Review of capital expenditure on the Roma to Brisbane Pipeline access arrangement

A REPORT PREPARED FOR THE AUSTRALIAN ENERGY REGULATOR

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Contents

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Tables and figures

1 Introduction

Frontier Economics was requested by the Australian Energy Regulator (AER) to provide advice on a number of regulatory issues relating to the buyout of the Pipeline Management Agreement (PMA) by APT Petroleum Pipelines Limited (APTPPL) in 2007. In its recent Access Arrangement Submission, APTPPL included just over $30 million (in 2007 dollars) of the cost of the PMA buyout as ‘stay in business’ capital expenditure for its Roma to Brisbane Pipeline (RBP), to be rolled into RBP’s regulated capital base (RCB) from the start of the forthcoming access arrangement period.[1] This figure was endorsed by the KPMG on behalf of the APA Group.[2]

The issues on which Frontier was requested to advise on include:

- Whether goodwill can be included in the regulatory asset base given the regulatory framework applicable to the Roma to Brisbane Pipeline (RBP)
- Whether the costs of the PMA contract buyout meet the capital expenditure criteria under Rule 79 of the National Gas Rules (NGR)
- Whether the PMA contract buyout promotes the National Gas Objective (NGO) and whether it reflects an efficient investment in natural gas services and promotes the long term interest of users of natural gas

We have structured this report as follows

- Section 2 briefly considers the ACCC decision on the previous access arrangement decision on the RBP
- Section 3 considers whether:
  - goodwill can be included in the regulated capital base (RCB) of the RBP (Section 3.1) and
  - the extent to which the PMA buyout meets the capital expenditure criteria under Rule 79 (Section 3.2.1) and satisfies the NGO (Section 3.2.2)

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1 APTPPL, *Access Arrangement Submission, Effective 12 April 2012 – 30 June 2017, Confidential*, October 2011 (Access Arrangement Submission), Table 4.1, p.36.

2 See KPMG, *APA Group Regulatory accounting treatment of Pipeline Management Agreement termination payment*, October 2011 (KPMG report), included as Attachment 4.3 to the Access Arrangement Submission.

2 Previous RBP decision

The ACCC's previous access arrangement decision on the RBP was published in December 2006 and covered the period 12 April 2007 to 11 April 2012. This decision was made under the National Gas Code, which operated prior to the NGR.

2.1 Capital expenditures

Clauses 8.15-8.16 of the Gas Code set out the criteria for the addition of new facilities investment to the RCB of a covered pipeline. The criteria in clause 8.16 were broadly similar to the requirements that now apply under Rule 79 of the NGR. The key difference is that one ground for the recoverability of expenditure used to be the provision of 'system-wide benefits' (clause 8.16(a)(ii)(B)); the equivalent ground is now that the overall economic value of the expenditure is positive (Rule 79(2)(a)).

APTPPL had proposed a relatively small amount of $8 million for new facilities investment over 2007/08-2011/12 and justified this as necessary for the ongoing safety, reliability and integrity of the RBP (satisfying Rule 79(2)(c)). Just over $4 million was forecast for 2006/07.

The ACCC did not object to APTPPL's forecasts for capital expenditures, but reserved the right – in accordance with the Gas Code – to assess actual expenditure over this period at the time of the next regulatory reset. The AER is now in the process of undertaking this assessment.

2.2 Non-capital expenditures

Clauses 8.36 and 8.37 of the Gas Code imposed virtually identical requirements on the recoverability of non-capital costs as now apply under Rule 91 of the NGR.

The ACCC considered the appropriateness of the arrangements between APTPPL's and Agility under the PMA struck in April 2000 in relation to the provision of operations and maintenance services for the RBP. The ACCC noted that while a number of parties could supply these services, Agility, as a former wholly-owned subsidiary of AGL, could probably provide the services cheaper than others due to its 'corporate memory' advantages. The ACCC also considered some broad comparators and benchmarks to determine the reasonableness of costs under the PMA. Finally, the ACCC held discussions with Agility and obtained confidential data from Agility consistent with APTPPL's proposal.

The ACCC concluded that:

> The costs to be paid by APTPPL to Agility for operations and maintenance and hence APTPPL's forecast operations and maintenance costs for the period 2006–11 were considered to be consistent with s. 8.37 of the code.[3]

Given the analysis undertaken by the ACCC prior to reaching this conclusion, we consider that we have no sound basis for questioning whether the level of APTPPL's allowed non-capital expenditures for the last access arrangement period was efficient.

