NEWGEN POWER KWINANA SUBMISSION IN RELATION TO THE ECONOMIC REGULATION AUTHORITY ISSUES PAPER – DAMPIER TO BUNBURY NATURAL GAS PIPELINE PROPOSED REVISIONS TO ACCESS ARRANGEMENT

1. Introduction

As an interested party NewGen Power Kwinana Pty Ltd ACN 116 827 546 (**NPK**) has reviewed the Access Arrangement revisions submitted by DBNGP (WA) Transmission Ltd (**DBP**) to the Economic Regulation Authority (**ERA**) in April 2010 and has significant concerns over the magnitude of the proposed price increase. NPK's response to DBP's proposed Access Arrangement revisions is structured around the major pricing related elements of the Access Arrangement.

In addressing concerns over the magnitude of the price increase, NPK is particularly concerned that the information provided by DBP does not provide sufficient transparency to enable users to replicate DBP's analysis or to make an informed decision as to the reasonableness of the proposal.

2. NPK Submission

2.1 Issue 5 Rate of Return

The ERA invited submissions from interested parties on:

- the proposed rate of return (WACC);
- the proposed cost of debt;
- the proposed cost of equity including the methods used for calculating the proposed cost of equity;
- DBP's supporting information to justify its approach and proposed rate of return; and
- any other matters in relation to the rate of return under the proposed revisions.

DBP Position

DBP has proposed the adoption of a 10.76% real pre-tax rate of return using a weighted average cost of capital (**WACC**) approach. This compares with DBP's current WACC of 7.24% and the ERA's recent determination for the Goldfields Gas Pipeline WACC of 7.7% pre-tax real or 9.76% post-tax nominal. The June 2010 Australian Energy Regulator (**AER**) Final Decision on the Jemena Gas Networks Access Arrangement provided for a 9.69% post-tax nominal WACC which is almost identical to the ERA's GGT WACC.

In terms of the return on equity component of the WACC, the principal difference in DBP's approach has been the use of a selected point estimate for the return on equity from within a range of estimates informed from various different estimation approaches rather than the standard regulatory approach of adopting the classic capital asset pricing model.

DBP justifies this approach as being consistent with the requirements of the National Gas Rules (NGR) and necessary due to the claimed downward bias of the classic capital asset pricing model (CAPM) when applied to gas transmission businesses.

In terms of the cost of debt, DBP has estimated its cost at 9.73%. The approach used is described as a “built-up” cost for an entity with a credit rating in the BBB range based on various domestic and international benchmarks.

NPK Submission

NPK’s general position on WACC is that the approach used to estimate the required rate of return should be based on standard regulatory precedent i.e. CAPM and WACC, as such an approach is now broadly understood and therefore provides increased transparency in terms of access seekers understanding whether the reference price is reasonable.

If DBP can show that use of the standard approach results in a downward biased WACC, then appropriate adjustment can be made by selecting values for the various parameters (such as Beta) from within the upper end of the reasonable range.

In terms of the return on equity component of the WACC, from Table 19 of DBP’s Access Arrangement Information, it would appear that DBP’s proposed rate of 13.5% is some 471 basis points higher than the estimate provided by the standard CAPM approach (8.79%), presumably estimated on a comparable basis. NPK has concerns that this premium is likely to be excessive and will result in prices well in excess of those that would be required in a competitive market.

In terms of the cost of debt, DBP’s proposal would result in a cost of debt of some 420 basis points higher than the assumed risk free rate. This seems an extraordinarily high margin for a BBB rated bond. Indeed, the AER in the June 2010 Jemena Final Decision concluded that a reasonable debt risk premium based on BBB bond yields would be 295 basis points or some 125 basis points less than the DBP claim.

While NPK acknowledges that it is currently difficult to price Australian BBB rated bonds, NPK is of the view that where this problem creates a risk of underestimating the debt margin, then the ERA should ensure that care is taken to select a value from the upper end of the reasonable range using the standard regulatory approach rather than adopting an estimate based on a non-transparent approach.

NPK also notes that DBP has assumed a zero value for imputation credits (gamma). While NPK understands there is significant uncertainty as to the market value of imputation credits, adopting a value of zero would seem unreasonable especially compared with historic precedent of a gamma of 0.5. Again, NPK would suggest that an estimate should be selected from within the reasonable range rather than simply adopting an extreme value as DBP appear to have done.

