ORC, a cost allowance, which is currently termed a "contingency", of 10% or alternatively no less than 7.5%, must be included in the value of ORC.

1.2. Code Section 8.10(c)

1.2.1. The Code

Section 8.10(c) of the Code provides that when a Reference Tariff is first proposed for a Reference Service provided by a Covered Pipeline that was in existence at the commencement of the Code, the value that would result from applying other well recognised asset valuation methodologies in valuing the Covered Pipeline should be considered in establishing the initial Capital Base for that Pipeline.

1.2.2. The Final Decision of the Commission

The Commission, at page 46, acknowledges that a NPV-based value established by reference to the HNEC, if it is not the DORC value, is a 'well recognised asset valuation methodology' that could be taken into account under section 8.10(c), but argues that the calculation of such a value would be subject to difficulty and uncertainty. The inference to be drawn from this is that the Commission would be disinclined to give consideration to such a value under section 8.10(c) for those reasons, even if it were otherwise appropriate to do so.

1.2.3. EAPL's response

EAPL's primary position is that the NPV-based HNEC value should be taken into account as the value of DORC under section 8.10(b) for the reasons set out in section 2 above. If the value is not to be considered under section 8.10(b), then it must be considered under 8.10(c) as a 'well recognised asset valuation methodology'. It would be unreasonable and unsustainable not to consider the NPV-based HNEC value under section 8.10(c) simply because assessment of the value may be difficult or involve dealing with uncertainty.

1.3. Code Section 8.10(f)

1.3.1. The Code

Section 8.10(f) of the Code provides that when a Reference Tariff is first proposed for a Reference Service provided by a Covered Pipeline that was in existence at the commencement of the Code, the basis on which Tariffs have been (or appear to have been) set in the past, the economic depreciation of the Covered Pipeline, and the historical returns to the Service Provider from the Covered Pipeline should be considered in establishing the initial Capital Base for that Pipeline.

1.3.2. The Final Decision of the Commission

The Final Decision deals with section 8.10(f) at pages 52 - 56. The discussion on section 8.10(f) is divided into sections titled “Residual Economic Value”, “50 year asset life assumed in the past”, and “Depreciation schedule in the face of a new entrant”.

At page 54, the Commission states:

> “In the *Draft Decision* the Commission noted that the historical financial accounts for the MSP suggested that assumptions of the pipeline’s economic life ranged from 30 to 50 years. The Commission gave considerable weight to the fact that EAPL had assumed an asset life of 50 years for depreciation purposes. The Commission applied a 50 year asset life to the ORC to determine a DORC value of $539 million. The Commission considered that this value (less deferred tax liabilities) formed an appropriate basis for the value of the ICB. The Commission commented that users would not be disadvantaged since they would not be required to support a double-up of depreciation, nor would EAPL be disadvantaged as the valuation approximated EAPL’s investment in the MSP.

The Commission also states at pages 54-55:

> “As mentioned earlier, the Commission’s use of past rates of recovery of depreciation to determine a value for DORC has received some criticism. The argument is that DORC is meant to be a forward looking concept and hence past depreciation is an irrelevant consideration. Whether this is correct or not, section 8.10(f) makes it clear, however, that the level of recovery of depreciation since EAPL acquired the pipeline and EAPL’s assumption of a 50 year asset life may still be relevant factors in the Commission’s determination of the value of the ICB. That is, even if the DORC methodology demands that depreciation is based on the revised asset life, the Code does not prevent the Commission taking into account the basis upon which the pipeline has been depreciated in the past in order to determine an ICB. Applying this approach to the revised ORC of $1092.9 million results in an asset valuation of $559.3 million. This figure has been calculated on the basis of a 50 year asset life to 2000, and from then an 80 year asset life (the useful life proposed by EAPL in 2000 and accepted by the Commission in the *Draft Decision*.”

At page 73, the Commission states:

> "For the purposes of the MSP access arrangement the Commission has determined a value for the ICB of $559 million. To support this valuation, the Commission has given considerable weight to section 8.10(f) of the Code, which requires the Commission to have regard to the basis on which tariffs have been set (or appear to have been set) in the past, the economic depreciation of the pipeline and historical returns to service providers.
>
> The basis of the valuation is ORC, which the Commission has depreciated on the assumption of a 50 year asset life to 2000, consistent with the useful asset life previously assumed by EAPL. From 2000 onwards, the Commission has used an 80 year, the life which EAPL has submitted is the current useful life and which the Commission has accepted. Use of ORC is preferred to some historical measure of costs as ORC reflects the current costs of the assets and eliminates any redundant assets."

1.3.3. EAPL's response

Section 8.10(f) of the Code provides that three components should be considered in establishing the initial Capital Base, namely:

- the basis on which Tariffs have been (or appear to have been) set in the past;
- the economic depreciation of the Covered Pipeline, and
- the historical returns to the Service Provider from the Covered Pipeline.

EAPL considers below how the Commission has dealt with each of these components in its Final Decision.

Economic depreciation

The Code requires that it is the economic depreciation that is taken into account under section 8.10(f). NECG summarise the characteristics of economic and accounting depreciation, and the distinction between the two, as follows:

> "Views on the definition of depreciation can be divided into two broad categories — economic depreciation and accounting depreciation. The basic conceptual difference between them is that economic depreciation involves a process of valuation, while accounting depreciation deals with allocation.
>
> Economic depreciation can be defined simply as the period-by-period change in the market value of an asset. The market value of an asset is equal to the present value of the income that the asset is expected to generate over the remainder of its useful life. In contrast, accounting depreciation reveals nothing about the decrease in market value of an asset over a period of time. Accounting depreciation, under historical cost accounting, simply means the allocation of the historical cost of a fixed asset to the

> periods in which services are received from the asset (Colditz, Gibbins and Noller 1988)."[3]

The 30 years and 50 years referred to by the Commission in the Final Decision are in fact a reference to the basis on which EAPL has applied accounting depreciation in the past.

That is, the value of $559.3 million in the Final Decision is calculated by applying accounting depreciation over the past life of the pipeline (1976-2000), followed by straight line depreciation based on an 80 year life from 2000, to an ORC value. It does not reflect the application of economic depreciation.

It is clear from the Final Decision (refer statements at section 1.3.2 above) that, in taking this approach, the Commission has not considered economic depreciation, but rather the basis adopted for accounting depreciation.

It is not valid for the Commission to calculate a value by reference to accounting depreciation under section 8.10(f) of the Code. Accounting depreciation reflects the conservatism required by accounting practice and is in no way comparable to economic depreciation.

EAPL submits that, to the extent that the Commission ignores economic depreciation and the resultant residual value, the Commission ignores the realities of historical pricing practices. Clearly, to the extent that the Commonwealth did not recover the "full cost" of the pipeline during the early years, (FD p66) it cannot be said that a 50 year life was necessarily assumed for pricing purposes – the two statements are inconsistent.

As further justification for its approach, the Commission has considered the depreciation schedule sought by EAPL in the original Access Arrangement, and extrapolated the concept of a "kinked depreciation schedule" to meet competition from a new entrant to apply to the initial Capital Base (ICB).

EAPL submits that the Commission's approach to effectively "kink" the depreciation schedule is incorrect as it bears no direct relevance to the factors to be considered under section 8.10(f). The Commission justifies its approach by reference to historical accounting practice and the proposition that such an approach is consistent with the performance of an incumbent firm that has recovered a substantial portion of its investment prior to the entry of a new firm. (FD p56) In addition, the Commission states that allowing an upward revaluation on account of prolonged asset life would allow recovery of more than the efficient costs of providing the service. (FD p67) This may be correct if there was historical evidence of full cost recovery – however, the Commission acknowledges elsewhere that full cost recovery did not occur during the relevant period.

In a competitive market, the ability to cost-effectively extend an asset's life would tend to increase the value of the asset (or in terms used by NERA, would tend to increase the price that an entrant would pay for the asset in preference to replacing the asset). However, the Commission's approach would deny the asset owner any benefit from an extension to the life of the asset.

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[3] Alexis Hardin, Henry Ergas and John Small, *Economic Depreciation in Telecommunications Cost Models,* Network Economics Consulting Group, July 1999

In EAPL's view, section 8.10(f) does not permit the Commission to rely on the depreciation schedule proposed initially to apply over the Access Arrangement Period in determining the ICB. A "kinked" [accounting] depreciation profile was not the basis upon which tariffs were set in the past, and neither is it the basis now proposed for setting tariffs under the revised Access Arrangement.

Basis on which tariffs have been (or appear to have been) set in the past and historical returns

EAPL notes that the Commission has not relied on the other heads of section 8.10(f), being the basis upon which tariffs have been (or appear to have been) set in the past and historical returns, to justify its decision.

1.3.4. Conclusion

EAPL considers that the Commission's conclusion has been arrived at by reference to factors which it is not permitted to consider under section 8.10(f). Accordingly, EAPL submits that the figure of $559.3 million calculated by the Commission as the ICB is not a value on which the Commission is able to rely.

EAPL submits that the proper application of section 8.10(f) requires that the initial cost of the pipeline, less economic depreciation over its life to date i.e. the economic written down value of $1,700 million as calculated by EAPL, be considered in establishing a value for the ICB.

1.4. Code Section 8.10(g)

1.4.1. The Code

Section 8.10(g) of the Code provides that when a Reference Tariff is first proposed for a Reference Service provided by a Covered Pipeline that was in existence at the commencement of the Code, the reasonable expectations of persons under the regulatory regime that applied to the Pipeline prior to the commencement of the Code should be considered in establishing the initial Capital Base for that Pipeline.

1.4.2. The Final Decision of the Commission

In the Final Decision, the Commission concluded that the Court of Appeal in the Epic case required that section 8.10(g) should be applied by examining not merely Epic's expectations, but whether those expectations were brought about or underpinned by the regulatory regime that applied at the time.

