SUBMISSION 73: DBP Response to the ERA Final Decision on Proposed Revisions to the Access Arrangement for the DBNGP

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1. INTRODUCTION

1.1. On 31 October 2011, the Economic Regulation Authority (ERA) made its Final Decision (Final Decision) in relation to the amended revised access arrangement proposal filed by DBNGP (WA) Transmission Pty Ltd (DBP) on 18 April 2011 (Revised AA Proposal).

1.2. The Revised AA Proposal responded to 109 amendments included in the ERA's draft decision released on 14 March 2011 (Draft Decision).

1.3. In accordance with Rule 59(5)(c)(iii) of the NGR, DBP also be filed a number of supporting submissions explaining the amendments and additions in the Revised AA Proposal made to address various matters raised in the Draft Decision (Post DD Submissions).

1.4. In accordance with Rule 62 of the NGR, the ERA's Final Decision is to not approve the Revised AA Proposal and to require some 74 amendments to be made to the Revised AA Proposal before a revised access arrangement can begin to take effect.

1.5. In the Final Decision, the ERA outlines its reasons for its decision with respect to which, DBP notes:

(a) some reasoning was not previously raised with DBP (either in the Draft Decision or elsewhere) – the ERA introduces reasoning that DBP has not had an opportunity to respond to; and

(b) the ERA has not addressed some matters raised by DBP in its Post Draft Decision Submissions as to why the ERA should not continue with certain amendments from the Draft Decision.

1.6. On 1 December 2011, the ERA issued a notice (FD Amendment Notice) advising of its intention to make changes to the following aspects of its Final Decision (Additional FD Amendments):

(a) It intends to amend Amendment 14 of the Final Decision so as to allow, as part of the forecast operating expenditure for the access arrangement period, an amount for forecast costs arising from the carbon tax; and

(b) It intends to amend the extension and expansion requirements of the Revised AA Proposal (which were not required to be amended as a result of the Final Decision) so as to provide that the access arrangement will apply to incremental services to be provided as a result of any expansion in capacity of the DBNGP, except in circumstances where DBP can demonstrate to the ERA's reasonable satisfaction that application of the access arrangement to such incremental services is inconsistent with the national gas objective.

(c) It intends to make consequential amendments to the sections of the Final Decision dealing with Total Revenue and Reference Tariffs to accommodate the intended amendment referred to in paragraph (a) above.

1.7. The ERA has invited parties to make submissions on these Additional FD Amendments by 15 December 2011.

1.8. The ERA is required, under Rule 64 of the NGR, to propose its own access arrangement to give effect to the matters in the Final Decision. It is not clear whether the ERA will make an amended Final Decision to give effect to the FD Amendment Notice before

making its own access arrangement or whether this will be done at the same time as issuing its own revised access arrangement under Rule 64(4) of the NGR.

1.9. As at the date of this submission, the ERA has not decided to make its own revised access arrangement.

1.10. Given the above, DBP intends to make further submissions in response to the ERA's reasons from the Final Decision that relate to the following amendments from the Final Decision:

(a) Amendments 2 & 3 – Pipeline Services – the removal of the R1 Service as a pipeline service and the inclusion of the T1 Service as a reference service. This is dealt with in Section 2 of this submission.

(b) Amendment 4 – Pipeline Services – the requirement to include a P1 Services as a reference service and the definition of P1 Service. This is dealt with in Section 3 of this submission.

(c) Amendments 5 & 16 – Correct CPI Measure in the roll forward of the capital base and the tariff variation mechanism. This is dealt with in Section 4 of this submission.

(d) Amendments 6 & 9 and part of amendment 10 – Capital expenditure for the period 2005 to 2010 and associated depreciation allowances and roll forward of the capital base. This is dealt with in Section 5 of this submission.

(e) Amendments 7, 9 and the remaining part of amendment 10 – Forecast capital expenditure for the period 2011 to 2015. This is dealt with in Section **Error! Reference source not found.** of this submission.

(f) Amendment 12 – Rate of Return. This is dealt with in Section 6 of this submission.

(g) Amendment 14 – Forecast Operating Expenditure – regulatory expenses. This is dealt with in Section 7 of this submission.

(h) Amendments 17 & 18 - Reference Tariff Variation Mechanism. This is dealt with in Section 8 of this submission.

