

GasNet Australia - Response to Draft Decision

Dated [28 April 2006]

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1 Executive Summary

In general, GasNet welcomes the ACCC's Draft Decision to pre-approve the augmentation of the Corio Loop. However, GasNet seeks further clarification from the ACCC on some aspects of the Draft Decision. The purpose of this response is to set out those issues. In summary, GasNet:

- (a) seeks the ACCC's confirmation that GasNet correctly understands:
 - (i) how the ACCC proposes to treat costs associated with the Corio Loop over the next two regulatory periods; and
 - (ii) specifically how the ACCC proposes to treat the capitalised return component of the project costs over the next regulatory period;
- (b) requests the ACCC to reconsider its draft decision not to approve a 10% contingency amount; and
- (c) seeks clarification on the method for calculating the capitalisation of return during construction.

2 Background

2.1 Application under section 8.21 of the Gas Code

On 23 December 2005 GasNet submitted an application under section 8.21 of the Gas Code for pre-approval of the system augmentation known as the Corio Loop. The construction of the Corio Loop will commence in the current access arrangement period but is not expected to be completed until after the start of the next access arrangement period.

Specifically, GasNet sought the ACCC's agreement that the Corio Loop will meet the roll-in requirements set out in section 8.16(a) of the Gas Code on the basis that the Corio Loop:

- (a) satisfies the Prudency Test in section 8.16(a)(i); and
- (b) satisfies the System-wide Benefits Test in section 8.16(a)(ii)(B).

2.2 Prudency Test

In its Application, GasNet submitted that \$70.3m represents a prudent amount for constructing, commissioning and financing the Corio Loop. The Application divided the total estimate into three cost elements:

- (a) forecast construction costs - \$61.7 million;
- (b) capitalisation of return during construction - \$2.2 million; and
- (c) a 10% contingency in the event of costs proving to be higher than the forecast level - \$6.4 million.

The ACCC recognised that \$61.7m does not exceed the amount that would be invested by a prudent service provider acting efficiently, in accordance with accepted good industry practice and so satisfies section 8.16(a)(i) of the Gas Code.

GasNet indicated that the total capitalised return over an efficient construction period amounted to \$2.2m. The ACCC indicated that they believed the capitalised return during construction up until 31 December 2007 was \$0.84 million.

The ACCC rejected GasNet's request for a \$6.4 million contingency.

2.3 System-wide Benefits Test

In its Draft Decision the ACCC agreed that the Corio Loop augmentation would provide system-wide benefits and therefore satisfies section 8.16(a)(ii)(B) of the Gas Code.

3 System-Wide Benefits

GasNet welcomes the agreement by the ACCC that the Corio Loop satisfies the System-wide Benefits Test.

GasNet also welcomes the ACCC's decision that it is not necessary for the benefits of the augmentation to accrue evenly to all users in order for the benefits to be system-wide. We note that this is consistent with previous decisions made by the ACCC in relation to section 8.16 of the Gas Code, in particular the Interconnect Decision.

4 Treatment of costs in next regulatory period

As foreshadowed above, the construction of the Corio Loop straddles the end of the current access arrangement period and the commencement of the access arrangement period that will run from 2008 to 2012.

GasNet seeks some further clarification of how the ACCC proposes to treat costs associated with the Corio Loop upon the commencement of the new access arrangements on 1 January 2008. The Application describes GasNet's preferred method for dealing with the roll-in process, referred to in the Application as Option 2.

Our understanding is that the ACCC has accepted the approach set out in Option 2, where the roll in of the construction costs into the capital base takes place in two instalments.

(a) 2008-2012 regulatory period

The first roll-in will occur at the start of the 2008-2012 access arrangements based on the best estimate of the cost of construction up to 31 December 2007 (up to the approved total amount). The balance of the project costs (being those forecast to occur post 1 January 2007) will be included in the forecast capital expenditure for the

2008-2012 access arrangement, provided the forecast total cost of the project does not exceed the approved amount.

Although it would be preferable to roll the actual cost of construction up until 31 December 2007 into the capital base at the start of the new access arrangement period, this is not a practical option given that GasNet's next access arrangement will be negotiated well before year-end. Our understanding is that the ACCC agrees with GasNet's view that the roll-in amount will be based on GasNet's best estimate of the actual cost incurred to the end of 2007. This estimate will be made before the end of the current access arrangement period, at a time and in a way that is compatible with the smooth and effective management of the access arrangement review.