The Commission stated at page 58:

> "Of significance of this part of the Court of Appeal's judgment is that it examined Epic's alleged expectations in terms of what it was led to expect by the tender process and the regulatory regime that applied at the time. It was not concerned simply with what Epic's expectations were, but rather whether it had been led to those expectations by the regulatory regime that applied to the pipeline at that time. This distinction is drawn out in the Epic Decision where the Court of Appeal stated:

> In Schedule 30 to the sale contract Epic identified $1.00 per GJ as its proposed tariff rate for the primary Dampier to Perth service. This had no contractual force, however, for purposes relevant to the determination of a tariff under the Code. Nor was the State in any way even committed to supporting such a tariff before the Regulator. **In essence, it was a statement by Epic of what it hoped to achieve under the Code, the risk lying with Epic whether it did so**." [Emphasis added]"[4]

Further, the Commission states at page 58 that:

> "The Court of Appeal appears to have applied section 8.10(g) by examining not merely Epic's expectations, but whether those expectations were brought about by or underpinned by the regulatory regime that applied at the time."

At page 59, the Commission states:

> Section 8.10(g) of the Code does not merely require the regulator to take into account the mere expectations that a person held prior to the commencement of the Code. The provision makes express reference to the reasonable expectations of a person **under the regulatory regime** that applied prior to the commencement of the Code. It draws a specific link between a person's expectations and the prior regulatory regime. In other words section 8.10(g) appears to be concerned with reasonable expectations brought about by, or to use EAPL's words, underpinned by the regulatory regime that applied prior to the Code."

1.4.3. EAPL's response

The Commission has applied section 8.10(g) on the basis that it is concerned with reasonable expectations **brought about by** the regulatory regime that applied prior to the Code.

According to this interpretation, a reasonable expectation should only be taken into account if there is a causal connection between the expectation and the regulatory regime prior to the Code (that is, if the expectation was caused by the regulatory regime).

In EAPL's view this interpretation is clearly incorrect.

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[4] It is noteworthy that, notwithstanding this statement by the Court of Appeal, the Relevant Regulator for the DBNGP did give weight to the $1.00/GJ price in determining the ICB for the pipeline:

"494. It is therefore my view that a factor to be accorded substantial weight in consideration of the Reference Tariff for the DBNGP and in consideration of the value of the Initial Capital Base is the Government's stated expectation and subsequent position of a $1.00/GJ tariff applying from 1 January 2000, with that tariff being the 100% load-factor tariff for a full- haul T1 Service."

and

"510. I am of the view that in establishing both the Initial Capital Base and the Reference Tariff for this first Access Arrangement Period, a significant consideration is a value of the Initial Capital Base that would be consistent with the full- haul tariff of $1.00/GJ for the T1 Service at 1 January 2000, given weight by the actions of government both during and after the Sale Process."

Independent Gas Pipelines Access Regulator Western Australia, Final Decision on the Proposed Access Arrangement for the Dampier to Bunbury Natural Gas Pipeline, 23 May, 2003

If a causal connection were required, as the Commission suggests, it would be expected that the provision would make that clear by using words like "caused by" or "resulting from" rather than "under". The correct interpretation is that section 8.10(g) refers to reasonable expectations in the regulatory environment that existed prior to the Code.

Reasonable expectations are shaped by many factors, including the applicable regulatory regime. Section 8.10(g) was clearly drafted so as to accommodate this reality. When considering the reasonableness of an expectation, whatever the causes of the expectation, section 8.10(g) requires the impact of the regulatory regime prior to the Code to be taken into account. It makes it clear that the relevant regulatory regime for these purposes is the one existing prior to the Code (as compared to, for example, the regime existing at the time of construction of the pipeline or under a proposed regime). There is nothing in the section to suggest that other factors relevant to determining the existence and reasonableness of an expectation should not also be taken into account.

The Commission suggests (in the passage from the Final Decision quoted above) that "underpinned by the regulatory regime", a phrase used by EAPL, is equivalent to "brought about by". This was not what EAPL intended. EAPL was simply trying to make the point that its expectations were consistent with the regulatory regime. That is not the same as saying they were caused by it, or that any causal connection is necessary under section 8.10(g).

The Final Decision also refers (at page 58) to a statement by the Western Australian Court of Appeal in *Epic* (at para 199) in support of its interpretation of section 8.10(g).

The statement of the Court of Appeal simply cannot be construed as supporting the causal connection requirement in section 8.10(g) suggested by the Commission.

The Court does not expressly refer to 8.10(g) in the relevant paragraphs of the judgment (paras 188 to 200) although it does expressly refer to 8.10(j). As the Commission notes at the top of page 58 of the Final Decision, however, the Court of Appeal refers (at para 188 of the judgment) to "the reasonable expectations of Epic under the regulatory regime that applied to the DBNGP prior to the commencement of the Code" so it may be inferred that one of the issues the Court was considering was the possible application of 8.10(g).

The Court does not, however, make any comment on the correct interpretation or application of 8.10(g). This is hardly surprising. The judgment states (at para 192) that Epic's case was that it had tendered for the pipeline:

> "on the understanding, induced by the tender terms and conditions and, in particular, the sale information memorandum and accompanying and other information, inter alia that, under the Code after January 2000, the public interest would be served by a future gas tariff in the order of $1 per GJ for the primary Dampier to Perth transmission service."

The Court found (at para 196) that this submission was without "an adequate factual foundation". This finding of fact disposed of the matter. There was no relevant expectation to be considered. The Court did not need to consider, and did not consider, the construction or operation of 8.10(g).

Even if the Court had found that there was a factual foundation for the Epic submission, the expectation Epic relied upon was clearly one about the tariffs that would apply under the anticipated future regulatory regime. This could not be regarded as an expectation under the regulatory regime prior to the Code. On any available view of the meaning of 8.10(g), this expectation could not have qualified for consideration under that provision.

The circumstances considered in *Epic* were very different from those relevant to the MSP. Epic purchased its pipeline anticipating that, under the Code about to be introduced, the tariffs would be fixed by an independent regulator. It should also have anticipated, as the Court of Appeal found, that the 1997 tariff levels could not be expected to be maintained and would be out of the government's control (see paras 196-197). By contrast, the MSP has been in operation for many years and was acquired by EAPL in 1994. EAPL's expectations, as explained in earlier submissions to the Commission, have to be assessed against the historical background. They were reasonable and supported by the available information.

At pages 59-60 of the Final Decision the Commission concludes that EAPL's expectations based on volumes and prices under the GTA should not form the basis for determining the ICB. In summary the Commission's reasons are that nothing in the prior regime preserved the prices under the GTA beyond the life of that agreement (to 31 December 2016) and, secondly, the GTA was replaced by the GTD in 2000.

Section 8.10(g) requires the Commission to consider EAPL's expectations, and the reasonableness of those expectations, prior to the introduction of the Code. These matters must be considered in the regulatory setting that existed prior to the Code. If, for instance, an expectation was inconsistent with the regulatory regime at the time, this might suggest it was unreasonable.

Once the reasonable expectations are determined, they must be taken into account in the way suggested by the Court of Appeal in *Epic*. In a passage quoted by the Commission at page 57 of the Final Decision, the Court said:

> "Obviously, if that regime was more favourable for present purposes than the Code, the reasonable expectations of the service provider would be, relevantly, for a more favourable return on the investment of the service provider in the pipeline."

The fact that the GTA was replaced by the GTD in 2000 does not constitute a valid reason for dismissing or giving little weight to EAPL's prior expectations based on the GTA. The GTD was entered into in different circumstances and under a different regulatory environment. The renegotiation of the GTA reflected the reality that it would be commercially unsustainable to require the MSP's foundation shipper to pay a higher price than new entrants relying on an Access Arrangement approved under the Code. Section 8.10(g) directs attention to EAPL's expectations under the prior regulatory regime. It is quite illogical, and contrary to the purpose of 8.10(g), to use EAPL's reasonable response to a different regulatory regime as a reason for giving less weight to its reasonable expectations under the prior regime.

Several other points may be made about the GTD:

- The GTD provides that until an Access Arrangement is approved, AGL will pay EAPL's published price - that is, the price of 66 cents which EAPL had adopted in response to competition from the EGP.
-
- The Code requires the Commission to take into account EAPL's reasonable expectations under the prior regime in considering the Access Arrangement.

EAPL operated under the GTA and the pre-Code regulatory regime for a number of years. There can be little doubt that it had reasonable expectations based on actual experience over that period.

1.4.4. Conclusion

The Commission has failed to properly interpret and apply section 8.10(g) and has wrongly excluded consideration of the reasonable expectations of EAPL under the prior regulatory regime.

1.5. Code Section 8.1(d)

At pages 70-72 of the Final Decision the Commission considers the principle in 8.1(d) that a Reference Tariff and Reference Tariff Policy should be designed so as not to distort investment decisions in pipeline systems.

When EAPL purchased the MSP in 1994 one of the matters which it took into consideration was the revenue which would be obtained from reasonably anticipated future volumes. The Commission incorrectly characterises (at page 72) EAPL's expectation as a "mere hope or expectation". For the reasons discussed above under 8.10(g), EAPL's expectation, both at the time of the purchase and immediately prior to the introduction of the Code was, in fact, quite reasonable.

The Commission suggests that EAPL would receive "a windfall" if the ICB were set at a value in excess of the purchase price. Achieving revenues consistent with those reasonably anticipated when making an investment decision cannot be treated as a windfall. To the contrary, denying EAPL the full benefit of them is a confiscation.

When setting the ICB the Commission should have given great weight to the value of the MSP based on the revenue stream EAPL expected to achieve. To do otherwise is contrary to the principle in 8.1(d).

1.6. Code Section 8.10(k)

1.6.1. The Code

Section 8.10(k) of the Code provides that when a Reference Tariff is first proposed for a Reference Service provided by a Covered Pipeline that was in existence at the commencement of the Code, any other factors the Relevant Regulator considers relevant should be considered in establishing the initial Capital Base for that Pipeline.

