Final Approval

East Australian Pipeline Limited
Access arrangement
for the Moomba to Sydney Pipeline System

8 December 2003

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Abbreviations and glossary

access arrangement	an arrangement for third party access to a pipeline provided by a service provider and approved by the relevant regulator in accordance with the Code
access arrangement information	information provided by a service provider to the relevant regulator pursuant to section 2 of the Code
access arrangement period	the period from when an access arrangement or revisions to an access arrangement takes effect (by virtue of a decision pursuant to section 2 of the Code) until the next revisions commencement date
ACCC	Australian Competition and Consumer Commission
Agility	Agility Management Pty Ltd
AGL	Australian Gas Light Company and AGL Energy Sales and Marketing
APT	Australian Pipeline Trust
CAPM	Capital Asset Pricing Model
Code	National Third Party Access Code for Natural Gas Pipeline Systems
Commission	Australian Competition and Consumer Commission
CPI	Consumer Price Index
DORC	Depreciated optimised replacement cost
EAPL	East Australian Pipeline Limited
EGP	Eastern Gas Pipeline
Epic Decision	*Re Dr Ken Michael AM; ex parte Epic Energy (WA) Nominees Pty Ltd & Anor [2002] WASCA 231*
ESC	Victorian Essential Services Commission
FRC	Full Retail Contestability
GJ	Gigajoules (1 000 000 000 joules)
GTA	Gas Transportation Agreement
GST	Goods and Services Tax
HNET	Hypothetical New Entrant Test
ICB	Initial Capital Base
IPO	Initial Public Offering
km	kilometre
KPI	Key Performance Indicator
MDQ	Maximum Daily Quantity

MMA	McLennan Magasanik Associates
MRP	Market Risk Premium
MSP	Moomba to Sydney Pipeline System
NCC	National Competition Council
NECG	Network Economics Consulting Group
NERA	National Economic Research Associates
NPV	Net Present Value
ORC	Optimised Replacement Cost
pa	per annum
PJ	Petajoule (equal to 1 000 000 Gigajoules)
PMA	Pipeline Management Agreement
SIB	Stay In Business
SKM	Sinclair, Knight Mertz Pty Ltd
TJ	Terajoule (equal to 1 000 Gigajoules)
Tribunal	Australian Competition Tribunal
WACC	Weighted Average Cost of Capital

Executive Summary

On 2 October 2003, the Commission released its *Final Decision* on East Australian Pipeline Limited's (EAPL's) proposed access arrangement for the Moomba to Sydney Pipeline System (MSP) under the *National Third Party Access Code for Natural Gas Pipeline Systems* (the Code). In accordance with section 2.16(b)(ii) of the Code the Commission decided not to approve the MSP access arrangement in its current form and outlined 41 amendments that would be required in order for the access arrangement to be approved.

On 23 October 2003, EAPL submitted a revised access arrangement which incorporated, or substantially incorporated, 22 of the amendments. Of the remaining 19, EAPL made nine amendments in a way that it considered addressed the matters raised by the Commission and rejected the others.

On 19 November 2003, the Minister for Industry, Tourism and Resources, the Hon. Ian Macfarlane decided to revoke coverage in relation to that part of the MSP which runs between Moomba and Marsden and to otherwise maintain coverage. The Commission considers, however, that the approval process which commenced in 1999 in relation to an access arrangement for the entire MSP applies equally to the covered pipeline as it will be configured once the Minister's decision takes effect (11 December 2003). Accordingly, the Commission considers it is appropriate at this time to assess the revised access arrangement submitted by EAPL on 23 October 2003 and to make a further final decision under section 2.19 of the Code.

After considering EAPL's revised access arrangement the Commission is not satisfied that it has incorporated all the amendments specified in the *Final Decision*. The Commission is also not satisfied that EAPL has substantially incorporated or otherwise addressed the Commission's reasons for requiring the amendments. Accordingly, pursuant to section 2.19(c) of the Code, the Commission has now made a further final decision not to approve the revised access arrangement submitted by EAPL on 23 October 2003. Pursuant to section 2.20(a) of the Code, the Commission has drafted and approved its own access arrangement for the MSP.

The form of the access arrangement approved by the Commission under section 2.20(a) of the Code closely follows that proposed by EAPL which was deliberately drafted to accommodate a partial revocation of coverage. For example, like EAPL's proposed access arrangement, the Commission's access arrangement is expressed to apply to 'such parts of the MSP as are covered'. Similarly, the tariffs are expressed without reference to geographic location but rather on a distance basis. Thus, upon the Minister's decision taking effect, the access arrangement will continue to apply to such parts of the MSP as are covered under the Code.

While the Commission considers the access arrangement it has approved under section 2.20(a) of the Code is appropriate for the parts of the MSP which will remain covered once the Minister's decision takes effect, the Commission notes that EAPL may, at any time, submit proposed revisions to the access arrangement under section 2.28 of the Code.

The reasons for the Commission's further final decision are set out in both this *Final Approval* and the *Final Decision*. The remainder of this Executive Summary provides a brief outline of the key issues arising within the *Final Approval.*

***Final Approval* at a glance**

Elements	Commission's Final Decision	EAPL's proposal	Commission's Final Approval
Interconnect	In the absence of clear direction from EAPL, the Commission assumed that the Interconnect formed part of the covered pipeline. The Commission, however, required EAPL to clarify this issue in its response to the *Final Decision*.	EAPL has used its discretion to remove the Interconnect from the access arrangement.	The Commission accepts EAPL's decision.
	The difference between values adopted in the *Final Decision* and the *Final Approval* reflect the removal of the Interconnect, which also has flow-on effects to other parameters such as capital expenditure, non capital costs, depreciation, revenue and the tariff path.		
ICB	$559m	$756.9m	$545.4m
Depreciation	Total $60.6m (real July 2003)	Total $10.5m (real July 2003)	Total $63.8m (real July 2003)
Rate of return	Equity beta: 1.0 return on equity: 11.3% term of risk free rate: 5 yr benchmark rating: BBB+	Equity beta: 1.0 return on equity: 11.5% term of risk free rate: 10 yr benchmark rating: BBB EAPL also submitted new claims for a cash flow allowance for: equity issuance ($1.2m pa); debt raising ($2.27m pa); and asymmetric risk ($3.26m pa).	Equity beta: 1.0 return on equity: 11.35% term of risk free rate: 5½ yrs benchmark rating: BBB+ The Commission has rejected EAPL's claims for $6.73m in additional allowances for equity issuance, debt raising and asymmetric risk.
Non capital costs	Average $18.8m pa (real July 2003) The Commission reduced forecast non capital costs by the value of two fees payable to Agility and Petronas.	Average $23.1m pa (real July 2003) EAPL rejected the Commission's arguments in relation to the fees payable to both Agility and Petronas.	Average $18.4m pa (real July 2003) The Commission considers that the two fees payable to Agility and Petronas would not have been incurred by a prudent service provider acting efficiently.
Forecast volumes	540 TJ pa upward adjustment required.	EAPL considered the adjustment to be 'trivial' particularly in view of its conservative estimate of coal seam methane production.	The Commission no longer requires this adjustment.
Tariff path and forecast revenue	Mainline X factor 1.60% Regional X factor 0.38% Average nominal revenue of $68.1m pa. Average tariff on Moomba to Sydney segment $0.53/GJ.	Mainline X factor 0.66%* Regional X factor -2.44%* Average nominal revenue of $85.8 m pa.* Average tariff on Moomba to Sydney segment $0.68/GJ.*	Mainline X factor 1.60% Regional X factor 0.60% Average nominal revenue of $67.8m pa. Average tariff on Moomba to Sydney segment $0.51/GJ.
Review and expiry	5 year access arrangement period and 12 month review period.	5 ½ year access arrangement period and 9 month review period.	5 ½ year access arrangement period and 12 month review period.

*When the additional claim of $1.76m pa for asymmetric risk is incorporated, EAPL's has effectively proposed average revenues of $86.2m, average tariffs of $0.69/GJ for the Moomba to Sydney segment, an X factor of +0.47% for the mainline and an X factor of -2.56 % for laterals.

Key Issues arising in the *Final Approval*

The Interconnect

One of the principal differences between the *Final Decision* and the *Final Approval* is that EAPL has decided not to incorporate the Interconnect within the access arrangement (the Interconnect is not presently covered under the Code). As the Interconnect previously formed part of the proposed Initial Capital Base (ICB) for the mainline, the decision to remove the Interconnect from the access arrangement has implications not only for the value of the mainline ICB but also for forecast non capital costs, capital expenditure, depreciation, the distance northbound/southbound gas is transported, revenue and tariffs. Accordingly, EAPL has submitted a revised value for the ICB and deducted approximately 2.84 per cent[1] from the total capital expenditure and non capital costs which it claims can be attributed to the Interconnect. These revised values have flowed through to tariffs, revenue and in turn economic depreciation.

As confirmed in the *Final Decision,* EAPL's decision to exclude the Interconnect from the access arrangement is within its prerogative. The Commission has examined the revised parameters submitted by EAPL and is satisfied that EAPL has made the necessary amendments to remove the costs attributable to the Interconnect.

Reference tariff methodology, tariffs and revenue

Using the NPV methodology and its revised assumptions for the value of the ICB, capital costs, non capital costs, rate of return and additional cash flow allowances for equity issuance, debt raising and asymmetric risk, EAPL has now proposed an X factor of 0.66 per cent for the mainline and -2.44 per cent for regional laterals commencing at current published tariffs.[2] These price paths produce average revenue of $85.8 million per annum (nominal) over the period 2004 – 2009 and an average tariff of 0.0526 cents/GJ/km on the mainline and 0.0569 cents/GJ/km on the regional laterals. This translates to an average tariff of 68 cents per GJ on the Moomba to Sydney segment of the pipeline. EAPL has retained the provision to vary tariffs on a financial year basis (1 July) using March CPI data.

The Commission has accepted EAPL's proposal to adjust tariffs on a financial year basis. Taking this into account as well as the adoption of a five and a half year risk free rate and the effect of the removal of the Interconnect on the mainline, the Commission has retained the X factor set out in the *Final Decision* of 1.60 per cent but has reduced starting tariff. The average tariff on the mainline is now 0.0389 cents/GJ/km which translates to an average tariff of 51 cents per GJ on the Moomba to Sydney segment. On the regional laterals, an X factor of 0.60 per cent has been adopted starting from current published tariffs. The average tariff on the regional laterals is now

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1 The 2.84 per cent is based on the ratio of the ORC of the Interconnect ($29.5 million) to the ORC of the total system ($1.042 billion).

2 Following the claim by EAPL on 11 November 2003 for an additional $1.76 million pa for asymmetric risk, the Commission has updated the models submitted by EAPL. When this additional allowance is included, EAPL's has effectively proposed an X factor of +0.47 per cent for the mainline and -2.56 per cent for regional laterals.

0.0535 cents/GJ/km. These price paths produce average revenue of $67.8 million per annum (nominal) over the period 2004 – 2009.

Initial capital base

EAPL did not agree with the Commission's value for the ICB of $559.3 million (real July 2003). EAPL submitted that the Commission did not correctly apply section 8.10(g) of the Code[3] and erred in concluding that EAPL's proposed ICB value of $779 million (real July 2001) did not satisfy the requirements of section 8.10(g). EAPL was also critical of the Commission's use of a 50 year asset life as a consideration under section 8.10(f)[4] in establishing the value of the ICB. Other areas of disagreement include the Commission's decision to exclude the 10 per cent allowance for contingencies from the optimised replacement cost (ORC) and the methodology for deriving the depreciated optimised replacement cost (DORC).

The Commission does not agree with EAPL's arguments and does not consider that EAPL has addressed the concerns raised in the *Final Decision*. For the purposes of the access arrangement the Commission has approved a value for the ICB of $545.4 million (real July 2003), which is the *Final Decision* ICB less the value of the Interconnect.

Depreciation

While the Commission accepted EAPL's depreciation methodology in the *Final Decision*, it did not accept the schedule of depreciation charges. Under the economic depreciation approach proposed by EAPL, depreciation is the residual after other costs are deducted from revenue. Accordingly, the differences in the level of depreciation charges proposed by EAPL and the Commission can be attributed to the differences in the input factors that comprise the revenue requirements, such as the value of the ICB.

Weighted average cost of capital

EAPL has accepted an equity beta of one, forecast inflation and the Commission's estimation of the effective tax rate. However, EAPL had some concerns with the term of the risk free rate and the credit rating assumed for the derivation of the debt margin. EAPL further submitted that it should receive additional allowances totalling $6.7 million for equity issuance, debt raising and asymmetric risk.

In relation to the risk free rate, EAPL submitted that the 10 year bond rate should form the basis of the risk free rate instead of rates matching the length of the regulatory period as was required by the Commission. The Commission disagrees with the arguments put forward by EAPL and still considers that the risk free rate should be based on bonds with maturity matching the regulatory period (now five and a half years). The issue of the term of the risk free rate is currently being considered by the Australian Competition Tribunal (the Tribunal) with respect to GasNet Australia (Operations) Pty Ltd. The Commission therefore notes that if the Tribunal decides that

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[3] Section 8.10(g) requires the regulator to consider the reasonable expectations of persons under the regulatory regime that applied prior to the commencement of the Code.

[4] Section 8.10(f) requires the regulator to consider the basis on which tariffs have been (or appear to have been) set in the past, economic depreciation and historical returns to the service provider.

a 10 year government bond rate is the appropriate risk free rate for GasNet (on the basis that these rates are the most appropriate irrespective of GasNet's specific circumstances), then EAPL may, in accordance with section 2.28 of the Code, submit revisions to the access arrangement.

In relation to the appropriate benchmark credit rating, EAPL disagreed with the BBB+ rating adopted by the Commission and submitted that a BBB rating was appropriate. The Commission has assessed EAPL's arguments for the adoption of a BBB benchmark rating, and considers that these contentions do not undermine the arguments put forward in the *Final Decision* in support of a BBB+ benchmark.

EAPL has also submitted that an annual allowance of $3.26 million for asymmetric risk arising from competition and reserve risk was appropriate, albeit conservative. The Commission does not consider that an additional cash flow allowance for competition risk and reserve risk is necessary. First, the Commission has concerns with the assumptions which underpin NECG's estimation of the annual $3.26 million allowance. Second, the Commission considers that an allowance for the loss of market share to the Eastern Gas Pipeline (EGP) and coal seam methane has already been incorporated into EAPL's forecast volumes over the access arrangement period. Finally, the Commission notes that EAPL's claims regarding reserve risk appear to be inconsistent with the volume forecasts it has submitted to the Commission and its argument that the relevant life of the pipeline assets is 80 years.

EAPL also claimed an allowance of $3.47 million for equity issuance and debt raising costs. These matters have not previously been submitted by EAPL in connection with its proposed access arrangement. Introduction of these new items at this late stage of the process does not permit the Commission to give them due consideration, including allowing appropriate public consultation. Accordingly, the Commission does not consider it appropriate to incorporate these provisions.

Non capital costs

EAPL submitted that the Commission erred in not allowing the Pipeline Management Fee within its non capital costs. EAPL also submitted that outsourcing of pipeline operations is economically efficient, prudent and part of recognised industry practice. In addition EAPL submitted that the Commission erred in reducing the level of marketing costs under the agreement with Petronas and stated that the costs reflected the costs incurred in performing this function prior to the float of the APT.

Despite comments by EAPL to the contrary, the Commission is not opposed to outsourcing of certain functions, provided it is undertaken in a manner which is consistent with the Code. The Commission does not, however, consider that EAPL has addressed its concerns regarding whether the two fees payable to Agility Management Pty Ltd (Agility) and Petronas would have been incurred by a prudent service provider acting efficiently.

Volumes

EAPL did not accept the Commission's adjustment of an average 540 TJ per annum to reflect an underestimation of the base year volume forecasts. EAPL asserted that the

adjustment was trivial and noted that if it had assumed higher coal seam methane production, forecast throughput on the MSP would have been lower.

The Commission maintains its view that the reasons for requiring the adjustment to the base year were not trivial given that section 8.2(e) requires forecasts to be best estimates arrived at on a reasonable basis. That said, the Commission acknowledges that when combined with EAPL's potentially conservative position on coal seam methane production, the amendment required in the *Final Decision* is unnecessary.

Reference tariff variation methodology

The *Final Decision* allowed EAPL to adjust tariffs for the impact of variations to taxes (and similar charges) and the costs associated with Full Retail Contestability (FRC), subject to these costs being exogenous, of pronounced magnitude and affecting the regulated firm disproportionately. The *Final Decision* also set out a mechanism for the submission and approval of pass through events that may arise.

EAPL's response broadly complies with the pass through proposals put forward by the Commission. Whilst EAPL did not incorporate the specific criteria for pass through events, the wording incorporated in the revised access arrangement addresses the reasons for the amendment as set out in the *Final Decision*. The Commission has made a number of minor amendments to the mechanics of the pass through mechanism to ensure consistency with the *Final Decision* and the relevant elements of the Code.

In the *Final Decision* the Commission also required a number of amendments to EAPL's proposal to impose a minimum distance on lateral tariffs. Whilst EAPL's response broadly complies with the Commission requirements, the Commission has amended the revised access arrangement so that the timeframes are in business day terms. The Commission has also amended the access arrangement to require EAPL to demonstrate how the variation satisfies the principles set out in section 8.1 of the Code.

Terms and conditions

EAPL largely accepted the Commission's amendments relating to terms and conditions although it had concerns with two of the proposed amendments. EAPL's first concern related to the Commission's inclusion of reciprocal indemnities in cases where it provides an express authorisation for the delivery of non-specification gas. EAPL submitted an amended clause which it considered would satisfy the Commission. The second concern related to the Commission's amendment of the liabilities and indemnities provision. EAPL was particularly concerned with the inclusion of sub clauses 73(f) (which imposed strict liability for damage or loss upon EAPL in cases where it failed to maintain the safety and integrity of the pipeline) and 73A (which limited liability in cases where the loss could have been mitigated or where the loss was suffered as a result of contributory negligence).

The Commission does not consider that EAPL's proposed amendment to the reciprocal indemnity provision will achieve the symmetry envisaged by the *Final Decision*. The Commission also notes that it is difficult to reach a firm view as to the reasonableness or otherwise of the proposed clause in advance of a dispute. The Commission considers that this would be better left to be negotiated between the parties and accordingly has decided not to include an indemnity clause in relation to non-

specification gas in the access arrangement. That is the Commission no longer requires the amendment set out in the *Final Decision*.

In relation to sub clause 73(f) and clause 73A, the Commission is satisfied that EAPL has adequately addressed the reasons for requiring sub clause 73(f) and clause 73A. Accordingly, the Commission no longer requires these amendments.

The review and expiry date

The Commission has accepted EAPL's proposed term of five and a half years to bring the financial year tariff adjustment into line. The Commission, however, maintains its view that a 12 month review period is appropriate.

1. Introduction

1.1 Background

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

The Commission released its *Draft Decision* on EAPL's proposed initial access arrangement on 19 December 2000. It proposed not to approve the access arrangement in its current form. The Commission identified a number of amendments to the proposed access arrangement that would need to be satisfactorily incorporated in a revised access arrangement in order for it to be approved (pursuant to section 2.13(b) of the Code).

In June 2001, EAPL applied to the National Competition Council (NCC) for partial revocation of coverage of the MSP under the Code. At the same time, EAPL requested that the Commission delay the release of its *Final Decision* on the access arrangement pending the NCC's *Final Recommendation* with regard to the revocation of coverage issue. The Commission agreed to EAPL's request subject to a six month review.

At the review of this decision in January 2002, the Commission received a further request from EAPL to postpone the *Final Decision*. After careful consideration of the request the Commission decided that it would not be in the public interest to delay the assessment process further. This was based on the fact that the *Draft Decision* was 12 months old and the NCC had made a *Draft Recommendation* not to revoke coverage based on the Commission's findings in the *Draft Decision*.

EAPL had previously advised the Commission (on 14 March 2001) of its concerns with the original access arrangement (submitted prior to Australian Pipeline Trust's (APT) acquisition of EAPL) and foreshadowed its intention to submit a revised access arrangement. The revised access arrangement was submitted on 30 April 2002. In November 2002, following the release of the WA Court of Appeal's ruling on the Dampier to Bunbury pipeline access arrangement[6] (the Epic Decision), EAPL submitted further revisions to the proposed value of the initial capital base (ICB). In May 2003, following the announcement by AGL that it had entered into a new portfolio of gas supply contracts, EAPL submitted further revisions to the proposed capital expenditure and volumes to be transported on the MSP.

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

[6] *Re: Dr Ken Michael AM; ex parte EPIC Energy (WA) Nominees Pty Ltd & Anor [2002] WASCA 231*, 23 August 2002.

The Commission's assessment of the proposed access arrangement was conducted in accordance with the requirements set out in the Code. It involved public consultation and the examination of information provided by EAPL and interested parties.

On 2 October 2003, the Commission issued a *Final Decision* in which it decided, pursuant to section 2.16(b)(ii) of the Code, not to approve the access arrangement proposed by EAPL. The *Final Decision* set out the amendments (or nature of the amendments) which would be required in order for the Commission to approve EAPL's access arrangement. The *Final Decision* required EAPL to submit a revised access arrangement to the Commission incorporating the required amendments by 23 October 2003.

On 14 October 2003, EAPL requested that the deadline for submission of the revised access arrangement be extended to 13 November 2003. In requesting this extension EAPL claimed, amongst other things, that:

- the *Final Decision* was voluminous and specified a total of 41 amendments;
- it needed to obtain advice on its response to various aspects of the *Final Decision* and the executive team needed to report to the Board of APT; and
- the time specified in the *Final Decision* was less than reasonable given the circumstances.

On 16 October 2003, the Commission responded to EAPL's request for an extension. The Commission noted that it had considered each of the reasons put forward by EAPL but had decided that 23 October 2003 would remain the last day for the submission of a revised access arrangement. In reaching this decision, the Commission noted that it had acted in accordance with section 2.21(c) of the Code, which states that there must be a period of at least 14 days between the publication of a final decision under section 2.16(b)(ii) and the date specified by the regulator as the last day for the service provider to submit a revised access arrangement.

