



REF: JW-PB-JW-SL: 0479

18 February 2015

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Dear Mr Watkinson

BHP Billiton's submission on Goldfields Gas Transmission's proposed revisions to the Access Arrangement for the Goldfields Gas Pipeline: cost allocation

On 1 December 2014, the Economic Regulation Authority (ERA) placed on its web site a submission from BHP Billiton Limited on the proposed revisions to the Access Arrangement for the Goldfields Gas Pipeline (GGP) which Goldfields Gas Transmission Pty Ltd (GGT) had submitted on 15 August 2014.

GGT is concerned about BHP Billiton's views on the allocation of the costs of the GGP between services provided by the covered (regulated) pipeline and services provided using capacity created by those pipeline expansions which are uncovered (unregulated). BHP Billiton is continuing to advocate an approach to cost allocation which has been rejected by the ERA and by the Western Australian Electricity Board of Review (ERB).

The reference tariff included in the proposed revisions to the GGP Access Arrangement was determined from the forecast total cost of the covered pipeline. No part of the cost of the covered pipeline was allocated to services provided using the capacity of the uncovered expansions.

In section 3 of the Supporting Information submitted with the access arrangement revisions proposal in August last year, GGT noted the decision of the ERB in relation to the 2010-14 Access Arrangement, that the costs of providing services using the capacity of the uncovered expansions were to be excluded from total revenue – that is, total revenue was not to include the costs of providing services using that part of the pipeline system which was uncovered. GGT explained that, for the proposed revisions, the total cost of providing pipeline services had been calculated as the total cost of providing services using the GGP excluding:

- (a) the capital costs of those parts of the pipeline system which are uncovered (a second compressor added at Paraburdoo, in 2006, and compressors installed a Wyloo West and at Ned's Creek in 2009);
- (b) the capital costs of the recent expansion for Rio Tinto Iron Ore and for BHP Billiton Iron Ore, pipeline expansion which GGT has elected be uncovered and in respect of which the ERA gave its consent to GGT's election on 30 May 2014; and

- (c) the costs of operating and maintaining those parts of the GGP which are uncovered, and the costs of operating and maintaining the expansion for Rio Tinto Iron Ore and BHP Billiton Iron Ore.

The Supporting Information advised that the total revenue of rule 76 had therefore been calculated as the total of:

- (a) the return on the projected capital base of the covered pipeline;
- (b) depreciation of the assets comprising the covered pipeline;
- (c) the cost of corporate income tax estimated using the forecast revenue from the provision of the reference service, negotiated services and services to the Goldfields Gas Transmission Joint Venture participants using the covered pipeline; and
- (d) the forecast costs of operating the covered pipeline.

In its 2010 Final Decision on the revisions to the current GGP Access Arrangement (and in the subsequent decision in which the ERA drafted and approved its own revisions), the ERA concluded that the national Third Party Access Code for Natural Gas Pipeline Systems (Code) required the capital and operating costs, and the capacity, of only the covered pipeline to be brought to account in determining total revenue, and that the services to be provided using only the covered pipeline should be used to derive a reference tariff for the GGP.¹

BHP Billiton sought review of a number of aspects of the ERA's decision, including the ERA's decision on the allocation of costs. The relevant review body, the Western Australian Electricity Review Board (ERB) did not find error in this aspect of the ERA's decision.²

BHP Billiton now submits that since the decision of the ERB in November 2011 there has been the replacement of the Code with the National Gas Law and Rules.³

BHP Billiton says that there are a number of differences between the Code and the National Gas Law and Rules that require a different approach to cost allocation. Relevantly, BHP Billiton submits that the qualification that was critical to the previous decisions of the ERA and the ERB has been removed and that "pipeline services" are not limited to the services provided by a "covered" pipeline.⁴

BHP Billiton concludes that the removal of the word "covered" indicates that, when allocating costs, services provided by means of the pipeline, and not just a "covered" pipeline, should be included in the calculation of total revenue. BHP Billiton submits that its conclusion is supported by its observation that the term "covered" is used in a number of other places in the National Gas Law and Rules, which BHP Billiton says suggests that the omission from this particular definition was intentional.⁵