It is also our understanding that the ACCC has agreed that the estimated cost expected to be incurred in the period from 1 January 2008 will be treated as forecast capital expenditure for the purpose of setting Reference Tariffs for the 2008-2012 regulatory period, provided the total cost does not exceed the approved amount.

(b) 2013-2017 regulatory period

The next roll-in will occur at the start of the 2013-2017 access arrangement period, when the actual costs post 1 January 2008 will be rolled in, again provided the actual cost does not exceed the approved amount.

The 2013 roll-in amount will be the difference between the estimated total actual cost and the cost rolled-in at 31 December 2007, in accordance with section 8.22 of the Gas Code.

5 Capitalisation of return during construction

GasNet understands that, consistent with the treatment of the project costs, the capitalised return during construction will be split into two parts.

The capitalisation of returns forecast to be incurred prior to 1 January 2008 will be included in the capital base based on the current WACC.

The capitalisation of returns forecast to be incurred from 1 January 2008 until the project commissioning date, will be included in the forecast capital expenditure for the 2008-2012 access arrangement period using the WACC approved for that access arrangement period.

6 Contingency allowance

GasNet noted in its Application that costs may be expected to vary from those outlined in the Application. This is because the cost estimates used in the Application were based on conditions at the time of the Application, for example the conditions in the steel market and pipeline construction market. While these are the two most significant costs there are other factors that will influence the overall construction costs.

GasNet requests that the ACCC reconsider its decision in relation to the approval of a contingency allowance. An allowance is important to provide comfort that, in an environment of likely cost changes, cost rises within a reasonable margin up to 10 percent will be recovered. GasNet notes that 10 percent is the level which the Essential Services Commission of Victoria finds compatible with the requirements of section 8.16(a) of the Gas Code in decisions on the Bairnsdale Gas Extension, Paynesville Gas Extension, SPI Networks Gas Extension and Multinet Yarra Valley Gas Extension.

Under a conventional ex post approval, costs are finalised by the time the regulator reviews the project. In contrast, ex ante approval means that there is a time lag between when the project is approved and when costs are finalised. This time lag provides time for increases (or decreases) in the price of inputs. Even if GasNet were to construct the Corio Loop in the most prudent manner possible, it still faces the risk of moderate (greater than 10 percent) price increases. Accordingly, GasNet's view is that any ex ante approval, including the approval GasNet seeks under section 8.21 in respect of the Corio Loop, should provide some flexibility in this regard.

The approval of an appropriate contingency allowance avoids the need for a project proponent to seek ex post approval for minor cost increases (ie cost rises up to 10 percent), a process which is inconvenient and may result in unnecessary tariff disturbance. Naturally, GasNet is not seeking comfort for price increases which result in total project costs exceeding 110 per cent of those forecast. Conversely, if the actual project costs are lower than the pre-approved amount, GasNet would only seek to roll in the actual costs.

One of the reasons that GasNet has sought to use the ex ante approval mechanism in section 8.21 is to mitigate the risk of the ACCC adopting a different view of prudence from GasNet, a risk which is inherent to the standard ex post approval process. The Draft Decision provides GasNet with considerable comfort in this respect. However GasNet seeks additional comfort that it will be able to roll in to its capital base a small, and in GasNet's view prudent, amount of up to 10 percent in the event of minor price increases. The approval of a 10% contingency allowance provides this comfort.

7 Calculation of Capitalisation of Return During Construction

The Draft Decision has accepted the concept of an allowance in the project cost for the costs of capital incurred during the construction phase.

The ACCC also appears to have accepted GasNet's contention that the appropriate cost of capital is the currently approved WACC for monthly costs incurred up until 31 December 2007, and the revised WACC, as approved, for costs incurred during 2008.

However, there was an apparent difference of opinion on the method for calculating the capitalisation of return during construction (referred to henceforth as CRC).

GasNet's analysis shows that the principal difference is in the method by which nominal costs are converted into real costs, and then converted back into nominal costs closer to the date that the asset is rolled in. The following analysis presents GasNet's methodology, as applied to the monthly cost profiles which have already been provided to the ACCC.