(i) Amendments 19 - 72 – Terms and Conditions for the reference service.

1.11. Substantive submissions on some of these amendments also affects amendments 10, 11, 15.

1.12. This submission addresses all of the above amendments apart from those referred to in paragraph 1.10(i) above. Submissions on the following amendments will be made to the ERA shortly:

(a) Forecast Capital Expenditure for 2011 to 2015

(b) Terms and Conditions

1.13. DBP also makes submissions on the first two of the Additional FD Amendments outlined above and one consequential issue in relation to the forecast operating expenditure Additional FD Amendment:

(a) Forecast Operating Expenditure – carbon costs. This is dealt with in section 9 of this submission

(b) Reference Tariff Variation Mechanism if Carbon costs are included as part of the forecast operating expenditure. This is dealt with in section 10 of the submission

(c) Extension and Expansion requirements – this is dealt with in section 11 of the submission.

1.14. DBP notes that the submissions referred to in paragraph 1.10 are being made to the ERA at a time where the ERA is not obliged to consider them. However, given their content and the fact that some of the submissions respond to new issues raised by the ERA that until now, DBP had not had the opportunity to respond to, DBP requests that the ERA exercise its discretion to consider these submissions.

2. PIPELINE SERVICES

Removal of the R1 Service as a Reference Service

2.1. Amendment 2 requires that the revised access arrangement proposal be amended to remove the proposed R1 Service as a reference service.

2.2. DBP's pre-draft decision submission

2.3. DBP's submission 3 explains the differences between the R1 Service and the T1 Service and the justification for including the R1 Service as a reference service.

ERA's draft decision

2.4. In deciding that the T1 Service should be included as a reference service and not the R1 Service in the draft decision, the ERA has had regard to the following:

(a) Rule 101 of the NGR is concerned with the pipeline services that are likely to be sought by users of the pipeline, rather than what pipeline services the Service Provider proposes to offer to provide by means of the pipeline. This requires consideration of the nature of services sought by users (and that pre-existing contracts are an important indicator of services that are likely to be sought by a significant part of the market) and prospective users, unconstrained by the availability of pipeline capacity during the relevant access arrangement period (paragraph 84 of the Final Decision).

(b) A number of current shippers submitted to the ERA that the proposed R1 Service was of an inferior quality to the existing T1 Service and that they would not be seeking to use the R1 Service (footnote 18 page 27, para 78 Final Decision). Based on those submissions, and the absence of any submissions that indicated demand for the proposed R1 Service, the ERA took the view in its draft decision that the R1 Service was unlikely to be sought by a significant part of the market and that the proposed R1 Service therefore did not meet the requirements for a reference service under Rule 101 (paragraph 79 Final Decision).

DBP's response to draft decision

2.5. In its response to the draft decision (Submission 50) DBP contended that:

(a) The services provided under pre-existing contracts are not an indicator of services that are likely to be sought by a significant part of the market, unless there is evidence that there is a likelihood that the services provided under the pre-existing contracts will be sought for new access contracts during the proposed Access Arrangement period;

(b) In this case, the pre-existing services cannot be sought for new access contracts during the proposed Access Arrangement period because there is a lack of spare capacity. Because there is no spare capacity these services cannot be sought for new access contracts. At the time of the submission there was no application for a T1 Service in the queue;

(c) It is wrong for the ERA to disregard what the Service Provider proposes to offer as a Reference Service. If the ERA's position were to be correct, it would mean that the Service Provider would be limited to being a re-active developer of services - having to wait until a significant part of the market decides that it would

like to change from the type of service the Regulator has approved to a Revised Service;

(d) The risks involved in providing the T1 Service are not reflected in the rate of return allowed in the draft decision, whereas the risks involved in providing the R1 Service are better reflected in the rate of return proposed by DBP. For example, the excess imbalance rights of shippers, the excess peaking rights of shippers, the aggregation rights are all examples of risks DBP is exposed to under the T1 Service but which the T1 Tariff does not reflect;

(e) When Rule 101 refers to a "Pipeline Service" likely to be sought by a significant part of the market, it is referring to the general character of the service - such as "firm" or "interruptible" in the broad senses those terms are understood in the industry. DBP does not need to assess, nor does the ERA, the more specific question of what precise terms and conditions the market may seek for a firm or priority service.