1.6.2. The Final Decision of the Commission:

At pages 63 – 65 of the Final Decision, the Commission considers prices derived by application of the Hypothetical New Entrant Test (HNET).

The Commission refers to advice provided by NERA in the context of the NCC's consideration of EAPL's application for revocation of coverage of parts of the MSP system, and NECG's advice in response.

The Commission states that:

> "NERA concluded that the hypothetical new entrant price was about $0.51/GJ, which was the maximum price that would be expected to be observed in a competitive market." (page 64)

The Commission concludes that:

> "Although the Commission has not applied the HNET test to determine reference tariffs, it considers that the HNET tariff calculated by NERA is a relevant factor in its consideration of the tariffs that would achieve the Code objective of replicating the outcomes of a competitive market (section 8.1(b)). Tariffs determined in accordance with the HNET (as calculated by NERA) are broadly consistent with an ICB of $559.3 million. While the Commission does not consider it appropriate to determine the ICB by reference to the HNET, the Commission considers that this analysis can be used to test the appropriateness of tariffs that result from a particular ICB value." (page 65)

1.6.3. EAPL's Response

EAPL assumes that the statement "Tariffs determined in accordance with the HNET (as calculated by NERA) are broadly consistent with an ICB of $559.3 million" (page 65) refers to the similarity between the value of $0.53/GJ determined by the Commission as the "Average tariff on the Moomba to Sydney segment over the [access arrangement] period" (FD p viii), and the NERA value.

It is clear that the experts disagree as to the price under the HNET – NECG are of the view that the correct value is $0.73/GJ. There were two principal reasons for the difference. NERA and NECG took different views as to the depreciation profile the hypothetical new entrant would adopt and as to the appropriate volumes on which to calculate the unit price. The Commission has not considered which of these views is the better one, and clearly at

least one of these views would result in a price inconsistent with the Commission's determination of ICB.

Further, in making its comparison, the Commission has failed to take into account differences between the values for annual non-capital costs and throughput on which the NERA and NECG prices were based, and the corresponding values in the Final Decision. When the level of non capital costs allowed in the Final Decision ($18.6 million) is taken into account, the NERA price increases by 4 cents to $0.55/GJ and the NECG price increases to $0.78/GJ. When the Final Decision volume of 95.8 PJ is taken into account, the NERA price increases further to $0.66/GJ while the NECG price returns to $0.73/GJ. (The remaining difference between the two prices is attributable to the consultants' different assumptions as to ORC, rate of return, and depreciation.) The conclusion that the NERA price is comparable to the Commission's ICB is no longer valid.

In any event, the Commission's price of $0.53/GJ is a function of all of the factors decided in the Final Decision including the ICB, WACC, non-capital costs and the values chosen by the Commission for the "Initial reduction in mainline tariffs" and "Associated X factor" where the Commission acknowledges that "there is almost an infinite number of combinations." (page 197). Each combination will produce a different value in place of the $0.53/GJ. It follows that any similarity observed between the NERA and Commission prices is no more than a coincidence.

Finally, and most importantly, a price at a particular point in time says nothing about the value of the assets in question. The value that follows from the HNET is determined by reference to the present value of the flows of revenue and costs that the hypothetical new entrant will face over time. Revenue is in turn the product of volumes and prices. It follows that a price evaluated at a particular point in time, such as the NERA HNET price, provides no useful information in the context of an ICB determination. The Hypothetical New Entrant Construct has relevance in determining the ICB, only in the context of the NPV-based HNEC value discussed previously in sections 1.1 and 1.2 above.

1.6.4. Conclusion

EAPL considers that the Commission has exercised its discretion unreasonably to the extent that it has relied on the NERA HNET price to inform its assessment of the value of the ICB.

1.7. Error in the Commission's calculation of the ICB value

The method adopted by the Commission to determine the ICB is described in section 8.10(f) and can be characterised as straight line depreciation of an ORC value. EAPL rejects the method as being incorrect in the context of 8.10(f) for reasons set out in section 1.3 above. Even if the method were valid, the Commission has applied it incorrectly. When Table 2.2.7.1 of the Final Decision is analysed it is apparent that:

- in calculating the ICB value of $559.3 million from the ORC value of $1,092.6 million, the Commission has assumed that the MSP system was a single asset commissioned in 1977;
- the life of the single asset was assumed to be 50 years until 2000 and 80 years thereafter; and

- the ICB values of the various laterals have been determined by allocating the total ICB of $559.3 million to the laterals in proportion to their ORC values.

If the Commission's method is to be applied at all, then it must be applied having regard to the fact that the laterals were commissioned at various dates after 1977. When this error is corrected the value produced by the Commission's methodology (which EAPL rejects) can be no less than $595 million ($ 2003). If the Commission is to be consistent with its proposition that "accelerated" depreciation to 2000 is consistent with anticipated competition from the EGP, then it would follow that the Young to Lithgow and Junee to Griffith laterals (which are not subject to competition) should be taken into the calculation on the basis that they have always had lives of 80 years. In that case the corrected value would be $602 million ($ 2003).

1.8. Conclusions on ICB

The following table summarises the position in relation to the factors to be considered under section 8.10.

Code section	Valuation method	ACCC value ($m)	EAPL value ($m)
8.10(a)	DAC	100	100
8.10(b)	DORC	715.1	972.3 ($ July 2000)
8.10(c)	Other well recognised methodologies	Not stated	Not stated
8.10(d)	Advantages and disadvantages	Referred to in section 8.1 discussion	
8.10(e)	International best practice	No established best practice found.	
8.10(f)	Basis of past tariffs, economic depreciation and historical returns	559.3 (subject to correction)	1,700
8.10(g)	Reasonable expectations	Not stated	756.9
8.10(h)	Efficient utilisation	Referred to in section 8.1 discussion	
8.10(i)	Comparability competing pipelines	Equivalent to DORC	Not stated
8.10(j)	Recent asset prices	533.4	Not stated
8.10(k)	Any other (HNET)	HNET value not stated, but said to be consistent with tariff based on ICB of $559 million	To be assessed properly, HNET requires a NPV evaluation

Specific issues with the Commission's derivation of these figures are dealt with above in the relevant subsections. In this summary, we focus on the Commission's process of deriving a preferred ICB from these reference points.

1.8.1. Commission's Balancing of Valuations

The Commission undertook a process of elimination either of the value determined under section 8.10, or its application as the basis to determine the ICB, to confirm its preferred ICB value of $559.3m.

EAPL's preferred ICB value of $779 (now $756.9) million was eliminated by the Commission because,

> "In proposing this value EAPL relied on section 8.10(g) of the Code which requires the Commission to consider the reasonable expectations of persons under the previous regime that applied to the pipeline prior to the commencement of the Code. The Commission does not consider that EAPL has demonstrated that this value was brought about or underpinned by the previous regulatory regime." (page 73.)

EAPL's DORC value of $972.3 million was eliminated by the Commission because it was held to be an incorrect calculation of DORC.

EAPL's value of $1,700 million based on past tariffs was "given little weight" by the Commission as being inconsistent with section 8.1(b) of the Code because,

> "Prices in excess of DORC would result in customers by-passing the incumbent in favour of a new entrant. For this reason, valuation methodologies that produce values for the ICB substantially in excess of DORC, such as EAPL's proposed residual value of $1700m, would be less likely to produce outcomes that replicate a competitive market." (page 68)

The DAC value of $100 million agreed by the Commission and EAPL was given little weight by the Commission because,

> "The Commission does not consider that a DAC of $100m would satisfy section 8.1(a) and 8.1(b), given the policy of the previous owner, the Australian Government, not to earn a commercial rate of return." (pages 73-74.)

The figure of $533.4 million derived by the Commission under section 8.10(j) of the Code (prices paid by the Service Provider for any asset recently purchased) was "given little weight" by the Commission because,

> "The Commission has some concerns with setting the value of a regulatory asset base equal to the price paid by the service provider to acquire the asset from the previous owner. … While not suggesting that the price paid by APT was excessive, the Commission notes, however, that the acqisition was not subject to competitive pressures. Accordingly, the Commission does not consider that the price paid by APT should form the basis of the ICB." (page 62.)

The Commission eliminated its own DORC value of $715.1 million because,

> "In addition, the Commission does not consider that a value equal to DORC of $715 million and based on an 80 year life is appropriate, since a 50 year life has been assumed in the past." (page 74.)

The one remaining value of $559.3 million prevailed as the ICB. The Commission sought to corroborate this estimate in three ways. Firstly, the Commission said that "The approach adopted by the Commission to determine the value of the asset base replicates the performance of an incumbent firm that has recovered a substantial portion of its investment prior to the entry of a new firm." (page 74.)

Secondly, the Commission said that "tariffs derived from an ICB value of $559 million are also broadly consistent with the tariffs that would be derived under the HNET." (page 74.)

Thirdly, the Commission said that "While the Commission does not consider that the price paid by EAPL in 1994 should form the basis of the ICB, the value of the ICB determined by the Commission will provide EAPL with the opportunity to recover the price it paid (after taking account of depreciation and capital expenditure to date)." (page 75.)

1.8.2. EAPL's response on balancing the valuations

The Commission's preferred ICB figure of $559.3 million was derived on a basis which is inconsistent with section 8.10(f). That figure was derived by applying a straight line depreciation to the ORC valuation assuming a 50 year life to 2000 and an 80 year life thereafter. The grounds for employing a 50 year life were that EAPL had followed a well-known accounting convention by applying depreciation over 50 years in its financial accounts. None of the parts of section 8.10(f) match, or are even consistent with that rationale:

- It is not the basis on which Tariffs have been (or appear to have been set).
- It is not economic depreciation.
- It is not related to the historic returns to the Service Provider.

Consequently, the Commission's ICB figure should not be admissible under section 8.10(f) of the Code. The Commission did not seek to support this figure under any other head of the Code, and it does not appear to be admissible under any other section.