Firstly, the CRC quoted in the Application of \$2.2m (\$2005) was the total CRC up until commissioning date. GasNet's preference is to roll in the asset cost in 2 stages, as described under Option 2 of the Application. It is our understanding that the ACCC has accepted this proposition in the Draft Decision.

Option 2 requires that two CRC values be computed, one from the commencement of the project until 31 December 2007, and the second from 1 January 2008 to commissioning (expected to be in March). Because the portion of the asset rolled-in at 31 December 2007 will be attributed a revenue stream from 1 January 2008, it is not appropriate to continue to accumulate CRC on monthly expenditures made before this date. Therefore the sum of the two CRC values will be significantly less than the total CRC to commissioning date of \$2.2m.

7.1 Calculation of CRC to 31 December 2007

GasNet has provided a forecast monthly expenditure profile to the ACCC totalling \$61.7m in \$2005. This is divided into 2 parts, \$X up until 31 December 2007, and \$Y for costs from 1 January 2008, where $X+Y = \$61.7\text{m}$. The values of X and Y will be reviewed using the most recent data as part of GasNet's reset submission in March 2007. The (real) cost profile is derived by taking the monthly (nominal) forecast costs and deflating to 31 December 2005 by the monthly inflation index in each month.

GasNet's method is to take the NPV of the (real) cost profile from now until 31 December 2007, discounted to 31 December 2005 (at the real WACC of 6.63%). This NPV represents the single expenditure made at 31 December 2005 which is financially equivalent to the cost stream up to 31 December 2007. However, the relevant amount is the amount to be rolled in to the capital base at 31 December 2007. This is obtained by escalating the aforementioned NPV by the time value of money between December 2005 and December 2007, which is 1.0663^2 .

The result is equal to \$X plus CRC, where the CRC is calculated to be \$0.84m (in \$2005). This is consistent with the ACCC calculation.

GasNet's method is consistent with the ACCC provided the amount rolled into the capital base at 31 December 2007 is $(\$X + \$0.84\text{m})$ escalated by inflation between 2005 and 2007. For example, if the inflation rate is 2.5% per annum, the roll-in amount would be $\$(X + \$0.84) * 1.051$.

7.2 Calculation of CRC from 1 January 2008

A similar method is applied to the costs forecast for January to March 2008 (any costs beyond this date are ignored). Based on the profile provided to the ACCC, the CRC is calculated to be \$0.095m in \$2005.

8 Interpretation

8.1 Terms defined in the Application

A term which has a defined meaning in the Application has the same meaning when used in this response unless it is expressly defined in this response, in which case the meaning in this response applies.

8.2 Definitions

Application means the application dated 23 December 2005 made by GasNet under section 8.21 of the Gas Code in relation to forecast New Facilities Investment.

Bairnsdale Gas Extension means ESC, *Bairnsdale Gas Extension Final Decision*, 12 May 2004..

Draft Decision means the ACCC's Draft Decision dated 5 April 2006 to approve the augmentation of the Corio Loop under section 8.21 of the Gas Code.

Gas Code means the National Third Party Access Code for Natural Gas Pipeline Systems.

GasNet means GasNet Australia (Operations) Pty Ltd (ABN 65 083 009 278).

CRC means Capitalised Return during Construction.

Interconnect Decision means ACCC, *Revisions to Access Arrangements for the Principal Transmission System - Final Decision*, 28 April 2000.

Multinet Yarra Valley Gas Extension mean ESC, *Multinet Yarra Valley Gas Extension Final Decision*, 17 August 2005.

NPV means net present value.

Paynesville Gas Extension means ESC, *Paynesville Gas Extension Final Decision*, July 2004.

SPI Networks Gas Extension means ESC, *SPI Networks Gas Extension Final Decision*, 17 May 2005.

WACC means Weighted Average Cost of Capital.