ERA's Final Decision

2.6. In its Final Decision the ERA made the following statements:

(a) That consideration of Reference Services cannot only occur according to the "general character" of the service and without regard to the terms and conditions of that service. The character of the service is, to a large part, determined by the principal terms on which the service is provided, and in the case of the R1 Service the ERA must consider the terms and conditions including curtailment, provision for overrun, imbalances and peaking and provisions for aggregation across inlet and outlet points;

(b) The relevant market to consider is the total market for pipeline services provided by the DBNGP, which will include any expected increase in provision of services during the Access Arrangement period for which the approved Access Arrangement will apply;

(c) Existing contracts for services comprise one source of evidence of the nature of services demanded by users. A second source of evidence is submissions from users. Both of these sources indicate a demand for services in the nature of T1, P1 and B1 Services. These are the only two sources of evidence available to the ERA on the nature of services sought by users;

(d) DBP had not provided any information to substantiate the claim that the difference in the terms and conditions between the existing T1 Service and the proposed R1 Service affects DBP's rate of return;

(e) The ERA has not disregarded DBP's proposal for the R1 Service as the sole Reference Service rather, the ERA considered the proposal and came to the view that there is no evidence to indicate the service was sought by a significant part of the market.

DBP's response to the Final Decision

2.7. DBP submits that it is not for the ERA to determine what precise terms and conditions should be included in the Reference Service proposed by the Service Provider. Rather it is for the service provider to propose a set of terms and conditions for assessment by the regulator.

2.8. Additionally, DBP contends that the ERA has not correctly understood what pipeline service is likely to be sought by a significant part of the market. The ERA's decision:

(a) Does not deal with the fact that the T1 Service in the existing Access Arrangement (**T1 Reference Service**) is not the service which is provided to Shippers - rather Shippers use the T1 Service set out in the Standard Shipper Contract (**T1 SSC Service**). They are two very different services, albeit with the same name.

(b) Should have concluded that the T1 Service that the ERA wants to include as a reference service (and which is a reference service in the current access arrangement) is not likely to be sought in the proposed access arrangement period because:

(i) the T1 capacity of the DBNGP is presently fully contracted under pre-existing contracts that extend beyond the end of the Access Arrangement period (these are a combination of the Alcoa Exempt Contract and contracts for a T1 service that is a non reference service); and

(ii) even if additional capacity were to be built during the course of the Access Arrangement period, it would be fully contracted for under either or both the T1 Service that is the non reference service and the Alcoa exempt contract and not the T1 Service that is a reference service. This is because:

(iii) since 2005, all expansions have been undertaken by DBP with the capacity having been fully pre-sold to customers who have contracted for the T1 service that is a non reference service;

(iv) it would not be economic for DBP to fund future expansions on the basis of the tariffs for the T1 Service that is a reference service; and

(v) the existing contracts for the T1 service that is a non reference service and the Alcoa Exempt Contract contain mechanisms that provide for the expansion of the DBNGP in not only a more expeditious manner than is provided for under the NGL and NGR but also in a manner that ensures the additional capacity can be commissioned before the shipper demands it.

(c) Does not acknowledge the fact that the T1 capacity of the DBNGP, while currently fully contracted, is presently only being utilised by the existing shippers at about 80% load factor. Therefore any increase in use in T1 Service is likely to come from existing Shippers under these pre-existing contracts (and therefore using the T1 service that is a non reference service).

(d) Does not consider the prior submissions made by DBP that there is no access request in the queue for a T1 service that is a reference service (or for the T1 service that is a non reference service for that matter).

(e) Fails to recognize that the provision of the R1 Service is a more efficient use of pipeline capacity than is the case with either the T1 Reference Service or the T1 SSC Service.

2.9. Taken together, this should mean that:

(a) the R1 Service will better promote 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; and

(b) there is no likelihood of demand, during the proposed Access Arrangement period, for the T1 Reference Service.

2.10. To refute these submissions, the ERA argues that the relevant market to consider is the total market for pipeline services provided by the DBNGP, which will include any expected increase in provision of services during the Access Arrangement period for which the approved Access Arrangement will apply. This statement does not explain where the expected increase in provision of services will come from.