EAPL agrees with the Commission that the DAC valuation for the Pipeline is $100 million and that the Commission was correct to reject that valuation in establishing the ICB, although the most appropriate basis for rejection is that it would violate section 2.24(a) of the Code. Such an ICB (which is substantially lower than the amount paid by EAPL to buy the pipeline, an amount which the Commission agrees was not excessive, and the value to EAPL in the purchase arrangements) would be contrary to the Service Provider's legitimate business interests and investment in the Covered Pipeline.

The Commission's rejection of DORC as the ICB is inconsistent with its past final decisions under the Code. This point is illustrated by the table below which summarises those decisions.

Regulatory precedents for Initial Capital Base		
Pipeline or system	Date of Final Decision	Initial Capital Base
TPA Principal Transmission System	6/10/1998	DORC
Marsden – Dubbo (Central West Pipeline)	19/10/2000	111% of DORC
Moomba – Adelaide Pipeline System	12/09/2001	DORC
Amadeus Basin – Darwin Pipeline	4/12/2002	Between 71% and 87% of DORC depending on value of DORC[5]
Moomba – Sydney Pipeline System	2/10/2003	78% of Commission's DORC

The Commission's stated reason for rejecting its own DORC of $715 million as the ICB, was that "a 50 year life has been assumed in the past." We have already shown that the 50 year life referred to was nothing more than an accounting convention which bore no relationship to the manner in which MSP tariffs were determined. Given that this argument was the only ground on which DORC was rejected as the appropriate basis for determining the ICB, EAPL submits that on a proper consideration of section 2.24 and section 8.1 of the Code, the Commission's determination of DORC is in fact the minimum value which could be attributed to the ICB.

As discussed in greater detail previously, the Commission's rejection of EAPL's reasonable expectations figure is based on the erroneous assumption that section 8.10(g) requires that an expectation, to be reasonable, must have been "brought about or underpinned by the previous regulatory regime."

In conclusion, the Commission's preferred ICB of $559.3 million must be rejected because it is not supported by any part of section 8.10, least of all section 8.10(f) by which it is purported to be justified. Section 2.24(a) provides grounds for rejecting valuations lower than the 1994 purchase price for the MSP. Section 8.10, as interpreted by reading sections 8.1 and 2.24, provide no grounds for rejecting either the DORC valuation or the EAPL reasonable expectations valuation, which deliver an ICB of between $715 million and either $756.9 million ($ July 2000) or $1,045 million when DORC is given its true economic value.

Accepting the weighting given to the remaining valuations by the Commission, there is no ICB valuation lower than the Commission's estimate of DORC at $715 million which would

[5] The approach taken by the Commission in setting the ICB for the ABDP reflects special considerations that are unique to that pipeline. "The Commission [chose] not to determine a specific DORC as this would involve making an assumption about the likely timing and possible cause of any reduced utilisation of the pipeline beyond 2011. The possible timing and circumstances of such an event remains unclear." (ABDP Final Decision p ix). Instead, the Commission determined a range for DORC reflecting alternative assumptions about utilisation after 2011. The Commission questioned whether an ICB based on a DORC value would be recoverable given the uncertainty surrounding long term utilisation, and instead adopted as the ICB an optimised deprival value which takes into account the economic value of the pipeline. No such considerations affect the MSP.

be consistent with the Code. EAPL submits that the ICB should be established at $756.9 million ($ July 2000), being a value which reflects EAPL's reasonable expectations under the regulatory regime that applied to the Pipeline prior to the commencement of the Code and which, in any event, is a value that would represent a reasonable exercise of the Commission's discretion having regard to all the circumstances.

B. NEW FACILITIES INVESTMENT (section 2.3 Final Decision)

2. FDA 2

EAPL has amended its Access Arrangement in accordance with the amendment required by the Commission in its Final Decision.

3. FDA 3

EAPL has amended its Access Arrangement in accordance with the amendment required by the Commission in its Final Decision.

4. FDA 4

EAPL has amended its Access Arrangement so that it substantially incorporates the amendment specified by the Commission in its Final Decision.

EAPL has not included a reference to section 8.16(a) of the Code, but EAPL has referred to satisfying the requirements of the Code.

EAPL notes that, as a result of other amendments, section 14.3 is now section 8.7 of the Access Arrangement.

5. FDA 5

EAPL has made the amendment specified by the Commission in its Final Decision.

As set out above, as a result of other amendments, section 14.3 is now section 8.7 of the Access Arrangement.

C. CAPITAL REDUNDANCY (section 2.4 Final Decision)

6. FDA 6

EAPL has amended its Access Arrangement so that it substantially incorporates the amendments specified by the Commission in its Final Decision.

EAPL notes that the amendment it has made to its Access Arrangement is in the same terms as the clause in NT Gas Pty Ltd's Access Arrangement for Amadeus Basin to Darwin Pipeline.

The relevant section of EAPL's Access Arrangement is now section 8.8.

D. DEPRECIATION (section 2.5 Final Decision)

7. FDA7

In the Final Decision, the Commission has accepted that EAPL's proposal for back-ended depreciation is consistent with the NPV methodology under the Code.

However, while the Commission has accepted EAPL's economic depreciation methodology, the Commission has required EAPL to adopt different depreciation charges based on different values for variables used to calculate Total Revenue. The Commission has stated that, in order for EAPL's access arrangement for the MSP to be approved, EAPL must adopt the depreciation schedule contained in Table 2.5.7.1 of the Final Decision.

EAPL has considered the Final Decision's required changes to the variables used to calculate Total Revenue (eg ICB, Rate of Return and non capital costs) in responses to FDAs 1, 8, 9, and 10. These variables also impact on the Commission's calculation of depreciation applied in the Final Decision. In these cases EAPL believes that the Commission's reasoning is incorrect. EAPL has addressed the Commission's reasons and revised the Commission's required amendments to adjust for these variables.

EAPL has not adopted the depreciation schedule contained in Table 2.5.7.1 of the Final Decision. However, EAPL considers that, its revised Access Arrangement should address, to the Commission's satisfaction, the matters the Commission identified in its Final Decision as being the reasons for requiring the amendments specified in the Final Decision.

EAPL has adopted its corrected variables in its recalculation of Total Revenue and the recalculation of depreciation.

EAPL has revised its forecast depreciation charges in line with these variables as follows:

Table: EAPL proposed depreciation (July 2001 $million)

	2004	2005	2006	2007	2008	2009
Depreciation	-4.9	-1.29	-1.17	+1.24	+5.13	+9.27

Central West Pipeline (CWP) - a greenfields pipeline

In addition, as a part of its considerations on depreciation, the Commission has asserted that the CWP is not a greenfields pipeline in the correct sense of the term[6]. This view is not correct, as the CWP was built to a market which to that point had not been supplied with gas and the CWP was a totally new pipeline built to serve that market. These are key characteristics of a greenfields pipeline.

The fact that the CWP is a greenfields pipeline has already been recognised by the Commission in the CWP Final Decision for the CWP. The Commission incorporated statements that the CWP was a greenfields pipeline (CWP Final Decision page ix) and

[6] Page 90 – Final Decision

effectively based its approach to greenfields depreciation on the CWP in its Draft Greenfields Guideline.[7]

[7] page 2 Draft Greenfields Guideline for Natural Gas Transmission

E. RATE OF RETURN (section 2.6 Final Decision)

8. FDA 8

8.1. The Final Decision

At page 319 of the Final Decision, the Commission stated that:

> "In order for EAPL's access arrangement for the MSP to be approved the WACC estimates and associated parameters forming part of the access arrangement ad access arrangement information must be amended to reflect the current financial market settings by adopting the parameters set out by the Commission in Table 2.6.7.7 of this Final Decision. The calculation of total revenue must reflect these parameters."

8.2. EAPL's Response

EAPL has not amended the WACC estimates and associated parameters which form part of its Access Arrangement and Access Arrangement Information by adopting the parameters set out by the Commission in Table 2.6.7.7 of the Final Decision. However, EAPL considers that, for the reasons set out below, its revised Access Arrangement should address, to the Commission's satisfaction, the matters the Commission identified in its Final Decision as being the reasons for requiring the amendments specified in the Final Decision.

The Commission has redetermined a majority of the parameters of WACC proposed by EAPL as set out in Table 2.6.7.7 of the Final Decision.

EAPL has sought expert advice on the Rate of Return section (Section 2.7) of the Final Decision from Network Economic Consulting Group (NECG) (see attached report) and in line with NECG's expert opinion, believes the Commission's decision on MSP should be corrected in a number of areas. These areas (which are dealt with in the attached report) are summarised below.

8.2.1. Risk free rate

The Commission has based the bond maturity for the risk free rate on the length of the regulatory period. It has done this for the estimation of the cost of debt and the cost of equity. EAPL believes this is incorrect.

In reaching its position, the key argument relied upon by the Commission is that under the Code, the total revenue and tariffs for a pipeline are reviewed every access arrangement period, and hence an investor does not need to be compensated for risk longer than that period.

In non-regulated environments, the optimal policy of a firm is to finance assets consistent with the life of the major assets – not the period under which prices are set. EAPL can see no good reason why under the presence of regulation the firm should change its optimal setting of debt maturity to align with the regulatory cycle. While the firm may choose to have some lending subject to short term interest rates, this lending is subject to the cost of swaps and periodic re-financing. In any case, this does not alter the conclusions that the lending itself is long term and will extend beyond the regulatory period.

EAPL believes the risk free rate for both estimations should be based on the yield to maturity of the longest traded bond, namely the 10-year Commonwealth bond. With the exception of the Commission, there has been universal adoption of the 10-year bond by regulators in pricing decisions in Australia. This practice is seen as uncontentious by these other regulators. The adoption of a 10 year bond rate as opposed to a 5 year bond rate would result in an increase in EAPL's cost of capital by 22 basis points.

