GGT Response to WMC Submission to ERA dated 6 January 2005

Economic depreciation

WMC set out, in paragraph 3.4.2 of the submission, its view of the way in which GGT proposed that the Initial Capital Base ("ICB") of the GGP be determined for the purpose of the revised Access Arrangement lodged with the Economic Regulation Authority ("ERA") on 17 November 2004.

WMC's view of the determination of the ICB is incorrect.

In WMC's view, the starting point for GGT's ICB determination was a 1999 estimate of the replacement cost of the GGP of $586 million. This was incorrect.

GGT's determination of an ICB at 1 January 2000 proceeded from the actual construction cost of the pipeline during the period from 1994 to 1996.

Proceeding from actual construction cost, GGT determined the capital recovery during each quarter through until the final quarter of 1999. The unrecovered asset value at the beginning of each quarter was the unrecovered asset value at the beginning of the preceding quarter, less the capital recovery - economic depreciation - during the quarter, plus new facilities investment. (The economic depreciation could be positive, indicating a recovery of capital, or negative, indicating that further financing of the investment was required). The unrecovered asset value at the end of the fourth quarter of 1999, determined in this way, was proposed by GGT as the ICB for the GGP at 1 January 2000.

The quarterly capital recovery, or economic depreciation, was determined as the difference between the revenue earned in each quarter, less costs incurred during the quarter. Costs incurred were GGT's actual costs of operating and maintaining the GGP, plus the cost of financing the unrecovered asset value at the beginning of the quarter.

In determining the ICB in this way, GGT followed the method adopted by the ERA for its determination of the ICB of the Amended Draft Decision. GGT proceeded, as the ERA had done, from the actual construction cost of the pipeline. GGT, however, proposed values for the revenue earned in each quarter, and for non capital costs, which were different from those used by the ERA, and which better accorded with its actual cash flows from the provision of gas transportation services. GGT also proposed a different value for the rate of return which should be applied in determining the cost of financing the unrecovered asset value.

WMC's conclusion (at page 18 of its submission), that GGT had changed the valuation method for the GGP, and that the change did not "incorporate, substantially incorporate, or otherwise address any amendment required in the Amended Draft Decision" was not correct. Furthermore, the error was carried through, invalidating a number of other comments made by WMC in subsequent sections of its submission.

Adjusting the Rate of Return

In section 3.4.4 of its submission, WMC argued that GGT's proposed use, in determining the ICB for the GGP, of the rate of return established for tariff setting immediately prior to the original commitment to invest in the pipeline, was inappropriate. The use of this rate of return was, in WMC's view, inappropriate because GGT had, for the purpose of its revised Access Arrangement, adopted a fundamentally different risk profile by for the pipeline. GGT had done so by using:

(a) a 1999 replacement cost estimate in establishing the ICB; and

(b) demand forecasts and other cost estimates that diverged from the forecasts prepared at the time of project initiation.

On its own terms, WMC's argument is invalid because GGT did not use a 1999 replacement cost estimate in establishing the ICB for the GGP. WMC's error in this respect has been discussed earlier in this response.

Furthermore, WMC appears to hold the view that investors in the GGP should no longer be compensated for the risks they undertook to bear at the time of the initial commitment to invest in the GGP because revenues and costs – both actual and expected in the future – are now different from the expectations which prevailed at that time.

The investors will, however, have expected, at the time of the initial commitment to invest, that the actual revenues from, and costs of, operating the GGP, and their future expectations of those revenues and costs, will almost certainly be different from the expectations they currently had. They will have invested on the basis of the risks that this entailed, and on the expectation of being compensated for those risks. To now change the rate of return would be an arbitrary expropriation of their opportunity to be compensated for the risks borne at project initiation. If that expropriation had been anticipated at the time of the initial commitment to invest, the investment in the GGP would not have been made. To change the rate of return in the way proposed by WMC would be similar to asking the winner of a lottery to pay, after the event, a much higher price for the winning ticket.

CPI adjustments

GGT's use, in determining the economic depreciated value of the GGP, of the inflation rate assumed at the time of the commitment to invest reflected its long term view of the risks of investment in the pipeline, and a requirement for compensation for those risks over the life of the asset.

WMC argues, in section 3.4.5 of its submission, that GGT does not appear to acknowledge the possibility that economic structural change might give rise to a long term CPI forecast which diverges from the assumed rate of 4%.

GGT notes that, in its Supplementary Submission (at page 12), it effectively acknowledged that economic structural change could give rise to inflation at a rate different from its assumed 4%. Economic structural and policy changes are likely over the long life of a gas transmission pipeline, and these changes are likely to ensure that inflation will sometimes be above 4%, and sometimes below. In these circumstances, maintaining the original inflation expectation was appropriate.