3 ACCC, *Final Decision, Roma to Brisbane Pipeline*, 20 December 2006, p.130.

3 Recoverability of PMA buyout cost through the RCB

This section addresses two questions:

- Can goodwill be included in the RCB of the RBP?
- To what extent does the PMA buyout cost satisfy Rule 79 of the NGR and meet the National Gas Objective?

3.1 Inclusion of goodwill in the RCB

In principle, we consider that any capital expenditure that satisfies the criteria in Rule 79 (see Section 3.2.1 below) ought to be able to be included in the RCB of a covered pipeline under Rule 77(2)(b).

This means that so long as the payment of goodwill can be considered 'capital expenditure', as contended by KPMG on behalf of APTPPL,[4] and meets the criteria for conforming capital expenditure under Rule 79, it should be eligible to be added to the RBP's RCB.

Part 9 of the NGR (Rule 69) simply defines capital expenditure to be "costs and expenditure of a capital nature incurred to provide, or in providing, pipeline services". While no further elaboration is provided, this implies that there needs to be a nexus between the expenditure and the provision of pipelines services.

Whether the PMA buyout cost is of a capital nature raises accounting, economic and regulatory issues. We are not qualified to comment on the accounting issues. However, from a first-principles economic perspective, we see no reason why these costs should not be regarded as capital expenditure. They are costs incurred at a particular time in order to provide a stream of future benefits, those benefits being the avoided charges payable for future capital investment and for operations and maintenance services under the PMA.

From a regulatory perspective, the NGR does not further define the meaning of costs of a capital nature. Similarly, the AER's access arrangement guideline does not appear to provide further commentary on the distinction between capital and non-capital costs.

The KPMG report noted that the Essential Services Commission of Victoria is the only Australian access regulator to specifically require an adjustment to

4 KPMG report, sections 3-4, pp.17-26.

accounting policies under official accounting standards to exclude goodwill. This requirement is in Electricity Industry Guideline No 3.[5]

However, the KPMG report suggested that:

> ..the regulator wished to exclude goodwill on the acquisition of a distribution [business] by its owner, because it was not an asset of the regulated business itself. This was a different situation to that described… in this report where expenditure on goodwill has been made by and on behalf of the regulated business for the purposes of the regulated business.
>
> The ORG's adjustment therefore aimed to exclude assets that were outside the scope of the regulated business, rather than to adjust an accounting policy on goodwill that complied with Accounting Standards. The ORG precedent is not therefore relevant to consideration of whether the PMA premium should be capitalised in the capital base of a Covered Pipeline.[6]

Upon reviewing Guideline No 3, we are also inclined to the view that Guideline No 3 should not prevent the PMA buyout costs from being classed as a form of capital expenditure. The treatment of goodwill in clause 3.7.4 of Guideline No 3 is similar to the treatment of asset revaluations and adjustments in clause 3.7.2. In both cases, the prime objective appears to be to prevent a service provider using an acquisition to pass inflated asset purchase costs on to customers. 'Inflated asset purchase costs' in this context refers to costs in excess of book value. However, in the PMA buyout transaction, the premium amount known as goodwill was paid (at least in part) to compensate Agility for its loss of profits on the provision of services under the PMA.

Further, the definition of capital expenditure in Guideline No 3 includes expenditure that "will significantly reduce the ongoing maintenance of the assets". If 'maintenance' is read as referring to maintenance costs rather than the actual activity of maintenance, this definition would appear to allow expenditures made up front to reduce future maintenance costs to be classed as capital expenditures.

We also considered the effect of the Australian Competition Tribunal's Mine Subsidence Decision.[7] This decision considered whether expenditure by Jemena Gas Networks (NSW) Ltd to address mine subsidence could be classified as capital expenditure. The Tribunal found that it is not always necessary for expenditure to provide an enduring benefit, nor to be 'once and for all' to qualify

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5 Essential Services Commission, *Electricity Industry Guideline No. 3, Regulatory Information Requirements Issue No. 7*, May 2010, clause 3.7.4, available here, accessed January 2012.

6 KPMG report, p.22.

7 *Application by Jemena Gas Networks (NSW) Ltd (No 3)* [2011] ACompT 6.

as capital expenditure.[8] In our view, the classification of the PMA buyout premium as capital expenditure is consistent with the Tribunal's decision.