BHP Billiton also draws on the introduction of the national gas objective being relevant to interpreting the appropriate allocation of costs.⁶

As set out below, GGT submits that although there have been substantial amendments to the regulatory framework, there is nothing in those amendments that that would now permit total revenue to be calculated on a basis that incorporates the costs associated with the covered and uncovered capacity of the GGP, or

¹ ERA, *Final Decision on GGT's Proposed Revisions to the Access Arrangement for the Goldfields Gas Pipeline*, 13 May 2010, [59].

² Western Australian Electricity Review Board, Applications No. 1 and 2 of 2010, 22 November 2011.

³ BHP Billiton, *Public Submission by BHPB in response to Goldfields Gas Transmission Pty Limited's Proposed Revisions to the Goldfields Gas Pipeline Access Arrangement*, 27 November 2014, p. 4 (BHPB Submission).

⁴ BHPB Submission, p. 4.

⁵ BHPB Submission, p. 4.

⁶ BHPB Submission, p. 4.

for total revenue to be allocated as between services provided by the covered and uncovered capacity of the GGP.

Reform of the regulatory framework: from the Code to the National Gas Law and Rules

Although the replacement of the Gas Pipelines Access Law and Code, with the National Gas Law and Rules, resulted in changes to the regulatory framework, the core concepts of the previous regulatory framework were carried over into the new regulatory framework. Further, highly relevant aspects of the previous framework (such as the approach to dealing with extensions to, and expansions of the capacity of, a covered pipeline) were retained.

The second reading speech accompanying the introduction of the National Gas Law notes:

The National Gas Law retains the structure of the Gas Code where economic regulation is only applied to covered pipelines which exhibit a level of market power where the benefits of regulation outweigh the costs. Coverage of pipelines is a process for determining whether or not economic regulation should or should not be applied to the services provided by a particular pipeline ... Consistent with the current Gas Code, a coverage decision may apply to more or less of the pipeline than is the subject of the application or recommendation.⁷

As part of the process in which the National Gas Law and Rules were developed, the fact that the Code operated in a manner so as to exclude uncovered expansions from the calculation of reference tariffs was identified.⁸ However, the recommendation made by the Productivity Commission that could have addressed that issue in part (that section 3.16 of the Gas Code be amended so that if any expansion of a covered pipeline would be covered)⁹ was not adopted. The Ministerial Council on Energy's response to the Productivity Commission's recommendation was that the issue would be progressed in the drafting of the National Gas Law and the National Gas Rules.¹⁰

The Expert Panel on Energy Access Pricing¹¹ did not deal with the issue of extensions/expansions.

The Standing Committee of Officials of the Ministerial Council on Energy (MCE) explanatory material that accompanied the release of the 2006 legislative package for the gas legislative framework set out the different categories of pipeline and the key obligations the National Gas Law applies to each. In respect of "Uncovered pipelines" it is noted that "no regulation" applies (although coverage can be sought) and that access arrangements are not applicable to such pipelines.¹²

The first draft of the National Gas Law continued the arrangements in the Code that provided for extensions/expansions to either form, or not form, part of the covered pipeline, and to affect, or not affect, a reference tariff.¹³

The first draft of the Rules also continued to provide for the extension and expansion requirements in an access arrangement to set out the basis upon which an extension or expansion is or is not to be treated as part of the covered pipeline and, if it is to be treated as part of the covered pipeline, the effect the extension or expansion may have on tariffs.¹⁴ The draft provided for an access arrangement to state the "target revenue" to be derived from reference services, and for that to be based on a building block approach.¹⁵ The

⁷ South Australia, *Parliamentary Debates*, Legislative Council, 30 April 2008, p. 2542 (Paul Holloway).

⁸ Productivity Commission, *Review of the Gas Access Regime*, Inquiry Report No. 31, 11 June 2004, p. 327.