Cost Breakdown Brooklyn-Crio Loop

				2005	2006	2006	2006	2006	2006	2006
				Dec	Jan	Feb	Mar	Apr	May	Jun
Cost Profiles (\$2005)										
(\$000,s)										
Materials	\$	15800	15805000	0	0	0	0	0	0	0
	%			0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Construction	\$	32000	31999950	0						
	%			0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
EPCM	\$	3700	3702164	0	69028	9028	9028	9028	0	0
	%			0.0%	1.9%	0.2%	0.2%	0.2%	0.0%	0.0%
Licences, Easements	\$	3400	3400730	0	68023	54172	52005	84391	84391	84391
	%			0.0%	2.0%	1.6%	1.5%	2.5%	2.5%	2.5%
Facilities	\$	6800	6799600	0	12600	12600	12600	12600	12600	12600
	%			0.0%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%
Total	\$	61700	61707444.46	0	149651	75800	73633	106019	96991	96991
	%									
Convert to \$ Nominal										
CPI	0.206%			1.000	1.002	1.004	1.006	1.008	1.010	1.012
Materials	\$	16506124		0	0	0	0	0	0	0
Construction	\$	33604034		0	0	0	0	0	0	0
EPCM	\$	3851587		0	69170	9065	9084	9103	0	0
Licences, Easments	\$	3494875		0	68163	54395	52327	85088	85263	85439
Facilities	\$	7103807		0	12626	12652	12678	12704	12730	12757
Total	\$	64560427		0	149959	76113	74089	106895	97994	98195
	%			0.0%	0.2%	0.1%	0.1%	0.2%	0.2%	0.2%
IDC (standard)	0.74%	Nom		0	0	1115	1689	2252	3064	3815
Deemed Roll-in at end March 2007		\$2005		0	0	1110	1679	2234	3033	3768
IDC (split cost recovery)		Nom		0	0	1115	1689	2252	3064	3815
		\$2005		0	0	1110	1679	2234	3033	3768

2006	2006	2006	2006	2006	2006	2007	2007	2007	2007	2007	2007	2007
Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul
0	0	0	0	0	0	0	0	0	0	0	0	0
0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
142369	154672	154672	154672	154672	68986	68986	68986	68986	68986	68986	68986	12304
3.8%	4.2%	4.2%	4.2%	4.2%	1.9%	1.9%	1.9%	1.9%	1.9%	1.9%	1.9%	0.3%
90327	127765	148250	511221	855292	432688	19200	19200	19200	19200	0	31200	31200
2.7%	3.8%	4.4%	15.0%	25.2%	12.7%	0.6%	0.6%	0.6%	0.6%	0.0%	0.9%	0.9%
156667	156667	156667	156667	156667	12667	12667	12667	12667	12667	12667	12667	12667
2.3%	2.3%	2.3%	2.3%	2.3%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%
389362	439104	459589	822560	1166630	514341	100853	100853	100853	100853	81653	112853	56170
1.015	1.017	1.019	1.021	1.023	1.025	1.027	1.029	1.031	1.033	1.036	1.038	1.040
0	0	0	0	0	0	0	0	0	0	0	0	0
0	0	0	0	0	0	0	0	0	0	0	0	0
144434	157240	157563	157888	158213	70711	70856	71002	71148	71295	71442	71589	12794
91637	129886	151021	521849	874872	443505	19721	19761	19802	19843	0	32377	32444
158940	159267	159595	159924	160253	12983	13010	13037	13064	13091	13118	13145	13172
395011	446392	468180	839661	1193338	527199	103587	103800	104014	104228	84559	117111	58410
0.6%	0.7%	0.7%	1.3%	1.8%	0.8%	0.2%	0.2%	0.2%	0.2%	0.1%	0.2%	0.1%
4574	7545	10919	14481	20832	29859	34001	35023	36056	37097	38148	39060	40221
4508	7421	10719	14187	20366	29131	33103	34029	34960	35895	36836	37640	38679
4574	7545	10919	14481	20832	29859	34001	35023	36056	37097	38148	39060	40221
4508	7421	10719	14187	20366	29131	33103	34029	34960	35895	36836	37640	38679