As such, NPK considers that the DBP approach to estimating the WACC lacks transparency and is likely to result in a WACC significantly higher than that required to compensate for the financial risks faced.

2.2 Issue 3 Capital Expenditure

The ERA invited submissions from interested parties on:

- the capital expenditure in the 2005 to 2010 access arrangement period conforms to Rule 79(1)(a) as expenditure that would be incurred by a prudent service provider acting efficiently, in accordance with good industry practice, to achieve the lowest sustainable cost of providing services;
- DBP has adequately demonstrated that capital expenditure in the 2005 to 2010 access arrangement period is justifiable under the terms of rule 79(2);
- the forecast of conforming capital expenditure for the 2011 to 2015 access arrangement period has been arrived at on a reasonable basis and represents the best possible forecast or estimate possible in the circumstances; and
- the forecast of conforming capital expenditure for the 2011 to 2015 access arrangement period has been adequately demonstrated to meet the requirements for conforming capital expenditure under rule 79.

DBP Position

DBP have assumed an opening capital base as at 31 December 2010 of some $3.3 billion (AAI Table 8). This reflects DBP's claim for the inclusion of some $1.8 billion in conforming capital expenditure over the prior access arrangement period.

NPK Submission

NPK is aware that the DBP has been significantly expanded over the last regulatory period. NPK's principal concerns are whether the magnitude and timing of the expansions were reasonable given the result is a virtual real-terms doubling of the asset base compared to the start of the previous regulatory period.

NPK is concerned that the pipeline was expanded during a period of exceptionally high construction costs and during a period where there were significant concerns over future availability of gas for the domestic market. As such, a prudent operator may well have temporarily or permanently deferred some of the expansions.

While DPB has provided considerable information to justify the expansions, NPK remains concerned that future demand will not be sufficient to justify the expansions and that rolling all of the capital expenditure into the regulated capital base has the potential to result in future users facing higher reference tariffs than would have been the case had a more measured approach been adopted to expansion.

The issue of likely demand is discussed further in the following section.

2.3 Issue 9 Demand

The ERA invited submissions from interested parties on:

- future demand including future demand for each pipeline service;

- DBP's supporting information that seeks to justify the demand information; and
- any other matters in relation demand under the proposed revisions.

DBP Position

DBP have indicated that the pipeline will be fully contracted over the regulatory period.

NPK Submission

DBP's Submission number 7 provides a capacity and throughput forecast. This submission goes into some detail in terms of explaining why there is unlikely to be any growth in demand for pipeline services over the next regulatory period and outlines a range of risks faced by the pipeline while also noting that throughput is only 70% to 80% of contracted capacity.

NPK notes that DBP appears to have only undertaken the capacity expansions after ensuring all new capacity was fully contracted. NPK is of the view that DBP has undertaken a risky commercial investment in expanding the pipeline but that the decision to undertake that expansion was made in light of the commercial terms negotiated with shippers.

That is, DBP had the opportunity to ensure a suitable risk sharing agreement with shippers reflecting the fact that future demand was uncertain and therefore there could be no certainty that the entire capacity expansion would be needed for reference services in the future. As such, NPK is concerned to ensure that the future demand forecast is based on forecast throughput and that this underpins assessment of the extent to which capital expenditure is rolled into the regulated capital base as the majority of the difference between contract and forecast throughput will be compensated for via DBP's existing commercial contracts.

2.4 Issue 7 Operating Expenditure

The ERA invited submissions from interested parties on:

- whether the arrangements for fuel gas are reasonable and reflect existing arrangements in place;
- whether the level of operating expenditure (actual and forecast) and detail of the information provided by DBP is reasonable having regard to the legislation;
- DBP's supporting information to justify operating expenditure; and
- any other matters in relation to operating expenditure under the proposed revisions.

DBP Position

DBP's previous access arrangement forecast 2010 operating costs (excluding fuel gas) of some $53.45 million while actual 2010 operating costs are reported to be $66.42 million (excluding fuel gas). Further, DBP forecast that operating costs will rise to some $86 million excluding fuel costs in 2011 (or around $83.4 million in 2010 dollar terms).

