

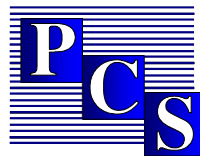
**SUBMISSION TO THE  
ECONOMIC REGULATION AUTHORITY  
  
IN REGARD TO  
  
THE ECONOMIC REGULATION AUTHORITY'S  
AMENDED DRAFT DECISION ON THE  
PROPOSED ACCESS ARRANGEMENT FOR  
THE GOLDFIELDS GAS PIPELINE**

Prepared for

**MURRIN MURRIN OPERATIONS**

by

**Project  
Consultancy  
Services  
Pty Limited**



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# **SUBMISSION TO THE ECONOMIC REGULATION AUTHORITY IN REGARD TO THE ECONOMIC REGULATION AUTHORITY'S AMENDED DRAFT DECISION ON THE PROPOSED ACCESS ARRANGEMENT FOR THE GOLDFIELDS GAS PIPELINE**

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## **1. BACKGROUND**

This submission has been prepared by Project Consultancy Services Pty Ltd ("PCS") on behalf of Murrin Murrin Operations Limited ("MMO") in response to the invitation issued by the Economic Regulation Authority (the "Authority") dated 29 July 2004 for submissions concerning the Authority's Amended Draft Decision on the proposed access arrangement for the Goldfields Gas Pipeline (the "Amended Draft Decision").

MMO is a third party user of the Goldfields Gas Pipeline (the "GGP") and a potential third party user of the GGP. MMO consumes almost 15% of the services of the GGP, on a distance weighted basis and, when the capacity commitments of the GGP owners are excluded from the calculation, accounts for almost 50% of the contracted load on the GGP.

## **2. THE INITIAL CAPITAL BASE**

The Authority focuses upon the determination of the Initial Capital Base (the "ICB") of the GGP between paragraphs 74 and 234 of the Amended Draft Decision. The Authority has adopted a sequential process in applying the criteria set out in sections 8.1, 8.10, 8.11 and 2.24 of the Code. In the course of this process the Authority repeatedly concludes that the ICB for the GGP should fall between the Depreciated Optimised Replacement Cost (the "DORC") estimate for the GGP and the Depreciated Actual Cost (the "DAC") estimate for the GGP.

However, the Authority's ultimate determination to set the ICB for the GGP at \$480 million, which is higher than both the DORC and the DAC ICB estimates, is flawed. In particular, there is reason to be concerned with the:

- ❑ apparent disregard for the DAC methodology and ICB estimate proposed by the Office of Gas Access Regulation ("the "Regulator") and the Authority's emphasis on a re-defined DAC methodology and ICB estimate;
- ❑ consideration of the ICB estimates derived using the prices paid for GGP assets;
- ❑ the inconclusive consideration of prices paid for the GGP interests; and

- ❑ arbitrary decision to substantially increase the ICB of the GGP over the Authority's DAC and DORC ICB estimates.

## **2.1 Depreciated Actual Cost**

At paragraph 102 of the Amended Draft Decision, the Authority confirms the DAC estimate of the ICB contained in the April 2001 Draft Decision of the Regulator on Goldfields Gas Transmission's ("GGT's") proposed access arrangement for the GGP (the "2001 Draft Decision"). This DAC estimate is \$435.4 million. The DAC described in the 2001 Draft Decision is a backward-looking accounting construct based upon actual expenditure and book depreciation of the asset(s).

In the Amended Draft Decision the Authority introduces a new method of estimating the ICB of the GGP. The Authority refers to the valuation derived using this new method as its DAC estimate and thereafter appears to disregard the earlier DAC ICB estimate. The new method adopted by the Authority was proposed by GGT in its 17 December 2002 submission, and:

- ❑ begins with the historic cost of the asset(s);
- ❑ estimates the revenue and costs generated by the asset(s) (including the cost of funds);
- ❑ estimates the net revenue generated by the assets up to the date of valuation; and
- ❑ deducts this net revenue from the historic cost of the assets.