On 23 October 2003, EAPL submitted an amended revised access arrangement, pursuant to section 2.18 of the Code. At the same time EAPL submitted revised access arrangement information and various submissions outlining its position regarding the 41 amendments set out in the *Final Decision*. These submissions included a report from the Network Economics Consulting Group (NECG) regarding the weighted average cost of capital (WACC).

Within its submission EAPL agreed to make, or substantially incorporate, 25 of the amendments specified by the Commission. The Commission notes, however, that three of these did not completely conform to the amendments specified in the *Final Decision.* Thus EAPL has only agreed to make, or substantially incorporate, 22 of the amendments specified by the Commission. Of the remaining 19 amendments, EAPL made ten amendments which it considered would address to the Commission's satisfaction the matters identified in the *Final Decision*. The remaining nine amendments were rejected.

Apart from responding to the issues raised in the *Final Decision,* EAPL's submission raised three new issues which it required additional allowance for:

- debt raising costs ($2.27 million per annum);
- equity raising costs ($1.2 million per annum); and
- asymmetric risk ($1.5 million – $3.26 million per annum) arising from:
  - competition risk;
  - reserve risk;
  - regulatory risk;
  - credit risk; and
  - deductibles in current insurance.

Since the submission of the revised access arrangement on 23 October 2003, the Commission requested clarification of a number of elements of EAPL's submission. EAPL responded to the Commission's requests and has also provided several additional submissions in relation to the ICB, asymmetric risks and terms and conditions. A brief overview of this correspondence is set out below.

On 24 October 2003, the Commission requested EAPL amend the revised access arrangement information to reflect its decision to remove the Interconnect. The Commission made this request because the access arrangement information submitted by EAPL on 23 October 2003 did not set out the impact that this removal would have on operating costs and capital expenditure elements of tariffs. The Commission also requested that EAPL submit the models used to derive tariffs. These were then submitted by EAPL on 27 October 2003.

On 29 October 2003, EAPL submitted partially revised access arrangement information to reflect the removal of the Interconnect and its decision to change the term of the access arrangement period to January 2004 – July 2009. At the same time EAPL submitted a consultancy report from Venton & Associates regarding the contingency included in the ORC estimation. A further report from NECG regarding the Hypothetical New Entrant Test (HNET) was also submitted.

On 31 October 2003, EAPL submitted a public version of its submission in response to the *Final Decision.*

On 6 November 2003, EAPL submitted further details regarding the relationship between the NERA and Agility formulations of NPV DORC.

On 11 November 2003, EAPL submitted further confidential legal advice in support of its rejection of amendments FDA 27 and 32. These two amendments related to authorised non-specification gas and liabilities and indemnities. EAPL also submitted a report from NECG which outlined its contentions regarding the quantum of the allowance required for asymmetric risk. This allowance was revised from the $1.5 million claimed in the original submission on 23 October 2003, to $3.26 million per annum.

The Commission notes that while EAPL considered the 21 day deadline for the submission of its revised access arrangement as unreasonable, from the chronology of submissions listed above it can be seen that this deadline has in no way restricted EAPL

from making further submissions during the two month period since the release of the *Final Decision* to the release of the *Final Approval*. The Commission further notes that within a number of the submissions EAPL has claimed new cash flow allowances totalling over $6.7 million which have not previously been brought to the attention of the Commission or interested parties.

1.2 Code requirements for the assessment of a revised access arrangement

Section 2.19 of the Code, provides that where, following the final decision, a service provider submits amended revisions, the regulator is required to issue a further final decision that:

a. if the Relevant Regulator is satisfied that the revised Access Arrangement incorporates the amendments specified by the Relevant Regulator in its final decision under Section 2.16(a)(ii) or (b)(ii), approves the revised Access Arrangement; or

b. if the Relevant Regulator is satisfied that the revised Access Arrangement either substantially incorporates the amendments specified by the Relevant Regulator or otherwise addresses to the Relevant Regulator's satisfaction the matters the Relevant Regulator identified in its final decision as being the reasons for requiring the amendments specified in its final decision under section 2.16(a)(ii) or (b)(ii), either approves or does not approve the revised Access Arrangement (in the Relevant Regulator's discretion); or

c. in any other case, does not approve the revised Access Arrangement.

Where the regulator does not approve the revised access arrangement (pursuant to section 2.19) or the service provider does not submit a revised access arrangement by the date specified by the regulator under section 2.16(b)(ii), the regulator must 'draft and approve its own Access Arrangement instead of the Access Arrangement proposed by the Service Provider' (section 2.20(a)).

In accordance with section 2.26 of the Code, a decision by the regulator under section 2.20(a) is:

> Subject to review by the Relevant Appeals Body under the Gas Pipelines Access Law. Subject to the Gas Pipelines Access Law, the Relevant Regulator's decision to approve the proposed Access Arrangement has effect on the date specified by the Relevant Regulator, which date must be not less than 14 days after the day the decision was made.

1.3 Revocation of coverage between Moomba and Marsden

On 19 November 2003, the Minister for Industry, Tourism and Resources, the Hon. Ian Macfarlane, released his decision on EAPL's application for the revocation of coverage on the Moomba to Wilton pipeline and the Canberra lateral. In accordance with section 1.34 of the Code, the Minister decided that:[7]

- The Canberra lateral satisfied each of the criteria in section 1.9 of the Code; and

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[7] Minister for Industry, Tourism and Resources, the Hon. Ian Macfarlane, *Statement of Reasons: Applications for revocation of coverage on certain portions of the Moomba to Sydney Gas Pipeline System*, 19 November 2003, p. 3.

- The MSP mainline in its entirety satisfied criteria a, c and d of section 1.9 of the Code, however, only the pipeline segment from Marsden to Wilton satisfied criterion b. Accordingly, the Minister decided to revoke coverage between Moomba and Marsden.

The effective date of the Minister's decision is 11 December 2003.

1.4 Further final decision

In accordance with the Minister for Industry, Tourism and Resources' decision, the Moomba to Marsden segment of the MSP mainline will no longer be covered from 11 December 2003.[8] The Commission considers, however, that the approval process which commenced in 1999 in relation to an access arrangement for the entire MSP applies equally to the covered pipeline as it will be configured once the Minister's decision takes effect. Accordingly, the Commission considers it is appropriate at this time to assess the revised access arrangement submitted by EAPL on 23 October 2003 and to make a further final decision under section 2.19 of the Code.

After considering EAPL's revised access arrangement submitted in response to the *Final Decision*, the Commission is not satisfied that it has incorporated all the amendments specified in the *Final Decision*. The Commission is also not satisfied that EAPL has substantially incorporated or otherwise addressed the Commission's reasons for requiring the amendments. Accordingly, pursuant to section 2.19(c) of the Code, the Commission has now made a further final decision not to approve the revised access arrangement submitted by EAPL on 23 October 2003. The reasons for this decision are set out in Chapter 2 of this *Final Approval* and the *Final Decision*. As a result of this decision, the Commission is required, in accordance with section 2.20(a) of the Code, to draft and approve its own access arrangement.

The access arrangement approved by the Commission under section 2.20(a) closely follows the form and structure of the access arrangements proposed by EAPL during the assessment process. It is deliberately drafted to accommodate a partial revocation of coverage. For example, like EAPL's proposed access arrangement, the Commission's access arrangement is expressed to apply to 'such parts of the MSP as are covered'. Similarly, the tariffs are expressed without reference to geographic location but rather on a distance basis. Thus, upon the Minister's decision taking effect, the access arrangement will continue to apply to such parts of the MSP as are covered under the Code.

While the Commission considers the access arrangement it has approved under section 2.20(a) of the Code is appropriate for the parts of the MSP which will remain covered once the Minister's decision takes effect, the Commission notes that EAPL may, at any time, submit proposed revisions to the access arrangement under section 2.28 of the Code.

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[8] The Commission notes that the decision by the Minister to revoke coverage of this segment of the pipeline is subject to appeal. If such an appeal occurs then the Minister's decision will be stayed pending the handing down of the Australian Competition Tribunal's decision.

2. Assessment of the revised access arrangement

Chapter 2 of this *Final Approval* sets out the Commission's assessment of whether the revised access arrangement submitted by EAPL on 23 October 2003:

- incorporates (or substantially incorporates) the amendments specified in the *Final Decision*; or
- otherwise addresses the matters identified in the *Final Decision* as being the reasons for requiring the amendments.

As outlined in the introduction, EAPL agreed to make or substantially incorporate 25 of the amendments specified by the Commission. The Commission notes however that three of these did not completely conform to the amendments specified in the *Final Decision* and should therefore be categorised as addressing the matters identified in the *Final Decision* as being the reasons for requiring the amendment. Thus EAPL has only agreed to make, or substantially incorporate, 22 of the amendments specified by the Commission. The amendments incorporated fully are set out in section 2.1. Of the remaining 19 amendments, EAPL made ten amendments which it considered would address to the Commission's satisfaction the matters identified in the *Final Decision*. These ten amendments related to:

- the tariff path (amendment FDA 12);
- the pass through mechanism (amendment FDA 14, 15, 16, 17 and 18);
- the minimum distance on laterals (amendment FDA 19);
- non-specification gas (amendment FDA 27);
- liabilities and indemnities (amendment FDA 32); and
- force majeure (amendment FDA 34).

EAPL rejected the remaining nine amendments which related to:

- the value of the ICB (amendment FDA 1);
- depreciation (amendment FDA 7);
- the WACC (amendment FDA 8);
- non capital costs (amendment FDA 9);
- volumes (amendment FDA 10);
- the tariff path (amendment FDA 11);
- tariffs (amendment FDA 13);
- the Interconnect (amendment FDA 39); and
- the review and expiry date (amendment FDA 41).

As can be seen in the list above one of those amendments which EAPL rejected was the treatment of the Interconnect. Specifically, EAPL has decided not to incorporate the Interconnect within the access arrangement (the Interconnect is not presently covered

under the Code). The Commission notes as it did in the *Final Decision* that the Interconnect is not currently a covered pipeline. Accordingly, EAPL's decision to exclude it from the access arrangement is within its prerogative.

As the Interconnect formed part of the mainline in the *Final Decision*, its removal from the access arrangement has implications not only for the value of the mainline ICB but also for forecast non capital costs, capital expenditure, depreciation, tariffs and the distance that northbound and southbound gas is transported. The mainline in the *Final Approval* is now defined as the Moomba to Wilton pipeline, the Young to Wagga Wagga lateral (Wagga lateral) and the Dalton to Watson lateral (Canberra lateral).

The only issue remaining for the Commission to consider is whether or not those clauses relating to the Interconnect have been removed from the access arrangement and in turn whether the costs associated with the Interconnect have been removed from the derivation of total revenue and the reference tariff.

With regard to the access arrangement, the Commission notes that all references to the Interconnect have been removed. The Commission further notes that EAPL has submitted a revised value for the ICB which excludes the value of the Interconnect. EAPL has also deducted approximately 2.84 per cent[9] from the total capital expenditure and non capital costs which it claims can be attributed to the Interconnect. The effect of the removal of the Interconnect on the value of the ICB, capital expenditure, depreciation, non capital costs, revenue and tariffs along with the Commission's assessment of EAPL's response to each of the amendments contained in the *Final Decision* is set out below.

2.1 Amendments incorporated fully

The Commission is satisfied that EAPL has incorporated, or substantially incorporated, the following amendments.

- FDA 2 relating to new facilities investment has been incorporated into clause 8.4;
- FDA 3 relating to new facilities investment has been incorporated into clause 8.6;
- FDA 4 relating to the speculative investment fund has been incorporated into clause 14.3 (now clause 8.7);
- FDA 5 relating to the speculative investment fund has been relocated and is now clause 8.7;
- FDA 6 relating to capital redundancy has been incorporated into clause 8.8;
- FDA 20 relating to terms and conditions has been incorporated into Attachment A;
- FDA 21 relating to receipt and delivery points has been incorporated into clause 77(f) of Attachment D;
- FDA 22 relating to balancing has been incorporated into clauses 2(b) and 6(b) of Attachment E;

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[9] The 2.84 per cent is based on the ratio of the ORC of the Interconnect ($29.5 million) to the ORC of the total system ($1.042 billion).

- FDA 23 relating to balancing has been incorporated into Attachment E;
- FDA 24 relating to balancing has been incorporated into Attachment C5 (now Attachment C2);
- FDA 25 relating to gas quality has been incorporated into Attachment G;
- FDA 26 relating to non-specification gas has been incorporated into clause 23 of Attachment D;
- FDA 28 relating to prudential requirements has been incorporated into clause 12.26;
- FDA 29 relating to prudential requirements has been incorporated into clause 76(h) of Attachment D;
- FDA 30 relating to prudential requirements has been incorporated into clause 1(a) of Attachment D;
- FDA 31 relating to overruns has been incorporated into clause 4(b) of Attachment C5 (now Attachment C2);
- FDA 33 relating to the order of priority of service has been incorporated into clauses 6.10, 9.2 and 10.1 of the access arrangement and into clause 54 of Attachment D;
- FDA 35 relating to assignment has been incorporated into clause 65 of Attachment D;
- FDA 36 relating to the trading policy has been incorporated into clause 76 of Attachment D;
- FDA 37 relating to the queuing policy has been incorporated into clause 12.23;
- FDA 38 relating to the extensions and expansions policy has been incorporated into the access arrangement and is now clause 14.2; and
- FDA 40 relating to the extensions and expansions policy has been incorporated with the removal of what was previously clause 14.2.

2.2 The initial capital base

Amendment FDA 1

2.2.1 Amendment required

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).

The Commission's reasons for requiring this amendment are set out on pages 39 – 75 of the *Final Decision*.

2.2.2 EAPL's response to the *Final Decision*

EAPL did not incorporate, nor substantially incorporate, the amendment specified by the Commission. EAPL sought to address the Commission's reasons for requiring this amendment by making submissions on the following issues:

- the methodology for deriving the depreciated optimised replacement cost (DORC) from the optimised replacement cost (ORC);
- the exclusion of a contingency factor in the calculation of ORC;
- the application of section 8.10(f) of the Code, which requires the regulator to have regard to the basis on which tariffs have been set (or appear to have been set) in the past, economic depreciation and historical returns;
- the interpretation of section 8.10(g) of the Code, which requires the regulator to have regard to the reasonable expectations of persons under the previous regulatory regime; and
- the construction of the hypothetical new entrant test.

2.2.3 Commission's considerations

Construction of DORC from ORC

The Commission used a straight line approach to derive DORC from ORC. The Commission's reasons for taking this approach are in its *Final Decision* at pages 45 – 46.

EAPL did not agree with the Commission's use of straight line depreciation to derive the value of DORC from ORC. EAPL reiterated its previous arguments that the NPV approach, advocated by Agility Management Pty Ltd (Agility), is the more appropriate methodology.

In a subsequent submission EAPL quoted from a report prepared by NERA in connection with the New Zealand Commerce Commission's Gas Control Inquiry. In that submission NERA stated:

> These recent statements by NERA suggest that the Commission's reliance on NERA's 2002 Report in regard to the difficulties and uncertainties in the cost-based calculation [NERA's approach to DORC] may have been misplaced.[10]

The Commission considers that the reference to NERA's report in relation to the New Zealand Commerce Commission's inquiry has been taken out of context and accordingly EAPL's conclusion is unfounded.

The Commission does not consider that EAPL's submission adequately addresses the concerns raised by the Commission in relation to construction of DORC for the MSP. For the reasons outlined in its *Final Decision*,[11] the Commission considers that the use

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10 EAPL, Submission to the Commission, 6 November 2003, p. 3.

11 ACCC, *Final Decision: East Australian Pipeline Limited Access Arrangement for the Moomba to Sydney Pipeline System*, 2 October 2003, pp. 40-47.

of straight line depreciation is the most appropriate methodology for deriving the DORC for the MSP.

It is worth noting that neither EAPL nor the Commission considered that the ICB should be established at the value of DORC.

EAPL also referred to the Agility approach to DORC in the context of section 8.10(c) of the Code, which requires the regulator to consider other well recognised valuation methodologies. EAPL stated that:

> The Commission, at page 46 [of the *Final Decision*] acknowledges that a NPV-based value established by reference to the HNEC [hypothetical new entrant construct], if not the DORC value, is a 'well recognised asset valuation methodology' that could be taken into account under section 8.10(c)…[12]

This is an incorrect interpretation of the Commission's position. The Commission did not acknowledge that the Agility approach to DORC was a well recognised asset valuation methodology. In fact the Commission suggested the opposite:

> …this suggests that the method to be used to determine the value of DORC must be a well recognised asset valuation methodology. Certainly the straight line method of depreciation falls within this category, in contrast with the Agility approach which would appear to be a relatively new method.[13]

Exclusion of the contingency factor

EAPL's proposed value for ORC included a 10 per cent allowance for an item it described as 'contingencies'[14], which accounted for $82 million (real July 2000) of the ORC of $1058 million estimated by EAPL's consultant, Venton and Associates Pty Ltd (Venton).

In establishing the value of ORC the Commission excluded this allowance. It considered that inclusion of an allowance for contingencies may be appropriate when a firm is estimating the costs of constructing a new pipeline. The Commission did not consider, however, that its inclusion was appropriate for determining the value of ORC for regulatory purposes of an existing pipeline.[15]

EAPL submitted that the Commission misunderstood the nature of the contingency factor. EAPL stated:

> 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.[16]

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12 EAPL, Submission in response to the Final Decision, 31 October 2003, p. 8.

13 ACCC, *Final Decision: MSP*, 2 October 2003, pp. 42-43.

14 The 10 per cent contingency factor was applied to most cost items that comprised the ORC.

15 ACCC, *Final Decision: MSP*, 2 October 2003, pp. 41-42.

16 EAPL, Submission in response to the Final Decision, 31 October 2003, p. 7. The Venton report referred to is Venton and Associates Pty Ltd, *Optimised design and cost estimate EAPL pipeline network,* 20 June 1999.

EAPL also provided a letter from Venton and Associates which was critical of the Commission's decision to exclude the $82 million allowance for contingencies. Venton stated:

> On review of the Venton report, I acknowledged that the reason for and the treatment of the contingency could have been better described and justified.
>
> No special comment was made because a contingency allowance was considered as part of a capital cost estimate, and it was not considered necessary to elaborate on the magnitude or reason for it.[17]

Venton further stated:

> The Venton estimate expects that the money in the contingency cost category will be spent, based on its experience. The money is allocated against a contingency item because at the level of detail at which the estimate was undertaken the estimator in his experience, knows that there are a multiple of real cost items that are not included in the major component costs. [18]

Venton stated that it is industry practice for these 'known but not identified items' to be allowed for in an item called contingency.[19]

Rather than identify and quantify each of these unspecified items, Venton has applied an across-the-board 10 per cent as an average cost to cover these items. Venton provided only a few examples of areas which justify the inclusion of a contingency factor. These mainly related to the granting of easements and compensation to landowners. Much of Venton's arguments seem to rely on comparisons with the cost of constructing new pipelines, such as the EGP. However, Venton did also discuss the changing circumstances surrounding the MSP since its construction in 1974, which Venton argued justified the inclusion of a contingency factor.

The Commission notes that the ORC estimate submitted by Venton contained cost categories for these items under the headings 'Survey & Easement' and 'Environment'. The combined contribution to the ORC of these two categories is $44.3 million, 10 per cent of which is only $4.4 million of the total allowance for contingencies of $82 million.

In other access arrangements that the Commission has assessed, the Commission has not allowed a separate allowance for contingencies. The Commission further notes that all service providers have not proposed a contingency in the valuation of ORC.

Despite the submissions of EAPL and Venton, the Commission does not consider that EAPL has sufficiently justified the inclusion of an across-the-board contingency factor amounting to $82 million to cover the costs of 'unspecified items which are anticipated but not itemised'.

The exact costs of replacing an existing pipeline are unknown and can only be estimated. The uncertainty surrounding estimates of ORC is illustrated in the Venton report, in which Venton has allowed a plus or minus 20 per cent tolerance level in the estimate, in addition to the 10 per cent allowance for contingencies. The Commission

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[17] Venton & Associates Pty Ltd, *Letter to APT*, 28 October 2003, p. 2.

[18] Venton & Associates Pty Ltd, *Letter to APT*, 28 October 2003, p. 2.

[19] Venton & Associates Pty Ltd, *Letter to APT*, 28 October 2003, p. 3.

considers that the value of ORC determined in the *Final Decision* is a reasonable estimate as an input factor in determining the regulated value of the ICB of the MSP.

Application of section 8.10(f) of the Code

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

EAPL's submission of 23 October 2003 stated that the Commission did not rely on two of the matters mentioned in section 8.10(f), namely the basis for past tariffs and historical returns, but focused solely on the other matter, economic depreciation. EAPL further argued that the Commission erred in its consideration of economic depreciation by having regard to an accounting concept of depreciation rather than the economic concept of depreciation.

The Commission considers this is an inaccurate characterisation of its discussion. Within the *Final Decision*[20] the Commission had regard to section 8.10(f) as a whole and has not restricted its analysis in the manner suggested by EAPL.

EAPL submitted that the proper application of section 8.10(f) required the Commission to have regard to an economic written down value, which EAPL estimated at $1,700 million. EAPL calculated this value as the initial cost of the MSP (from the time it was commissioned in 1977) less economic depreciation to date. The Commission considered EAPL's proposed written down economic value of $1,700 million in the context section 8.10(f). However, for reasons outlined in the *Final Decision*[21] the Commission gave it little weight in establishing the value of the ICB.

The Commission's *Final Decision* gave weight to fact that, until the year 2000, EAPL assumed a useful life of 50 years for the pipeline. EAPL submitted that the Commission ought not to have given weight to the 50 year asset life assumed by EAPL as this was used for accounting purposes only and did not reflect the basis upon which EAPL based tariffs.

Notwithstanding EAPL's comments, the Commission considers that the 50 year asset life is the basis on which tariffs appear to have been set since 1994. It is clear from EAPL's statutory accounts that EAPL assumed a useful life of 50 years (32.5 years remaining useful life) for the MSP to 2000. Moreover, EAPL's 'reasonable expectations' valuation, which represented EAPL's estimated future cash flows as at 1998, is based on an assumed asset life of 50 years. The Australian National Audit Office also noted that estimates of the value of the MSP at the time of the 1994 sale were based on the assumption of a 50 year life.[22]

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20 ACCC, *Final Decision: MSP*, 2 October 2003, pp. 52-56.