2007	2007	2007	2007	2007	2008	2008	2008	2008	2008	2008
Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun
5813000	5813000	1998167	1525167	526667	0	129000	0	0	0	0
36.8%	36.8%	12.6%	9.6%	3.3%	0.0%	0.8%	0.0%	0.0%	0.0%	0.0%
0.0%	4509650	4509650	5851200	6167700	6225200	2425050	753300	753300	268300	536600
	14.1%	14.1%	18.3%	19.3%	19.5%	7.6%	2.4%	2.4%	0.8%	1.7%
12304	326342	326342	326342	326342	314039	359039	359038.9	0	0	0
0.3%	8.8%	8.8%	8.8%	8.8%	8.5%	9.7%	9.7%	0.0%	0.0%	0.0%
31200	31200	31200	0	0	0	0	143754	143754	143754	143754
0.9%	0.9%	0.9%	0.0%	0.0%	0.0%	0.0%	4.2%	4.2%	4.2%	4.2%
12667	346833	830167	3083500	623500	762667	129333	12666.67	12666.67	12666.67	12666.67
0.2%	5.1%	12.2%	45.3%	9.2%	11.2%	1.9%	0.2%	0.2%	0.2%	0.2%
5869170	11027026	7695526	10786209	7644209	7301906	3042422	1268760	909721	424721	693021

1.042	1.044	1.046	1.048	1.051	1.053	1.055	1.057	1.059	1.061	1.064	1.066
6057221	6069698	2090702	1599084	553329	0	136090	0	0	0	0	
0	4708793	4718492	6134780	6479940	6553823	2558325	796337	797977	284798	570769	
12820	340754	341455	342159	342864	330617	378771	379551	0	0	0	
32511	32578	32645	0	0	0	0	151967	152280	152593	152908	
13199	362149	868612	3232943	655065	802927	136441	13390	13418	13446	13473	
6115751	11513972	8051906	11308966	8031197	7687367	3209627	1341245	963675	450837	737150	
9.5%	17.8%	12.5%	17.5%	12.4%	11.9%	5.0%	2.1%	1.5%	0.7%	1.1%	
40954	86728	172977	234127	319947	382036	442030	469180	9972	17211	20691	26325
39303	83060	165321	223304	304530	362880	419003	443824	9414	16214	19452	24698
							2320746				
				1214484			138596				
40954	86728	172977	234127	319947	0	57154	81442	92019	99868	103962	110216
39303	83060	165321	223304	304530	0	54176	77040	86867	94083	97739	103405

First Principles Calculation - Costs to Dec 2007

Nominal Model	Monthly Costs	50170528	0	149959	76113	74089	106895	97994	98195
	NPV1	43015989							
			0	0	0	0	0	0	0
	NPV2	43015989							
	Effective IDC	1214484							
Real Model	Monthly Costs	48066895	0	149651	75800	73633	106019	96991	96991
	NPV1	43015989							
			0	0	0	0	0	0	0
	NPV2	43015989							
	Effective IDC	842099							

First Principles Calculation - Costs from Dec 2007

Nominal Model	Monthly Costs	12238238	0	0	0	0	0	0	0
	NPV1	10133330							
			0	0	0	0	0	0	0
	NPV2	10133330							
	Effective IDC	138595							
Real Model	Monthly Costs	11613087	0	0	0	0	0	0	0
	NPV1	10133330							
			0	0	0	0	0	0	0
	NPV2	10133330							
	Effective IDC	94863							

1164817

513310

6115751 11513972 8051906 11308966 8031197

0 0 0 0 51385012 51385012 The rolled-in amount in nominal dollars, calculated by shifting the 2005 value to 2007, and by a goal seek method.

5869170 11027026 7695526 10786209 7644209

0 0 0 0 48908994 48908994 The rolled-in amount in real dollars, calculated by shifting the 2005 value to 2007, and by a goal seek method.

51385012 Convert real dollars 2005 into nominal dollars 2007.

Note cell AC55 equals cell AC46 - this verifies the calculation

0 0 0 0 0 7687367 3209627 1341245

0 0 0 0 0 0 0 12376834 12376834 The rolled-in amount in nominal dollars, calculated by shifting the 2005 value to Mar 2008, and by a goal seek method.

0 0 0 0 0 7301906 3042422 1268760

0 0 0 0 0 0 0 11707950 11707950 The rolled-in amount in real dollars, calculated by shifting the 2005 value to Mar 20082007, and by a goal seek method.

12376834 Convert real dollars 2005 into nominal dollars 2007.

Note cell AF69 equals cell AF60 - this verifies the calculation

Assumptions

Real WACC	6.63%	Monthly Real WACC	0.54%
CPI	2.50%	Monthly CPI	0.21%
Nom WACC	9.30%	Monthly Nom WACC	0.74%
Capital Cost (\$m2005)	61.7		