This methodology is also a backward-looking method but it is not equivalent to the DAC calculation method quoted previously. This methodology ignores book depreciation and combines accounting records of asset cost and estimates of the free cashflow generated by the asset over its life to estimate the ICB of the GGP. The value so derived is analogous to the unrecouped investment calculated using discounted cash flow ("DCF") methods but, in this case, no discounting is applied. Hereinafter this methodology will be referred to as the free cashflow ("FCF") method of estimating ICB. The data used in this valuation method are those that would be used in a DCF model.

This valuation method is a valid valuation technique which should be correctly considered under section 8.10(c) of the Code. However, the Authority's adoption of this FCF valuation method, to the exclusion of previous DAC valuations, is a matter for concern. This additional valuation method stands alongside, and not in place of, the Regulator's previous DAC estimate as an equally valid valuation method. The FCF ICB estimate provides added insights into the underlying ICB of the GGP.

## **2.2 Acquisition Price of the GGP**

The Authority goes on to consider the implications for the value placed on the GGP of the prices paid by the current owners of the GGP for their interests in the GGP. Unfortunately, the acquisition price-based ICB estimate adopted by the Authority seems excessive. This valuation methodology depends upon:

- ❑ a number of arbitrary adjustments which must be made to the source data to produce an ICB estimate; and
- ❑ the assumptions used by the buyer(s) of these assets to generate the “acquisition case” cashflows.

Such adjustments and assumptions relate, or should relate, to the removal of the value of unregulated assets from the acquisition price, adjustments for contractual concessions in contracts sold with the assets and assumptions about GGP sales and prices which vary from the regulated revenue scenario. These adjustments should correct for any unrealistic expectations of the buyer. The question of expectations is addressed below. The most uncertain adjustment which must be made to the purchase price is the adjustment of the 1998/99 acquisition price to produce a 1 January 2000 ICB valuation for the GGP. This uncertainty is exemplified by the recent acquisition, by the Australian Pipeline Trust (“APT”), of certain interests, including an interest in the GGP, from CMS Energy Pty Ltd. Based upon reports of this transaction, the ICB for the GGP could be expected to fall in the low \$500 millions.

Clearly, the prices paid to acquire GGP interests have been volatile in the period 1998/99 to 2004. It is difficult, therefore, to determine the acquisition price-based ICB estimate which is applicable on 1 January 2000. This can in fact only be achieved with access to actual acquisition models and assessments undertaken by the buyers and these data are not on the public record. In light of the acquisition costs established in 1998/99 and 2004, it would appear that the ICB of the GGP lies inconclusively between \$600 million and \$500 million.

Further, for any forecast cash flow generated by an asset or business, the acquisition price of the asset can only be derived (or recreated) if the cost of funds used in the acquisition model is applied. Any correction to the ICB of the GGP to reflect acquisition cost must similarly adjust the rate of return used to derive the Reference Tariff. Indeed, there is an argument for conducting parallel analyses of the Reference Tariff, one based on an ICB derived from DAC, DORC, etc and the Authority’s WACC and the other based on a properly constructed valuation which reflects the prices paid for the relevant assets and the acquisition cost of funds used in the acquisition model.

The DAC, DORC and FCF ICB estimates produced by the Authority are not necessarily inconsistent with an ICB derived from acquisition price information and in

the range noted above, provided that the appropriate adjustments and treatment are applied to the acquisition price valuation.

## **2.3 Reasonable Expectations of the GGP Owners and Users**

In spite of the Authority's conclusion in paragraphs 180 to 230 that the ICB for the GGP should fall in the range defined by the DORC, DAC and FCF ICB estimates, the Authority adds a substantial premium to its DAC, DORC and FCF ICB estimates to determine an ICB for the GGP of \$480 million.

GGT argues that this adjustment is justified because of its expectations regarding the value of the GGP and the level at which the GGP tariffs will be set. GGT argues, among other things, that:

- ❑ its tariffs have been set pursuant to the terms of the State Agreement and that users of the GGP ("Users") and the owners of the GGP could reasonably expect these tariffs to be considered when the Authority determines the GGP ICB;
- ❑ it is entitled under the State Agreement and, therefore, under the Code, to recover all construction and operating costs associated with providing third party services; and
- ❑ Users and the owners of the GGP would have expected that GGT tariffs would be set by GGT and not by the Authority.