2.11. Moreover, it ignores the reality, since 2005, that the expansions that have occurred have been as a result of an increase in provision of existing services (ie the T1 Service that is a non reference service) or as a result of prospective shippers securing new capacity for a T1 Service that is a non reference service.

2.12. The ERA then relies upon the existing contracts for services as demonstrating evidence of the nature of the services demanded by users, and the submissions from users that they will demand the T1 Service. As to the existing contracts, they are not contracts for the provision of the T1 Access Arrangement service rather they are for the provision of the T1 Service that is a non reference service.

2.13. Further, given the current T1 capacity of the DBNGP is fully contracted under these pre-existing contracts, there cannot be any new demand during the Access Arrangement period. As to the submissions from users that they will demand the T1 Service, this cannot demonstrate a likely demand in circumstances where there is no capacity. Further, the preference of Shippers for particular terms and conditions does not demonstrate the likely demand for a particular pipeline service, and nor should the Shipper's preference for particular terms and conditions be allowed to dictate the terms and conditions which will be offered by the Service Provider.

Inclusion of the T1 Service, the P1 and the B1 Services

2.14. Amendment 3 requires the revised access arrangement proposal should be amended to retain, as reference services, the T1 Service (ie the T1 Reference Service), P1 Service and B1 Service as described in the current access arrangement.

DBP's pre-draft decision submissions

2.15. In submission 3, DBP submitted that these pipeline services do not meet the requirements to be reference services and were not likely to be sought during the Access Arrangement period; accordingly, they were not services which were likely to be sought by a significant part of the market.

2.16. DBP also submitted that at the time of filing its submission, there was no access request in the queue from a prospective Shipper or Shipper seeking a pipeline service for commencement date during the Access Arrangement period

ERA's draft decision

2.17. In its draft decision, the ERA considered that there was evidence that demand for the T1, P1 and B1 Services would be maintained during the 2011 to 2015 Access Arrangement period. In particular:

(a) historic and forecast volume data for each of the reference services submitted by DBP indicate that the existing reference services are likely to continue to be sought by a significant part of the market; and

(b) submissions from interested parties indicated that they will continue to seek the existing reference services.

DBP response to the draft decision

2.18. In response to the ERA's draft decision, DBP stated:

(a) It is wrong to say that existing T1 SSC shippers "seek" a T1-equivalent Reference Service simply to enable them to determine the tariff for the T1 SSC services from 1 January 2016. The word "seeks" in the context of the NGR means that the user is actually seeking a service in the sense of wanting to apply for, be granted and utilise the service under the Access Arrangement. “Seeking” a particular service to be included in the access arrangement as a reference services in order to assist in exercising contractual rights, does not equate to “seeking” a service in the context of the NGR.

(b) None of the shippers with rights to a T1 SSC Service under pre-existing contracts seek a T1 Reference Service in the context of the NGR. Instead, they seek the inclusion of a T1 equivalent Reference Service in the Access Arrangement (as distinct from wanting to apply for, be granted and utilise a new T1 service) so that they can have an easy point of reference for determining the tariff to apply to the existing service being provided (and which it will continue to utilise) under the pre-existing contracts.

(c) In fact, DBP is not aware that any of the existing shippers has any expectation of a need for additional capacity during the proposed Access Arrangement Period.

(d) To the extent that existing shippers have referred to the possibility that they might want to contract for further capacity and if so, they would want further T1 capacity or that they like the T1 Reference Service, these are irrelevant considerations unless these shippers can show (which they have not) that they are likely to seek additional capacity within the Access Arrangement Period and that the volume of additional capacity is likely to constitute a significant part of the market (Para 3.19 of Submission 50).

ERA's Final Decision

2.19. The ERA address whether there are other pipeline services to be included in the access arrangement as reference services from paragraphs 81 to 105.

DBP's response to the Final Decision

2.20. DBP's response to required amendment 3 is as follows:

(a) Similarly to the removal of the R1 Service as a Reference Service, it is not for the ERA to design DBP's offering into the market. The Service Provider can not be forced to offer something it does not believe is appropriate to provide.

(b) The ERA has ignored or gave insufficient weight to the fact that DBP did not intend to offer a T1 Reference Service, a P1 Reference Service or a B1 Reference Service in the proposed Access Arrangement. They are therefore not available or able to be specified as Reference Services under Rule 48(1)(c).