Fuel gas was forecast to range from around $20 million in 2011 to $23.5 million in 2015 (in 2009 dollar terms). This compares to the previous regulatory period when nominal fuel gas costs varied from a low of $15.5 million in 2008 to a high of $30.6 million in 2007.

NPK Submission

NPK is very concerned over the dramatic increase in DBP operating costs (excluding fuel costs) between the 2010 forecast and the 2011 forecast (roughly 56%) and between the 2010 actual and the 2011 forecast (roughly 26%).

While NPK acknowledges DBP's argument that various components of operating costs have legitimately materially increased (such as wage rates and government charges), NPK is concerned that the magnitude of the non-fuel gas operating cost increases raises questions as to whether they are likely to be consistent with the costs that an efficient operator would incur.

NPK notes that the approved operating costs for the Goldfields Gas Pipeline were some $30 million in 2010 and that DBP's claim for $83.4 million in 2010 terms is nearly three times as large. NPK is not convinced that the larger capacity and greater throughput of DBP can justify the magnitude of the difference in operating costs.

DBP have indicated that they do not expect any further capacity expansions over the regulatory period and that the pipeline is fully contracted. This would indicate that the operations of the DBP will be focussed on the efficient routine operation of the existing asset.

NPK is concerned that the information provided by DBP does not provide sufficient detail or clarity to be able to assess the efficiency of the proposed non-fuel gas operating cost allowance and that there is a very real possibility that the proposed operating cost allowance is significantly in excess of those that an efficient operator would incur. NPK is also concerned with the lack of inclusion of an incentive mechanism especially in light of the significant increase in proposed operating costs.

In terms of fuel-gas costs, NPK notes that this may vary due to changes in throughput and in the cost of gas. NPK understands that the cost of fuel gas is set pursuant to gas purchase contracts and would assume that the ERA will ensure that fuel gas costs are consistent with, and limited to, any such contracts.

2.5 Issue 10 Tariffs

The ERA invited submissions from interested parties on:

- the proposed increase in the reference tariff;
- the proportion of cost of service to be recovered by each component of the reference tariff;
- the allocation of costs between reference and other services;
- DBP's supporting information to justify the tariffs; and
- any other matters in relation to tariffs under the proposed revisions.

DBP Position

DBP has proposed a single R1 full haul reference service with a reference tariff of $1.683/GJ. While the R1 service is new, the previous T1 service had a $1.192/GJ reference tariff.

NPK Submission

NPK is not convinced that a single R1 reference service will necessarily cover the services sought by the majority of users.

NPK is very concerned with the magnitude of the proposed tariff increase (some $0.49/GJ or 41%). The key issue is the magnitude of the total revenue sought to be recovered by DBP. NPK believes that the key drivers for this increase are:

- inclusion of potentially unjustified capital expenditure incurred over the preceding regulatory period;
- adoption of a WACC significantly in excess of that required to compensate for DBP investment risk; and
- inclusion of unreasonably high operating costs that do not reflect the efficient forward looking costs of a pipeline manager operating a mature gas transmission pipeline.

By way of example, and ignoring the possibility that the capital base is too high, the impact of adopting a WACC closer to that normally expected for infrastructure assets such as gas transmission pipelines (that is, closer to the GGP allowance) together with operating costs in line with current actuals (noting that this excludes increases in government charges but is still in excess of the 2010 forecast), would reduce annual required revenues by in the order of $100 million to $120 million.

NPK notes that as DBP is only proposing to offer a single reference service, there is no reference tariff for the part haul and back haul services. NPK is concerned to ensure that the adjustment to total revenues for non-reference services adequately recognises the revenue generating potential of those services. NPK considers that transparency would be heightened were these services to be treated as reference services.

3. Conclusion

For the reasons set out in this document, NPK submit that the tariff price increase proposed by the DBP is manifestly excessive and cannot be economically justified.

Should any further information be required please contact:

Derek McKay
NewGen Power Kwinana Pty Ltd
PO Box 7152
Riverside Centre QLD 4000

Ph: 07 3020 5127
Email: dmckay@ermpower.com.au