⁹ Productivity Commission, *Review of the Gas Access Regime*, Inquiry Report No. 31, 11 June 2004, p. 328 (recommendation 7.15).

¹⁰ MCE, *Review of the National Gas Pipelines Access Regime: Decision*, May 2006, Appendix 1, p. 7.

¹¹ Expert Panel on Energy Access Pricing, *Report to the Ministerial Council on Energy*, April 2006.

¹² MCE, *2006 Legislative Package: Gas Legislative Framework*, November 2006, p. 5.

¹³ National Gas Law Exposure Draft, 3 November 2006. See: definition of "extension and expansion requirements" (section 5); the circumstances in which an extension to, or expansion of the capacity of, pipelines are taken to be part of the covered pipeline (section 15).

¹⁴ Draft National Gas Rules, 21 November 2006, rule 11, p. 7.

¹⁵ Draft National Gas Rules, 21 November 2006, rule 25(1) and (2), p. 15.

draft did not deal with cost allocation other than to provide that the access arrangement information was to include the proposed approach to setting prices including the method used to allocate costs and a demonstration of the relationship between costs and prices.¹⁶

In the explanatory material accompanying the initial draft of the Rules, the MCE noted: "Part 8 of the NGR largely replicates s 8 of the Gas Code, which provided for the determination of prices and revenue for covered pipelines".¹⁷

In the second reading speech of the National Gas (South Australia) Bill it was noted that the intention has been for the rules concerning access arrangements to replicate the economic regulatory model operating under the Code while implementing the MCE's response to both the Productivity Commission Review of the Gas Access Regime and the Expert Panel on Energy Access Pricing. The second reading speech noted that "consistency with current practice will ensure business and user certainty in the transition between the current and new regimes".¹⁸

GGT submits that, while there are differences between the previous regulatory framework and the current regulatory framework, there is nothing in the explanatory materials which indicates an intention to alter the position under the Code that, in circumstances where a pipeline comprised both covered and uncovered capacity:

- (a) there is both a "covered pipeline" and "uncovered pipeline", where the covered pipeline comprises the capacity that is the subject of a relevant coverage determination, and the uncovered pipeline comprises the capacity that has been created by an extension to, or expansion of the covered pipeline, which (pursuant to a relevant extension / expansion policy or requirement) does not form part of the covered pipeline;
- (b) total revenue (cost) is to be calculated by reference to the costs associated with the capacity of the covered pipeline only; and
- (c) total revenue is to be allocated as between the services provided by means of the covered pipeline, being reference services and other services.

Cost allocation under the Rules

Rule 93 deals with cost allocation. It provides:

- (a) total revenue is to be allocated between reference and other services in the ratio in which costs are allocated between reference and other services; and
- (b) costs are to be allocated between reference and other services as follows:
 - (i) costs directly attributable to reference services are to be allocated to those services; and
 - (ii) costs directly attributable to pipeline services that are not reference services are to be allocated to those services; and
 - (iii) other costs are to be allocated between reference and other services on a basis (which must be consistent with the revenue and pricing principles) determined or approved by the AER.

¹⁶ Draft National Gas Rules, 21 November 2006, rule 21(h)(i), p. 14.

¹⁷ Standing Committee of Officials of the Ministerial Council on Energy, *2006 Legislative Package: Initial National Gas Rules*, November 2006, p. 7.

¹⁸ South Australia, *Parliamentary Debates*, Legislative Council, 30 April 2008, p. 2544 (Paul Holloway).

What rule 93 first requires is an identification of the allocation of "costs" between "reference" and "other services", and secondly, for the ratio in which costs are allocated to then be applied to allocate total revenue between reference and other services.

The key issue is what the term "other services" is referring to. There are two possibilities.

- (a) the term "other services" is referring to services provided by means of the covered pipeline, but which have not been specified as reference services; or
- (b) the term "other services" is referring to the services in (a) as well as any services that are provided by any part of the capacity of the pipeline that may be uncovered.