3.2 Rule 79 of the NGR and the NGO

3.2.1 Justifying expenditure under Rule 79

The criteria for new conforming capital expenditure are set out in Rule 79 of the NGR. In summary, this provides that capital expenditure is conforming if:

- It is such as would be incurred by a prudent service provider acting efficiently, in accordance with accepted good industry practice, to achieve the lowest sustainable cost of providing services (Rule 79(1)(a)) and
- It is justifiable on one of the following grounds (Rule 79(1)(b)):
  - the overall economic value of the expenditure is positive (Rule 79(2)(a))
  - the present value of the expected incremental revenue to be generated by the expenditure is greater than the present value of the capital expenditure (Rule 79(2)(b))
  - the expenditure is necessary to maintain the safety or integrity of the services (Rule 79(2)(c)(i) & (ii))
  - the expenditure is necessary to comply with a regulatory obligation (Rule 79(2)(c)(iii))
  - the expenditure is necessary to meet demand existing at the time the capital expenditure is incurred (Rule 79(2)(c)(iv))

The threshold question under Rule 79 is whether the buyout costs are justifiable under one or more of the grounds in Rule 79(2). In our view, the most relevant ground is that the overall economic value of the expenditure is positive (Rule 79(2)(a)). We are not sure if Rule 79(2)(b) applies in the absence of information about APTPPL's likely tariffs and customer demands. We also do not think any of the grounds in Rule 79(2)(c) apply given that maintaining the contract with Agility would have also met the criteria of 79(2)(c), implying that the termination of the contract was not necessary to meet this purpose.

8 See paras 33-35.

Under Rule 79(2)(a), the economic value of the buyout premium expenditure would be positive if the present value of the premium is less than:

(i) the present value of the charges that would have otherwise been payable by APTPPL under the PMA *less*

(ii) the net increase in the present value of APTPPL's directly-incurred costs due to the PMA buyout

In other words, the economic value from the PMA buyout would be positive if the net cost savings from terminating the contract are greater than the buyout premium.

Neither (i) nor (ii) are readily observable. KPMG attempted to calculate the difference between (i) and (ii) by separately calculating:

- differences between the non-capital costs allowed under the PMA as approved by the ACCC in 2006 and actual historical non-capital costs over the period 2007/08-2010/11 – in order to estimate total savings in non-capital costs and
- avoided profit margins and overheads on capital costs over the period 2007/08-2011/12 – in order to estimate total savings in capital costs over the period 2012/13-2019/20
- the value of net changes in allowable tax deductions

We have examined KPMG's methodology and sought and received further clarification from KPMG regarding certain queries. In spite of these clarifications, we have a number of concerns regarding the economic value of the buyout premium. Our concerns relate to both the purported capital and non-capital expenditure savings of the PMA buyout. As a result, we also question the purported value of the tax savings.

Capital expenditure savings

We do not believe that KPMG's estimate of capital cost savings due to the PMA buyout is defensible. In essence, this is because KPMG's analysis wrongly includes expenditure relating to growth in its calculation of average capital expenditure leading to a gross exaggeration of the potential value of the premium. Our reasoning is as follows.

As noted above, KPMG calculated the capital expenditure benefits of the PMA buyout as the avoided profit margins and overheads on capital costs that would have otherwise been payable under the PMA.

KPMG's analysis rests on two principal assumptions:

- the average capital expenditure for the 5-year period 2007/08-2011/12 is a reasonable indicator of likely capital expenditure over the period 2012/13-2019/20
- that termination of the PMA would avoid payment to Agility of a 9% profit margin and a 10% overhead margin on capital costs. According to KPMG, the recovery of profit and overhead margins was allowed by the AER under the outsourcing arrangements entered into by the Victorian electricity distribution businesses

Without commenting on whether the proposed margins are appropriate, we note that KPMG estimated the present value of capital expenditure profit margin savings at $10.5 million and the present value of overhead margin savings at $11.6 million (both in 2007 dollars). Based on KPMG's proposed margins and real discount rate of 5.45%,[9] this is consistent with a total present value of capital expenditure on the RBP of approximately $116.3 million (in 2007 dollars).