In response to these arguments, the Authority concludes that the rate of return earned by GGT is substantially in excess of a "commercial rate of return" and notes, further, that this conclusion was confirmed in studies commissioned by government agencies.

The Authority concludes that the third-party tariffs established for the GGP have embodied a rate of return that is substantially in excess of the likely cost of capital for the GGP. In spite of these conclusions, the Authority appears to suggest that the public interest will be served if the Authority determines an ICB which does not "claw back" these excessive returns. Taking this public interest concern into account, the Authority determines an ICB which is some \$70 million above its DORC estimate and \$45 million above the FCF and DAC estimates of the GGP's ICB.

The Authority should review its assessment of GGT's expectations and its assessment of the public interest regarding the determination of the ICB for the GGP. GGT's expectation that it will recover all operating and construction costs relating to the GGP could only derive from GGT's rights under the State Agreement. The State Agreement references to "costs" relate to the actual costs associated with the development and operation of the GGP and clearly connect with the DAC and FCF ICB valuation methodologies.

Further, since the State Agreement provides no mechanism whereby the Minister might set GGT's published tariffs, it must be accepted that GGT has the primary responsibility to determine its published tariffs. Under the State Agreement, GGT is simply required to provide the Minister with a current "indicative tariff schedule". If the Minister is not satisfied with the indicative tariff schedule, his/her options are extremely limited and, in some way, inconclusive. By contrast, GGT is required, according to the State Agreement and its approved tariff principles, to redetermine its tariff:

*"at any time when the tariffs for GGP services then being applied:*

- do not promote the use of the GGP; or*
- do not promote the efficient use of reserved capacity; or*
- generate a rate of return to the Owners which is inconsistent with Principle (2) above, except where the Owners elect to exercise Principle (13)".*

Clearly, the third party access regime enshrined in the State Agreement sets the published tariffs for the GGP without input from, or intervention by, the Minister. However, the State Agreement imposes a countervailing obligation on GGT to ensure that its tariffs conform with the requirements of the State Agreement and with GGT's approved tariff setting principles.

Where GGT sets tariffs which do not comply with the State Agreement and the approved tariff setting principles, that does not legitimise those tariffs. There is evidence to suggest that GGT should have expected that "(T)he State Government and Goldfields Gas Transmission will continue to review gas access arrangements in light of new legislation to be introduced this year", since that was the conclusion arrived at "following discussions between the State Government, and the owners of the Goldfields Gas Pipeline", as recorded in the then Minister's press release dated 24 February 1998. In February 1998, both the State and GGT clearly expected that future regulation of the GGP would be based on the access regime set out in the Gas Pipelines Access (Western Australia) Act 1998. In this light, the Authority's determination that GGT's tariffs are excessive, and that these tariffs embody rates of return in excess of a commercial rate of return, should not be taken to impute any suggestion of legitimacy to those tariffs or to the expectation of GGT which gave rise to those tariffs.

## **2.4 The Minister and the Authority**

GGT purports that the limited capacity of the Minister to intervene in the setting of its published tariffs extends to the Authority. GGT appears to assert that the Authority has no right to set GGT's published tariffs. Clearly, based upon the Minister's press release, the Authority's role was discussed, and apparently resolved, in February of

1998. Further, there is nothing in the State Agreement which contemplates any such limitation on the role of the Authority. The State Agreement explicitly provides for the introduction of by-laws, the promulgation of uniform laws or subsidiary legislation governing access to petroleum pipelines in Western Australia and the subsequent superseding of any by-laws by any uniform access laws.

Section 21(1) of the State Agreement goes on to say that any by-law shall have regard for all proposals approved pursuant to the State Agreement and to GGT's approved tariff setting principles. Section 20(2) of the State Agreement provides that the terms and conditions of Third Party access to the GGP shall be subject to and in accordance with by-laws from time to time made, altered or repealed.

Clearly, the State Agreement contemplates that by-laws and, or, uniform access law would address, and even prescribe, GGT's published tariffs. This is the thrust of the Minister's 1998 report on his discussions and agreements with GGT. There is clearly a very strong argument that the State Agreement provided a means whereby the Governor, or a body constituted under the "uniform laws" (the Authority), could set GGT's tariffs.