GGP submits that the correct interpretation of the term "other services" in rule 93 is that it is a reference to services provided by means of the covered pipeline, but which have not been specified as reference services.

It is a requirement pursuant to rule 48 of the National Gas Rules that a full access arrangement, among other things:

- (a) identify the pipeline to which the access arrangement relates;
- (b) describe the pipeline services the service provider proposes to offer to provide by means of the pipeline; and
- (c) specify the reference services (and for each reference service, specify the reference tariff and the other terms and conditions on which the reference service will be provided).

An access arrangement is in respect of a covered pipeline only.¹⁹ In that context, what rule 48 requires is for an access arrangement to identify the covered pipeline to which the access arrangement relates, describe the pipeline services the service provider proposes to offer to provide by means of the covered pipeline, and the specify the reference services.

Rule 101 deals with the specification of reference services in an access arrangement. It provides that a full access arrangement must specify as a reference service at least one pipeline service that is likely to be sought by a significant part of the market, and any other pipeline service that is likely to be sought by a significant part of the market and which the AER considers should be specified as a reference service.

As only a service that is provided by means of a covered pipeline could legitimately be specified as a reference service, it is clear from the context that where rule 101 refers to a "pipeline service" it is referring to a pipeline service that is provided by means of a covered pipeline.

For most pipelines, the reference service will typically be a firm haulage service. The "other services" that may be provided by means of the covered pipeline and which are often not classified as reference services include: interruptible haulage service; spot haulage service; and backhaul haulage service.²⁰ Other services may also include services ancillary to a haulage service, such as connection, disconnection, and meter reading.²¹

¹⁹ This is clear from rule 46 (which deals with the situation where an access arrangement is first submitted after a pipeline becomes a covered pipeline, and requires the submission of an access arrangement proposal proposing a full access arrangement "for the covered pipeline"). See also the relevant subject matter that the Rules are permitted to deal with in Schedule 1 of the National Gas Law. Item 29 deals with the submission to the AER of access arrangements or revisions to applicable access arrangements for approval by the AER including service providers to submit full access arrangements for pipeline services provided by means of covered pipelines.

²⁰ These are examples of "pipeline services" in section 2 of the National Gas Law.

²¹ Services that are ancillary to the provision of services provided by means of a pipeline come within paragraph (b) of the definition of "pipeline service" in section 2 of the National Gas Law.

In the case of the covered capacity of the GGP, the reference service is a firm haulage service from the inlet point at Yarraloola.²² The other services that may be provided by means of the covered pipeline are specified as “negotiated services”. These are services that GGT will offer to meet the requirements of a user or prospective user that cannot be satisfied through the reference service. Such services include gas transportation from an inlet point other than Yarraloola and interruptible services.²³

As uncovered capacity does not form part of the covered pipeline, and as an access arrangement only applies to the capacity of a covered pipeline, the services that an access arrangement is concerned with are:

- (a) reference services; and
- (b) other services provided by means of the covered pipeline.

The operation of the extensions/expansions policy (Code) and extension and expansion requirements (Rules) confirms “other services” are services provided by means of the covered pipeline that are not reference services

The primary significance of an extensions/expansions policy (under the Code) and extension and expansion requirements (in the Rules) is that its application determines when an extension to, or expansion of the capacity of, the covered pipeline will be treated as forming part of the covered pipeline. There is no difference as between the provisions of the Code and the Rules in this respect.

Where an extension to, or expansion of the capacity of the covered pipeline does not form part of the covered pipeline, two “notional” pipelines are formed, one covered and one uncovered.

In submissions to the ERB, GGT made the submission that the notion of coverage under the Code is not so much concerned with the physical characteristics of a pipeline, as with the capacity of the pipeline to deliver gas.²⁴ As the purpose of coverage is concerned with third party access to capacity of the pipeline, a reference to coverage of part of the pipeline must be construed as drawing a distinction between access to that amount of capacity to which a service provider is obliged to provide access on regulated terms and conditions, and other capacity of the pipeline to which a service provider is not obligated to provide access on regulated terms and conditions. GGT submits that this position is unchanged as between the Code and the Rules.