According to APTPPL's Access Arrangement Submission for the present regulatory review, APTPPL's allowed 'stay in business' capital expenditure for 2007/08-2011/12 was only $10.9 million (nominal) and its actual expenditure was only $15.8 million (nominal).[10] This actual nominal figure is equivalent to about $14.9 million in 2007 dollars. Projecting this value forward across the whole 13-year period of 2007/08-2019/20, the total capital expenditure should have been only about $38.8 million (in 2007 dollars) (being 14.9 x 13/5), with a present value of $27.3 million (in 2007 dollars). This is a long way from the $116.3 million present value figure (in 2007 dollars) used by KPMG to estimate capital expenditure savings.

The reason for this discrepancy is that KPMG included 'growth' as well as 'stay-in-business' capital expenditure when calculating average capital expenditure for the 5-year period 2007/08-2011/12.[11] The Access Arrangement Submission shows that APTPPL undertook approximately $60.8 million of growth capital expenditure (in nominal terms) over the period 2007/08-2011/12.[12] Three-quarters of this ($45.95 million) was expected to be incurred in 2011/12 alone, with most of the remainder in 2010/11 and 2009/10. Less than $0.5 million growth capital expenditure was incurred over the three year period 2006/07-2008/09.

9 KPMG report, p.31.

10 Access Arrangement Submission, Table 4.1, p.36.

11 KPMG report, Table E-5, pp.56-57.

12 Access Arrangement Submission, Table 4.1, p.36. The figure for 2011/12 was a forecast.

We have two issues with the inclusion of growth capital expenditure in the estimation of capital expenditure savings from the PMA buyout.

First, the growth capital expenditure over 2007/08-2011/12 was driven by spending on two major projects: the Lytton Lateral ($9.1m) and the RBP8 augmentation ($50.6m).[13] Spending on these projects ceases by 2012 and the Access Arrangement Submission does not include any material growth capital expenditure over the 2012/13-2016/17 period.[14] APTPPL said that future congestion was likely to require augmentation at some point in the future. However, this would not be until the end of the forthcoming access arrangement period or the start of following period and hence APTPPL did not include any costs in its Access Arrangement Submission.

This means that past capital expenditure, to the extent it includes growth capital expenditure, is a poor basis on which to estimate future capital expenditure. Indeed, APTPPL's forecast capital expenditure for 2012/13-2016/17 is only $18.3 million in nominal terms[15] (similar in 2007 dollars to the stay-in-business capital expenditure for 2007/08-2011/12) whereas actual nominal capital expenditure for 2007/08-2011/12 (including growth capital expenditure) was $76.5m.[16]

In addition, APTPPL's growth expenditure over 2007/08-2011/12 largely related to the provision of non-reference services. As APTPPL stated in its Access Arrangement Submission, the Lytton Lateral and RBP8 projects will be used to provide negotiated services and hence the costs associated with these expansions were excised from the capital expenditure in the AER's Asset Base Roll Forward Model.[17] This means that these costs will not be recovered through reference tariffs, but rather, through negotiated charges.

However, it appears the entire PMA buyout cost attributable to the RBP[18] has been included in APTPPL's stay-in-business capital expenditure costs[19] even though the buyout in large part avoids capital expenditure costs incurred to provide negotiated services. This suggests that APTPPL's approach will lead to customers of reference services funding assets that will be used to provide negotiated services.

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13 Access Arrangement Submission, p.37

14 See Table 4.3, p.44.

15 Access Arrangement Submission, Table 4.3, p.44.

16 According to Table 1 in the KPMG note.

17 Access Arrangement Submission, p.38 and p.99.

18 Subject to the adjustments noted on p.15 of the KPMG report.

19 Access Arrangement Submission, Table 4.1, p.36.

As noted by KPMG:[20]

> I conclude that the capital nature of the premium does not necessarily mean that all of the premium expenditure should be included in a Covered Pipeline's Capital Base.
>
> This is because I reason that the premium expenditure should only be considered as recoverable by a Reference Tariff to the extent that it reduces costs that are recoverable by a Reference Tariff.

For these reasons, we consider that KPMG's approach to calculating capital expenditure savings from the PMA buyout is not defensible. Future likely capital expenditure – and hence capital expenditure savings from the PMA buyout – should have been much lower than calculated by KPMG.

Therefore, it would be appropriate to reduce the value of capital expenditure savings attributable to the PMA buyout:

- from $22.1 million (in 2007 dollars), being 19% of the assumed $116.3 million present value of future capital expenditure over the life of the PMA
- to $5.2 million (in 2007 dollars), being 19% of the $27.3 million present value capital expenditure savings calculated above.