Adjustment of deemed revenue

WMC appears to maintain, in section 3.4.6 of its submission, that GGT has, in some way, manipulated the revenues it received in the past in a way inconsistent with the Tariff Setting Principles which applied under the access regime of the State Agreement. WMC's argument is, however, hard to follow, and that may be a consequence of it not clearly understanding the way in which the economic depreciated value of the pipeline was determined (both by the ERA, and by GGT for its revised Access Arrangement), and the role of that value in establishing the ICB.

As noted above, GGT was in agreement with the position of the ERA's Amended Draft Decision on the use of economic depreciated value in establishing the ICB of the GGP. Indeed, GGT had proposed such an approach to the ERA's predecessor in December 2002. GGT, however, proposed, for the purpose of its revised Access Arrangement, values for past revenues (and costs) which were different from those which had been used by the ERA in support of its reasoning in the Amended Draft Decision.

GGT's reason for this, which was set out in its Supplementary Submission, was that a proper construction of economic depreciated value required the best possible assessment that could be made of revenues actually received by the pipeline owner, and not the use of the so-called "notional revenues". There were, as GGT acknowledged, difficulties in establishing actual revenues in the circumstances which had prevailed (where a number of the pipeline users were entities closely related to the previous owners). Nevertheless, GGT was able to make a careful assessment of those revenues on the basis of the documentation it had.

Furthermore, fully appreciating the importance of the past revenues for the determination of an economic depreciated value for the GGP, GGT undertook to make its records available to the ERA permitting, as WMC now requires, the Authority's rigorous scrutiny of GGT's revenue figures.

Linepack cost

In section 3.4.7 of its submission, WMC drew the ERA's attention to the cost of linepack gas which GGT had included as an element of pipeline asset value on which it was entitled to earn a return. WMC did not question the appropriateness of including the cost of linepack in the calculation of the proposed reference tariff of the revised Access Arrangement. Rather, it directed the ERA to ensure that the value of the gas had been properly established, and that there had been no "double counting" through the cost also having been capitalised as "initial fill", included in "commissioning costs", or included in working capital.

Linepack volume calculations for the GGP are made daily by the pipeline operator, Agility, and the results of these calculations were used to determine the build up of linepack to 31 December 1999. The volume of linepack on 31 December 1999 was valued at about $2.00/GJ, which was – approximately – the price at which gas could be purchased at that time.

At the time it lodged the revised Access Arrangement with the ERA, GGT was of the view that the value of linepack had not previously been taken into account in any pipeline costing. It was not included in the estimates of working capital which GGT had prepared. GGT has subsequently reviewed its records of the construction costs of the GGP, and has confirmed that they do not include any amount for linepack, in the form of "initial fill" or "commissioning costs". GGT notes, however, that it was not the builder of the GGP, and is reliant on records which were provided by the previous owners of the pipeline.

Alternative view

WMC summarises, in section 3.4.9 of its submission, its view on the rate of return to be used in establishing the ICB for the GGP. According to WMC, to properly construct the ICB using cost and revenue data which diverge from the forecasts prepared at the time of project initiation, the rate of return must be set to reflect the risks inherent in the revised data set.

GGT maintains that this view is incorrect. As GGT has argued in its Supplementary Submission, the economically relevant rate of return – the true measure of the opportunity cost of the investment – was the rate of return used in the original investment decision. To change that rate during the life of the GGP would be an arbitrary imposition of a new risk assessment for the one made by the original investors. As GGT advised in its Supplementary Submission (and this was not questioned by WMC in its submission), that risk assessment, and its implications for pipeline valuation, carry through a series of sale transactions to the current owners of the GGP. To change the risk assessment now would, arbitrarily, either under- or over-compensate the current owners for the investment they have made in the pipeline.

Rate of return

In section 3.5 of its submission, WMC reiterates its views on the risks faced by GGT, and on their implications for the rate of return used for the purpose of determining the reference tariff of the revised Access Arrangement. WMC believes these risks are low, and that this justifies a low rate of return.

WMC's view follows from the arguments it made, earlier in the submission, that project risk reduces over time, particularly as the specific risks listed on page 29, materialise or do not materialise.

GGT maintains that this view, and the conclusions which follow from it concerning a low rate of return to be used in determining the reference tariff for the GGP, are incorrect. As GGT argued in its Supplementary Submission, and earlier in this response to WMC, the risks are assessed immediately prior to the commitment to invest, and compensation for bearing those risks is then provided over the life of the GGP. There is no basis for progressively lowering the rate of return through changing the risk assessment that was originally made, and no basis for adopting a rate of return lower than that proposed by GGT for determination of the reference tariff of is revised Access Arrangement.