21 ACCC, *Final Decision: MSP*, 2 October 2003, pp. 52-53 and pp. 66-72.

22 ANAO, *Sale of the Moomba to Sydney Gas Pipeline,* Audit Report No. 10, 1995-96, p. 25.

The Commission considers that the evidence suggests that the assumed 50 year life was more than an accounting convention as stated by EAPL, but had represented the expected life of the pipeline. That the assumed life is now 80 years can be attributed to factors such as the increasing prospect of Moomba becoming a hub for northern gas and the extension of the technical life of the Moomba to Wilton mainline through refurbishment.

Commission's calculation of the ICB

While not agreeing with the Commission's methodology to determine its ICB of $559.3 million, EAPL submitted that the Commission erred in its application.

First, EAPL submitted that the Commission, in using a 50 year life to determine the value of the ICB from the ORC, had assumed that the MSP is a single asset commissioned in 1977. According to EAPL, if account is taken of the fact that the laterals were built after 1977, a value for the ICB of no less than $595 million would result.

EAPL's arguments appear to contradict the approach adopted by EAPL in practice. EAPL treated the MSP as a whole when it assumed an asset life of 50 years and did not distinguish between pipelines of different ages. Moreover, EAPL's argument contradicts the assumptions in its NPV approach to setting tariffs in which EAPL assumed that the life of all pipelines comprising the MSP expires in 2056. In other words, EAPL has not assumed a later expiry date for the laterals notwithstanding they were constructed after the Moomba to Wilton mainline.

Second, EAPL submitted that the Commission should have assumed a life of 80 years for two of the laterals, Young to Lithgow and Junee to Griffith, as these pipelines are not in competition with the EGP. EAPL's argument seems to be based on the incorrect assumption that the Commission adopted a 50 year life for the MSP in anticipation of the construction of the EGP. This is not the case. What is relevant is that EAPL assumed a 50 year life, not the reasons why it did so. The Commission did not state that EAPL assumed a 50 year life in anticipation of the construction of the EGP.

EAPL's 'reasonable expectations' under section 8.10(g)

Section 8.10(g) requires the Commission to consider:

> …the reasonable expectations of persons under the regulatory regime that applied to the Pipeline prior to the commencement of the Code.

EAPL submitted that the appropriate ICB is represented by the NPV of the cash flows that EAPL would have reasonably expected under the prior regulatory regime, which it asserted was at least $784 million.[23] The Commission rejected this argument for the reasons set out at pages 56 to 60 of the *Final Decision*.

EAPL's submission of 23 October 2003 argued that the Commission misinterpreted section 8.10(g). EAPL argued that the Commission had wrongly interpreted the

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[23] EAPL, Submission to the Commission, 5 November 2002, pp. 10 – 11 and EAPL, Access arrangement information, 29 October 2003, p. 11.

provision such that a service provider's expectations are relevant only where they were brought about by, or caused by, the previous regulatory regime.

EAPL set out its view as to the correct interpretation of section 8.10(g) as follows:

> 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.[24]

In its *Final Decision*, the Commission proceeded on the basis that s 8.10(g) required consideration of reasonable expectations only where those expectations were brought about or underpinned by the prior regulatory regime. The Commission continues to believe that this is the appropriate construction of this provision.

Even if some different connection between the expectations and the prior regime was thought to be more appropriate, the Commission is of the view that the express reference in section 8.10(g) to the regulatory regime that applied prior to the Code can have a practical meaning and effect only if some relationship between a service provider's expectations and the prior regime is established. The legislature has, in section 8.10(g), made specific reference to the regulatory regime that existed prior to the Code and to no other factor. The natural and ordinary meaning of this language requires consideration of the relationship between the expectations that are said to exist and the prior regulatory regime under which they existed.

The expectations that EAPL seeks to have considered under section 8.10(g) are that it would be able to charge the tariffs under the Gas Transportation Agreement (GTA) for volumes under that agreement, and that it would be able to charge its published tariffs for other additional forecast volumes, not only under the prior regulatory regime, but beyond the life of that regime. Whatever the relationship that is required under section 8.10(g) between a person's expectations and the prior regulatory regime, on the facts before the Commission there is nothing to link the prior regulatory regime that applied to the MSP with the particular expectations that EAPL claims to have held.

EAPL's tariffs were not approved or endorsed under that regulatory regime. There was no finding or determination under that regime that suggested that the tariffs were appropriate. The regulatory regime did not offer any comfort as to whether EAPL's tariffs could continue to be relied upon or whether a particular volume would be supplied, either under that regime or after the regime had lapsed. Moreover, no finding was ever made as to the value of the capital base of the pipeline or whether the tariffs

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[24] EAPL, Submission in response to the Final Decision, July 2003, pp 11–12.

that existed at the time of the prior regime reflected the appropriate value of the capital base for the pipeline.

The previous regime may have justified an expectation that the GTA would continue to have effect. However, to the extent that it did, this expectation is met by section 2.25 of the Code. In the absence of any approval or endorsement under the previous regulatory regime, this is not a factor that gives any weight to this expectation as a basis for establishing the ICB for the pipeline.

In any event, the Commission notes that its consideration of the extent to which various ICB valuations would satisfy the objectives in section 8.1 takes EAPL's expectations into account on a contingent basis (see *Final Decision* pp. 65 – 75, especially p. 69).

Hypothetical new entrant test

EAPL was critical of the Commission's consideration of the Hypothetical New Entrant Test (HNET) under section 8.10(k) of the Code. EAPL submitted a letter from National Economics Consulting Group (NECG)[25] in support of its arguments.

Section 8.10(k) allows the regulator to have regard to any other factors that the regulator considers relevant in establishing the value of the ICB. While the Commission did not derive reference tariffs from the HNET, it observed that the tariffs approved in the *Final Decision* (and the underlying value of the ICB) were consistent with the HNET tariff derived by National Economics Research Associates (NERA).

NECG raised the HNET in the context of the National Competition Council's (NCC's) consideration of EAPL's application for revocation of coverage of the MSP. The HNET is a means of estimating a hypothetical 'competitive' market price for an industry that is not competitive. In applying the HNET, NECG assumed that the hypothetical new entrant would completely displace the incumbent firm and would operate efficiently and invest optimally.

The Commission engaged NERA to assess NECG's report. As EAPL mentions, the fundamental difference between the approaches taken by NECG and NERA concerns the assumption of the appropriate level of volumes. NECG applied the level of volumes transported by the MSP to determine the HNET price whereas NERA applied NSW and ACT market volumes. Since MSP volumes are less than the total market, HNET prices derived by NECG are higher than HNET prices derived by NERA. In justifying the use of market volumes, rather than firm-specific volumes, NERA argued that it would be more efficient for one pipeline to supply the total NSW and ACT markets than two pipelines.

Both EAPL and NECG have raised arguments against NERA's use of market volumes. The Commission considers that these arguments are flawed. EAPL states that 'When the *Final Decision* volume of 95.8 PJ is taken into account the NERA price increases further to $0.66/GJ.' Similarly, NECG stated that:

> …if the HNET calculation performed by NERA was updated to reflect the current views – particularly on volume – then the resulting tariff would be no less than $0.66/GJ.[26]

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[25] NECG, *Letter to APT*, 29 October 2003.

However, as stated above the use of MSP volumes is inconsistent with NERA's application of the HNET.

To support its argument in favour of the use of firm-specific volumes rather than market volumes, NECG referred to recent industry events, such as the construction of the EGP. NECG suggested that because the EGP did not capture 100 per cent of the market when it was commissioned it is inappropriate for market volumes to be used when determining the HNET price for the MSP. The Commission does not agree with this line of reasoning. The fact that the EGP has not captured the entire NSW and ACT market is irrelevant to the construction of the HNET.

Similarly, NECG argued for consistency between the volume assumptions for setting reference tariffs and the HNET price. NECG noted that the Commission has approved forecast volumes for the MSP (rather than market volumes) for the purposes of setting reference tariffs. NECG concluded that the same volumes should be used to determine the HNET price. Again the Commission does not agree with the logic of this argument: it is not necessarily the case that one should follow the other. The Commission is required to consider many factors in determining reference tariffs. As noted above and in the *Final Decision*, the Commission has not used the HNET to derive tariffs, but has observed that the approved reference tariffs are consistent with the HNET as applied by NERA.

Both EAPL and NECG noted that adoption of higher operating costs by the Commission in the *Final Decision* over the *Draft Decision* would increase NERA's HNET price from $0.51/GJ to $0.55/GJ. While it is true that higher operating costs would increase the HNET price, the operating costs referred to by NECG relate to an existing pipeline, not a new one, for which the operating costs may be lower.

Moreover, it is worth noting that NERA took a conservative view of the HNET price in assuming that the optimal pipeline is one from Moomba to Sydney rather than one from the gas fields in Longford in Victoria (with likely lower costs given Longford's closer proximity to the Sydney and ACT markets than Moomba). NERA considered that its HNET price of $0.51/GJ represented an upper bound.[27]

A further point of difference between NECG and NERA is the treatment of depreciation. For depreciation purposes NECG assumed a 30 year life, corresponding to what NECG stated was the duration of a lengthy foundation contract,[28] whereas NERA used an 80 year economic life. Determining the hypothetical new entrant tariff on the basis a 30 year life results in higher depreciation charges and tariffs.

NECG's use of a 30 year life is difficult to reconcile with the position it took in its original submission to the NCC, in which it suggested an 80 year life might be

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26 NECG, *Letter to APT*, 29 October 2003, p. 5.

27 NERA, *The hypothetical new entrant test in the context of assessing the Moomba to Sydney Pipeline prices – a report to the ACCC,* September 2002, pp. 15-16.

28 NECG, *Revocation of Coverage for the Moomba-Sydney Pipeline, attachment in support of EAPL response to NERA/ACCC submissions*, September 2002, p. 9.

appropriate.[29] The approach now proposed by NECG is also at odds with the approach used by Agility in its construction of DORC from ORC, which EAPL described as a 'hypothetical new entrant construct'[30] and for which an 80 year life is assumed.

The Commission is not persuaded of the merits of using the term of a contract as the basis for determining the hypothetical new entrant test as opposed to the economic life of the asset.

EAPL also noted the Commission's acknowledgment in the *Final Decision* that there are almost an infinite number of feasible price paths. In view of this, EAPL concluded that 'any similarity observed between the NERA and Commission prices is no more than a coincidence.'[31] While it is true that mathematically there is any number of possible price paths, not all price paths would satisfy the requirements of the Code. The Commission chose that price path which it considered best met the requirements of the Code, including the objective of replicating the outcomes of a competitive market (through the path of economic depreciation). The Commission does not agree that the consistency between the approved reference tariffs and NERA's HNET tariff is purely a matter of coincidence.

For the reasons outlined in the *Final Decision*[32] the Commission considers that the HNET tariff as derived by NERA is an appropriate factor for the Commission to consider in determining not only the value of the ICB under section 8.10(k), but also the overall reference tariff policy and reference tariffs.

EAPL's interpretation of the Commission's position

In its submission EAPL included what purported to be a summary of the Commission's position on the issue of the ICB. EAPL stated that:

> 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 $559.3 million.[33]

After some discussion, EAPL then concluded that:

> …there is no ICB valuation lower than the Commission's estimate of DORC at $715 million which would be consistent with the Code. EAPL submits that the ICB should be established at $756.9 million…[34]

The Commission considers that EAPL's discussion is an inaccurate portrayal of the Commission's position and that EAPL's conclusion that the Commission's value for DORC of $715 million represents a minimum value for ICB is unfounded. The Commission refers to the reasoning in its *Final Decision* at pages 65 to 75.

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[29] NECG, *Critique of ACCC draft decision on MSP tariff in the context of the hypothetical new entrant price*, 11 February 2002, p. 12.

[30] EAPL, Submission in response to the Final Decision, 31 October 2003, p. 4.

[31] EAPL, Submission in response to the Final Decision, 31 October 2003, p. 18.

[32] ACCC, *Final Decision: MSP*, 2 October 2003, pp. 63-65.

[33] EAPL, Submission in response to the Final Decision, 31 October 2003, p. 19.

[34] EAPL, Submission in response to the Final Decision, 31 October 2003, pp. 22-23.

Moreover, EAPL stated that:

> The Commission's rejection of DORC as the ICB is inconsistent with its past final decision under the Code.[35]

The Commission has not adopted DORC as the ICB for all access arrangements it has considered to date under the Code, as the contents of the table presented by EAPL demonstrate.[36] The Commission considers that the Code requires each case to be considered on its merits.

Conclusion on ICB

EAPL has not made, or substantially made, amendment FDA 1 of the Commission's *Final Decision*. Further, the Commission does not consider that EAPL has satisfactorily addressed the matters identified in the *Final Decision* as being the reasons for requiring the amendment.

For the purposes of the access arrangement approved by the Commission, the Commission has established the value for the ICB at $545.4 million. This represents the *Final Decision* ICB less the amount attributed to the Interconnect, which will not now be covered by the access arrangement.

In establishing the value of the ICB the Commission considered all the factors in section 8.10 of the Code and weighed them in accordance with the objectives of section 8.1. The Commission considers that a value for the ICB of $545.4 million (real July 2003) best satisfies the requirements of the Code. The Commission's revised access arrangement is drafted accordingly.

2.3 New facilities investment

EAPL's decision to withdraw the Interconnect from the access arrangement has an effect on EAPL's forecast capital expenditure. The revised forecast capital expenditure submitted by EAPL and approved by the Commission is shown in Table 2.3.1. The Commission's revised access arrangement is drafted accordingly.

Table 2.3.1: Estimated capital expenditure (July 2001 $ million)

Year ending 30 June	2004	2005	2006	2007	2008	2009
Northern lateral expansion			4.05			
In-line inspections	2.70					
Compressor overhaul		1.10			1.10	
Stay in business	0.15	0.39	0.39	0.39	0.87	0.39
Total	**2.85**	**1.49**	**4.43**	**0.39**	**1.97**	**0.39**

Source: Access arrangement information, 29 October 2003, p. 14.

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[35] EAPL, Submission in response to the Final Decision, 31 October 2003, p. 22.

[36] EAPL, Submission in response to the Final Decision, 31 October 2003, p. 22.

2.4 Depreciation

Amendment FDA 7

2.4.1 Amendment required

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* (this table is replicated below).

The Commission's reasons for requiring this amendment are set out on pages 89 – 90 of the *Final Decision*.

Final Decision Table 2.5.7.1: Commission approved depreciation charges (July 2003 $ million)

Year ending 30 June	2004	2005	2006	2007	2008	Total
Mainline	16.01	13.77	12.24	9.05	7.95	**59.01**
Regional laterals	0.22	0.31	0.42	0.28	0.33	**1.56**
Total Depreciation	**16.22**	**14.08**	**12.66**	**9.33**	**8.28**	**60.58**

Note: Totals may not add up due to rounding.

2.4.2 EAPL's response to the *Final Decision*

EAPL did not agree with the depreciation schedule required by the Commission in its *Final Decision*. However, EAPL submitted a revised depreciation schedule in light of changes it made to the input variables that determine the total revenue. EAPL's proposed depreciation schedule is shown in Table 2.4.1.[37]

Table 2.4.1: EAPL's revised depreciation charges (July 2000[(a)] $ million)

Year ending 30 June	2004	2005	2006	2007	2008	2009
Mainline	3.85	4.14	4.02	1.91	(1.92)	(6.02)
Regional laterals	(1.44)	(2.88)	(2.87)	(3.12)	(3.09)	(3.05)
Total Depreciation	**2.41**	**1.26**	**1.15**	**(1.21)**	**(5.01)**	**(9.07)**

Source: Access arrangement information, 29 October 2003, p. 24.
Note: (a) Although EAPL's submission states that the base year is 2000, models submitted to the Commission confirm that the base year is in fact 2001.

2.4.3 Commission's considerations

While the Commission accepts EAPL's depreciation methodology, the Commission and EAPL disagree on the level of depreciation charges to apply over the access arrangement period.

Under EAPL's proposed economic depreciation approach, depreciation is the residual after deducting the return on assets, non capital costs and taxes from the revenue requirements. Accordingly, any differences in the depreciation schedules are a

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[37] The Commission notes that these charges were submitted prior to the inclusion of an additional annual allowance of $1.76 million for asymmetric risk which would affect revenue and in turn the economic depreciation charges under the NPV approach.

consequence of differences in the factors that comprise the revenue requirements, such as the value of the ICB. The depreciation schedule approved by the Commission is shown in Table 2.4.2. The Commission has incorporated this depreciation schedule into the access arrangement.

Table 2.4.2: Commission approved depreciation charges (July 2003 $ million)

Year ending 30 June	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**
Mainline	17.87	14.25	13.64	10.46	8.25	5.98
Regional laterals	0.30	0.39	0.49	0.35	0.46	0.39
Total Depreciation	**18.17**	**14.65**	**14.13**	**10.81**	**8.71**	**6.37**

2.5 Rate of return

Amendment FDA 8

2.5.1 Amendment required

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 and access arrangement information must be amended to reflect the current financial market settings as set out by the Commission in Table 2.6.7.7 of the *Final Decision*.

Final Decision Table 2.6.7.7: Commission approved WACC parameters

General parameters		**17 September 2003**
Real risk free rate	rr_f	3.03%
Expected inflation	f	2.19%
Nominal risk free rate	r_f	5.29%
Debt to total assets	D/(D+E)	60.0%
Taxation		
Corporate tax rate	T	30.0%
Effective tax rate	T_e	23.5%
Value of imputation credits	γ	0.5
Return on equity		
Equity beta	β_e	1.00
Market risk premium	MRP	6.0%
Post-tax nominal return on equity	r_e	11.3%
Post-tax real return on equity	rr_e	8.9%
Cost of debt		
Debt margin	DM	0.92%
Nominal cost of debt	r_d	6.20%
Real cost of debt	rr_d	3.92%
WACC estimates		
Post-tax nominal WACC		6.5%
Pre-tax nominal WACC		8.8%
Pre-tax real WACC		6.56%
Nominal vanilla WACC		8.2%

The Commission's reasons for requiring this amendment are set out on pages 105 – 139 of the *Final Decision*.

2.5.2 EAPL's response to the *Final Decision*

EAPL's revised access arrangement did not incorporate nor substantially incorporate amendment FDA 8.[38] Rather, EAPL sought to address the Commission's reasons for requiring the amendment by providing further submissions (including consultancy reports from NECG) to the following effect:

- the risk free rate should be based on a ten year bond rate rather than rates matching the regulatory period;
- the debt margin should be based on a BBB benchmark credit rating rather than a BBB+ rating;
- an allowance of 50 basis points (or $2.27 million per annum) should be made for debt issuance costs;[39]
- an annual allowance of 0.397% of equity value (or $1.2 million per annum) as a perpetuity should be made for equity raising costs;[40]
- an allowance of $1.5 million should be made for asymmetric risk arising from:
  - competition;
  - reserves;
  - insurance deductibles;
  - credit risk; and
  - regulatory risk.

  EAPL later informed the Commission that an allowance of $3.26 million for asymmetric risk was appropriate, albeit conservative.[41]

EAPL's specific contentions with regard to these claims are set out in further detail below.

Risk free rate

Responding to the *Final Decision* EAPL submitted a report by NECG which discussed the approach to the risk free rate adopted by the Commission in the *Final Decision*. A large part of the discussion criticised the paper completed by Associate Professor Martin Lally on behalf of the Commission.[42] In summary, NECG stated that:[43]

1. The basis of the conclusions presented by Lally is a model which assumes that it is optimal for a business to finance its debt based on the duration of the regulatory

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[38] EAPL, Submission in response to the Final Decision, 31 October 2003, p. 30.

[39] EAPL, Submission in response to the Final Decision, 31 October 2003, p. 30.

[40] EAPL, Submission in response to the Final Decision, 31 October 2003, p. 30.

[41] EAPL, Letter to the Commission, 11 November 2003.

[42] M Lally, *The risk free rate for regulated companies,* August 2002.

[43] NECG, *Key contentions on WACC components of ACCC MSP Decision: A report to East Australian Pipeline Limited,* October 2003, p. 5.

period. It is therefore appropriate for the regulator to set the maturity of the risk free rate in the Capital Asset Pricing Model (CAPM) and WACC to align with the regulatory cycle.

2. The model developed by Lally has a number of extreme assumptions including that: future output sold is known with certainty; there is no uncertainty over operating costs; there is no regulatory risk; and the only risk facing the business is the impact of interest rate fluctuations on output prices. If these assumptions are relaxed, then the results obtained by Lally will generally not hold.
3. Frequent regulatory reviews do not reduce the cost of capital as claimed by Lally. The real impact of more frequent regulatory reviews is to increase the cost of capital on account of increased regulatory risk.
4. Applying Lally's approach distorts economic and commercial decision making, thereby leading to losses in productive and allocative efficiency. If the regulator adopts a WACC below the opportunity cost of capital facing the service provider, the result will be less than socially optimal levels of investment.
5. Lally's model fails to consider the full nature of the CPI adjustment as inflationary expectations are not fully reflected in interest rates. This means that the CPI adjustment does not provide a perfect hedge against the inflationary expectations component in the interest rates.
6. An investor cannot be confident that the regulatory framework will be unchanging. This means that the business will be less willing to structure its debt based on the regulatory period and will revert to standard commercial practice of matching debt maturity with asset life.

Apart from the critique of Lally, NECG also claimed that the appropriate bond rate that should be adopted in regulatory decisions is the 10 year rate. NECG argued that this is true for both the determination of the cost of equity and the cost of debt.