(c) The ERA has ignored or gave insufficient weight to the fact that DBP has not contracted, nor did it ever offer to a shipper, a T1 Reference Service, a P1 Reference Service or a B1 Reference Service in the current Access Arrangement.

(d) The ERA ignored or gave insufficient weight to the fact that none of the existing Shippers had any expectation of a need for additional capacity during the period of the proposed Access Arrangement. None of those Shippers therefore currently seek a T1 Reference Service in the sense that they wish to contract for capacity on those terms.

(e) The ERA took the view that whether a pipeline service is likely to be sought by a significant part of the market requires consideration of the totality of the demand for services and should not be limited to a consideration of only new demand. Even if this approach is correct, the ERA should have found that there was no new demand for the T1, P1 and B1 Reference Services, and should have found that the fact that these services are included in the existing Access Arrangement and Standard Shipper Contract did not mean that those services would be likely to be sought by a significant part of the market during the Access Arrangement period.

3. DEFINITION OF P1 SERVICE AS A REFERENCE SERVICE

3.1. Amendment 4 requires the definition of "part haul service" in the revised proposed access arrangement and the terms and conditions of reference services should be amended to: Part Haul Service means a service to provide Forward Haul in the DBNGP which is not a full haul service and which includes, without limitation, Services where the Inlet Point is upstream of main line valve 31 on the DBNGP and the Outlet Point is upstream of Compressor Station 9 on the DBNGP, Services where the Inlet Point is downstream of main line valve 31 on the DBNGP and the Outlet is downstream of Compressor Station 9 on the DBNGP, and Services where the Inlet Point is downstream of main line valve 31 on the DBNGP and the Outlet Point is upstream of Compressor Station 9 on the DBNGP.

The specification of the P1 Service as a reference service in the access arrangement should be consistent with this definition of part haul service.

ERA's draft decision

3.2. DBP notes the requirements of Amendment 4 were not included in the draft decision.

3.3. However, the APA Group did make a submission calling on the ERA to change the definition of the P1 Reference Service because it does not support the use of the Mondarra Gas Storage Facility.

3.4. DBP responded to this submission, although it was not related to this Amendment 4.

ERA's Final Decision

3.5. At paragraphs 138-145 of the Final Decision, the ERA refers to the APA Group's submission.

3.6. In these paragraphs, the ERA notes that the APA Group expressed a concern that, under the defined terms in the current access arrangement, the P1 Service is potentially limited to transport gas between inlet points downstream of MLV31 and upstream of CS9. If that was correct, the P1 Service could not be used for either transfer of gas from upstream of MLV31 to the Mondarra Gas Storage Facility, or transfer of gas from the Mondarra Gas Storage Facility to customers with contracted capacity at outlet points downstream of CS9.

3.7. Although the ERA expressed the view at paragraph 145 of the Final Decision that it did not necessarily agree with the detailed interpretation of the terms and clauses by the APA Group, it concluded that the definition of the term "part haul service" in the revised proposed access arrangement should be revised to achieve clarity in the nature of the P1 service, consistent with the intent for this service in the current access arrangement and for inclusion of this service in the access arrangement for the 2011 to 2015 access arrangement period.

3.8. However, it then made Amendment 4 which amends the definition of the term "Part Haul Service" to make it clear that a Part Haul Service could include transportation where in the inlet point is downstream of MLV31 and the outlet point is downstream of compressor station 9.

DBP's response to the Final Decision

3.9. DBP's first submission is that Amendment 4 does not reflect the ERA's reasoning contained in paragraph 145 of the Final Decision - the amendment is not "consistent with the intent for the P1 service in the current access arrangement". The current P1 service definition does not allow for transportation to outlet points downstream of CS9, regardless of where the inlet point is.

3.10. Under the current access arrangement, the P1 Service clearly does not apply to a contract with an outlet point that is downstream of CS9

3.11. Not only is it not consistent with the current access arrangement, this amendment fundamentally changes the nature of a P1 service that has been in place since the 1990s – ie that the outlet point is upstream of CS9.