## 2.5 ICB Summary

The Authority's assessment of alternative ICB estimates against the criteria set out in sections 8.1, 8.11 and 2.24 of the Code attempts to reflect the decision of the Supreme Court of Western Australia in, what the Authority refers to as, the Epic Decision. The Authority concludes, in virtually every instance where it applies the relevant Code criteria that the ICB for the GGP should fall within the range established by the DAC, DORC and FCF ICB valuation methods, between \$407 million and \$434 million. The Authority goes on to suggest that the ICB of the GGP is in the order of \$495 million. The Authority arrives at this suggestion because of a concern that GGT's "legitimate", but excessive, earnings prior to 1 January 2000 should not be "clawed back" as part of the regulatory process. The Authority, in recognition of public interest concerns regarding sovereign risk, determines an ICB for the GGP of \$480 million.

The problem with this analysis is that, if GGT did not honour its obligation to produce published tariffs which conform to the rules set out in the State Agreement and to the approved tariff setting principles, this does not give rise to a legitimate right or expectation to capture a rate of return in excess of a commercial rate of return. On the contrary, the Minister's 1998 press release confirms that GGT's 1998 tariff reductions represented the "*substantial benefits the Government imagined would flow from energy deregulation when it gave approval for the construction of the Goldfields Gas Pipeline*" and that these tariffs would continue to be reviewed in a Gas Pipeline Access (Western Australia) Act-based regulatory environment.



The public interest is not necessarily being advanced by adding the proposed premium to the ICB of the GGP. At paragraph 82, the Authority estimates the windfall which has been received by GGT as a result of delays in settling GGT's proposed access arrangement. By consciously adding to this windfall, through adding a premium to the GGP's ICB, the Authority serves only to undermine the public interest.

### **3. FORECAST DEMAND**

The Amended Draft Decision considers a number of GGT forecasts of demand for GGP services, including those set out in paragraph 400 and paragraph 402 of the Amended Draft Decision. The Authority concludes that *"the Authority is prepared to accept the forecasts provided by GGT for the purpose of the Amended Draft Decision"*. It is not clear whether this conclusion means that the Authority has accepted the GGT demand forecasts described in paragraph 400 of the Amended Draft Decision or the forecast described in paragraph 402. The information behind both sets of data appears to have been provided by GGT for the purpose of the Amended Draft Decision.

The data set described in paragraph 402 should be used by the Authority in its assessment of GGT's Reference Tariffs. These data appear to be the most recent and most reliable GGT demand forecast and there is no reason to discount these data.

### **4. THE REGULATED RATE OF RETURN AND OTHER TARIFF DETERMINANTS**

The analysis undertaken by the Authority, and reported in paragraphs 235 to 399 and paragraphs 405 to 425, reflects current practice for determining regulated rates of return. It should be noted that the Authority's decisions to adopt the proposed 42 year regulated asset life, and the proposed depreciation model, appear to favour GGT at the expense of Users.

The Authority should confirm that the ICB estimates quoted in the Amended Draft Decision were derived using the same asset life assumptions. In particular, the Regulator's original DAC and DORC ICB estimates should be recalculated to reflect the reduction of the effective life of the GGP to 42 years.

### **5. GENERAL TERMS AND CONDITIONS**

The detailed assessment of GGT's terms and conditions undertaken by the Authority, and reported upon from paragraph 426 to paragraph 675 of the Amended Draft Decision, will assist MMO in its capacity as a potential User of the GGP. Based upon PCS's discussions with MMO, we understand that MMO supports the general thrust of the Authority's recommendations. In this light, the comments set out in this review address only a small number of particular issues.

First, MMO supports the Authority's proposal not to allow the application of penalties on Users when those Users exceed their MDQ or MHQ and, or, for failing to equate nominations with actual gas injections/withdrawals when such occurrences have no consequence for GGT, or for any other User. MHQ is an important consideration when designing pipeline receipt and delivery facilities and when setting limits on GGT's liability when Users request gas deliveries above MHQ. As a general rule, however, the mere fact that a User exceeds MHQ has no consequence for GGT, or for other Users.