8.2.2. Cost of debt

The benchmark credit rating applied by the Commission (BBB+) is inconsistent with its own preferred methodology, namely benchmarking credit rating of gas transmission providers. As a result, the Commission is likely to systematically bias upwards the credit rating - and systematically bias downwards the debt margin - applied to determine the cost of debt in the decision.

The case of GasNet, which is consistent with the Commission's own stated approach, supports a credit rating of BBB. During the period sampled in the Commission's final decision, data from CBA Spectrum indicates that the applicable debt margin on BBB rated debt was between 20 and 25 basis points above the margin on BBB+ rated debt.

The Commission's decision included no allowance for the costs of debt issuance in either the WACC or regulatory cash flows. The GasNet decision supports a value of 12.5 basis points. However, EAPL believes a higher value of up to 50 basis points is applicable based on evidence of the difference in interest costs for private – rather than public - debt placement.

It is considered that the most appropriate approach is to treat these costs as transaction costs associated with raising debt, with recovery in the cash flows rather than the cost of capital. Based on EAPL's proposed asset base of $756.9 million, this translates into an increase in expenditure of $2.27 million per annum.

8.2.3. Cost of equity issuance

The Commission has not provided any allowance for the cost of equity issuance. However, APT (on behalf of EAPL) faces substantial costs in raising both debt and equity financing for the MSP.

In raising equity, a company such as APT incurs costs to prepare financial information and documentation required for an equity issue, whether an initial public offering or a subsequent offering. To a substantial extent, the internal costs that a company must bear will be included in its O&M as salaries and related expenses. However, a company will also necessarily incur substantial external costs that would not be included in O&M. These costs include legal and accountancy expenses, and the expenses of engaging an investment bank to organise, manage, underwrite and execute the offering.

Using the appropriate cost of equity in the GasNet calculation, EAPL believes the fee per year as a perpetuity should be at least 0.397% of equity value (and even higher if regard is had to the life of the asset in the calculation of the allowance).

It is considered that the most appropriate approach is to treat these costs as transaction costs associated with raising equity, with recovery in the cash flows rather than the cost of capital. Based on EAPL's proposed asset base of $756.9m million, this translates into an increase in expenditure of $1.2 million per annum.

8.2.4. Asymmetric risk

The Commission's decision should reflect various asymmetric risks faced by MSP.

It is well known that the real world has some unavoidable risks that are not included in the CAPM. If these are risks that investors in a security cannot avoid by diversification, investors can be expected to require a return for bearing that risk.

EAPL faces a number of asymmetric risks. The largest extreme risks for APT that are not covered by insurance or are covered but still leave significant exposure include property related risks, deductibles in current insurance, credit risk, risk from terrorism, and asset stranding risk which could arise from regulatory changes, competition from the EGP or reserve risk.

The cost of asymmetric risk can be recovered in a number of ways, including an actuarially fair insurance premium, an increment on the WACC and by pass through provisions. Each of these approaches have merit and there is a strong case for using more than one mechanism. For example, for asymmetric risks that are routine in nature – for example, deductibility on insurance policy, the impact can be readily estimated and included in the cash flows. However, for activities such as terrorism, a pass through provision may be most appropriate. Accordingly, based on the asymmetric risk of the following occurrences being addressed in the cash flows:

- competition will result in an inability for EAPL to recover the full cost of providing the Reference Services;
- reserve risk;
- credit risk;
- deductibles in current insurance; and
- regulatory risk,

on the basis of the extent of analysis that time permitted to submit the Access Arrangement, a cash flow allowance of $1.5 million per annum is appropriate. A more accurate estimate can be developed with the benefit of more detailed modelling of these impacts.

F. NON CAPITAL COSTS (section 2.7 Final Decision)

9. FDA 9

EAPL has not adopted the non capital costs set out in Table 2.7.8.2 of the Final Decision. However, EAPL considers that, for the reasons set out below, its revised Access Arrangement should address, to the Commission's satisfaction, the matters the Commission identified in its Final Decision as being the reasons for requiring the amendments specified in the Final Decision.

9.1. The Code

Sections 8.36 and 8.37 of the Code deal with Non Capital Costs.

Section 8.37 provides:

> "A Reference Tariff may provide for the recovery of all Non Capital Costs (or forecast Non Capital Costs, as relevant) except for any such costs that would not be incurred by a prudent Service Provider, acting efficiently, in accordance with accepted and good industry practice, and to achieve the lowest sustainable cost of delivering the Reference Service."

9.2. The Final Decision

The Commission deals substantively with non capital costs at pages 141 to 156 of the Final Decision and in confidential Appendix E.

9.2.1. Expectation that if volumes fall, non capital costs should also fall

The discussion in section 2.7 (page 153) of the Final Decision makes it clear that the Commission has the expectation that if the volumes fall, then non capital costs should also fall.

9.2.2. PMA Contract

The Commission deals substantively with the assessment of the PMA at pages 151 and 152 of the Final Decision.

At page 151 of the Final Decision, the Commission states:

> "Under the PMA, Agility provides the following services to APT:
> - Specified Services. These include specified marketing and technical services in respect of specified pipelines; and
> - Additional Services. These include a number of further marketing and technical services.
>
> The Commission notes the comprehensive nature of the services provided under the PMA and therefore its substantial influence (both in terms of amount and structure) on the MSP's total non capital costs. As such the Commission has considered both the PMA in its entirety and as separate components."

9.2.3. Management Fee

At page 153 of the Final Decision, the Commission states:

> "The service for which Agility receives the management fee under the terms of the PMA is not specified. However, a significant proportion of this $6 million annual fee is allocated to the MSP. It appears that while Agility charges separately for various services performed under the PMA, the management fee however is not for any particular service. The Commission has considered further aspects of the management fee within the terms of the PMA and provides its detailed considerations in Confidential Appendix E of this document.
>
> In conclusion, the Commission considers the management fee is a cost that would not be incurred by a prudent service provider, acting efficiently, in accordance with accepted and good industry practice, and to achieve the lowest sustainable cost of delivering the reference service as is required by section 8.37 of the Code."

9.2.4. Marketing Fee

At page 153 of the Final Decision, the Commission states that it recognised that sales and marketing costs are genuine non capital costs which a service provider is able to recover, but that it has some concerns with the magnitude of the costs claimed by EAPL in this instance.

The Commission notes that it has:

- Examined the sales and marketing costs incurred by other pipelines;
- Considered the circumstances surrounding the outsourcing of the sales and marketing function; and
- Considered the extent to which the payment is linked to performance or allows for any efficiencies to be captured by EAPL.

The Commission notes that Table 2.7.8.1 demonstrates that EAPL's proposed sales and marketing costs are nearly four times that of other service providers, despite the fact that the majority of the MSP's throughput is covered by the GTD.

The Commission also states that it has concerns with the circumstances surrounding the outsourcing arrangements and the fact that it was not the result of an arms length transaction or was market tested.

Finally, the Commission notes (at page 155) that the fee does not appear to be linked in any way to performance as it remains relatively constant despite a forecast drop in throughput (sales) on the MSP.

9.2.5. Benchmarking

At page 155 of the Final Decision, the Commission refers to some benchmarking analysis in support of its conclusion that the proposed costs in their entirety do not meet the criteria in section 8.37 of the Code. The Commission states that it recognises the limitations of

benchmarking and, in particular, the debate surrounding which parameters should be used as normalising factors.

The Commission notes that it has sought to compare non capital costs excluding system use gas and compressor maintenance costs. The Commission has performed its benchmarking using $/km/PJ throughput.

9.3. EAPL's response

9.3.1. Expectation that if volumes fall, non capital costs should also fall

EAPL notes that, in fact, operating expenditure is not affected by throughput except in relation to the frequency of compressor overhauls. This is due to the fact that the pipeline licence conditions and good industry practice mean the operating regime must be complied with irrespective of throughput.

EAPL notes that, in section 2.12 (pages 227, 228), the Commission implicitly agrees that the majority of the cost allocation should be to fixed costs. The Commission's position on the impact of throughput on operating costs is inconsistent. The correct view is that throughput has only a very small impact on operating costs – see the analysis of this issue under Benchmarking.

Therefore, the Commission's argument that the PMA is not efficient or prudent because the charges do not vary with throughput is not valid.

9.3.2. Management Fee

As part of its establishment, APT out-sourced the field and management services of the pipeline to Agility as the organisation that had the specific experience with the MSP as well its broad general experience with a significant proportion of Australia's major transmission pipelines. In EAPL's opinion, the out-sourcing of the operations function including the Management Fee is both economically efficient and prudent.

The approach adopted in the formation of APT, which included outsourcing of key management and operational services to a company with wide general and specific experience with the pipeline assets concerned, is now becoming part of recognised industry practice. A clear and relevant example is Envestra – for which Origin Energy Asset Management (OEAM) provides such services. Other relevant examples are TXU and the Alinta/United Energy restructure.

In the case of Envestra's Victorian gas network the ESC accepted the inclusion of a management fee associated with OEAM's management services agreement calculated as 3% of Envestra's revenue. The exact structure of management fees as part of these types of outsourcing arrangements is dependent on the particular circumstances of the arrangements. What is clear is that industry is adopting outsourcing arrangements which include

management fees as part of the evolution of the industry. It is clearly part of prudent practice of leading companies in the energy industry.

EAPL believes it has provided sufficient evidence that the level of the management fee paid to Agility under the PMA is appropriate and that it would be unreasonable and inappropriate for a fee which is clearly part of prudent industry practice to be excluded.

9.3.3. Marketing Fee

The Commission, in its review of marketing costs, made a factual error that EAPL wishes to correct. No Agility staff undertake any marketing activities in relation to the MSP.

EAPL's marketing costs include costs associated with marketing staff, pipeline expansions, establishing numerous contracts annually (including legal review costs), inter-pipeline operating activities (including balancing arrangements for the NSW gas market), and specific initiatives to increase pipeline utilisation in a competitive market.