3.12. The Gas Transmission Regulations (1994), being the first third party access regime in place for the DBNGP, provided the following definition:

3.13. "part-haul capacity" means capacity at an outlet point located upstream from CS9, and downstream from the inlet point or points at which a shipper's delivery of gas gives rise to an entitlement to gas either at the transmission outlet point or at a distribution outlet point in the associated sub-network.

3.14. The DBNGP Access Manual followed on from the Gas Transmission Regulations in 1998 and provided the following definition:

3.15. "part-haul capacity" means capacity at an outlet point located upstream from the compressor station site known as Compressor Station 9, and downstream of the inlet point or points.

3.16. The initial access arrangement approved in 2004 adopted a zonal tariff structure but made it clear that the last zone within which the highest tariff was to apply was for deliveries downstream of CS9.

3.17. The revisions to the Access Arrangement that were approved in 2005 by the regulator reintroduced the concept of part haul services (known as P1 Service). It provided for a service with an outlet point upstream of CS9 as follows:

> ***Part Haul*** *means a Forward Haul Gas transportation service on the DBNGP which is not Full Haul.*
>
> *(**Full Haul** means a Gas transportation service on the DBNGP where the inlet point is upstream of main line valve 31 on the DBNGP and the outlet point is downstream of Compressor Station 9 on the DBNGP)*

3.18. Not only has the third party access regulatory regime for the DBNGP constantly maintained a requirement that a part haul service only could provide for an outlet point upstream of CS9, the Standard Shipper Contract also provides for this:

> ***Part Haul*** *means a Gas transportation service on the DBNGP where the Outlet Point is upstream of Compressor Station 9 on the DBNGP, regardless of the location of the Outlet Point, but does not include Back Haul.*

3.19. Secondly, it does not promote the efficient operation and use of gas services and therefore could not be construed to be in the long term interests of consumers of natural gas. This is so for the following reasons:

(a) There is currently no capacity available to offer a part haul service on the DBNGP with an outlet point downstream of CS7 (including downstream of CS9). If however, capacity were to become available, DBP would not be able to enter into a contract for this service with an Inlet Point downstream of mlv31 and an Outlet Point downstream of CS9 because it would reduce the T1 capacity of the DBNGP and therefore cause DBP to be in breach of its existing contractual obligations to T1 shippers

(b) it would also reduce the amount of T1 capacity on the pipeline more so than would be the case were a part haul service to be contracted under the current definition of the P1 Service. The impact on the full haul (T1) capacity of the pipeline is shown by comparing the impact of transporting an additional 50TJ/day of part haul as per the current access arrangement definition (Scenario 1) with that proposed by Amendment 4 (Scenario 2), but for the same distance.

(i) Scenario 1: current part haul Service

Gas Inlet: CS1 Discharge
Gas Outlet: MLV106
Part haul Distance: approximately 1100km
Parthaul quantity: 50TJ/d

(ii) Scenario 2: Final Decision pPart haul Service

Gas Inlet: MLV31
Gas Outlet: Kwinana Junction
Part haul Distance: approximately 1100km
Part haul quantity: 50TJ/d

(c) The impact of the 50TJ/d of incremental part haul load (with the same gas flow distance) on DBNGP full-haul T1 capacity for the two Scenarios is summarized in the following table:

	Post Stage 5B	Scenario 1 Current part haul definition 50TJ/d	Scenario 2 Final Decision part haul definition 50TJ/d
T1 Capacity	845 TJ/d	801 TJ/d	795 TJ/d
Reduction in T1 Capacity		44 TJ/d	50 TJ/d

(d) Not only would scenario 2 result in less full haul capacity being available, scenario 2 would ensure that DBP earns less revenue than would be the case under scenario 1 – ie it would earn only 1100/1400 or 78.6% of the T1 tariff under scenario 2.

(e) Even if additional capacity were to be built to accommodate the Final Decision part haul service with an outlet point downstream of CS9, it would also be the case that DBP would not recover its full costs of providing the service. This is because, the service would have the same impact on capacity as a T1 service, yet DBP would only be able to earn a part haul tariff.

(f) So, not only does the Final Decision part haul service have a more significant impact on the T1 capacity of the pipeline (compared to the existing part haul definition), it would also mean that DBP would not be able to recover its capital costs.