Under the National Gas Law and Rules, services are considered to be provided either by means of covered capacity or by means of uncovered capacity of a pipeline. Pursuant to section 18 of the National Gas Law, an extension to, or expansion of the capacity of, a covered pipeline will only be taken to be part of the covered pipeline (and the pipeline as extended or expanded will be taken to be a covered pipeline) where the extension and expansion requirements provide that the applicable access arrangement will apply to pipeline services provided by means of the covered pipeline as extended or expanded.

As:

- (a) an access arrangement is submitted in respect of a covered pipeline, and;
- (b) an extension to, or expansion of, the capacity of the covered pipeline is not to be treated as forming part of the covered pipeline (where an extensions/expansions policy or extension and expansion requirements relevantly so provide),

²² GGP access arrangement (approved 5 August 2010 and as amended by the Western Australian Electricity Review Board), 30 March 2012, p. 1 (Introduction).

²³ GGP access arrangement (approved 5 August 2010 and as amended by the Western Australian Electricity Review Board), 30 March 2012, clause 4.2, p. 4.

²⁴ GGT outline of written submissions in reply to BHPB submissions, 22 March 2011, [4.8].

a reference in Part 8 (access arrangements) and Part 9 (price and revenue regulation) of the Rules to “pipeline” is to be read as “covered pipeline”.

Therefore, in rule 93 the reference to “other services” and “pipeline services that are not reference services”, is to be properly read as a reference to services provided by means of the covered pipeline which have not been specified as reference services.

BHP Billiton notes that its conclusion that “pipeline services” are not limited to the services provided by a covered pipeline is supported by its observation that the term “covered” is used in a number of other places in the National Gas Law and Rules, suggesting that the omission from this particular definition was intentional.²⁵ However, in a number of places in the National Gas Law and Rules the terms “pipeline” and “pipeline services” are used where the context in which they are used makes clear that the relevant provisions are concerned with the covered pipeline or services provided by means of the covered pipeline. For example:

- (a) The definition of “access arrangement” in section 2 of the National Gas Law provides that it is “an arrangement setting out terms and conditions about access to pipeline services provided or to be provided by means of a pipeline”. It should be uncontroversial that an access arrangement can only deal with terms and conditions about access to pipeline services provided or to be provided by means of a covered pipeline.
- (b) The definition of the term “reference service” in section 2 of the National Gas Law which is defined as “a pipeline service specified by, or determined or approved by the AER under, the Rules as a reference service”, although only a pipeline service provided by a covered pipeline could properly be designated as a reference service.

Calculation of total revenue focuses on the covered pipeline

In the review process before the ERB, BHP Billiton had submitted that the reference tariff should have been determined “by reference to Total Revenue, which should have been calculated by reference to the cost of providing all Services”.²⁶ BHP Billiton said that this would include the capital and non-capital costs of the new compressors²⁷ and all or part of the additional services^{28, 29}.

In its submission to the ERA, BHP Billiton submits that when allocating costs, services provided by means of the pipeline (not just a “covered” pipeline) should be included in the calculation of total revenue.³⁰ However, it is clear that the calculation of total revenue is only to be undertaken by reference to the covered pipeline.

- (a) The capital base (which is an input into two of the building blocks used to determine total return, being the return on the projected capital base and depreciation on the projected capital base) is calculated by reference to the opening capital base of the covered pipeline³¹, as adjusted for specified matters including adding “conforming capital expenditure made, or to be made, during the earlier access arrangement period”.³² Whether or not capital expenditure is conforming capital expenditure or not is only relevant where a service provider is seeking to have that capital expenditure included in the capital base of the covered pipeline. Where a service provider is not seeking for capacity associated with extensions/expansions to form part of the covered pipeline, it is irrelevant whether the capital

²⁵ BHPB Submission, p. 4.