With respect to the cost of equity, NECG argued that the appropriate time horizon for equity is the life cycle of the business. In Australia, the convention is to base the assumed maturity of the risk free rate in the CAPM on the life of the assets, which is 50 years in the case of the MSP. However, given the absence of 50 year government bonds, NECG argued that the 10 year risk free rate should be used.[44]

With regard to the cost of debt, NECG noted that in a competitive environment, a prudent and efficient service provider would generally structure its debt to match the maturity to the life of the asset. According to NECG this reduces the risk that the company would be unable to pay the debt at the end of the loan or it would be unable to refinance on similar terms due to factors such as changes in its credit rating, changes in economic climate, changes in expectations and increasing competition. NECG argued that it is also common to have some form of variability in interest rates in order to reduce interest rate risk when changes in interest rates impact on the company's net revenues. Given the long term nature of most debt and the additional transaction costs

[44] NECG, *Key contentions on WACC components of ACCC MSP Decision: A report to East Australian Pipeline Limited,* October 2003, pp. 5-10.

associated with swaps, it is argued that as with equity 10 year bonds should also be used as the basis of the cost of debt calculation.[45]

In addition, NECG criticised two additional arguments: that the 5 year rate is appropriate for the single period nature of the CAPM and that there is no need for consistency of the risk free rate with the rates used to determine the market risk premium (MRP). NECG claimed that there is nothing in the CAPM which supports the use of the regulatory period, and the model provides no guidance as to the appropriate length of the bond maturities. NECG also sought to demonstrate through algebra that the methodology used to measure the risk free rate must be equivalent to the methodology used to calculate the MRP.[46]

Debt margin

As with the risk free rate, EAPL commissioned NECG to provide comments on the Commission's approach to the debt margin adopted by the Commission in the *Final Decision*. NECG argued that the benchmark BBB+ credit rating applied by the Commission is inconsistent with the Commission's own preferred methodology of benchmarking the credit rating of gas transmission providers. Specifically, NECG noted that the Commission assumed a benchmark credit rating of BBB+ by considering the average credit rating of AGL, AlintaGas, Envestra and GasNet, despite only one of those parties being a gas transmission company.[47]

In support of an alternative benchmark, NECG noted that the GasNet decision supports a credit rating of BBB. Further, NECG stated 'that given the greater exposure to competitive pressure, including stranding risk on the MSP compared to the Victorian network, there would appear to be no clear case for assuming a credit rating above that of GasNet.'[48] NECG recognised, however, that in order to complement such an analysis it would be necessary to estimate an appropriate credit rating by undertaking cash flow modelling and interest coverage ratios under different risk scenarios.[49]

On the basis of these arguments, NECG suggested the adoption of a benchmark credit rating of BBB. Based on this conclusion, NECG submitted that data from CBA Spectrum indicated that the applicable debt margin on BBB rated debt was between 20 and 25 basis points above the BBB+ margin in September 2003. Relying on this analysis, EAPL proposed that a 25 basis points premium be added to the rate adopted by the Commission in the *Final Decision*.[50]

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45 NECG, *Key contentions on WACC components of ACCC MSP Decision: A report to East Australian Pipeline Limited,* October 2003, pp. 10-13.

46 NECG, *Key contentions on WACC components of ACCC MSP Decision: A report to East Australian Pipeline Limited,* October 2003, pp. 14-16.

47 NECG, *Key contentions on WACC components of ACCC MSP Decision: A report to East Australian Pipeline Limited,* October 2003, p. 17.

48 NECG, *Key contentions on WACC components of ACCC MSP Decision: A report to East Australian Pipeline Limited,* October 2003, p. 17.

49 NECG, *Key contentions on WACC components of ACCC MSP Decision: A report to East Australian Pipeline Limited,* October 2003, p. 18

50 NECG, *Key contentions on WACC components of ACCC MSP Decision: A report to East Australian Pipeline Limited,* October 2003, p. 18.

Debt raising costs

EAPL also engaged NECG to examine the issue of debt raising costs. NECG was critical of the Commission's decision for failing to make an allowance for the cost of debt issuance in either the rate of return or regulatory cash flows.

Within its report NECG outlined its view that an allowance to reflect the cost of issuing debt previously awarded by regulators, such as the Commission and the Victorian Essential Services Commission (ESC), had been insufficient. Referring to US data, NECG claimed that a more appropriate premium for debt issuance would be up to 50 basis points given the difference in costs for private, rather than public debt placement.

Relying on NECG's analysis, EAPL submitted that a 50 basis points allowance when coupled with its proposed ICB value of $756.9 million and a 60:40 debt to equity ratio would equate to an additional annual allowance for debt issuance of $2.27 million.

Equity issuance costs

NECG also examined equity issuance costs. Within its report NECG noted that EAPL faced substantial costs in raising equity finance for the MSP. According to NECG, the source of equity raising costs included legal, accounting and underwriting expenses.

The NECG report noted that an allowance for equity raising costs of 0.224 per cent of the regulated equity had been accorded to GasNet as a cost in perpetuity. NECG was, however, critical of the approach adopted by the Commission in the GasNet decision and stated that a more appropriate rate to use for the calculation was the cost of equity. Using GasNet's cost of equity, NECG claimed that the fee per year as a perpetuity should have been at least 0.397 per cent of equity value. NECG concluded that on balance the corrected allowance of 0.397 per cent of regulated equity would provide the minimum bound for an equity allowance for EAPL.

Once again relying on NECG's analysis, EAPL submitted that a 0.397 per cent allowance when combined with its proposed value for the ICB value of $756.9 million and a 60:40 debt to equity ratio, would equate to an additional annual allowance for debt issuance of $1.2 million.

Asymmetric risk

A further area which EAPL argued had been overlooked by the Commission was asymmetric risk. EAPL claimed that it is exposed to asymmetric risk arising from a number of sources including competition from the EGP, reserve risk, regulatory risk, deductibles in current insurance and credit risk. In its submission of 23 October 2003, EAPL claimed that an annual cash flow allowance of $1.5 million was appropriate, based on some preliminary analysis undertaken by NECG. EAPL noted, however, that a more accurate estimate could be developed with more detailed modelling.

Following further work carried out by NECG, EAPL submitted that it was of the view that an annual allowance of $3.26 million for asymmetric risk was appropriate, albeit conservative.[51] EAPL noted that NECG had used parameters approved by the

[51] EAPL, Letter to the Commission, 11 November 2003.

Commission in the *Final Decision*. EAPL submitted that the use of these parameters demonstrated that the $3.26 million annual allowance was conservative. EAPL also submitted that if the Commission were to adopt a figure less than $1.5 million it would be 'unreasonable'.

While EAPL has submitted that an allowance of $3.26 million is appropriate, EAPL has not submitted revised tariff or revenue estimates which incorporate the additional $1.76 million now claimed. Accordingly, it is unclear to the Commission whether or not EAPL are in fact claiming an allowance of $3.26 million or $1.5 million. For the purpose of this assessment, the Commission has proceeded on the basis that the claim is for $3.26 million.

An overview of the work undertaken by NECG was submitted by EAPL to the Commission in support of this claim. EAPL has requested that the details contained within the NECG report remain confidential. The Commission does not agree that the NECG report in its entirety would be unduly harmful to the legitimate business interests of EAPL. That said, the Commission has agreed to EAPL's request and has set out a detailed discussion on the claim and the NECG report in confidential Appendix C of this *Final Approval*.

2.5.3 Commission's considerations

Risk free rate

The Commission retains its view that it is appropriate to align the term of the risk free rate to the length of the regulatory period. The Commission's reasoning is detailed in the *Final Decision* on pages 116 – 118.[52]

As set out earlier NECG criticised the Lally report on six fronts.[53] These are addressed in the following paragraphs.

First, NECG claimed that the model used by Lally in support of his arguments assumes that it is optimal for a business to finance its debt based on the duration of the regulatory period. The paper by Lally, however, does not make any such claim. The only reference made in the paper to debt maturity is in the context of transaction costs, as follows:

> ElectraNet SA (2002) argued for the ten year rate because the transaction costs of reissuing five year debt would be too high. No evidence to support this cost claim is offered. In fact Macquarie Bank (2002, p. 22) indicates that the average term is about five years. Nevertheless, even if some incremental transaction cost were incurred by borrowers, this cost would be dominated by the arguments presented….for the use of the five year rate. [54]

Nothing in the above quote supports the assertion by NECG that 'in this model, it is optimal for the business to finance its debt based on maturity equivalent to the duration

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[52] ACCC, *Final Decision: MSP*, 2 October 2003, pp. 116-118.

[53] Details of Associate Professor's Lally's credentials are set out in his Curriculum Vitae.

[54] M Lally, *The risk free rate for regulated companies,* August 2002, p. 14.

of the regulatory period…'[55] Moreover, Lally actually recognises that even if the average term of debt issued by service providers is not five years, any resulting transaction costs do not detract from the position that rates should match the regulatory period (this issue is discussed in further detail below).

Second, NECG claimed that Lally's model is based on several assumptions that undermine the results of the analysis if they are relaxed. The Commission, however, disagrees with this conclusion. The assumptions made by Lally relate to various specific risk factors, that is volume uncertainty, operating costs and regulatory risk. Under the regulatory structure facing EAPL, uncertainties associated with returns are limited to a five year time horizon – at the end of the five years tariffs are reset to underwrite the written down value of the asset at that time. These specific risks, if they do exist, should be compensated for in the cash flow modelling, not in the calculation of the risk free rate. The determination of the risk free rate, by definition, must exclude all such risks.

Third, NECG argued that on account of the existence of regulatory risk Lally's assertion that frequent regulatory reviews will reduce the cost of capital is incorrect. A discussion of the appropriate length of the regulatory period is not actually presented by Lally. Nonetheless, the Commission notes that under the Code EAPL had the opportunity to elect a longer regulatory period, such as 10 years, if it considered that it was in its interests to do so. Moreover, NECG did not provide any evidence of the existence of regulatory risk, and in the event that such risk does arise, this has no bearing on the risk free rate.[56] Further, such compensation would, even then, only be appropriate if regulatory risk was asymmetric and had the effect of lowering the expected value of future returns. This does not appear consistent with either EAPL or the Commission's current expectations.

Fourth, NECG suggested that adopting Lally's approach will distort economic and commercial decisions and lead to under-investment. This is because the service provider is not compensated with the opportunity cost of investment capital. The Commission, however, disputes this claim. As noted in the *Final Decision*, only by using rates which match the regulatory period will the present value of expected cash flows (including the residual capital base) match the ICB. If 10 year rates are adopted, there is the possibility that the NPV of regulated revenues will be higher or lower than the value of the initial investment, which may lead to a situation where rational investors will not find it in their interests to invest.[57] As argued by Lally, 'the opportunity cost is the expected return available in the alternative investment with equal risk'.[58] The return available elsewhere must also take into account the nature of the regulatory framework, that is, the regular resetting of rates.

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[55] NECG, *Key contentions on WACC components of ACCC MSP Decision: A report to East Australian Pipeline Limited,* October 2003, p. 5.

[56] In its submission in response to the *Final Decision*, EAPL request compensation for regulatory risk as a component of asymmetric risk.

[57] M Lally, *The risk free rate for regulated companies,* August 2002, p. 13.

[58] M Lally, *The risk free rate for regulated companies,* August 2002, p. 12.

Fifth, it is claimed by NECG that Lally's model fails to consider that inflationary expectations are not fully reflected in interest rates, and accordingly regulated businesses face an inflation risk that is not addressed in Lally's model. The Commission considers that this claim is a misrepresentation of the regulatory model. Given that tariffs are adjusted for actual inflation (with a one year lag) under the CPI-X framework proposed by EAPL, the service provider faces only limited inflationary risk.[59] Given the absence of this risk in the revenue calculation, it is most appropriate to set the risk free rate using a real framework, as adopted by Lally.

Finally, NECG claimed that an investor cannot be confident that the regulatory framework will be unchanging, and that consequently businesses will match debt to the remaining life of the asset in question. As noted above, NECG has not provided any evidence of regulatory risk. Moreover, regulatory risk, if it exists, should not influence the determination of the 'risk free' rate, but be compensated for through regulated cash flows.

Apart from the critique of Lally, NECG claimed that instead of rates matching the regulatory period, 10 year bond rates should be used to set the risk free rate. NECG argued that rates matching the life of the asset should be used as the basis of the cost of equity, but in the absence of such long term rates 10 year rates should be used as a proxy. The Commission reiterates its view that the use of rates that do not match the regulatory period may lead to over or under compensation, thereby distorting investment decisions.

NECG also claimed that a prudent and efficient service provider will structure its debt similar to the life of the asset to overcome refinancing risk, but may also have some form of variability in order to balance interest rate risks. The Commission notes that refinancing risk does not modify the arguments presented by Lally.[60] As with volume uncertainty, operating and regulatory risks, refinancing risk is not relevant for the discussion of the risk free rate. Refinancing risk, if it exists, would be reflected in the benchmark debt margin (see below for details).

With regard to interest rate risk, sections 8.30 and 8.31 of the Code invite consideration of a financing structure reflecting standard industry structures and best practice. In relation to the specific financing arrangements of a particular service provider, the Commission notes that the service provider may elect to borrow for a period longer than the access arrangement period, and the interest associated may be higher or lower than the rate matching the regulatory period. The additional cost (or benefit) attained by a service provider should not, in the Commission's view, be reflected in approved revenues: users should not underwrite the risk that the service provider elects to take. Similarly, if such a service provider considers that on top of entering into a long term debt arrangement it should engage in interest rate swaps to 'reduce its interest rate risk by having the cost of its debt move when changes in interest rates in the economy feed

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59 The only inflation risk present in the framework arises from the fact that forecast inflation is used to set tariffs in the first six months of EAPL's access arrangement.

60 Refinancing risk represents the risk that the service provider may not be able to obtain finance when it refinances its debt in the future.

through'[61], the Commission is of the view that it is free to do so if the service provider considers that the approach provides a more efficient balance between total debt costs and risk than the benchmark used.

The preceding discussion noted NECG's concern with two additional arguments raised by the Commission. First, NECG questioned the argument that the single period nature of the CAPM supports the use of rates matching the regulatory period. The Commission agrees with NECG's claim that the CAPM provides no indication as to the most appropriate period. However, the Commission does consider that the parameters adopted in the CAPM must reflect the time in which the cash flows in the project arise. Simply put, the use of 10 year rates to determine cash flows over the succeeding five years is not consistent with the CAPM approach. This is because, as discussed earlier, only by using rates matching the regulatory period will the present value of the expected cash flows (including the value of the residual capital base at the end of the regulatory period) equal the capital base at the start of the access arrangement.

Second, NECG asserted that it is not appropriate for the Commission to base the risk free rate (denoted as r_{f1}) on a different variable than the risk free rate used to estimate the MRP (r_{f2}). NECG supports its position by reference to a mathematical rearrangement of the CAPM formula. This formula illustrated that r_{f1} must equal r_{f2}, assuming that the equity beta is one. The Commission considers, however, that this algebra does little to support NECG's position. This formula can equally be used to demonstrate that where the equity beta is assumed to be zero, the return on equity $E(R_e)$ must equal r_{f1}. As noted previously, if r_{f1} (and hence $E(R_e)$) does not match the length of the regulatory period, then the present value of expected cash flows will not match the initial capital base.

The Commission also notes that NECG's claim that the Commission based its MRP estimate solely on the 10 year bond is factually incorrect. As discussed in the *Final Decision,* the approval of the MRP of 6.0 per cent was in part justified by a consultancy also completed by Associate Professor Lally on the cost of capital.[62] In this paper, Lally referenced a number of different approaches to estimating the MRP. One approach referenced was historical averages of the risk free rate in Australia, which utilised the 10 year risk free rate as its base. International studies which relied on short term bond rates to estimate the MRP were also used in the analysis. On the basis of a total of four different approaches, Lally estimated that the appropriate estimate for the MRP was 6.1 per cent. As noted in the *Final Decision*, Lally concluded that:

> ...the range of methodologies examined give rise to a wide range of possible estimates for the market risk premium and these estimates embrace the current value of 6 per cent.[63]

In light of the above analysis, the Commission is not satisfied that EAPL has adequately addressed its reasons for requiring that the risk free rate be based on government bonds with a maturity period reflecting the length of the regulatory period.

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[61] NECG, *Key contentions on WACC components of ACCC MSP Decision: A report to East Australian Pipeline Limited,* October 2003, p. 12.

[62] M Lally, *The cost of capital under dividend imputation,* June 2002.

[63] M Lally, *The cost of capital under dividend imputation,* June 2002, p. 43.

As discussed with regard to amendment FDA 41, the Commission has now agreed to an access arrangement period of five and half years duration (in contrast to five years proposed in the *Final Decision*). For consistency, the Commission has therefore adopted a risk free rate of five and a half years in its tariff path modelling as follows.

Table 2.5.1: Financial market interest rates interpolated to 30 June 2009

Bond rates interpolated to 30 June 2009	**40 day moving average to 17 September 2003 (%)**
Estimated 5 year inflation indexed government bond rate	3.08
Estimated 5 year nominal government bond rate	5.35

The issue of the term of the risk free rate is currently being considered by the Australian Competition Tribunal (the Tribunal) with respect to GasNet Australia (Operations) Pty Ltd. The Commission therefore notes that if the Tribunal decides that a 10 year government bond rate is the appropriate risk free rate for GasNet (on the basis that these rates are the most appropriate irrespective of GasNet's specific circumstances), then EAPL may, in accordance with section 2.28 of the Code, submit revisions to the access arrangement.

Debt margin

The debt margin represents a payment to debt providers for the systematic and specific risk associated with a particular entity. Relevant risks include general business risk, insurable risks, inflation risks and refinancing risks.[64]

EAPL proposed the adoption of a BBB benchmark for establishing the applicable debt margin for the MSP and on this basis proposed the addition of 25 basis points to the calculated cost of debt. In support of this claim EAPL submitted a report by NECG in which NECG made several arguments against the Commission's adoption of a BBB+ benchmark. The Commission does not consider that these arguments adequately address its position set out in the *Final Decision*, and therefore intends to maintain a BBB+ benchmark for the purposes of the *Final Approval*. The three main arguments raised by NECG are evaluated here.

First, NECG argued that the businesses used to establish the Commission's benchmark are inappropriate, given that only one of the four companies referenced is actually a gas transmission business. The Commission recognises the limited number of observations available for establishing a benchmark. There is currently only one Australian stand-alone gas transmission company which has an established credit rating – GasNet. In the *Final Decision* the Commission was reluctant to rely solely on GasNet's rating, particularly given the company's gearing ratio of 67 per cent which is higher than the 60 per cent benchmark assumption.[65]

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64 See Macquarie Bank, *Issues for debt and equity providers in assessing greenfields gas pipelines,* May 2002.

65 A high gearing ratio may have an adverse impact on the credit rating of the entity given the greater level of default risk for debt holders.

In these circumstances the Commission considered it reasonable to establish the benchmark through reference not only to GasNet but to stand-alone listed gas distribution/retail companies (specifically, AlintaGas, Envestra and AGL). These companies share a number of broad characteristics with gas transmission companies (such as network characteristics and regulated returns) and provide the closest proxy available given limited data. The Commission maintains that the inclusion of these companies in the sample is appropriate and provides a more robust outcome than reliance on just one company as the basis of the benchmark.

This position is supported by NECG who recognised that it is not appropriate to rely on one comparator alone in the assessment of the benchmark credit rating.[66] However, rather than referring to similar publicly traded entities, NECG suggested that it is necessary to undertake modelling of the cash flows and interest coverage ratios to determine a relevant benchmark. NECG and EAPL did not however engage in such an exercise or refer to any such tasks that had been completed in order to substantiate their claim.[67]

Third, NECG argued that the 'GasNet precedent, which is consistent with the ACCC's own stated approach, supports a credit rating of BBB'. This claim is factually incorrect. In the GasNet *Final Decision*, the Commission proposed a BBB+ benchmark based on the same sample used to establish the benchmark for the MSP in the Commission's *Final Decision.*[68] This approach was accepted by GasNet in its revised access arrangement, not the benchmark of BBB as suggested by NECG.[69] It is also of note that NT Gas Pty Ltd, of which 96 per cent is owned by APT, accepted a BBB+ credit rating benchmark in the 2002 Amadeus to Darwin Pipeline approval process.[70] As previously noted APT raises debt jointly on behalf of all of its subsidiaries and then allocates these costs to the various pipelines, including both NT Gas and EAPL.[71] It therefore appears inappropriate to approve a different debt margin methodology for these two access arrangements.

In light of the above analysis, the Commission considers that the arguments raised by EAPL in response to the *Final Decision* do not address its reasons for requiring a

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[66] NECG, *Key contentions on WACC components of ACCC MSP decision,* October 2003, p. 18.

[67] The Commission is aware of one such cash flow analysis that was undertaken by UBS Warburg on behalf of SPI PowerNet (Letter from Nick Wade, Director, Credit Research, UBS Warburg, to Jim Lamborn, Treasurer, SPI PowerNet, 28 November 2001). While SPI PowerNet is not a gas transmission entity, the objective of this analysis was to determine an appropriate credit rating for an entity which is regulated; exhibited a gearing level of 60 per cent and a EBIT interest cover of 2.0x. Using these assumptions and standard ratios supplied by Standard and Poors, UBS Warburg concluded that 'standard regulated transmission or distribution business would be rated around BBB+'. It is notable that UBS Warburg did not distinguish between transmission and distribution. Further, UBS Warburg did not even distinguish between regulated gas and electricity entities, though the Commission's analysis in this case does not draw on data from the electricity industry.

[68] ACCC, *Final Decision: GasNet Australia access arrangement revisions for the Principal Transmission System*, 13 November 2002, pp. 90-91.

[69] ACCC, *Final Approval: GasNet Australia access arrangement revisions for the Principal Transmission System*, 17 January 2003 and GasNet Australia access arrangement, 17 January 2003.

[70] ACCC, *Final Approval: Access Arrangement proposed by NT Gas Pty Ltd for the Amadeus to Darwin Pipeline*, 26 March 2003.

[71] EAPL, Letter to the Commission, 10 June 2003, pp. 7-8.

BBB+ benchmark credit rating. The Commission has therefore maintained a benchmark debt margin of 0.92 per cent in the determination of regulated tariffs.

Effective tax rate

As set out previously, EAPL's decision to remove the Interconnect from the access arrangement has had implications for the modelling of costs, revenue, tariffs and taxes on the mainline. As a consequence the value of the effective tax rate for the mainline has been revised. The revised estimate of the effective tax rate for the mainline is 24 per cent which is slightly higher than the 23.5 per cent previously estimated. The change in the tariff path to financial year basis has also led to a change in the effective tax rate applying to the regional laterals, as has the adoption of a 5 ½ year government bond rate of the MSP. The revised effective tax rate for the regional laterals is now approximately 14.8 per cent.