Similarly, GGT has adopted the United States practice of requiring Users to balance their injections into and out of the GGP daily. In the United States, this practice was introduced to put an end to opportunistic behaviour whereby some users maintained daily imbalances which impacted adversely on other users and on pipeline owners. There is no history of this opportunistic behaviour in Australia. In this context, GGT proposes that Users who fail to match daily GGP injection with daily withdrawals should be penalised. Further, GGT proposes that Users, who fail to match their daily gas nominations with their daily gas injections into, and withdrawal from, the GGP, should be subject to a penalty. However, nominations are made at least 18 hours in advance of a "Gas Day" and a User has only limited rights under GGT's general terms to adjust its nominations and, or, its actual pipeline injections and withdrawals to reflect daily weather and plant operating conditions.

MMO endorses the Authority's decision to limit GGT's right to penalise a User for exceeding MDQ or MHQ, experiencing a daily injection-withdrawal imbalance or for variation between actual and nominated GGP utilisation. Such penalties should only apply when GGT and, or, another User, is adversely affected and where GGT's terms and conditions give the User rights which allow it to manage its use of the GGP to avoid these situations.

Second, MMO shares the concern of the Authority regarding the lack of transparency regarding the need for, and the quantum of, any bond or credit support that a User may be required to lodge with GGT. Under its approved tariff principle, GGT is only entitled to require credit support from Users in those instances where GGT has "*a genuine concern regarding Users credit worthiness*" (approved tariff principle #5). It seems reasonable that this expectation should be reflected in GGT's general terms and conditions.

Bonds and requirements to provide credit support can obviously be used to discourage access to pipeline services and the Authority should ensure that GGT is constrained in its right to require credit support and that any such requirement is transparent in the way it is applied.

Third, MMO supports the determination of the Authority that GGT should specify a standard of reliability for its various services and that GGT should bear the cost of any service interruption by refunding all charges relating to the supply of GGP services in the period of any interruption.

Fourth, MMO has experience of GGT's requirement that Users must pay any disputed invoice in full. As such, MMO supports the Authority's conclusion that this arrangement is unreasonable and urges the Authority to require that this arrangement be made more equitable.

Fifth, MMO commends the Authority for drawing the parallel between gas supply interruptions in general and force majeure interruption in particular. The decision that GGT should take responsibility for, and bear the cost of, all interruptions to supply which are not caused by the User, or by a force majeure event affecting the User, is entirely appropriate.

Sixth, the Authority proposes to amend clause 3.2 of GGT's general terms and conditions. The Authority proposes to preclude GGT from unilaterally terminating a services agreement if the start of the service is predicated upon GGT first upgrading the GGP and GGT fails to complete that upgrade in a specified time. The Authority must be careful to ensure, however, that any such amendment does not preclude the User, in such a situation, terminating the agreement when the installation of enhancements and, or, additions to the GGP, are delayed. If this right of the User is removed, the User may not be able to seek an alternative energy supply and, thereby, secure an alternative fuel supply. That is to say, the User may be bound into a failed contract until GGT agrees to termination.

Finally, MMO submits that any connection charge paid to GGT when a prospective user of the GGP wishes to connect to the GGP should be a transparent fee for services actually provided by GGT. The connection fee should not be an arbitrarily determined entry price which might, in itself, be used to discourage connection.

## **6. REVIEW AND EXPIRY OF THE ACCESS ARRANGEMENT**

The Authority's Amended Draft Decision is presented in a form that will accommodate "Revisions Submission Dates" of either 30 June 2005 or 30 June 2009 and "Revisions Commencement Dates" of either 1 January 2006 or 1 January 2010. The Authority requests submissions regarding the Revisions Commencement Date. It is proposed that the Revisions Commencement Date for GGT's access arrangement should be 1 January 2007.

This date will allow the decision of the Authority regarding the currently proposed access arrangement to be finalised and bedded in whilst it limits the risk that forecasting errors will disadvantage either GGT or Users.

## **7. APPENDIX B AND APPENDIX D**

Whilst, in Appendix B and Appendix D, the Authority has sought to outline the analysis which underpins a number of its key conclusions, the appendices are shrouded in confusion, presumably in the interests of GGT's confidentiality. Since the analysis reported in these appendices is crucial to the Authority's assessment of GGT's proposed access arrangement, MMO should request the Authority to extend these explanations and to provide greater disclosure in regard to the analysis.