Petronas' role in marketing for the MSP is based on its key role in marketing for the MSP via East Australian Pipeline Marketing prior to the establishment of APT. In addition, EAPL receives direct services from Petronas for the fee which include:

- Additional staff: This covers full-time Petronas employees on and off site assisting with the marketing function of the pipeline;
- Access to marketing modelling software;
- Training; and
- Marketing management.

The Commission utilises benchmarking for comparison of marketing costs across four pipelines. Whilst benchmarking may provide some comparison between different entities, on an individual cost component basis the comparison used is not relevant as it is not possible to ascertain what costs or level of marketing activity has been incorporated into each category and each pipeline. A review of the marketing activities between the pipelines benchmarked is relevant:

Examples of differences:

- GasNet:
  - EAPL's understanding is that VENCorp undertakes the majority of the market and operational liaison functions on behalf of GasNet which are activities undertaken by EAPL on the MSP.
  - GasNet is a market carriage system and marketing for a market carriage pipeline is considerably different to marketing for a contract carriage pipeline.
  - GasNet is at full capacity.
  - The Commission accepted in the GasNet Final Decision that GasNet's costs are understated by $660,000 being an estimate of non capital costs being otherwise incurred by VENCorp (GasNet Final Decision page 295).

- ABDP
  - the pipeline is fully contracted to 2011 and there is little scope for additional reserves in the Amadeus Basin and as such, the marketing activity for the pipeline is limited.

Importantly, the Commission's benchmarking of EAPL's marketing expenditure does not reflect the fact that the MSP is now in an environment of competition for pipeline services. None of the pipelines against which the MSP was benchmarked have to market capacity in a competitive pipeline market. The effect of competition on marketing costs is quite profound as marketing of capacity requires a proactive approach because users have a choice about pipelines as well as fuel. EAPL believes that the costs of such a proactive approach are an order of magnitude greater than where there is no competing pipeline. The level of costs experienced by the MSP for marketing is consistent with this.

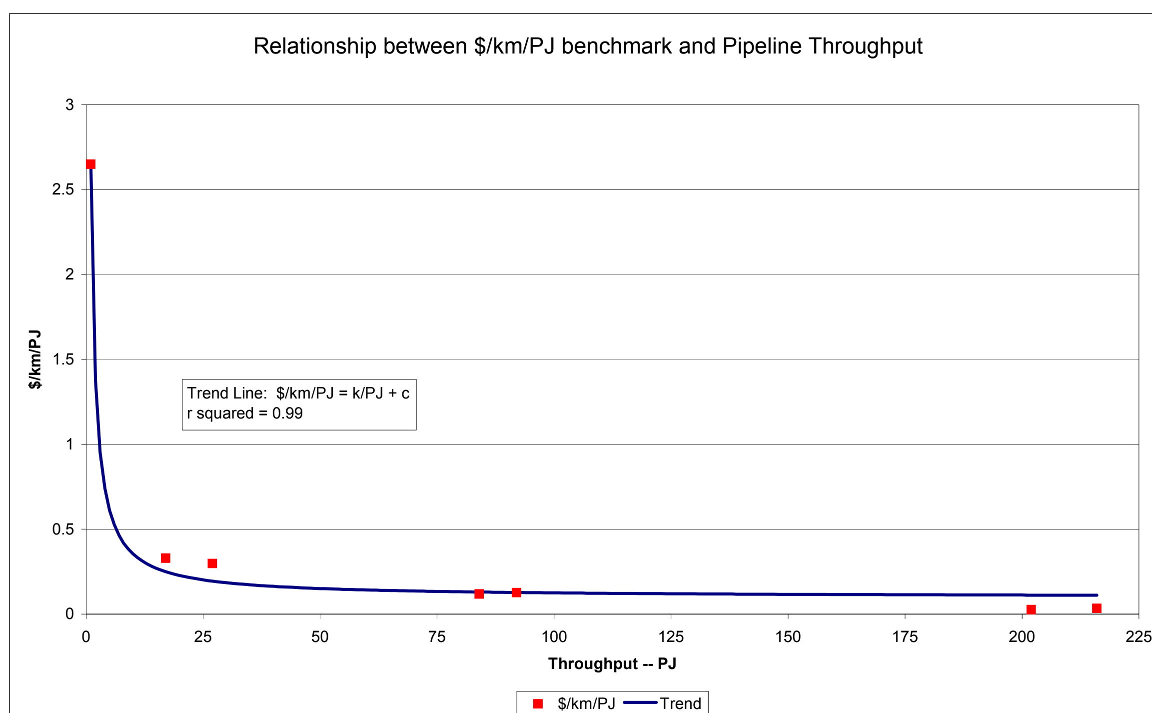
The additional information above clearly describes the services provided to EAPL by Petronas. The services are part of EAPL's marketing efforts necessary to maintain and grow utilisation of the MSP in respect of which, in a regulated environment, users are the beneficiaries through the maximisation of pipeline throughput. EAPL submits that, in the long term the expenditure on marketing of pipeline services is likely to result in reductions in tariffs well in excess of the price effect of including marketing costs for calculation of Total Revenue.

EAPL believes it has provided sufficient evidence that the level of the Petronas marketing fee is appropriate and that it would be unreasonable and inappropriate for the Commission to disallow a fee which is part of EAPL's arrangements to optimise MSP throughput.

9.3.4. Benchmarking

The Commission's use of $/km/PJ as a benchmark for non capital costs is manifestly incorrect. The Commission relies on a comparison of $/km/PJ (where $ are operating costs excluding compressor maintenance costs and fuel costs) to provide "secondary support to the view that EAPL's costs may exceed those that would be incurred by an efficient and prudent service provider." (FD p156)

The measure $/km/PJ is an incorrect basis for comparing pipelines. As identified above, it is well understood that, for transmission pipelines, operating costs do not vary materially with throughput. This is even more the case when the principal components of throughput-related operating costs ie. compressor maintenance costs and fuel costs, are excluded as in the Commission's analysis. The point is illustrated by considering the extreme case where throughput is zero. If the integrity of the pipeline is to be maintained, major items of operating and maintenance expenditure must still be incurred - apart from savings on compressor costs and fuel, costs will be essentially the same even though throughput is zero. At the same time, the value of the $/km/PJ measure will be infinite. In addition, the measure, says nothing meaningful about the efficiency of the costs incurred. The Commission's data confirm that $/km/PJ is inversely related to throughput as shown in the following graph:



There is a very strong relationship between $/km/PJ and PJ ie. if two pipelines are of similar length, the one which carries more gas will always be expected to have lower $/km/PJ benchmarks. Pipelines with the largest throughput will invariably have the smallest value for $/km/PJ, not because they are more efficient, but because they have more throughput.

The observed relationship between $/km/PJ for the Commission's sample can be explained almost entirely by reference to the different throughputs of the sample pipelines[8]. Any differences that may be attributable to the relative efficiencies of the operations represented by the sample are overshadowed by the volume effect. In particular the figures provide no support for the conclusion that "EAPL's costs may exceed those that would be incurred by an efficient and prudent service provider".

EAPL agrees that the Commission should only allow prudent costs in accordance with accepted and good industry practice. On this basis, the only meaningful comparisons that can be made are $/km and $/ORC. The proposed MSP Access Arrangement Information provides the $/km and $/ORC comparisons from which the only valid conclusion is that EAPL's costs are well within the range of other Australian pipelines. As a result, the entire costs proposed by EAPL should be included in the Access Arrangement.

9.4. Conclusion

The Commission's analysis includes an incorrect and inappropriate benchmark as justification that there should be a reduction in non capital costs. When corrected, the

[8] In this context it should also be noted that the benchmark value for GasNet is understated as follows:

- GasNet's costs must be adjusted upwards by $660,000 at the very least, and probably significantly more, for VENCorp costs as discussed above.
- GasNet is a market carriage system and its cost structure differs from that of a contract carriage system, as discussed above.

analysis does not support the Commission's decision to reduce EAPL's proposed non capital costs.

EAPL submits that the costs it proposed for the Access Arrangement are prudent and efficient and they are supported by the only relevant benchmarks that can be used to compare pipelines that are not fully contracted or fully utilised which is the operating cost/km and operating costs/ORC. The use of a benchmark that uses throughput as a divisor, such as $/km/PJ, is manifestly incorrect.

G. VOLUME FORECASTS (section 2.8 Final Decision)

10. FDA 10

EAPL has not adopted the total MSP throughput forecasts contained in Table 2.8.7.2 of the Final Decision. However, EAPL considers that, for the reasons set out below, its revised Access Arrangement should address, to the Commission's satisfaction, the matters the Commission identified in its Final Decision as being the reasons for requiring the amendments specified in the Final Decision.

10.1. Required amendment

The amendment requires EAPL to increase its forecasts by an average additional 540 TJ per annum or 0.58% increase in forecasts over the access arrangement period due to a possible underestimate of the base year in EAPL's forecasts, as identified in McLennan Magasanik Associates' report (June 2003)[9]. The separate elements of the required adjustment are described as:

- An average amount of 150 TJ per annum attributable to an underestimate of 2 PJ in total NSW/ACT market demand in 2001/02[10;]
- An amount of 360 TJ attributable to the MSP due to an unseasonably warm winter in the base year [2001/02][11].