Equity raising and debt issuance costs

The April 2002 access arrangement originally proposed by EAPL did not include any allowance for debt or equity issuance costs. EAPL did not seek to recover these costs through the rate of return in any of its submissions throughout the assessment period up to the *Final Decision*. This was acknowledged by NECG, who stated that EAPL did not seek explicit inclusion of debt raising costs in its building block claims.[72]

The Commission does not dispute NECG's claim that in past decisions it has provided an allowance for the transaction costs associated with raising debt finance and new equity. In this context, the Commission actually invited EAPL to consider whether it wished to recover these costs through the building blocks. Specifically, on 16 August 2002, the Commission requested further details from EAPL on the operating costs associated with the establishment of APT.[73] Information in response to this request was provided in an email to the Commission on 9 September 2002,[74] and a response on 1 October 2002.[75] Summarising these submissions, the consolidated information document stated that:

> With respect to the details of the costs relating to the establishment of APT, APT internally allocates the EAPL's portion of the costs of establishing the IPO through higher interest cost recovery rates to EAPL. As a result, the costs relating to the EAPL IPO is not included in the operating expenditure forecasts.[76]

Further, on 26 May 2003 in a letter to EAPL, the Commission asked for 'details of debt raising costs incurred by EAPL, including detail as to which category of the building block model these costs are incorporated', and 'an explanation of the way in which APT internally allocated EAPL's portion of the costs of establishing the IPO and how these costs are recovered from users'.[77] In a letter to the Commission on 10 June 2003,

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72 NECG, *Key contentions on WACC components of ACCC MSP decision, A report for EAPL,* October 2003, p. 18 (footnote 11).

73 ACCC, Letter to EAPL, 16 August 2002.

74 EAPL, Letter to the Commission, 9 September 2002.

75 EAPL, Letter to the Commission, 1 October 2002.

76 EAPL, Consolidated information based on questions from the Commission, 8 April 2003, pp. 5-6.

77 ACCC, Letter to EAPL, 26 May 2003, p. 3.

EAPL responded that it has not included debt raising costs in the building blocks and that IPO costs are not allocated to any of the building blocks for recovery.[78] Further discussion of EAPL's justification for the exclusion of IPO costs is provided in confidential Appendix E of the *Final Decision*.[79]

In the *Final Decision* the Commission required amendments to the WACC estimates and parameters used by EAPL. The Commission's reasons for requiring these changes did not include any reference to debt or equity issuance costs. To the extent that the amendments proposed by EAPL following the *Final Decision* rely on the inclusion of such costs, they do not address the matters identified in the *Final Decision* as being the reasons for requiring amendment FDA 8. Accordingly, section 2.19 of the Code does not allow the Commission to approve amendments that allow for such costs.

The Commission notes that even if EAPL's proposed amendments and submission in relation to debt and equity issuance could be interpreted as addressing matters identified in the *Final Decision* as being the reasons for requiring amendment FDA 8, the Commission does not consider that it would be appropriate to include amendments to incorporate these items.

As a consequence of:

- the late inclusion of these new claims which combined amount to $3.47 million;
- the limited information provided with the claims; and
- the absence of any argument regarding their consistency with the provisions of the Code,

the question of whether they should be included in the rate of return has not been the subject of the usual assessment process under the Code. Introducing these new items at this stage of the process does not permit the Commission to undertake a proper or adequate consideration of whether provision should be made in the access arrangement for these items. Accordingly, the Commission does not believe that it would be appropriate to approve amendments to the access arrangement for debt raising and equity issuance costs.

Finally, the Commission notes that while it has not considered an allowance for equity raising costs, an allowance for the ongoing costs of being a part of a publicly listed trust have been accounted for in the corporate overheads charged to the MSP by APT and are reflected in the non capital costs approved by the Commission.[80]

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[78] EAPL, Letter to the Commission, 10 June 2003, pp. 7-8.

[79] ACCC, *Final Decision: MSP,* 2 October 2003, p. 338.

[80] EAPL, Consolidated information based on questions from the Commission, 8 April 2003, pp. 5-6. and ACCC, *Final Decision: MSP,* 2 October 2003, p. 150.

Asymmetric risk

As set out previously, EAPL has claimed that an annual allowance of $3.26 million for asymmetric risk arising from competition with the EGP, reserves, regulation, insurance deductibles and credit risk is appropriate.

The Commission notes that EAPL has not within any of its previous submissions claimed to be exposed to asymmetric risk arising from insurance deductibles, credit risk or regulation. Further, the Commission notes that while competition with the EGP and reserve risk previously formed the basis for EAPL's claim regarding the appropriate value of the equity beta, the magnitude of this risk was never quantified. Consequently, the actual sources of asymmetric risk, the magnitude of the claims and the proposed remedies have not been subject to the usual assessment process under the Code.

Competition and reserve risk

EAPL previously cited risk arising from both competition and uncertainty surrounding the deliverability from the Cooper/Eromanga Basin as the basis for an equity beta of 1.45. Within the *Final Decision*, the Commission noted that these two forms of risk were specific in nature and in accordance with the CAPM framework allowance for such risks should not be made in the equity beta. Rather, the Commission noted that where specific risks could be identified and quantified, the net impact on earnings should be factored into projected cash flows. The Commission therefore rejected these factors as the basis for a higher equity beta. Although rejecting these specific risks as the basis for a higher equity beta, the Commission did consider whether the claims were legitimate and if they could be quantified and factored into projected cash flows.

In relation to the risk arising from competition, the Commission noted that allowance for this form of risk, where it can be quantified, should be made in demand forecasts. The Commission noted that EAPL had in fact already accounted for this risk when deriving the throughput forecasts for the MSP over the access arrangement period. In particular, the Commission noted that the throughput forecasts submitted by EAPL made an explicit allowance for the market share it expected to lose to the EGP and the Sydney Gas Company. Given that the impact of this specific form of risk had already been appropriately accounted for in the projected cash flows via volume forecasts, the Commission concluded that an additional cash flow allowance for this form of risk would be inappropriate.

The *Final Decision* also briefly discussed EAPL's claim in relation to the long term uncertainty surrounding deliverability from the Cooper/Eromanga Basin. Within this discussion, the Commission noted that if it was expected that the MSP would become a stranded or partially stranded asset, this would have been reflected in EAPL's long term volume forecasts and accommodated in the depreciation profile adopted for the pipeline. That is, where there is a real risk that the asset will be by-passed then long term volume forecasts should reflect this. Similarly, the assets at risk of by-pass should be assigned an economic life less than the technical life, enabling an earlier return of the capital investment ahead of the assets being stranded. This would equate to a

relatively front end loaded depreciation profile.[81] The Commission concluded that this was the appropriate manner to accommodate the risk of complete or partial stranding.

Although these remedies for dealing with reserve risk were set out in the *Final Decision*,[82] EAPL has elected not to assume a shorter life for its assets or to adjust its long term forecasts to reflect the claimed risk. Rather, EAPL has simply submitted that it should receive an annual cash flow allowance.

The Commission has examined the report written by NECG and submitted by EAPL on a confidential basis, but notes that this examination has been limited by the absence of the models and simulations actually used to estimate the allowance required. The Commission has a number of concerns with NECG's analysis, particularly with a number of the assumptions which underpin NECG's conclusions. As a result of these concerns the Commission has significant reservations about the results of NECG's analysis and in particular its conclusion that any additional cash flow allowance is required (A detailed discussion of these concerns can be found in confidential Appendix C of this *Final Approval*.)

The Commission also has reservations about the veracity of the claims made by EAPL given that its claims appear to be inconsistent with:

- the proposal to adopt a back-end loaded depreciation profile which reflects EAPL's expectation that volumes over the medium to longer term will increase as a result of Moomba becoming a hub for northern gas supplies (from Timor or PNG) and coal seam methane;[83] and
- the assumption that the relevant life of the pipeline assets is 80 years.

Given this inconsistency it would appear to the Commission that the risk of partial asset stranding, now cited by EAPL, does not in EAPL's view present a real risk in the short to medium term or over the longer term if northern gas is supplied via Moomba.

In view of the inconsistency in EAPL's own claims regarding reserve risk, the allowance which has already been made with regard to the loss of market share and the fundamental problems with the assumptions relied upon by NECG in its estimation of the required allowance, the Commission considers that any additional allowance would result in EAPL earning a stream of revenue that exceeds the efficient costs of delivering the reference service over the expected life of the assets (section 8.1(a)). In addition the allowance would result in a distortion in the level and structure of the reference tariff (section 8.1(e)) and in turn a distortion in investment decisions in the MSP and in upstream and downstream industries (section 8.1(d)). Moreover, tariffs based on the inclusion of the additional allowance would not replicate the outcome of a competitive market (section 8.1(b)), nor would the tariffs provide an incentive for

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81 ACCC, *Draft Statement of Principles for the Regulation of Transmission Revenues*, May 1999, p. 26.

82 These issues have also been addressed in earlier decisions by the Commission such as the Moomba to Adelaide Pipeline System Final Approval, 31 July 2002, p. 17 and have also been discussed in the *Draft Statement of Principles for the Regulation of Transmission Revenues*, May 1999, p. 26., and the *Draft Greenfields Guideline for natural gas transmission pipelines,* June 2002, pp. 31-32

83 EAPL, Revised access arrangement information, 29 October 2003, p. 37.

EAPL to reduce costs and develop the market for the reference and other services (section 8.1(f)). Accordingly, the Commission does not consider that an additional allowance for competition and reserve risk is appropriate.

While the Commission does not consider that an additional allowance is appropriate it notes as it did in the *Final Decision* that if the likelihood of stranding becomes greater in the future, then EAPL could consider accommodating this by adopting a shorter life for the pipeline. This would allow EAPL to recover the capital costs incurred in providing the reference service ahead of the stranding. The Commission considers that this approach, which is consistent with section 8.34(d)[84] of the Code, would result in a closer alignment with the objectives in section 8.1 of the Code.

Regulatory, insurance deductibles and credit risk

In relation to the remaining three claimed sources of 'asymmetric risk' the Commission notes that EAPL has not within any of its submissions leading up to the *Final Decision* claimed to be exposed to these risks or quantified the magnitude of these risks. As a result, EAPL's claims in relation to these sources of 'asymmetric risk' have not been the subject of the usual assessment process under the Code including public consultation. Introducing these new items at this stage of the process does not permit the Commission to undertake a proper or adequate consideration of whether provision should be made in the access arrangement for these items.

Furthermore, the Commission notes that its reasons for requiring the amendment to the parameters used to derive the WACC estimates did not include any reference to asymmetric risk arising from regulation, insurance deductibles and credit risk. Accordingly, to the extent that the amendments proposed by EAPL following the *Final Decision* rely on the inclusion of such costs, they do not address the matters identified in the *Final Decision* as being the reasons for requiring amendment FDA 8. As a result, section 2.19 of the Code does not allow the Commission to approve amendments that allow for such claims. The Commission does not therefore consider that it would be appropriate at this time to approve an additional allowance for these claimed sources of risk.

Commission's conclusion on WACC

In view of the Commission's decision to accept a five and a half year access arrangement, the real risk free rate and forecast inflation have been revised. These revisions have in turn resulted in changes to the cost of debt, the post tax nominal return on equity and the WACC. The WACC parameters used by the Commission for determining tariffs in the *Final Approval* are set out in Table 2.5.2. The Commission's revised access arrangement is drafted accordingly.

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[84] This is the relevant section of the Code because EAPL has proposed the NPV methodology to determine total revenue.

Table 2.5.2: WACC parameters used by the Commission for the *Final Approval*

General parameters		17 September 2003
Real risk free rate	rr_f	3.08%
Expected inflation	f	2.19%
Nominal risk free rate	r_f	5.35%
Debt to total assets	D/(D+E)	60.00%
Taxation		
Corporate tax rate	T	30.00%
Effective tax rate	T_e	24.11%*
Value of imputation credits	γ	0.50
Return on equity		
Equity beta	β_e	1.00
Market risk premium	MRP	6.00%
Post-tax nominal return on equity	r_e	11.35%
Post-tax real return on equity	rr_e	8.96%
Cost of debt		
Debt margin	DM	0.92%
Nominal cost of debt	r_d	6.26%
Real cost of debt	rr_d	3.98%
WACC estimates		
Post-tax nominal WACC		7.58%*
Pre-tax nominal WACC		8.97%*
Pre-tax real WACC		6.63%*
Nominal vanilla WACC		8.30%

* Derived for the mainline segment of the pipeline. The effective tax rate for the regional laterals is 14.8 % which results in a post-tax nominal WACC=7.84%, a pre-tax nominal WACC=8.72% and a pre-tax real WACC=6.39%.

2.6 Non capital costs

Amendment FDA 9

2.6.1 Amendment required

In order for EAPL's access arrangement for the MSP to be approved, EAPL must adopt the non capital costs set out in Table 2.7.8.2 of the *Final Decision* (this table is replicated below).

Final Decision Table 2.7.8.2: Commission approved non capital costs (July 2003 $ million)

Year ending 30 June	2004	2005	2006	2007	2008
Total non capital costs	18.57	18.62	18.76	18.91	19.05

The Commission's reasons for requiring this amendment are set out at pages 148 – 156 and Confidential Appendix E pages 336 – 348 of the *Final Decision*.

2.6.2 EAPL's response to the *Final Decision*

EAPL did not incorporate, nor substantially incorporate, amendment FDA 9 into its revised access arrangement of 23 October 2003. As such, in accordance with section 2.19(b), the issue is whether EAPL's accompanying submission otherwise addresses to the Commission's satisfaction the matters identified in the *Final Decision* as being the reasons for requiring amendment FDA 9.

EAPL sought to address the Commission's reasons for requiring amendment FDA 9 by making further submissions on the following matters:[85]

- the relationship between volumes and non capital costs;
- the Management Fee;
- the Marketing Fee; and
- the use of benchmarks.

EAPL's submissions and the Commission's response to these are set out below.

2.6.3 Commission's considerations

At the outset the Commission notes that EAPL has revised downward its forecast non capital costs by 2.84 per cent as a consequence of its decision not to include the Interconnect in the access arrangement. This 2.84 per cent represents the proportional value of the Interconnect ($29.5 million) within the total ORC of the MSP ($1042.3 million). The Commission has no concerns with this aspect of EAPL's proposal, and the access arrangement approved by the Commission is drafted accordingly.

The relationship between volumes and non capital costs

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

EAPL also contended that the Commission had been inconsistent in its position on the impact of throughput on operating costs as it had '…implicitly agreed that the majority of cost allocation should be to fixed costs' with its approval of a 96:4 split in throughput and capacity charges.[86] This is an incorrect interpretation of section 2.12 of the *Final Decision*, which refers to the total costs of a pipeline and not just non capital costs.[87] Total pipeline costs include depreciation, return on capital, capital expenditure and non capital costs. The Commission notes that the first three are a sizable component of total costs, the majority of which are fixed. Non capital costs do not, however, exhibit the same characteristics. The Commission has not accepted a 96:4 split in relation to non capital costs.

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85 EAPL, Submission in response to the Final Decision, 31 October 2003, pp. 34-37.

86 EAPL, Submission in response to the Final Decision, 31 October 2003, p. 34.

87 ACCC, *Final Decision: MSP*, 2 October 2003, pp. 227-228.

Moreover, EAPL has not addressed the Commission's observation that EAPL's position on the responsiveness of non capital costs to throughput has changed substantially between its access arrangement information of 5 May 1999 and its access arrangement information of July 2003.[88] EAPL has not demonstrated that this proposition is invalid.

Finally, EAPL contended that the Commission was of the view that the PMA is neither efficient nor prudent because charges do not vary with throughput.[89] The Commission considers this is not an accurate portrayal of its reasoning and refers to the *Final Decision* (page 153), where the point is made that an efficient and prudent operator would not (in the Commission's view) enter into a contract which provided such little opportunity to capture efficiencies.

Accordingly, EAPL's submissions on the relationship between volumes and non capital costs do not address to the Commission's satisfaction the matters identified in the *Final Decision* for requiring amendment FDA 9.

The Management Fee

EAPL's submission stated:

> The Management Fee is a fixed fee for the management of the pipeline (including Agility's significant pipeline expertise, experience and intellectual property) as well as representing a margin for all the services under the PMA.
>
> As part of its establishment, APT out-sourced the field and management services of the pipeline to Agility as the organisation that has the specific experience with the MSP as well (sic) its broad general experience with a significant portion 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.[90]

EAPL referred to other gas entities which have outsourced operational functions and concluded:

> EAPL believes it has provided sufficient evidence that the level of 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.[91]

EAPL's submission does not address the matters identified in the Commission's discussion of the Management Fee at pages 344 – 345 of the *Final Decision.* As set out in the *Final Decision*, the PMA provides for the payment of separate charges for the services Agility actually delivers under that agreement, and those separate charges (without the addition of the Management Fee) appear to reflect EAPL's view of a reasonably competitive price for those services, for the reasons stated at page 344 of the *Final Decision.*

The Commission has no objection to the contracting out of services. The Commission considers such an inference cannot fairly be drawn from its discussion of the

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88 ACCC, *Final Decision: MSP*, 2 October 2003, p. 152.

89 EAPL, Submission in response to the Final Decision, 31 October 2003, p. 34.

90 EAPL, Submission in response to the Final Decision, 31 October 2003, p. 34.

91 EAPL, Submission in response to the Final Decision, 31 October 2003, p. 35.

Management Fee. However, the mere fact that services have been contracted out does not of itself prevent the Commission from examining whether the proposed costs exceed those that would be incurred by a prudent service provider acting in the manner contemplated by section 8.37 of the Code.

EAPL also stated that the Management Fee in part represents 'a margin for all the services under the PMA.'[92] However, this characterisation has no bearing on the Commission's reasoning. No case has been made that a prudent service provider acting in the manner contemplated by section 8.37 of the Code would incur such a cost.

Thus, to the extent that EAPL's revised access arrangement provides for the recovery of the Management Fee, it does not address to the Commission's satisfaction the matters relating to this fee set out in the *Final Decision.*

The tariffs in the access arrangement drafted and approved by the Commission do not provide for the recovery of the Management Fee.

The Marketing Fee

The Commission's *Final Decision* concluded that the marketing cost component of EAPL's proposed non capital costs exceeded those that would be incurred by a prudent service provider acting in the manner contemplated by section 8.37 of the Code.[93]

EAPL submitted that the quantum of its proposed marketing expenditure is appropriate. In support of this position, EAPL briefly described Petronas' role in providing marketing services in respect of the MSP. EAPL also submitted that the marketing cost comparisons referred to in the *Final Decision* are not relevant and do not reflect what EAPL describes as the 'environment of competition' in which it claims the MSP operates.

In relation to EAPL's proposition that the MSP is now exposed to such additional competition that it must take a 'proactive approach' to marketing (resulting in costs of 'an order of magnitude greater' than where there is no competing pipeline), the Commission notes that the marketing costs provided for in amendment FDA 9 (and for which provision is made in the access arrangement approved by the Commission under section 2.20 of the Code) remain well in excess of (that is, it is nearly double) the marketing costs of other pipelines. The marketing costs proposed by EAPL, however, appear to be four times those of other pipelines. The Commission does not consider the competitive pressures faced by EAPL could justify costs of this magnitude.

Further, EAPL's submission about the effect of the 'competitive environment' on marketing costs does not sit well with the view expressed in a report by NECG, that pipeline operators have relatively little influence over a shipper's choice of pipeline.[94] The NECG report was commissioned by EAPL and submitted to the Commission in support of its revised access arrangement and claimed asymmetric risk.

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[92] EAPL, Submission in response to the Final Decision, 31 October 2003, p. 34.

[93] ACCC, *Final Decision: MSP*, 2 October 2003, pp. 155, 346.

[94] NECG, *Quantification of Asymmetric Risk in Expected Returns faced by the Moomba to Sydney Pipeline*, November 2003, p. 16.

While the Commission believes that section 8.37 of the Code invites consideration of operating cost levels of other service providers, the Commission has not restricted its analysis to such comparisons.

The Commission examined EAPL's historic non capital costs. EAPL advised that the non capital costs in the initial access arrangement related to '…operation, maintenance, **marketing** and administration of the Moomba to Sydney natural gas pipeline system.'[95] Further discussion of this matter is contained in confidential Appendix B to this *Final Approval*.

The Commission has approached EAPL on a number of occasions seeking explanation and clarification regarding these costs.[96] Despite its considerable efforts, the Commission has been unable to reconcile the costs EAPL says it will incur with the services it says will be provided. A more detailed assessment of the marketing fee is set out in confidential Appendix B to this *Final Approval*.

The Commission has noted some inconsistencies in regards to EAPL's advice as the number of staff that the Petronas marketing fee provides for. By way of example in a submission to Commission on the *Final Decision* EAPL advised that:

> Petronas Marketing Fee- This fee paid to Petronas for the provision of marketing services including **one** staff member. This service relates exclusively to the MSP.[97]

However in response to the *Final Decision* EAPL submitted that:

> …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…[98]

Thus, to the extent that EAPL's revised access arrangement provides for the recovery of the Marketing Fee, it does not address to the Commission's satisfaction the matters relating to EAPL's marketing costs set out in the *Final Decision.*

The tariffs in the access arrangement drafted and approved by the Commission do not provide for the recovery of the marketing fee.

The use of benchmarking

The Commission's *Final Decision* noted that the non capital costs proposed for the MSP, on a dollar per kilometre per Petajoule ($/km/PJ) basis, were higher than the costs of comparable pipelines. The Commission's discussion of this comparison is set out on pages 347 – 348 of the *Final Decision.*

EAPL submitted that the $/km/PJ measure is an incorrect basis for comparing pipelines.[99] EAPL stated that operating costs do not vary materially with throughput. Regardless of volumes, major items of operating and maintenance expenditure must

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95 EAPL, Access arrangement information, 5 May 1999, p. 40.