²⁶ BHPB outline of submissions in No. 1 of 2010, 8 March 2011, [15].

²⁷ The compressors at Wyloo West and Ned's Creek.

²⁸ The services provided by means of the uncovered expansions.

²⁹ BHPB outline of submissions in No. 1 of 2010, 8 March 2011, [15].

³⁰ BHPB submission, p. 4.

³¹ See rule 77(1) reference to “covered pipeline”, and then subsequent references to “the pipeline” which refers back to the “covered pipeline” referred to in rule 77(1).

³² Rule 77(2)(b).

expenditure associated with the extension/expansion is conforming and there is no ability for it to be included in the capital base of the covered pipeline.

- (b) The estimate of taxable income for the relevant regulatory years, which is an input to the corporate income tax building block, is calculated as an estimate of taxable income that would be earned “as a result of the provision of reference services”.³³
- (c) The rate of return is determined by reference to a benchmark efficient entity with a similar degree of risk as that which applies to the service provider in respect of the provision of reference services.³⁴

In this regard, GGT submits that there is nothing different as between the Code and the Rules that would lead to a conclusion different from the one reached by the ERA in its final decision on the previous revisions to the access arrangement, being that the capital costs, operating costs and capacity of only the covered pipeline should be brought to account in determining the total revenue and that the services to be provided using only the covered pipeline should be used to derive a reference tariff.³⁵

Regulatory process is only concerned with the covered pipeline

In its final decision on the previous revisions to the access arrangement, the ERA also noted that the Code as a whole, adopts a consistent approach that “confines the Authority to considering the price and terms of access required for the Covered GGP only”.³⁶ Again, GGT submits that there is nothing different as between the Code and the Rules that would lead to a conclusion different from the one reached by the ERA in its final decision on the previous revisions. That the ERA is confined to considering the price and terms of access required for the covered pipeline only is clear from provisions such as:

- (a) the definition of “AER economic regulatory function or power” which is expressed to be a function or power performed or exercised by the AER under the National Gas Law or Rules that relates to the economic regulation of pipeline services provided by a service provider by means of, or in connection with, a scheme pipeline (which in turn is defined, relevantly for these purposes, as a covered pipeline); and
- (b) when exercising a discretion in approving or making those parts of an access arrangement relating to a reference tariff, the ERA is required to take into account the revenue and pricing principles which are focussed on reference services.³⁷

The issue of cost allocation is critically important to the determination of a revised reference tariff for the GGP, and to commercial outcomes for the Goldfields Gas Transmission Joint Venture participants. In making a decision on the proposed revisions to the GGP Access Arrangement, the ERA should now give consideration to the proper construction of the current regulatory framework. In particular, the ERA should give consideration to the fact that there is no provision in the Rules for the total revenue to be allocated between services provided using the capacity of the covered pipeline and services provided using the capacity of the uncovered expansions.

³³ Rule 87A(1).

³⁴ Rule 87(3).

³⁵ ERA, *Final Decision on GGT's Proposed Revisions to the Access Arrangement for the Goldfields Gas Pipeline*, 13 May 2010, [59].

³⁶ ERA, *Final Decision on GGT's Proposed Revisions to the Access Arrangement for the Goldfields Gas Pipeline*, 13 May 2010, [57].

³⁷ For example: section 24(2) of the National Gas Law, which provides that a service provider should be provided with a reasonable opportunity to recover at least the efficient costs the service provider incurs in providing reference services; section 24(3), which provides that a service provider should be provided with effective incentives in order to promote economic efficiency with respect to reference services, and the economic efficient that should be promoted includes efficient investment in, or in connection with, a pipeline with which the service provider provides reference services; and section 24(5), which provides that a reference tariff should allow for a return commensurate with the regulatory and commercial risks involved in providing the reference service to which the tariff relates.

If further discussion on this matter would be of assistance to the ERA, please contact me, on (08) 6189 4594, or at john.williams@apa.com.au.

Yours sincerely

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