10.2. EAPL's response

EAPL has identified four significant issues:

10.2.1. The base year adjustment

EAPL's response to the MMA report acknowledged that there was some scope for underestimation of the total NSW/ACT demand in its methodology[12] and that the year 2001/02 had a warm winter[13]. EAPL maintains its conclusion that, using its methodology:

> "the consequent impact on forecast volumes for the MSP of such an underestimate [ie 2 PJ] will be trivial" since it would add less than 200 TJ per annum to the forecast load by the end of the access arrangement period."[14]

Further, the Final Decision adds the "warm year" adjustment to the "base year" adjustment to arrive at a total average adjustment of 540 TJ. It was never EAPL's view that these effects would be additive; rather, EAPL demonstrated that *any adjustment* to the base year as a result of the MMA recommendations would be "trivial".[15]

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[9] *Final Decision* p 175
[10] *Final Decision* p 175
[11] *Final Decision* pp 175-176
[12] *EAPL response* 14 July 2003, p 5
[13] *EAPL response,* 14 July 2003, p 6
[14] *EAPL response,* 14 July 2003, p 8
[15] *EAPL response,* 14 July 2003, section 2

10.2.2. The warm year effect

In its response to the MMA report, EAPL concluded that the warm winter effect might have reduced gas demand in 2001/02 by no more than 200- 400 TJ[16]. EAPL then attempted to estimate the effect of the warm winter based on available information in the 2001/02 AGL annual report. EAPL calculated that AGL had gained some 360 TJ of new residential gas load in 2001/02 which might notionally have offset any loss due to a warm winter[17].

EAPL makes the following comments on the warm winter adjustment required by the Final Decision:

EAPL's estimation of the "warm winter" effect of 360 TJ was a purely illustrative exercise designed to show that "any loss due to the warm winter was insignificant in terms of total pipeline deliveries into NSW/ACT, and that EAPL's adjustment to ABARE numbers does not incorporate a significant over-correction as a result of this factor"[18]. It was not suggested that the 360 TJ was rigorously derived or that any adjustment by this amount was necessary.

The MMA report treats the "warm winter" effect in 2001/02 in isolation, implying that all future years will have "normal" weather. MMA did not raise the issue of the (well-recognised) long term trend in urban warming. This trend was recognised as a significant issue in the Commission's Final Decisions for the 2002 GasNet and VENCorp access arrangements[19]. The following are significant points from the GasNet Final Decision:

- the Commission accepted the existence of a long term warming trend which had the effect of reducing gas volume forecasts below historical trends;
- the adjustments necessary to account for a re-assessment of weather effects were extremely significant – estimates by VENCorp and GasNet indicated that forecast annual demand over 2003-2007 would have been about 13.6 PJ higher if the forecast trends over 1998-2002 had been allowed to continue[20]; and
- the Commission concluded that GasNet had lost revenue in its first access arrangement period due to overestimation of gas demand, but added "this loss would not be expected to recur following recognition of the temperature trend."[21]

EAPL notes that a long term warming effect impacting on gas forecasts would equally apply in NSW/ACT (and that this effect was accepted by IPART in its June 2003 review of AGL Retail Energy's NSW gas prices)[22]. EAPL contends that a single year upwards adjustment for warm weather, as proposed by MMA and applied by the Commission, without recognition of past and future annual trends to warmer weather (which would result in lower forecasts) is incorrect and is inconsistent with the Commission's other recent Final Decisions.

Further, notwithstanding EAPL's position that any adjustment for the warm weather effect is inappropriate the Final Decision incorrectly attributes the entire warm weather adjustment to

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[16] *EAPL response,* 14 July 2003, p 6
[17] *EAPL response,* 14 July 2003, p 7
[18] *EAPL response,* 14 July 2003, p 7
[19] ACCC *Final Decision GasNet access arrangement 2002,* section 7
[20] ACCC *Final Decision GasNet access arrangement 2002,* footnote 476 p 205
[21] ACCC *Final Decision GasNet access arrangement 2002,* p 205
[22] Independent Pricing and regulatory Tribunal *Mid-term review of AGL Retail energy's gas retail prices to 2004* p 16

the MSP on the grounds that "those segments of demand affected by the unseasonably warm weather are serviced by AGL."[23]

EAPL's response to the MMA report noted that the EGP carried a number of small shipper loads in 2001/02 (including AGL) amounting to ██ PJ. A proportion of these loads almost certainly would have been weather sensitive and so should logically bear a proportion of any "warm year" adjustment. Additionally, since the Final Decision concluded that an underestimate of 2 PJ in the base year was attributable to the EGP, if such an adjustment were accepted it would be equally logical to attribute some of the "warm year" effect to this load.

10.2.3. Broad range of MSP forecasts provided to the Commission by experts

The following contrasting forecasts of MSP gas flows in the final year of the access arrangement period (2007/08) were presented to the Commission:

- MMA medium term MSP forecast[24] — 99.0 PJ
- EAPL (excluding Interconnect flows)[25] — 85.9 PJ
- ACIL Tasman MSP forecast[26] — 61.6 PJ

There is a 60% variation between the highest of these forecasts (MMA) and the lowest (ACIL Tasman). Put another way, MMA's 2007/08 forecast is 15% higher than EAPL's while ACIL Tasman's forecast is nearly 30% lower than EAPL's. (It is noted that EAPL's forecasts for the MSP generally lie between those of MMA and ACIL Tasman, not only for 2007/08, but for all years up to 2007/08 and beyond).

MMA have cited at least ten different modelling factors which drive their medium-term forecasts of gas flows through the MSP and other pipelines in NSW/ACT[27] and ACIL Tasman concur that the majority of these factors are significant[28]. Given that different modelling assumptions by independent forecasters can result in a potential variation to the annual EAPL forecast for the MSP of +15% to -30% by the end of the access arrangement period, the Commission's assertion that an equivalent 0.58% per annum adjustment to the EAPL forecasts will result in a "best estimate" is not supported by the expert evidence before it.

10.2.4. Potential adjustment for coal seam methane (CSM) underestimate

The Final Decision concluded that:

> "EAPL's forecasts appear to substantially underestimate the potential future market share of Sydney Gas Company given the contracts in place with AGL."[29]

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[23] *Final Decision* p 176
[24] MMA, *Report to ACCC* 6 June 2003, table 3.5, p 27
[25] In their comparisons of MSP flows with their own forecasts, both MMA and ACIL Tasman do not appear to include flows across the Interconnect.
[26] ACIL Tasman, *The MSP/EGP Split* 30 June 2003, table 1, p 3
[27] MMA, *Report to ACCC* 6 June 2003, Section 3, p 17
[28] ACIL Tasman, *The MSP/EGP Split* 30 June 2003, p 1-2
[29] *Final Decision* p 180

A major uncertainty in developing the MSP forecasts is the timetable under which the Sydney Gas Company will fulfil its contracts with AGL to supply up to 14.5 PJ of gas per annum over the next decade. Both MMA and ACIL Tasman assumed much more rapid CSM development than did EAPL in its forecasts.

Given the degree of precision which the Commission appears to desire in the EAPL forecasts, and given the Final Decision's insignificant adjustment required for the base year, there was even greater reason to decrease the MSP forecast as a result of assumed higher CSM production than to increase the entire MSP forecast by 0.54 PJ per annum.

EAPL forecast CSM production rising from █ PJ in 2003 to █ PJ in 2008. In contrast, MMA assumed about x PJ in 2008 while ACIL Tasman assumed █ PJ. On the basis of the MMA and ACIL Tasman reports, the MSP forecast could reasonably be reduced by between █ and █ PJ per annum by 2008 on a gross basis.

10.3. Conclusion

Given all the uncertainties surrounding the MSP forecast, the experts' opinions on those uncertainties and EAPL's conservatism in relation to CSM production, it is unreasonable to require an adjustment to EAPL's forecast. EAPL has therefore retained its forecasts for the MSP over the access arrangement period.

H. FORECAST REVENUE AND TARIFF PATH (section 2.9 Final Decision)

11. FDA 11

EAPL has included details of the price path adjustment mechanism in its Access Arrangement.

EAPL has not made the other amendments specified by the Commission in its Final Decision. However, the amendments EAPL has made to its Access Arrangement should address, to the Commission's satisfaction, the matters the Commission identified in its Final Decision as being the reasons for requiring the amendments specified in the Final Decision.

The Commission has required that EAPL alter the tariff escalation date to 1 January and the corresponding CPI as the basis for the tariff escalation to September quarter data. EAPL has not altered the tariff escalation date to 1 January. The reason for this is that EAPL has had regard to the interests of users. An escalation date of 1 January would mean that the users were advised about changes to tariffs leading into the Christmas holiday break, resulting in potentially significant difficulties for users. Further, historically, EAPL has only ever adjusted its tariffs from the 1st July. In addition, the MSP is linked to the CWP, which also has an escalation date of 1 July. Accordingly, EAPL does not consider that this amendment is appropriate.

Further, EAPL notes the concerns of the Commission (at pages 192 and 193 of the Final Decision). EAPL considers that the Commission's concerns can be addressed in the modelling of tariffs.

EAPL will use the CPI applicable for the 6 months ending March 2004. EAPL will use March quarter data as the basis of the annual CPI adjustment. As the escalation date will be 1 July, this will be the most current data at the time EAPL submits its tariff variations for approval.

EAPL notes that the relevant section of its Access Arrangement is 8.11.

12. FDA 12

The amendments EAPL has made to its Access Arrangement should address to the Commission's satisfaction the matters the Commission identified in its Final Decision as being the reasons for requiring the amendments specified in its Final Decision.

EAPL notes that the relevant sections of the Code are 8.3 and 8.3A – 8.3H. The amendments have been drafted with a view to avoiding any unnecessary duplication or overlap between the Access Arrangement and the Code and need to be read in conjunction with the Code. At the same time the provisions are consistent with the Code.

EAPL also notes that, as it has stated in its response to Amendment 11, the escalation date for tariffs will remain 1 July each year. EAPL's amendments to tariff calculations reflect this.

13. FDA 13

EAPL has not replaced the tariffs proposed in Attachment C1 with those set out in Table 2.9.1.4. See responses to FDA 1, 7, 8, 9, 10 and 11.

EAPL has deleted Attachments C2, C3 and C4 from its Access Arrangement.

I. REFERENCE TARIFF VARIATION POLICY (section 2.10 Final Decision)

14. FDA 14

The amendments EAPL has made to its Access Arrangement should address, to the Commission's satisfaction, the matters the Commission identified in its Final Decision as being the reasons for requiring the amendments specified in its Final Decision.