96 ACCC, *Final Decision: MSP*, 2 October 2003, Confidential Appendix D.

97 ACCC, Request for additional information, 26 May 2003, p. 4.

98 EAPL, Submission in response to the Final Decision, 31 October 2003, p. 34.

99 EAPL, Submission in response to the Final Decision, 31 October 2003, p. 36.

still be incurred. EAPL sought to illustrate this concept with an example of two pipelines of similar length. Under this scenario the pipeline which carries the most gas will always be expected to have lower $/km/PJ benchmarks. Accordingly EAPL argued that a comparison which takes into consideration volumes says nothing meaningful about the efficiency of costs incurred by a service provider.[100]

EAPL reiterated its earlier position that the only meaningful comparisons are given by $/km and $/ORC. On this basis EAPL contended its forecast non capital costs were well within the range of other Australian pipelines and as such the entire proposed non capital costs should be included in the access arrangement.[101]

Even though this indicator represents just one of several key performance indicators (KPIs) discussed in the *Final Decision*, the Commission maintains that reference to this indicator is justified on three main grounds.

First, the Commission notes that EAPL has been inconsistent in its views on different benchmarking indicators. For example in its initial access arrangement EAPL commissioned Ernst and Young to assess its costs against 15 participating companies from the USA, Canada, UK, Brazil, Argentina, Indonesia and New Zealand. This study provided a number of indicators in support of its cost claims, two of which were normalised on a *volume-distance basis* (namely general and administrative costs and total expenses). These indicators supported the claim that 'EAPL is well below the median of expense per volume distance' and 'EAPL is well below the median' in terms of general and administrative costs per volume distance'.[102] The fact that EAPL relied on volume distance measures in support of its original cost claims but now suggests that such measures are 'manifestly incorrect' is inconsistent.

Second, the use of volume-distance indicators was not disputed by EAPL (in its 1999 access arrangement information) or by other gas transmission service providers and stakeholders. For example, GasNet did not dispute the inclusion of operating and maintenance costs/km/PJ in its access arrangement information in response to an amendment proposed by the Commission. The Commission notes that Energy Advice also recommended the inclusion of this benchmark in one of its submissions to the GasNet decision.[103]

Third, as set out in the *Final Decision*, the Commission considers that volume-distance benchmarks provide useful information not available from other indicators. Volume-distance measures provide the Commission and interested parties with an indication of how well a company is performing at doing what it does, that is, transporting energy over defined distances.

The Commission considers it important to include this KPI measure as one of the indicators of EAPL's performance. This analysis may be deficient if all the KPIs

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[100] EAPL, Submission in response to the Final Decision, 31 October 2003, p. 36.

[101] EAPL, Submission in response to the Final Decision, 31 October 2003, p. 37.

[102] EAPL, Supplementary access arrangement information, 28 October 1999, pp. 43 and 45.

[103] Energy Advice submission, *GasNet Australia access arrangement revisions for the Principle Transmission System*, 30 May 2002.

provided are cost based (such as output per kilometre of pipeline), as it would be possible to establish that an asset is performing well, even if it has zero throughput. Whilst the Commission recognises that this indicator is in part a function of throughput, it is of the view that the inclusion of services delivered should be incorporated in at least one indicator supporting the performance of an asset.

The Commission therefore does not agree with EAPL that the only meaningful comparisons are given by non capital costs per kilometre and non capital costs divided by ORC. The Commission reiterates that a variety of KPIs should be included and that these KPIs can only be used as broad secondary support for the cost claims made by the service provider. Consequently, EAPL's conclusion that the 'entire costs proposed by EAPL should be included in the access arrangement' on the basis of the company's performance against just two benchmarks is therefore questionable.

The Commission has had regard to a range of operating cost indicators in its *Final Decision.*[104] The Commission is aware of the limitations of benchmarking given that such indicators are influenced by different pipeline characteristics and each indicator does not capture all relevant information. As a result, the Commission recognises the advantages and disadvantages of different indicators, and is of the view that a 'variety of KPIs can elucidate the cost claims made by service providers'.[105]

Whilst the Commission does refer to the benchmark non capital costs per km per PJ to provide some secondary support to its position of EAPL's costs, it also refers to other indicators in chapter 4 of the *Final Decision* as providing 'broad evidence in support of the Commission's concerns…'.[106] Accordingly, EAPL's claim that the Commission relies on non capital costs per km per PJ as secondary support for its assertions is clearly selective and ignores the extensive discussion of other benchmarks provided in other areas of the *Final Decision*.

Accordingly, EAPL's submissions in relation to the use of benchmarks do not address to the Commission's satisfaction the matters addressed in the *Final Decision* for requiring amendment FDA 9.

The non capital costs used by the Commission for determining tariffs in the *Final Approval* are set out in Table 2.6.1. The Commission's revised access arrangement is drafted accordingly.

Table 2.6.1: Non capital costs used by the Commission for the *Final Approval* (July 2003 $ million)

Financial year	2004	2005	2006	2007	2008	2009
Total non capital costs	**18.1**	**18.2**	**18.3**	**18.4**	**18.6**	**18.6**

[104] ACCC, *Final Decision: MSP*, 2 October 2003, sections 2.7 and 4.

[105] ACCC, *Final Decision: MSP*, 2 October 2003, p. 311.

[106] ACCC, *Final Decision: MSP*, 2 October 2003, p. 317.

2.7 Volumes

Amendment FDA 10

2.7.1 Amendment required

The Commission's *Final Decision* stated that in order for EAPL's access arrangement for the MSP to be approved, EAPL must adopt the total MSP throughput forecasts contained in Table 2.8.7.2 of the *Final Decision* (this table is replicated below).

The Commission's reasons for requiring this amendment are set out on pages 175 – 176 of the *Final Decision*.

Final Decision Table 2.8.7.2: Commission approved forecast volumes (PJ)

Year ending 30 June	2004	2005	2006	2007	2008
Total NSW/ACT demand	123.7	126.0	129.0	132.8	139.2
Total MSP throughput[a]	95.8	92.9	94.2	93.8	90.6

Notes: (a) Includes southbound flows on the Interconnect

2.7.2 EAPL's response to the *Final Decision*

EAPL rejected the adoption of total NSW/ACT demand forecasts and forecast MSP throughput contained in table 2.8.7.2 of the *Final Decision* and provided responses to the Commission's reasons for requiring the amendment. That is, the underestimation of total NSW/ACT gas deliveries in 2001/02 and the impact of using a base year with a warm winter.[107]

With regard to the first issue, EAPL noted that it maintained its view that the impact on forecast volumes for the MSP of this underestimation would be 'trivial'. EAPL then stated that the 360 TJ per annum estimate of the effect of the underestimation of actual deliveries in the base year was merely illustrative and not designed to represent a rigorously derived estimation.

With regard to the warm winter effect, EAPL contended that a single year upward adjustment without recognition of past and future annual trends to warmer weather would be incorrect. EAPL went on to state that it was never its view that the effect of an underestimation of actual deliveries in NSW/ACT in 2001/02 and the effect of the warm winter would be additive.

Another factor referred to by EAPL in support of its rejection of the amendment was its conservative estimation of the forecasts for coal seam methane. EAPL submitted that the Commission's recognition of EAPL's conservative estimation of forecasts for coal seam methane meant that there was an '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'.[108]

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[107] EAPL, Submission in response to the Final Decision, 31 October 2003, pp. 39-42.

[108] EAPL, Submission in response to the Final Decision, 31 October 2003, p. 42.

EAPL concluded that in view of the uncertainty surrounding the MSP forecast, the external consultant's estimates and its conservatism regarding coal seam methane production, it was unreasonable to require an adjustment to its forecast volumes.

2.7.3 Commission's considerations

Following EAPL's submission of revised volume forecasts in May 2003, the Commission engaged external consultants McLennan Magasanik Associates (MMA) to examine the forecasts submitted by EAPL. MMA's advice to the Commission indicated that there were two potential areas of concern regarding the methodology employed by EAPL to estimate the value of the base year. Specifically, MMA noted that actual deliveries in the base year may have been underestimated by as much as 4 PJ. MMA also noted EAPL's failure to take into account the unseasonably warm winter which occurred in the 2001/02 base year and submitted that this may account for an additional 1-2 PJ to 'normalise' the NSW/ACT load.

EAPL was provided with an opportunity to respond to these issues and in correspondence with the Commission acknowledged that it may have failed to include these effects. However, EAPL disputed the extent to which these factors would have affected the base year. After carrying out some analysis EAPL concluded that the underestimation of actual deliveries in the base year would translate to an additional 200 TJ per annum by the end of the access arrangement period.[109] In relation to the unseasonably warm winter, EAPL concluded that an additional 360 TJ could have offset any loss due to warm weather.[110] While acknowledging these factors may have resulted in an underestimation of the base year, EAPL asserted at that time that it considered these volumes to be trivial.

The Commission maintains its view that these methodological issues are not trivial and should have been addressed by EAPL to ensure the forecasts were based on best estimates arrived at on a reasonable basis as required by section 8.2(e). That said, the Commission acknowledges that overall when combined with EAPL's potentially conservative position on coal seam methane production by the Sydney Gas Company, the adjustment is unnecessary. Accordingly, the Commission is satisfied that EAPL has addressed to its satisfaction the issues raised in the *Final Decision* for requiring the amendment. The volumes used by the Commission for determining tariffs in the *Final Approval* are set out in Table 2.7.1. The Commission's revised access arrangement is drafted accordingly.

Table 2.7.1: Forecast volumes used by the Commission for the *Final Approval* (PJ)

Year ending 30 June	2004	2005	2006	2007	2008	2009
Total NSW/ACT demand	121.2	123.5	126.5	130.1	136.5	141.7
Total MSP throughput[(a)]	95.4	92.4	93.6	93.2	89.9	86.9

Notes: (a) Includes southbound flows to Victoria via the Wagga lateral

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109 EAPL, Comments on McLennan Magasanik Associates Review of EAPL Forecasts for the ACCC, 15 July 2003, p. 8.

110 EAPL, Comments on McLennan Magasanik Associates Review of EAPL Forecasts for the ACCC, 15 July 2003, p. 7.

2.8 Forecast revenue and tariff path

Amendment FDA 11

2.8.1 Amendment required

In order for EAPL's access arrangement for the MSP to be approved, EAPL must:

- include details of the price path adjustment mechanism in its access arrangement;
- use September quarter data as the basis of the annual CPI adjustment in 2004 through to 2007;
- specify that the annual CPI adjustment would come into effect on 1 January for the years 2005 through 2008; and
- specify that forecast inflation will be used to calculate tariffs in the first year of the access arrangement period.

The Commission's reasons for requiring this amendment are set out on pages 192 – 193 of the *Final Decision.*

2.8.2 EAPL's response to the *Final Decision*

Clause 8.11 of EAPL's revised access arrangement specifies that EAPL may vary reference tariffs within the access arrangement period in accordance with the following escalation formula:

$$RT_n = RT_{n-1} \times \left[1 + \frac{CPI_n - CPI_{n-1}}{CPI_{n-1}}\right] \times (1 - X)$$

Where:

RT_n = reference tariff in year n

RT_{n-1} = reference tariff in year n-1

CPI = Consumer Price Index (All Groups – weighted Average Eight Capital Cities) published quarterly by the Australian Bureau of Statistics. If the Australian Bureau of Statistics ceases to publish the quarterly value of that index, then CPI means the quarterly values of another Index which EAPL reasonably determines most closely approximates that Index.

CPI_n = the CPI published for the March quarter in year n.

CPI_{n-1} = the CPI published for the March quarter in year n-1.

Mainline X (XML) = + 0.66%

Regional Laterals (XRL) = -2.44%[111]

[111] Following the claim by EAPL on 11 November 2003 for an additional $1.76 million pa for asymmetric risk, the Commission has updated the models submitted by EAPL. When this additional allowance is included, EAPL's has effectively proposed an X factor of +0.47 per cent for the mainline and -2.56 per cent for regional laterals.

The revised access arrangement also sets out the reference tariff for the first partial year of the proposed access arrangement period (1 January 2004 to 30 June 2004).

Mainline:	Capacity Charge: 0.04764 cents per GJ per km
	Throughput Charge: 0.00299 cents per GJ per km
Regional laterals:	Capacity Charge: 0.04764 cents per GJ per km
	Throughput Charge: 0.00299 cents per GJ per km

In addition, clause 8.12 of the revised access arrangement specifies that the proposed variation to reference tariffs applies from 1 July of the relevant year (clause 8.12(d)) and that EAPL may submit a notice in the years 2004 through 2008 (clause 8.12(a)).

2.8.3 Commission's considerations

As required by amendment FDA 11, EAPL has set out the proposed price path adjustment mechanism in the access arrangement. A number of the specific elements of this price path mechanism, however, do not comply with the requirements of amendment FDA 11.

First, amendment FDA 11 stated that the annual CPI adjustment should come into effect on 1 January of each year and that CPI data from September of the previous year should be used as the basis of the CPI adjustment. EAPL, however, has retained the use of March CPI data as the basis of the annual escalation formula and has specified in clause 8.12 that these tariffs apply from 1 July of the relevant year (2004 through to 2008). In addition, EAPL submitted that for the adjustment undertaken in 2004, CPI data for the six months ending March 2004 should be adopted.[112] In support of its position, EAPL argued that an escalation date of 1 January would not be in the interests of users given that tariff changes would come into effect in the holiday period. Further, EAPL claimed that historically it had only ever adjusted tariffs from 1 July and that the adjustment to reference tariffs on the Central West Pipeline also occurred on a financial year basis.[113]

The Commission has considered the arguments presented by EAPL and acknowledges the difficulties associated with a tariff path adjustment on a calendar year basis in this instance. In addition, the Commission has assessed the reasons for its decision to require the calendar year tariff adjustments and considers that EAPL's proposal overcomes the Commission's initial concerns. Accordingly, the Commission accepts EAPL's proposal to adopt a financial year adjustment and has amended its tariff models and calculations accordingly. With regard to the first adjustment in June 2004, the Commission considers that for consistency purposes CPI data for the year ending March 2004 should be adopted as opposed to data over the previous six months to March 2004 (as proposed by EAPL).

Second, EAPL has not explicitly stated that forecast inflation will be used as the basis of tariffs in the first year of the access arrangement period, as required by amendment

[112] EAPL, Submission in response to the Final Decision, 31 October 2003, p. 43.

[113] EAPL, Submission in response to the Final Decision, 31 October 2003, p. 43.

FDA 11. The Commission, however, recognises that this assumption is implicit in the models and tariffs provided by EAPL and is therefore of the view that an explicit statement to this effect is not required in the access arrangement.

Third, the X factor and starting tariffs adopted by EAPL are different from those proposed by the Commission in the *Final Decision*. In part this difference reflects EAPL's decision to remove the Interconnect, but is also a function of EAPL's rejection of amendments relating to the ICB, WACC, volumes and non capital costs proposed in the *Final Decision*. Whilst these elements are discussed in other sections of this *Final Approval*, the Commission maintains that an X factor of 1.60 per cent (now combined with an initial fall in tariffs of 25 per cent) for the mainline is appropriate. The Commission also considers that it is appropriate given the tariff elements to adopt an X factor of 0.60 per cent for the regional laterals starting at current published tariffs. The Commission therefore considers that EAPL's response to amendment FDA 11 does not comply with the *Final Decision*. Accordingly the Commission has adjusted the X factors and starting tariffs in the approved revised access arrangement.

Amendment FDA 12

2.8.4 Amendment required

In order for EAPL's access arrangement for the MSP to be approved, EAPL must include the following provisions in the access arrangement:

- EAPL must provide a notice to the Commission of its proposed revised tariffs in accordance with the reference tariff formula and approved X values 30 business days prior to 31 December 2004 and on the same day each subsequent year until 31 December 2007.
- This notice must specify that the proposed variations to the reference tariff applies from 1 January of the relevant year.
- The Commission will assess the proposed tariffs provided by EAPL and determine if they comply with the relevant CPI-X formula. The Commission will publish its decision within 20 business days of EAPL lodging its submission. The Commission may either approve the revision, disallow the variation or may specify a complying variation. If a complying variation is required, this will be taken to be approved on the 21st business day after lodgement and come into effect on 1 January of the relevant year.
- If the Commission does not provide a notice within 20 business days, the Commission will be taken to have approved the revised tariffs, which will come into effect on 1 January of the relevant year.
- Before the expiry of the 20 business days after submission, the Commission may request additional information if it considers that such information will assist its assessment. This will extend the relevant assessment period by the number of days commencing on the day on which the Commission gave notice to EAPL and ending on the day on which EAPL submits the required information.
- The Commission may grant an extension on application by EAPL of any of the time periods associated with this process.

The Commission's reasons for requiring this amendment are set out on page 196 of the *Final Decision.*

2.8.5 EAPL's response to the *Final Decision*

EAPL's response to amendment FDA 12 is contained in clause 8.12 of the revised access arrangement. This clause states:

> EAPL may vary the Reference Tariffs using the CPI-X formula in accordance with the Code subject to the following:
>
> a. during the period 2004 to 2008, if EAPL wishes to vary tariffs, EAPL must provide a notice to the Regulator 30 business days prior to 30 June each year;
>
> b. this notice must contain EAPL's proposed variations to the Reference Tariffs and the proposed effective date for those variations;
>
> c. the proposed variations to the Tariffs must be in accordance with the CPI-X formula and approved X values;
>
> d. this notice must specify that the proposed variations to the Reference Tariffs apply from 1 July of the relevant year;
>
> e. the minimum notice period for the purposes of section 8.3D(b)(i) of the Code shall be 20 business days from the date that EAPL submits its notice under section 8.12(a).

EAPL's submission to the *Final Decision* also noted that its proposed amendment had been drafted to avoid duplication with sections 8.3A to 8.3H of the Code and thus the amendment should be read in conjunction with the Code.[114]

2.8.6 Commission's considerations

As noted with regard to amendment FDA 11, the Commission has considered EAPL's request to undertake the tariff variation on a financial year basis and considers this to be appropriate. The Commission, however, notes two minor elements of EAPL's response that do not comply with amendment FDA 12.

First, clause 8.12(a) of EAPL's revised access arrangement states that EAPL may submit a reference tariff variation only if it 'wishes to vary tariffs'. The Commission does not consider that the reference tariff formula approved in the *Final Decision* allows EAPL any discretion as to whether or not it should submit a tariff variation notice. Accordingly, the Commission has removed this phrase from the approved revised access arrangement.

Second, the amendment required EAPL to specify that the Commission may approve a variation, disallow a variation, specify a complying variation, or request additional information from the service provider. EAPL, however, has not complied with these elements of amendment FDA 12. Since these elements are specified in sections 8.3A to 8.3H of the Code, the Commission concurs with EAPL that there would be some degree of duplication if these provisions were repeated in the revised access arrangement. The Commission notes that EAPL has included the phrase in clause 8.12 of the revised access arrangement which states that 'EAPL may vary Reference Tariffs using the CPI-X formula in accordance with the Code'. Whilst this phrase appears to

[114] EAPL, Submission in response to the Final Decision, 31 October 2003, p. 43.

address these elements of FDA 12, for the removal of any doubt the Commission requires that the phrase be amended to read 'in accordance with sections 8.3B to 8.3H of the Code'. The Commission has accordingly changed the approved revised access arrangement to incorporate this addition.

Amendment FDA 13

2.8.7 Amendment required

In order for EAPL's access arrangement for the MSP to be approved, EAPL must replace the tariffs proposed in Attachment C1 with those set out in Table 2.9.1.4 (this table is replicated below). EAPL must also delete Attachments C2, C3 and C4 from the revised access arrangement.

The Commission's reasons for requiring this amendment are set out on pages 196 – 200 of the *Final Decision.*

Final Decision Table 2.9.1.4: Tariffs required by the Commission (nominal cents/GJ per km)

	2004	2005	2006	2007	2008
Mainline					
Capacity charge	0.03773	0.03794	0.03815	0.03836	0.03858
Throughput charge	0.00237	0.00238	0.00239	0.00241	0.00242
Regional laterals					
Capacity charge	0.04850	0.04938	0.05027	0.05118	0.05211
Throughput charge	0.00304	0.00310	0.00316	0.00321	0.00327

Note: These tariffs do not include GST.

2.8.8 EAPL's response to the *Final Decision*

EAPL has deleted attachments C2, C3 and C4 from the revised access arrangement. EAPL, however, has not incorporated the tariffs set out in table 2.9.1.4 of the *Final Decision*. The tariffs proposed by EAPL differ not only because of the decision to exclude the Interconnect, but also because EAPL has not adopted the ICB, non capital costs, volumes and elements of the WACC required in the *Final Decision*. Tariffs and revenues proposed by EAPL are set out in the Table 2.8.1, Table 2.8.2 and Table 2.8.3 below. The Commission notes that as with the X factors, these figures do not include the claim by EAPL on 11 November 2003 for an additional $1.76 million pa for asymmetric risk (in addition to the $1.5 million included in revised tariffs and revenues below).

Table 2.8.1: Tariffs submitted by EAPL (nominal cents/GJ/km)

Financial year	2004	2005	2006	2007	2008	2009
Mainline						
Capacity charge	0.04764	0.04836	0.04910	0.04985	0.05060	0.05137
Throughput charge	0.00299	0.00306	0.00312	0.00319	0.00326	0.00333
Regional laterals						
Capacity charge	0.04764	0.04869	0.04975	0.05084	0.05196	0.05310
Throughput charge	0.00299	0.00306	0.00312	0.00319	0.00326	0.00333

Source: EAPL, Revised access arrangement, 23 October 2003, p. 29.
Note: Based on CPI of 2.19 per cent.

Table 2.8.2: Total revenue proposed by EAPL – mainline (July 2001 $million)

Financial year	2004[(a)]	2005	2006	2007	2008	2009
Return on assets	22.59	44.84	44.65	44.40	44.29	44.56
Operating costs[(b)]	12.38	24.69	24.69	24.69	24.69	24.59
Economic depreciation	3.85	4.14	4.02	1.91	(1.92)	(6.02)
Total revenue[(c)]	**38.83**	**73.67**	**73.36**	**71.00**	**67.06**	**63.13**

Source: EAPL, Revised access arrangement information, 29 October 2003, p. 24.
Note: (a) Total revenue for the financial year 2003/04 is for 6 months of the access arrangement period (1 January 2004 to 30 June 2004).
(b) Includes non capital costs, debt issuance costs of $2.27m pa, equity issuance costs of $1.2m pa and asymmetric risk of $1.50m pa.
(c) Totals may not add up due to rounding.