Of this $5.2 million, $2.5 million refers to savings of profit margins and $2.7 million refers to savings of overhead margins.

Non-capital expenditure savings

KPMG's calculation of non-capital cost savings is based on the differences between the non-capital costs allowed by the ACCC under the PMA and actual historical costs over the period 2007/08-2010/11. Subsequent to further enquiries, KPMG showed how its estimate of $7.7 million (in 2007 dollars) could be reconciled with the operating expenditure figures incorporated in APTPPL's Access Arrangement Submission.[21]

KPMG's methodology appears to be based on the assumption that the regulator would have continued to allow the same level of RBP operating costs it allowed over the period 2007/08-2010/11 for the entire term of the PMA. However, there are two reasons why this may not be the case.

First, historical operating expenditure over the previous access arrangement period was likely related to the relatively high level of capital expenditure undertaken over the corresponding period. Given that most of the historical capital expenditure was undertaken for the provision of negotiated services, it is likely that both past and future operating expenditure avoided by the PMA buyout is significantly less than calculated by KPMG. Unfortunately, it is difficult

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20 KPMG report, p.4.

21 See *KPMG response to AER questions*, 27 January 2012.

to estimate the extent to which non-capital expenditure savings have been exaggerated due to this effect without more detailed analysis.

Second, after the initial 5-year term of the PMA, the charges for these services were to be agreed based on negotiation between APTPPL and Agility.[22] This means that APTPPL had some control and responsibility for the extent of and growth in these costs. Therefore, rather than assuming that the ACCC would have simply allowed charges for recovery of non-capital costs under the PMA to be recovered without any adjustment for the term of the PMA, it would have been more appropriate to assume that real charges under the PMA would have fallen over time in line with improvements in productivity. This would reduce the measured benefits of terminating the PMA, although once again, it is difficult to say by how much in the absence of further analysis.

Estimated tax savings

A consequence of the reduced value of capital expenditure savings discussed above is a reduced value for both tax deductions foregone due to the PMA buyout and tax deduction benefits on the termination payment.

Using the same methodology as KPMG, we estimated the value of:

- Tax deductions foregone at $2.7 million rather than the $4.3 million as calculated by KPMG and
- Tax deduction benefits at $3.3 million rather than the $7.6 million as calculated by KPMG

for a net tax benefit of about $600,000.

Net economic value

We believe that the amount of the PMA buyout premium attributed to the RBP that reflects net economic value is considerably less than submitted by APTPPL and suggested in the KPMG report. Under Rule 79(2)(a), capital expenditure is only conforming if, *inter alia*, the overall economic value of the expenditure is positive.

22 KPMG report, pp.10-11.

In our view:

- conservatively accepting KPMG's figure for non-capital cost savings of $7.7 million (although in reality it is likely to be significantly less) and
- allowing $5.18 million for capital expenditure margins savings and
- allowing $0.6 million for net tax benefits

meeting the requirements of Rule 79(2(a) would require that the expenditure that APTPPL seeks to add to the RCB of the RBP in respect of the PMA buyout must not exceed **$13.5 million in 2007 dollars**.

This compares to the $33.2 million calculated by KPMG in its report[23] and the $30.1 million included by APTPPL in its Access Arrangement Submission.[24]

3.2.2 National Gas Objective

The National Gas Objective is "to promote efficient investment in, and efficient operation and use of, natural gas services for the long term interests of consumers of natural gas with respect to price, quality, safety, reliability and security of supply of natural gas."[25]

Although we have suggested that the PMA buyout premium has a much lower net economic benefit than put forward by APTPPL and KPMG, we nevertheless believe that the transaction appears likely to reduce the costs of providing gas to end consumers. If one accepts the proposition that APTPPL can perform certain activities more cheaply in-house than by contracting out those activities, one must also accept that the buyout is likely to promote efficiency compared to the pre-existing arrangements. Having regard to the National Gas Objective, we consider that it would be unfortunate if service providers were deterred from pursuing cost savings because to do so would reveal that their original processes were sub-optimal and hence that their efforts to reduce costs were not worthy of reward. The real issue, as discussed above, is the extent to which these claimed premium costs should be included in the RCB.

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23 KPMG report, Table 5.1, pp.31-32.

24 See Table 4.1, p.36.

25 *National Gas Law*, section 23.

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