In making the amendments, to avoid inconsistency between the Access Arrangement and the Code, EAPL has had regard to the relevant provisions of the Code. The amendments need to be read in conjunction with the Code.

Further, EAPL has amended the clause to include a reference to "exogenous". However, EAPL has not amended the clause to include a reference to "pronounced magnitude" and "affect the regulated firm disproportionately".

EAPL considers that these expressions are very unusual and vague in meaning and will result in uncertainty. EAPL suggests that instead, the words "where the amounts involved are material, and the detriment or benefit (as the case may be) to EAPL is significant." EAPL has amended the Access Arrangement accordingly.

EAPL notes that clause 8.7 is now clause 8.14 (see also 8.17, 8.18).

15. FDA 15

The amendments EAPL has made to its Access Arrangement should address, to the Commission's satisfaction, the matters the Commission identified in its Final Decision as being the reasons for requiring the amendments specified in the Final Decision.

In making the amendments, to avoid inconsistency between the Access Arrangement and the Code, EAPL has had regard to the relevant provisions of the Code and attempted to avoid any unnecessary duplication or inconsistency between the Access Arrangement and the Code. The amendments need to be read in conjunction with the Code.

Further, EAPL has amended clause 6.13 (now 8.15, 8.19 and 8.20) of its Access Arrangement to deal with Full Retail Contestability (FRC). EAPL has not amended its Access Arrangement to specify that the financial impact of the event must be of a "pronounced magnitude" and that "the event must affect the company disproportionately".

EAPL considers that these expressions are very unusual and vague in meaning and will result in uncertainty. EAPL suggests instead, the words "where the financial impact is material, and the detriment or benefit (as the case may be) to EAPL is significant". EAPL has amended the Access Arrangement accordingly.

16. FDA 16

EAPL has made amendments to its Access Arrangement that substantially incorporate the amendments specified by the Commission.

17. FDA 17

EAPL has made amendments to its Access Arrangement that should address, to the Commission's satisfaction, the matters the Commission identified in its Final Decision as being the reasons for requiring the amendments specified in the Final Decision.

In making the amendments, EAPL has had regard to the relevant provisions of the Code and has attempted to avoid unnecessary duplication or inconsistency between the Access Arrangement and the Code. The amendments should be read in conjunction with the Code.

18. FDA 18

The amendments EAPL has made to its Access Arrangement substantially incorporate the amendments specified by the Commission.

19. FDA 19

The amendments EAPL has made to its Access Arrangement should address, to the Commission's satisfaction, the matters the Commission has specified in its Final Decision as being the reasons for requiring the amendments.

This section of the Access Arrangement is now section 8.16.

J. TERMS AND CONDITIONS (section 3.2 Final Decision)

20. FDA 20

EAPL has made the amendments specified by the Commission in its Final Decision.

21. FDA 21

EAPL has made the amendments specified by the Commission in its Final Decision.

22. FDA 22

EAPL has made the amendments specified by the Commission in its Final Decision.

23. FDA 23

EAPL has made the amendments specified by the Commission in its Final Decision.

24. FDA 24

EAPL has made the amendments specified by the Commission in its Final Decision.

25. FDA 25

EAPL has made the amendments specified by the Commission in its Final Decision.

26. FDA 26

EAPL has made the amendments specified by the Commission in its Final Decision.

27. FDA 27

The amendments EAPL has made to its Access Arrangement should address, to the Commission's satisfaction, the matters the Commission has specified in its Final Decision as being the reasons for requiring the amendments.

The Commission has stated:

> "The Commission considers that it would be unreasonable for EAPL to expressly permit a user to deliver non-specification gas into the pipeline while still exposing the user to any damages arising out of that authorisation. Such an exposure would clearly be contrary to the interests of users (section 2.24(f))." (page 253).

EAPL does not agree with the reasoning.

If a User wants to transport non-specification gas, then they must accept the risk associated with that. It is only fair that they bear the risk of loss to other users. In regards to other users, EAPL will accept that it is to give an indemnity to other users, and rely on a "back to back" indemnity from the particular user transporting the non-specification gas.

28. FDA 28

EAPL has made the amendments specified by the Commission in its Final Decision.

29. FDA 29

EAPL has made the amendments specified by the Commission in its Final Decision.

30. FDA 30

The amendments EAPL has made to its Access Arrangement substantially incorporate the amendments specified by the Commission.

EAPL has amended clause 1(a) of Attachment D to state that EAPL will be entitled to require a user to provide security for the performance of its obligations under a transportation agreement as set out in clause 81 of this Attachment D to the Access Arrangement. EAPL has added the words " this Attachment D to" to make it clear that the reference is to clause 81 of Attachment D.

31. FDA 31

EAPL has made the amendments specified by the Commission in its Final Decision.

32. FDA 32

The amendments EAPL has made to its Access Arrangement should address, to the Commission's satisfaction, the matters the Commission has specified in its Final Decision as being the reasons for requiring the amendments.

EAPL has made the amendments specified by the Commission to the first line of Clause 73. EAPL has added a new sub-clause (a) and modified old sub-clause (a) (now sub-clause (b)). EAPL does not agree with the Commission's requirement to include sub-clause (f) for the reasons set out below:

The Commission, and others making submissions, agree with the concept that liability should be limited to direct loss in certain circumstances. The User gets the benefit of this limitation in many circumstances.

The proposed new sub-clause (f) will mean that EAPL will not get the benefit of the limitation in many circumstances. For example, much, if not all, of what EAPL is required to provide under the access arrangements arguably can be said to go to the "safety and integrity" of the pipeline.

To the extent that EAPL fails to maintain the safety and integrity of the pipeline as a result of it acting in a manner which is grossly negligent or amounts to wilful misconduct, then the indemnity in clause 72 applies and the limitation in clause 73 will not apply.

EAPL understands that it may be liable for direct losses in cases where it has not been grossly negligent or acted in a way that amounts to wilful misconduct.

The proposed new clause 73(f) means that EAPL will also be liable for indirect losses in cases where it has not been grossly negligent or acted in a way which amounts to wilful misconduct, possibly in regard everything it does. This is an unusual and unfair position.

EAPL is not clear what clause 73A is meant to cover. The drafting presented is not very precise. The general law deals with concepts of mitigation and contributory negligence (in various ways in various circumstances). If the Commission is trying to restate the general law, then the change is unnecessary and may lead to confusion. If the Commission is trying to change the general law, EAPL does not understand why.

33. FDA 33

The amendments EAPL has made to its Access Arrangement substantially incorporate the amendments specified by the Commission.

34. FDA 34

The amendments EAPL has made to its Access Arrangement substantially incorporate the amendments specified by the Commission

EAPL has not made the amendment the Commission specified to clause 59 of Attachment D. Throughput charges are only charged where gas is actually delivered. Accordingly, where there is an interruption of Services for any reason, no throughput charge will apply. However, where there is a curtailment of Services, if gas is delivered through the system, throughput charges will apply to the quantity delivered.

EAPL has made the amendments the Commission specified to clause 60 of Attachment D, other than in respect of the throughput charges.

35. FDA 35

The amendments EAPL has made to its Access Arrangement substantially incorporate the amendments specified by the Commission.

EAPL notes that the Commission's amendment omitted the word "written" in relation to prior consent. EAPL has included the word "written".

36. FDA 36

The amendments EAPL has made to its Access Arrangement substantially incorporate the amendments specified by the Commission

EAPL believes that the reference to clause 77 should have been a reference to clause 76. EAPL has made the amendments specified in FDA 36 to clause 76 of its Access Arrangement.

37. FDA 37

The amendments EAPL has made to its Access Arrangement substantially incorporate the amendments specified by the Commission.

EAPL has made the amendments required by the Commission in its Final Decision, although the Commission referred to “negotiated service”. EAPL considers that the reference should have been to the defined term “Negotiable Service” and has amended the Access Arrangement to refer to “Negotiable Service”

K. EXTENSIONS AND EXPANSIONS POLICY (section 3.6 Final Decision)

38. FDA 38

The amendments EAPL has made to its Access Arrangement substantially incorporate the amendments specified by the Commission

39. FDA 39

EAPL has decided to remove the Interconnect from the Access Arrangement. Accordingly, EAPL has not made the amendment specified by the Commission, however EAPL notes that at page 297 of the Final Decision, the Commission appears to allow EAPL to decide not to include the Interconnect in the capital base. The Commission notes that if EAPL decides not to include the Interconnect in the capital base, then EAPL must address the other provisions and aspects of the access arrangement which provide for the inclusion of the Interconnect.

EAPL has made consequential changes to the Access Arrangement.

40. FDA 40

EAPL has made the amendment specified by the Commission in its Final Decision.

L. REVIEW AND EXPIRY OF ACCESS ARRANGEMENT (section 3.7 Final Decision)

41. FDA 41

EAPL has not made the amendments specified by the Commission but has made amendments to its Access Arrangement that should address, to the Commission's satisfaction, the matters the Commission identified in its Final Decision as being the reasons for requiring the amendments specified in the Final Decision.

The Commission has requested EAPL amend its revisions submissions date to being 4 years after the Access Arrangement comes into effect. EAPL has considered the amendment with the Commission's amendment requiring a change to the date for tariff escalation.

As EAPL explained in its response to FDA 11, EAPL considers that maintaining a financial year focus is in the customers interests and the Access Arrangement period should be set to 30 June each year. In addition, rather than relative dates, EAPL has specified fixed dates.

EAPL also considers that a 12 month review period is excessive. EAPL notes that the GasNet Access Arrangement provided a 9 month assessment period. EAPL does not consider that the history of the assessment of the MSP Access Arrangement should impact on the review of the next Access Arrangement. EAPL has amended its Access Arrangement to provide for a Revisions Submission Date on 1 October 2008.