Table 2.8.3: Total revenue proposed by EAPL – laterals (July 2001 $million)

Financial year	2004[(a)]	2005	2006	2007	2008	2009
Return on assets	2.32	4.86	5.06	5.53	5.75	5.97
Operating costs[(b)]	1.07	2.13	2.13	2.13	2.13	2.12
Economic depreciation	(1.44)	(2.88)	(2.87)	(3.12)	(3.09)	(3.05)
Total revenue[(c)]	**1.95**	**4.11**	**4.32**	**4.55**	**4.79**	**5.04**

Source: EAPL, Revised access arrangement information, 29 October 2003, p. 24.
Note: (a) Total revenue for the financial year 2003/04 is for 6 months of the access arrangement period (1 January 2004 to 30 June 2004).
(b) Includes non capital costs, debt issuance costs of $2.27m pa, equity issuance costs of $1.2m pa and asymmetric risk of $1.50m pa.
(c) Totals may not add up due to rounding.

2.8.9 Commission's considerations

As discussed above, amendment FDA 13 required EAPL to remove attachments C2 to C4 of the access arrangement and to incorporate tariffs set out in the *Final Decision*. Whilst EAPL has removed the relevant attachments, the reference tariffs are substantially different from those set out in the *Final Decision*. Despite the fact that the Commission has amended tariffs to incorporate the exclusion of the Interconnect and the adoption of a five and a half year risk free rate, the tariffs proposed by EAPL do not align with those now required. Accordingly, the Commission is not satisfied that

EAPL's tariffs incorporate, substantially incorporate or otherwise address amendment FDA 13 of the *Final Decision*.

The respective capacity and throughput charges (nominal cents per GJ per km) now required by the Commission are set out in Table 2.8.4 and Table 2.8.6. Attachment C1 of the approved revised access arrangement has been amended to incorporate these tariffs.

Table 2.8.4: Tariffs required by the Commission (nominal cents/GJ/km)

Financial year	2004	2005	2006	2007	2008	2009
Mainline						
Capacity charge	0.03605	0.03625	0.03646	0.03666	0. 03687	0.03707
Throughput charge	0.00226	0.00228	0.00229	0. 00230	0.00231	0.00233
Regional laterals						
Capacity charge	0.04839	0.04916	0.04994	0.05073	0. 05153	0.05234
Throughput charge	0.00304	0.00309	0.00313	0. 00318	0.00323	0.00329

Source: Commission modelling.
Note: These tariffs do not include GST.

As these tariffs are distance based they must be applied to the relevant distance the gas is transported. The table below sets out the distances to a number of locations from Moomba, Culcairn and the lateral offtake (this table is also contained in the access arrangement at Attachment C3).

Table 2.8.5: Pipeline distances

Mainline			Regional Laterals	
Mainline Delivery Points / Lateral Offtake Points	Distance from Moomba	Distance from Culcairn	Regional Lateral Delivery Points	Distance from Lateral Offtake
Mainline			*Griffith Lateral*	
Bulla Park Ethane	578	586	Junee	6
Marsden (West Wyalong)	942	222	Coolamon	40
Marsden (Central West Pipeline)	942	222	Ganmain	56
Boorowa	1077	175	Narranderra	104
Blakney Creek (Yass)	1114	212	Rockdale	116
Goulbum	1185	282	Leeton	125
Marulan	1207	305	Griffith	179
Sally's Corner	1231	329		
Moss Vale	1246	344		
Bowral	1256	354	Northern Lateral	
Bargo	1284	382		
Wilton	1299	397	Cowra	58
			Blayney	125
Canberra	1189	286	Millthorpe	121
			Orange	138
Young (township)	1046	118	Bathurst	161
Wallendbeen (Temora)	1072	92	Oberon	201
Cootamundra	1090	79	Wallerawang	204
Illabo	1125	39	Lithgow	212
Wagga Wagga	1164	0		
Lateral Offtake Points				
Griffith Lateral (at Burnt Creek)	1138	26		
Northern Lateral (Young junction)	1033	131		

Source: Access arrangement, 8 December 2003, Attachment C3.

Using these distances and the baseline tariffs set out in Table 2.8.4 generates the indicative tariffs set out in Table 2.8.6 on a dollar per GJ basis.

Table 2.8.6: Indicative tariffs between Moomba and various centres (nominal $/GJ)

Financial year	2004	2005	2006	2007	2008	2009
Moomba to:						
Wilton	0.498	0.500	0.503	0.506	0.509	0.512
Young	0.396	0.398	0.400	0.402	0.405	0.407
Lithgow	0.640	0.650	0.661	0.671	0.682	0.693
Griffith	0.677	0.688	0.699	0.710	0.721	0.733
Canberra	0.456	0.458	0.461	0.463	0.466	0.468

Source: Commission modelling.
Note: These tariffs do not include GST.

The tariffs in Table 2.8.4 are associated with the revenue set out in Table 2.8.7 and Table 2.8.8. The difference between the revenue contained in the *Final Approval* and those set out in the *Final Decision* reflect the exclusion of the Interconnect, the removal of the adjustment to forecast volumes and the adoption of a five and a half year access arrangement period.

Table 2.8.7: Total revenue – mainline (July 2003 $ million)

Financial year	2004	2005	2006	2007	2008	2009
Return on assets	30.0	29.1	28.3	27.5	26.9	26.5
Non capital costs	16.7	16.7	16.8	17.0	17.1	17.1
Economic depreciation	17.9	14.3	13.6	10.5	8.2	6.0
Total revenue	**64.5**	**60.0**	**59.2**	**58.4**	**55.3**	**52.3**

Source: Commission modelling.
Note: Totals may differ due to rounding.

Table 2.8.8: Total revenues – regional laterals (July 2003 $ million)

Financial year	2004	2005	2006	2007	2008	2009
Return on assets	2.6	2.6	2.6	2.8	2.8	2.8
Non capital costs	1.5	1.5	1.5	1.5	1.5	1.5
Economic depreciation	0.3	0.4	0.5	0.4	0.5	0.4
Total revenue	**4.4**	**4.5**	**4.5**	**4.6**	**4.7**	**4.8**

Source: Commission modelling.
Note: Totals may differ due to rounding.

2.9 Reference tariff variation policy

Amendment FDA 14

2.9.1 Amendment required

In order for EAPL's access arrangement for the MSP to be approved, EAPL must amend clause 8.7 of its revised access arrangement to specify that taxes and charges incorporated in the pass through are exogenous, of pronounced magnitude and affect the regulated firm disproportionately. In addition, EAPL must amend clauses 8.7 of its revised access arrangement to take into account the financial impact of the removal of taxes, charges, levies, duties imposts or fees.

The Commission's reasons for requiring this amendment are set out on pages 208 – 209 of the *Final Decision.*

2.9.2 EAPL's response to the *Final Decision*

Clause 8.14 (which replaces clause 8.7 of the access arrangement submitted in May 2002) of EAPL's revised access arrangement sets out EAPL's response to amendment FDA 14 as follows:

> EAPL has established Reference Tariffs for the Reference Service on the basis of government taxes, charges, levies, imposts and fees applying at 30 April 2002. In the event that:
>
> a. any new or increased taxes, charges, levies, duties, imposts or fees occur, or
>
> b. there is a reduction in the level of those taxes, charges, levies duties, imposts or fees below the level assumed by EAPL in deriving Reference Tariffs, or
>
> c. any of those taxes, charges, levies, duties, imposts or fees are removed,
>
> and where:
>
> i those taxes, charges, levies, duties, imposts or fees are exogenous,
>
> ii the amounts involved are material, and
>
> iii the detriment or benefit (as the case may be) to EAPL is significant, and
>
> iv the effect of the increase, reduction or removal occurs in the Access Arrangement period,
>
> EAPL will adjust the Reference Tariffs to recover such costs or address the reduction or removal of the taxes, charges, levies, duties, imposts or fees (as the case may be).

2.9.3 Commission's considerations

As noted above, amendment FDA 14 required EAPL to specify that taxes and charges incorporated in the pass through mechanism are exogenous, of a pronounced magnitude and affect the regulated firm disproportionately. EAPL's revised access arrangement, however, does not comply with this requirement. Alternatively, the revised access arrangement states that an adjustment to reference tariffs is appropriate in cases where taxes, charges, levies, duties, imposts or fees are exogenous, the amounts involved are material, and the detriment or benefit to EAPL is significant. EAPL has not incorporated the phrases 'pronounced magnitude' and 'affect the regulated firm

disproportionately' on the basis that the terms are vague in meaning and will result in uncertainty.[115]

The Commission considers that EAPL's approach is consistent with the intent of the amendment, which was to ensure that only significant exogenous changes in costs which have a specific material impact on the firm can be accounted for through the pass through mechanism. Accordingly the Commission is satisfied that this element of EAPL's revised access arrangement addresses amendment FDA 14.

Amendment FDA 14 also required EAPL to change its access arrangement to take into account the financial impact of the removal of taxes, charges, levies, duties imposts or fees. The Commission is satisfied that clause 8.14(c), which specifies that reference tariffs will be adjusted as a consequence of the removal of taxes and charges, substantially addresses this requirement.

Amendment FDA 15

2.9.4 Amendment required

In order for EAPL's access arrangement for the MSP to be approved, EAPL must amend clause 6.13 of the revised access arrangement to specify that:

- any new legal or procedural requirements related to Full Retail Contestability (FRC) result from either: the introduction of a new law relating to retail contestability; stipulated in a direction of a relevant Minister; or stipulated by a body appointed to implement retail contestability in the gas industry;
- that the financial impact of the event must be of a pronounced magnitude; and
- the event must affect the company disproportionately.

EAPL must also amend clause 6.13 to allow for both positive and negative changes in FRC costs.

The Commission's reasons for requiring this amendment are set out on pages 209 – 210 of the *Final Decision.*

2.9.5 EAPL's response to the *Final Decision*

Clause 8.15 of EAPL's revised access arrangement addresses a number of the requirements set out in amendment FDA 15 of the *Final Decision*. Specifically this clause states:

> If the introduction of full retail contestability in New South Wales, the Australian Capital Territory or Victoria leads to the introduction of new legal or procedural requirements affecting management or operation of the pipeline and those legal or procedural requirements result from either the introduction of a new law relating to retail contestability, a direction of the relevant Minister or a body appointed to implement retail contestability in the gas industry, and
>
> i. the financial impact is material;
>
> ii. the detriment or benefit (as the case may be) to EAPL is significant; and

115 EAPL, Submission in response to the Final Decision, 31 October 2003, p. 45.

iii. the effect occurs in the Access Arrangement period;

then EAPL may address the financial impact of those new requirements through adjustment to Reference Tariffs.

Clause 8.19 of the revised access arrangement states that EAPL may adjust reference tariffs under clause 8.15 as follows:

a. if new legal of procedural requirements result in an increase in costs during the Access Arrangement period, EAPL may adjust the Reference Tariff to recover the increase in costs; or

b. if the new legal or procedural requirements result in a reduction in costs during the Access Arrangement period, EAPL will adjust the Reference Tariffs to reflect the reduction in costs.

2.9.6 Commission's considerations

As noted above, amendment FDA 15 required EAPL to amend its access arrangement to allow for both positive and negative changes in FRC costs. The Commission considers that this element is satisfied by clause 8.15(ii) of the revised access arrangement which states that the financial impact of the event can be either positive or negative. In addition, clause 8.19 of the revised access arrangement recognises that the adjustment to reference tariffs may reflect an increase or a reduction in legal/procedural costs relating to FRC.

Amendment FDA 15 also noted that an FRC pass through will only be appropriate where the introduction of new legal or procedural requirements results from: the introduction of a new law relating to retail contestability; a direction of the relevant Minister; or a body appointed to implement retail contestability in the gas industry. The Commission considers that EAPL has incorporated this element of the amendment in clause 8.15 of its revised access arrangement.

Further, amendment FDA 15 stipulated that the financial impact of an FRC pass through must be of a pronounced magnitude and must affect the company disproportionately. EAPL, however, did not comply with this element of the *Final Decision*. Rather, EAPL stated that the financial impact of the FRC event must be material and the detriment or benefit (as the case may be) of the event must be significant. Notwithstanding this difference, the Commission is of the view that EAPL's approach is consistent with the intent of the amendment, which was to ensure that only significant changes in costs which are specific to the firm are accounted for in the FRC pass through. The Commission is therefore satisfied that EAPL's revised access arrangement addresses the reasons set out in the *Final Decision* for requiring amendment FDA 15.

Amendment FDA 16

2.9.7 Amendment required

In order for EAPL's access arrangement for the MSP to be approved, EAPL must amend clauses 8.7 and 6.13 to clarify that the financial impact of a pass through is incurred in the initial access arrangement period and that any claim does not include

costs accepted under a previous pass through submission or in approved regulated revenues. Only the cumulative financial impact of a pass through may be claimed.

The Commission's reasons for requiring this amendment are set out on pages 210 – 211 of the *Final Decision.*

2.9.8 EAPL's response to the *Final Decision*

Clause 8.14 of EAPL's revised access arrangement states that the effect of the increase, reduction or removal of taxes, charges, levies, duties, imposts or fees must occur in the access arrangement period. Clause 8.14 also states that the amounts involved in the pass through are material.

Similarly, clause 8.15 of EAPL's revised access arrangement proposes that the effect of an FRC event must occur in the access arrangement period and that the financial impact (of the FRC event) must be material.

2.9.9 Commission's considerations

Amendment FDA 16 required that the financial impact of a pass through event be incurred within the access arrangement period. Clauses 8.14 and 8.15 both have statements to this effect. The Commission is therefore satisfied that this aspect of amendment FDA 15 has been incorporated within EAPL's proposed revised access arrangement.

Clauses 8.14 and 8.15, however, do not explicitly set out that a pass through claim cannot include costs accepted under a previous pass through submission or in approved regulated revenues, or that only the cumulative financial impact of a pass through may be claimed. As with the tax pass through, the Commission is of the view that the amendments proposed by EAPL address the matters identified in the *Final Decision* as being the reasons for requiring the amendment. Specifically, as noted earlier clauses 8.14 and 8.15 both have provisions which require that the detriment or benefit of the specified event be significant to EAPL. The Commission is of the view that this requirement would by extension prevent EAPL claiming costs accepted under a previous pass through or in approved regulated revenues. Accordingly, the Commission is satisfied that EAPL's revised access arrangement addresses the reasons set out in the *Final Decision* for requiring amendment FDA 16.

Amendment FDA 17

2.9.10 Amendment required

In order for EAPL's access arrangement for the MSP to be approved, EAPL must amend clause 6.13 of its revised access arrangement to specify that the financial impact of FRC can only be recovered through reference tariffs. EAPL must also remove from clause 6.13 any reference to variations of the terms of Transportation Agreements.

In addition, EAPL must amend clauses 8.7 and 6.13 of its revised access arrangement as follows:

- EAPL must provide a written notice to the Commission specifying that a pass through event has occurred, the scope of the financial impact, how the claim is consistent with the pass through mechanism, the proposed variations to the reference tariff and an effective date for the changes.
- EAPL must provide for a minimum 40 day assessment period for any pass through claims submitted to the Commission. This period may be extended by the Commission should it seek further information from EAPL.
- EAPL must submit only one pass through notice a year, which must be submitted at least 50 days prior to the end of each financial year. This notice may incorporate a number of pass through claims or may specify that no specific events defined in the reference tariff policy have occurred.
- EAPL must state that it can apply for an extension of the relevant assessment period and that the Commission may extend the time period in the situation that it has proposed its own revisions to reference tariffs.
- EAPL must specify that the Commission can initiate its own pass through review.

The Commission's reasons for requiring this amendment are set out on pages 211 – 212 of the *Final Decision.*

2.9.11 EAPL's response to the *Final Decision*

Clause 8.15 of EAPL's revised access arrangement states that the financial impact of FRC requirements will be addressed through adjustment to reference tariffs. EAPL has removed reference to variations of the terms of transportation agreement relating to FRC from the revised access arrangement.

Clause 8.17 of the revised access arrangement states that before EAPL adjusts reference tariffs as set out in clause 8.14, it must provide a written notice to the regulator specifying the new or changed taxes, charges, levies, duties, imposts or fees, the scope of the financial impact, how the claim is consistent with clause 8.14, the proposed variation to the reference tariff and an effective date for changes (a 'tax pass through notice').

Clause 8.18 of the revised access arrangement states that EAPL must submit only one tax pass through notice each year, which must be submitted 50 days prior to the end of each financial year. This notice may incorporate a number of claims relating to the introduction, increase, reduction, or removal of taxes, charges, levies, duties, imposts or fees or may specify that none of the matters set out at clause 8.14 have occurred. For the purposes of section 8.3D(b)(i) of the Code the minimum notice period for a tax pass through notice is 40 days.

Clause 8.20 of the revised access arrangement states that prior to adjusting reference tariffs, EAPL must provide a written notice to the regulator specifying that new legal or procedural requirements affecting the management or the operation of the pipeline have been introduced, the scope of the financial impact, how the claim is consistent with clauses 8.15 and 8.19, the proposed variations to the reference tariff and an effective date for the changes (a 'FRC pass through notice').

Clause 8.21 provides that EAPL must submit only one FRC pass through notice each financial year, which must be submitted at least 50 days prior to the end of each financial year. This notice may incorporate a number of claims relating to the introduction of new legal and procedural requirements affecting the management or operation of the pipeline or may specify that none of the events set out at clauses 8.15 and 8.19 have occurred. For the purposes of section 8.3D(b)(i) of the Code, the minimum notice period for a FRC pass through notice is 40 days.

2.9.12 Commission's considerations

As noted, amendment FDA 17 required EAPL to amend its access arrangement so that the financial impact of the FRC can only be recovered through reference tariffs. The amendment also set out procedural requirements that must be met each year relating to pass through. As requested, EAPL has specified that the financial impact can only be recovered through tariffs, and have complied with elements of the reference tariff methodology. The Commission is of the view, however, that the access arrangement does not comply with two of the elements of amendment FDA 17.

First, clauses 8.18 and 8.21 of the revised access arrangement both require that EAPL submit pass through notices 50 days prior to the end of the financial year and are subject to a minimum notice period of 40 days. Whilst amendment FDA 17 stipulates these timeframes, the intent of this amendment was for EAPL to submit these notices 50 *business* days prior to the end of the financial year, and that the assessment period be 40 *business* days in length. As noted in the *Final Decision*, a 40 business day assessment timeframe will allow the Commission to undertake a detailed analysis of the pass through notice, consult with interested parties if required and should ensure that any pass through variation will be implemented at the same time each year as the tariff path adjustment. In addition a 40 business day assessment period will not materially affect EAPL given that the reference tariff variation policy allows the service provider to submit a notice relating to events that have occurred in previous years. Accordingly, the Commission has adjusted the amended revised access arrangement to reflect this change.

Second, EAPL has not set out the mechanics of the reference tariff variation should a tax or FRC event occur. As discussed in relation to amendment FDA 12, the Commission concurs with EAPL that there would be some degree of duplication if the elements specified in sections 8.3A to 8.3H of the Code were repeated in the revised access arrangement. However, for the avoidance of any doubt, the Commission has added a phrase to clauses 8.18 and 8.21 stating that the tariff variation must comply with clauses 8.3B to 8.3H of the Code.

Amendment FDA 18

2.9.13 Amendment required

In order for EAPL's access arrangement for the MSP to be approved, EAPL must amend clauses 6.13 and 8.7 to state that EAPL must provide the Commission with documentary evidence (if available) which substantiates the financial impact of the pass through event. EAPL must use best endeavours to ensure that such information is available to the Commission.

The Commission's reasons for requiring this amendment are set out on page 213 of the *Final Decision.*

2.9.14 EAPL's response to the *Final Decision*

Clause 8.17(b) of the revised access arrangement states that EAPL must use all reasonable endeavours to provide the regulator with documentary evidence (if available) which substantiates the financial impact set out in the tax pass through notice.

Similarly, clause 8.20 (b) states that EAPL must use all reasonable endeavours to provide the regulator with documentary evidence (if available) which substantiates the financial impact set out in the FRC pass through notice.

2.9.15 Commission's considerations

As noted above, EAPL has proposed the inclusion of phrases stating that it must use reasonable endeavours in providing documentary evidence to the Commission. This differs from the *Final Decision*, which required EAPL to use 'best endeavours to ensure that this information is available'.

The Commission retains its position that EAPL should use best endeavours in the provision of documentary evidence and notes that EAPL has not provided any reasons for adopting the alternative expression. Accordingly, the Commission is of the view that the changes proposed by EAPL do not incorporate or address the reasons set out in the *Final Decision* for amendment FDA 18. The approved revised access arrangement has been incorporated to reflect this change.

Amendment FDA 19

2.9.16 Amendment required

In order for EAPL's access arrangement for the MSP to be approved, EAPL must amend clause 7.5 to state that EAPL will:

- provide a written notice to the Commission specifying the minimum distance for the calculation of lateral tariffs and demonstrate how this policy complies with section 8.1 of the Code.
- provide for a minimum 40 day assessment period by the Commission which may be extended by the Commission should it seek further information from EAPL.
- specify that the proposed changes will be deemed approved within the variation period, unless the Commission notifies EAPL that is does not approve the pass through claim or proposes a relevant variation to the proposal.
- state that it can apply for an extension of the relevant assessment period and that the Commission may extend the time period in the situation that it has proposed its own revisions to reference tariffs.

The Commission's reasons for requiring this amendment are set out on pages 214 – 215 of the *Final Decision.*

2.9.17 EAPL's response to the *Final Decision*

Clause 8.16 of EAPL's revised access arrangement stipulates that:

> EAPL may elect to specify that the Capacity Charge and Throughput Charge for delivery from Regional Laterals will be calculated on the basis of a deemed minimum distance. Before EAPL does so:
>
> a. EAPL will provide a written notice to the Regulator specifying the minimum distance for the calculation of lateral tariffs and setting out its calculation methodology;
>
> b. EAPL will provide for a minimum 40 day assessment period by the Regulator which may be extended in accordance with section 8.3D of the Code should it seek further information from EAPL in accordance with 8.3D of the Code;
>
> c. Unless the Regulator has disallowed the variation under section 8.3E of the Code, the proposed changes will be deemed approved at the end of the 40 day assessment period.

2.9.18 Commission's considerations

Amendment FDA 19 required EAPL to amend its access arrangement to incorporate, in accordance with the Code, the reference tariff variation methodology relating to the minimum distance for the calculation of lateral tariffs. The Commission is of the view that elements of EAPL's response to FDA 19 of the *Final Decision* do not incorporate, substantially incorporate nor otherwise address the Commission's reasons for requiring the amendment.

In accordance with amendment FDA 19, clause 8.16(a) of EAPL's revised access arrangement states that it must provide a written notice to the regulator specifying the minimum distance for the calculation and outline its calculation methodology. However, one disparity with this element of the amendment is that EAPL fails to acknowledge that the notice must demonstrate how the reference tariff variation complies with section 8.1 of the Code. The Commission maintains that this information is important as section 8.3 of the Code requires that the Commission be satisfied that the reference tariff variation is consistent with the section 8.1 principles. An understanding of EAPL's justification in support of its proposals would be of value to the Commission's assessment, and EAPL has not provided any reasons why this requirement should be excluded from the access arrangement. Accordingly, as specified in the *Final Decision* the Commission has amended clause 8.16 to require EAPL to submit its reasoning as part of its tariff path variation application.

As with the clauses relating to FRC and tax events, clause 8.16 of EAPL's revised access arrangement specifies that the minimum assessment period of any notice submitted under this provision is 40 days. As noted with regard to FDA 17, the intent of the amendment as set out in the *Final Decision* was for a 40 business day assessment period. Since this requirement will not have a material affect on EAPL, the Commission has adjusted the amended revised access arrangement accordingly.

Finally, for the avoidance of doubt, the Commission has added a phrase to clause 8.16 stipulating that if a reference tariff variation relating to lateral tariffs is submitted, it must comply with sections 8.3B to 8.3H of the Code.

2.10 Terms and conditions

Amendment FDA 27

2.10.1 Amendment required

The Commission's *Final Decision* stated that, in order for EAPL's access arrangement for the MSP to be approved, EAPL must amend clause 24 of Attachment D to state that:

a. the user will indemnify EAPL for any loss, cost, expense or damage which arises out of or in connection with the receipt by EAPL from or on behalf of the user of any quantity of unauthorised non-specification gas at a receipt point (including direct, indirect and consequential loss); and

b. EAPL will indemnify the user for any loss, cost, expense or damage which arises out of or in connection with EAPL's express authorisation for the delivery of non-specification gas by a user into the pipeline (including direct, indirect and consequential loss).[116]

The Commission's reasons for requiring this amendment are in the *Final Decision* at page 253.

2.10.2 EAPL's response to the *Final Decision*

EAPL's revised access arrangement did not incorporate amendment FDA 27. Instead it proposed the following clause:

> a. The User will indemnify EAPL for any loss, cost, expense or damage which arises out of or in connection with the receipt by EAPL from or on behalf of the User of any quantity of non-Specification gas (whether authorised or unauthorised) at a Receipt Point (including direct, indirect and consequential loss), including for any loss, cost, expense or damage which arises out of or in connection with EAPL's indemnity to other users of the pipeline in regard the transport of authorised non-Specification gas by the User into the pipeline (including direct, indirect and consequential loss).
>
> b. EAPL will indemnify the User for any loss, cost, expense or damage which arises out of or in connection with EAPL's express authorisation for the delivery of non-Specification gas by another user of the pipeline (including direct, indirect and consequential loss) but only to the extent that EAPL actually recovers monies from such other user of the pipeline under indemnities on terms substantially similar to that in section 24(a). For the avoidance of doubt, this indemnity will not extend to the delivery of non-Specification gas by the User
>
> c. For the purpose of clause 24(b), 'non-Specification gas by another user of the pipeline':
>
> i. does not include gas that meets amended or new specifications or which EAPL is compelled to transport by law, regulation, directive of any governmental or statutory body, or which it transports for a reason associated with safety or any emergency; and
>
> ii. is gas which EAPL expressly agrees in writing with another user of the pipeline is non Specification gas and which is not gas of a type contemplated by paragraph (i).[117]

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116 ACCC, *Final Decision: MSP*, 2 October 2003, p. 254.

117 EAPL, Revised access arrangement, 23 October 2003

EAPL submitted that this clause addressed the matters identified by the Commission in the *Final Decision* for requiring amendment FDA 27.[118] In particular, EAPL:

- rejected the Commission's reasoning regarding the inclusion of reciprocal indemnities in cases where it provides an express authorisation for the delivery of non-specification gas. EAPL stated that if a user wants to transport non-specification gas then it must accept the associated risks and bear the risk of loss to other users; and
- stated it would 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.[119]

2.10.3 Commission's considerations

Under EAPL's proposal, its indemnity to receiving users would apply only in cases where EAPL actually recovers monies from the injecting user. Moreover, EAPL would not be required to indemnify receiving users in cases where EAPL itself had done something to cause gas to fall outside specification. As a consequence, EAPL's proposal would not achieve the symmetry envisaged by the *Final Decision*.

Moreover, while the terms and conditions for reference services contained in an access arrangement must, in the Commission's view, be reasonable (section 3.6 of the Code), it is intrinsically difficult to reach a sufficiently firm view as to the reasonableness or otherwise of such a clause in advance of a dispute. The very nature of such a clause is to change the allocation of risk and loss from that which would ordinarily apply under general principles of liability.

Accordingly, the Commission has not included an indemnity clause in the access arrangement it has drafted and approved under section 2.20(a) of the Code but rather considers it is better left to be negotiated between the parties, with recourse to the dispute resolution provisions of the Code if necessary.

Amendment FDA 32

2.10.4 Amendment required

In order for EAPL's access arrangement for the MSP to be approved EAPL must amend clause 73 of Attachment D to state:

Unless agreed by the parties and set out in the transportation agreement, any liability of either party will be limited to direct losses only, and does not extend to any

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118 On 11 November 2003, EAPL provided a further letter on this issue together with an advice from its solicitors, Atanaskovic Hartnell. While EAPL asserts that the letter and the advice are confidential the Commission is unable to ascertain within their contents anything of a confidential nature. However, as this correspondence consists primarily of arguments that EAPL has already made publicly, it is unnecessary to refer directly to the content of the letter or the advice. The 11 November correspondence also addressed amendment FDA 32, discussed below.

119 EAPL, Submission in response to the Final Decision, 31 October 2003, p. 47.

consequential loss, loss bought by third parties or loss of business or other income, except where such damage or loss arises out of:

a. gross negligence or wilful misconduct by either EAPL or the user;

b. the delivery of unauthorised non-specification gas into the pipeline;

c. the failure by the user to deliver gas within a specified pressure range;

d. an unauthorised overrun by the user;

e. liability of EAPL arising due to the user's imbalances; or

f. failure by EAPL to maintain the safety and integrity of the pipeline.

73A However, neither party will be liable for loss which could have been mitigated against or for loss suffered as a result of contributory negligence on the part of the other party.

The Commission's reasons for requiring this amendment are set out at pages 259 – 262 of the *Final Decision*.

2.10.5 EAPL's response to the *Final Decision*

EAPL agreed to a number of the amendments set out in amendment FDA 32, however, it proposed a minor amendment to proposed sub clause 73(b) and rejected the inclusion of sub clause 73(f) and clause 73A. EAPL also proposed an amendment to sub clause 73(b) to clarify its operation. The proposed amendment was to incorporate the phrase 'by the user' within the sub clause as follows: [120]

> the delivery of unauthorised non-specification gas *by the user* into the pipeline.

With regard to sub clause 73(f), EAPL stated that much, if not all, of what it is required to provide under the access arrangement can be defined as going to the 'safety and integrity' of the pipeline. Accordingly, EAPL submitted that the inclusion of sub clause 73(f) would in effect mean that it would not get the benefit of limitation of liability in many circumstances. EAPL noted that if it failed to maintain the safety and integrity of the pipeline as a result of it acting in a manner which was grossly negligent or amounted to wilful misconduct, then the indemnity in clause 72 would apply and the limitation in clause 73 would not apply. EAPL concluded that the inclusion of sub clause 73(f) would mean that it would be liable for indirect losses in cases where it had not been grossly negligent or in a way which amounted to wilful misconduct.

With regard to clause 73A, EAPL noted that the general law deals with concepts of mitigation and contributory negligence and thus the proposed amendment was unnecessary and may lead to confusion.[121]

2.10.6 Commission's considerations

Although EAPL's revised access arrangement does not include clauses 73(f) and 73A which were required by amendment FDA 32, the Commission is satisfied that EAPL

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[120] EAPL, Letter to the Commission, 11 November 2003.

[121] EAPL, Submission in response to the Final Decision, 31 October 2003, p. 49.

has adequately addressed the reasons for requiring those provisions. The Commission also accepts EAPL's proposed amendment to sub clause 73(b). The Commission's revised access arrangement is drafted accordingly.

Amendment FDA 34

2.10.7 Amendment required

In order for EAPL's access arrangement for the MSP to be approved, EAPL must amend clause 59 of Attachment D to state that in the event of interruption or curtailment of services as a result of a force majeure claimed by EAPL, the user will be relieved from liability to pay the capacity and throughput charge, but will not be relieved from liability to pay any other charge.

EAPL must also amend clause 60 of Attachment D to state that the capacity charge and throughput charge relief will be pro-rated to the reduction in the user's MDQ at the time the user's MDQ is reduced following the occurrence of the force majeure and terminating at a time when the user's MDQ is no longer affected by the force majeure.

The Commission's reasons for requiring this amendment are set out on pages 269 – 271 of the *Final Decision.*

2.10.8 EAPL's response to the *Final Decision*

EAPL accepted the Commission's argument that the provision of capacity charge relief should not be limited to 24 hours after the commencement of the force majeure. However, EAPL argued that the Commission's proposal to include throughput charge relief was complicated by the potential for services to be either totally interrupted or simply curtailed. EAPL submitted that where there is an interruption of services for any reason, users would not incur throughput charges. In contrast, EAPL noted that where there is a curtailment of services, such that gas is still delivered through the system, then throughput charges would still apply to the quantity delivered.

2.10.9 Commission's considerations

Within the *Final Decision*, the Commission expressed two principal concerns with capacity charge relief. The first of these related to the limitation of relief to 24 hours after the commencement of the force majeure event. The Commission concluded that 24 hour limitation was arbitrary and that relief should be accorded as soon as the force majeure results in a reduction in the user's MDQ. As outlined above, EAPL has accepted the Commission's arguments in relation to this and has made the necessary amendments to clause 60. Accordingly, the Commission is satisfied that EAPL has addressed its concerns regarding this aspect of the capacity charge relief provision.

The second concern expressed by the Commission related to the provision of throughput charge relief. The Commission has considered EAPL's claims regarding the potential for the force majeure event to simply result in a curtailment of services. The Commission acknowledges that in such cases the throughput charge should still apply to that quantity of gas actually delivered.

With regard to the interruption of services, the Commission notes that the definition of throughput charge, as set out in clause 7.3 of EAPL's revised access arrangement, states that the throughput charge is a function of the quantity of gas delivered to the user on that day. In accordance with this provision, a total interruption of services would result in no throughput charge being payable by the user. Given that clause 7.3 in effect already provides users with throughput charge relief in the event of a total interruption of services, the Commission is satisfied that users will be accorded adequate relief in this instance. In light of the above, the Commission no longer requires the amendment relating to the inclusion of throughput charge relief within clauses 59 and 60. The Commission's revised access arrangement is drafted accordingly.

2.11 Extensions and expansions policy

Amendment FDA 39

2.11.1 Amendment required

The Commission's *Final Decision* stated that in order for EAPL's access arrangement for the MSP to be approved, EAPL must amend the extensions and expansions policy to provide that the pipeline from Wagga Wagga to Culcairn is part of the Covered Pipeline.

The Commission's reasons for requiring this amendment are set out on pages 269 – 297 of the *Final Decision*.

2.11.2 EAPL's response to the *Final Decision*

As set out previously, EAPL has decided to remove the Interconnect from the access arrangement and has made what it claims are the consequential changes arising from this decision.[122]

2.11.3 Commission's considerations

Within the *Final Decision,* the Commission noted the number of provisions within EAPL's proposed access arrangement which appeared to demonstrate EAPL's intention that the Interconnect form part of the covered pipeline. However, the Commission also noted the absence of any express provision which would provide for the inclusion of the Interconnect within the capital base. The Commission concluded that as the Interconnect was not a covered pipeline pursuant to the Code, any decision as to whether or not the Interconnect should be included within the extensions and expansions policy could only be made by EAPL.

For the purpose of the *Final Decision* the Commission assumed that the Interconnect formed part of the covered pipeline but noted that if EAPL decided not to include the Interconnect in the capital base then it would also have to address a number of provisions within the access arrangement including:

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[122] EAPL, Submission in response to the Final Decision, 31 October 2003, p. 51.

- clauses 2.1, 2.2, 8.5 and Attachment A of the revised access arrangement;
- submit a revised value of the ICB; and
- submit revised forecast operating costs and SIB capital expenditure.

As confirmed in the *Final Decision,* EAPL's decision to exclude the Interconnect from the access arrangement is within its prerogative. EAPL has made the necessary amendments to remove references to the Interconnect and the costs attributable to the Interconnect from the access arrangement. The Commission is therefore satisfied with EAPL's proposal to exclude the Interconnect from the access arrangement. The Commission's revised access arrangement is drafted accordingly.

2.12 Review and expiry of the access arrangement

Amendment FDA 41

2.12.1 Amendment required

In order for EAPL's access arrangement for the MSP to be approved, EAPL must amend clause 4.2 of the revised access arrangement to state that EAPL will submit revisions to the access arrangement together with the applicable access arrangement information (as required under sections 2.28 of the Code) four years after the date this access arrangement comes into effect.

EAPL must also amend clause 4.3 to state that the revisions to this access arrangement will commence on the latter of 12 months after the Revisions Submissions Date or the date on which the approval of the revisions takes effect.

The Commission's reasons for requiring this amendment are set out on pages 302 – 304 of the *Final Decision.*

2.12.2 EAPL's response to the *Final Decision*

Section 4 of EAPL's revised access arrangement sets out EAPL's response to amendment FDA 41, as follows:

> 4.1 This access arrangement comes into effect on the later of 1 January 2004 and the date specified by the Regulator in its approval of this Access Arrangement.
>
> 4.2 EAPL will submit revisions to this Access Arrangement together with applicable Access Arrangement Information on or before 1 October 2008 ('Revisions Submission Date').
>
> 4.3 The revisions to this Access Arrangement will commence on the later of 1 July 2009 and the date on which the approval by the Regulator of the revisions takes effect ('Revisions Commencement Date').
>
> 4.4 This Access Arrangement contains tariffs from 1 January 2004 to 30 June 2009, the anticipated Revisions Commencement Date.

EAPL submitted that the Commission's amendment requiring a five year access arrangement was not appropriate, given that it would require EAPL to change the date for its tariff escalation. EAPL argued that maintaining a financial year focus was in the

interests of users and that the access arrangement period should be aligned with the financial year.[123]

EAPL also argued that a 12 month review period was excessive, and that the GasNet access arrangement provided for a nine month assessment period. In support of its position, EAPL stated that it 'does not consider that the history of the assessment of the MSP Access Arrangement should impact on the review of the next Access Arrangement.'[124]

2.12.3 Commission's considerations

As noted with regard to amendment FDA 11 of the *Final Decision*, the Commission has considered EAPL's concerns with adjusting tariffs at the end of each calendar year, and now concurs with EAPL that varying tariffs on a financial year basis is appropriate in this instance. In light of this, the Commission also considers it reasonable to allow EAPL to adopt a five and a half year access arrangement period. This will reduce the complexity of reference tariff adjustments that will occur in subsequent access arrangement periods and may be in the interest of users given consistency with tariff adjustments on the Central West Pipeline.

One concern initially raised in the *Final Decision* with regard to a five and half year access arrangement period was that the service provider may be at a disadvantage since the WACC is based on expected returns over five years. To accommodate this, the Commission has now adjusted the nominal and real risk free rate to correspond with rates matching a five and a half year regulatory period. The real risk free rate has consequently been adjusted upwards in the Commission's modelling from 3.03 per cent to 3.08 per cent.

Another concern raised in the *Final Decision* with regard to adopting a five and half year regulatory period was that EAPL had not provided interested parties with data relating to the first half of 2009 which would be included in tariffs under EAPL's proposal.

Section 3.18 of the Code specifies that if an access arrangement is greater than five years, the regulator must consider whether mechanisms should be included in the access arrangement to address the potential risk that forecasts are incorrect. Examples given include triggers for early submission or mechanisms which stipulate the sharing of profits or revenues with users in excess of a certain threshold. Given that the proposed access arrangement period is only six months in excess of five years, the Commission considers that there may be limited benefit associated with the implementation of such sharing mechanisms in EAPL's initial access arrangement. The Commission, however, does not rule out the possibility that such mechanisms may be appropriate in future access arrangement periods.

As noted above, EAPL has proposed a nine month review period for its revisions to the access arrangement. The Commission, however, maintains that a 12 month assessment period is appropriate. As set out in the *Final Decision*, the assessment process from

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[123] EAPL, Submission in response to the Final Decision, 31 October 2003, p. 52.

[124] EAPL, Submission in response to the Final Decision, 31 October 2003, p. 52.

EAPL's submission of a revised access arrangement in May 2002 through to the publication of the *Final Decision* took in excess of one year and four months. The Commission notes that the delay in this assessment process may be attributed to a number of external events as well as EAPL's inability to meet deadlines and information requests made by the Commission. The Commission is of the view that this recent history should be taken into account when making this decision, given that any delay in the assessment process may not be in the interest of users and prospective users. The revised access arrangement has been amended to reflect this requirement.

3. Final Approval

3.1 Further final decision

For the reasons set out in both chapter 2 of this *Final Approval* and the *Final Decision,* the Commission has made a further final decision, pursuant to section 2.19(c) of the Code, not to approve the revised access arrangement submitted by EAPL on 23 October 2003.

3.2 Revised access arrangement

In accordance with section 2.20(a) of the Code, the Commission must, where it does not approve the revised access arrangement submitted by the service provider, draft and approve its own access arrangement.

For the reasons set out in chapter 2 of this *Final Approval,* the Commission has drafted and approved its own revisions to the access arrangement to incorporate the following amendments:

- FDA 1: ICB – the value of the ICB has been set at $545.4 million.
- FDA 7: Depreciation –the depreciation charges have been set to the values contained in Table 2.4.2 of this *Final Approval.*
- FDA 8: WACC – the WACC parameters have been set to the values contained in Table 2.5.2 of this *Final Approval.*
- FDA 9: Non capital costs – the non capital costs have been set to the values contained in Table 2.6.1 of this *Final Approval*.
- FDA 11: Tariff path – the initial CPI adjustment occurring in July 2004 will be based on CPI for the year ending March 2004.
- FDA 12: Tariff path – clause 8.12(a) of the revised access arrangement has been amended to remove the statement ‘if EAPL wishes to vary tariffs’.
- FDA 13: Tariff path – the tariffs have been set to the values specified in Table 2.8.4 of the *Final Approval*.
- FDA 17: Pass through mechanism – clauses 8.18 and 8.21 of the revised access arrangement have been amended to:
  - state 50 business days and 40 business days; and
  - included a phrase stating that the tariff variation must comply with sections 8.3B to 8.3H of the Code.
- FDA 18: Pass through mechanism – clauses 8.17 and 8.20 of the revised access arrangement have been amended to state that EAPL must use best endeavours to provide the regulator with documentary evidence.
- FDA 19: Minimum distance on laterals – clause 8.16 of the revised access arrangement has been amended to:

- require EAPL to demonstrate how the policy complies with section 8.1 of the Code;
- to state 40 business days; and
- included a phrase stating that the tariff variation must comply with sections 8.3B to 8.3H of the Code.

- FDA 41: Review and expiry – clause 4.2 of the revised access arrangement has been amended to require a 12 month review period.

3.3 Commencement date

Section 2.26 of the Code states that a decision made by the Commission pursuant to section 2.20(a) is subject to review by the Australian Competition Tribunal under the Gas Pipelines Access Law. For this reason, an access arrangement drafted and approved by the Commission cannot commence for at least 14 days after the decision to approve it is made.

The Commission's decision under section 2.20(a) of the Code was made and published on 8 December 2003. Subject to the Code and the Gas Pipeline Access Law, the revised access arrangement drafted and approved by the Commission for the MSP commences on 1 January 2004.

3.4 Documents

Copies of EAPL's proposed access arrangement and associated documents are available (subject to confidentiality restrictions) from the Commission's website (www.accc.gov.au) and placed on the public registers held by the Commission and the Code Registrar. Copies of the Commission's decision documents and the access arrangement drafted and approved by the Commission can also be found on the Commission's website.

Appendix A: Location of amendments in the Final Decision

Table A.1 below provides a reference for each amendment specified in the *Final Decision* with its location in that document.

Table A.1: Location of amendments in the *Final Decision*

Amendment FDA	**Topic**	**Location in *Final Decision* (page number)**
1	Initial Capital Base	75
2	New facilities investment	81
3	New facilities investment	82
4	Speculative investment fund	83
5	Speculative investment fund	84
6	Capital redundancy	85
7	Depreciation	91
8	Rate of return	139
9	Non capital costs	156
10	Forecast volumes	176
11	Tariff path	194
12	Tariff path	196
13	Tariffs	200
14	Pass through mechanism	209
15	Pass through mechanism	210
16	Pass through mechanism	211
17	Pass through mechanism	212
18	Pass through mechanism	213
19	Minimum distance on laterals	215
20	Insolvency event	242
21	Receipt and delivery points	244
22	Balancing	249
23	Balancing	249

24	Balancing	250
25	Gas specification	252
26	Non-specification gas	253
27	Non-specification gas	254
28	Prudential requirements	256
29	Prudential requirements	256
30	Prudential requirements	256
31	Overruns	259
32	Liabilities and indemnities	262
33	Order of priority of service	266
34	Force majeure	271
35	Assignment	272
36	Trading policy	281
37	Queuing policy	287
38	Extensions and expansions policy	295
39	Extensions and expansions policy	297
40	Extensions and expansions policy	300
41	Review and expiry	303

Appendix B (confidential): Non capital costs

The content of this Appendix is confidential.

Appendix C (confidential): Asymmetric risk

The content of this Appendix is confidential.