3.20. Thirdly, assuming that there is capacity to offer the Final Decision part haul service for delivery downstream of CS9 (which is presently not the case), entering into a contract for the Final Decision part haul service with an outlet point downstream of CS9 will also result in DBP having to incur more operating costs which are not presently factored into the calculation of the reference tariffs. The costs that DBP will incur are explained below. Accordingly, DBP would be deprived of an opportunity of recovering these additional costs, even when they are efficiently incurred.

3.21. Consistent with the definition of the part haul service to date and the fact that there are no outlet points between Mondarra and CS9, CS8 and CS9 have never been designed to accommodate additional part haul load over and above what has currently been contracted for as T1 capacity. Every 1TJ of extra part haul load received in at Mondarra and delivered downstream of CS9 will not only take away 1TJ contracted full haul T1 capacity, it will also increase flow through CS8 and CS9 (which have not been designed to handle the additional part haul load). The available CS8/CS9 power will be exceeded, resulting in lower suction pressure and discharge pressure and hence lower system linepack and higher fuel usage.

3.22. In addition, there will be additional compressor maintenance cost due to higher run hours.

3.23. None of these costs have been assumed in the calculation of the reference tariffs

3.24. Fourthly, the amended definition of a P1 service will create uncertainty because a part haul service with an outlet point downstream of CS9 will fall within the definitions of both “part haul” and “full haul” services. While the proposed definition of part haul in Amendment 4 states that "part haul service" is a service "to provide Forward Haul on the DBNGP which is not a full haul service” , it goes on to list a number of examples, one of which is a service with an outlet point downstream of CS9. Yet the definition of full haul service then also defines a service as being one with an outlet point downstream of CS9. This will therefore lead to disputes about what type of service it is and what tariff and terms and conditions apply.

3.25. Fifthly, if DBP were required to enter into a contract for this Final Decision P1 Service with a contracted outlet point downstream of CS9, it would put DBP in breach of one of its key obligations owed to at least one shipper under an existing contracts - being to not discriminate in respect of price between shippers who have outlet points downstream of CS9.

3.26. Sixthly, if DBP were required to enter into a contract for this P1 Service with a contracted outlet point downstream of CS9, this could also trigger most favoured nation (or MFN) arrangements with Verve which, in turn could trigger MFN arrangements with other shippers. If the shipper that secures a P1 Service contract is a competitor with Verve, this

would enable Verve to pay a reduced tariff under its contract equal to the tariff to be paid by the competitor.

3.27. Seventhly, applying the analysis outlined above, the implementation of this amendment would mean that, if DBP has any contracts presently on foot for the provision of the part haul service whereby the definition of the service is tied to the definition of the part haul service in the access arrangement, it would result in DBP not being able to meet its contractual obligations to deliver contracted capacity to existing T1 SSC shippers. DBP has not had the ability to undertake this assessment in the time available.

4. USE OF ALL GROUPS, EIGHT CAPITAL CITIES CPI IN THE MEASUREMENT OF INFLATION

4.1. Required Amendment 5 of the Final Decision requires that any inflation escalation applied in the calculation and subsequent annual adjustment of reference tariffs be based on actual or forecast values (as appropriate) of the all groups eight capital cities CPI published by the Australian Bureau of Statistics.

4.2. Required Amendment 16 from the Final Decision requires that the proposed revised access arrangement should be amended to change the definition of CPI in the reference tariff variation mechanism to “CPI means the Consumer Price index, all groups, eight capital cities”.

ERA draft decision

4.3. The Required Amendments of the Draft Decision were not explicit in the requirement for use of the all groups eight capital cities CPI. However, the required use of that index was implied. Draft Decision Required Amendment 5, for example, required that the value of conforming capital expenditure for the 2005 to 2010 access arrangement period be amended to values as indicated in Table 15 of the Draft Decision. Earlier, in paragraph 106 of the Draft Decision, the ERA advised that it had undertaken calculations of total revenue in real terms with real values of financial information calculated by applying escalation factors derived from December quarter values of the Consumer Price Index (All Groups, Eight Capital Cities).

DBP’s response to the draft decision

4.4. In its Submission 49, DBP maintained and further supported its position that the appropriate measure of inflation to be applied in the calculation and subsequent annual adjustment of reference tariffs be the CPI (All groups, Perth) published by the Australian Bureau of Statistics.

ERA arguments in the Final Decision

4.5. In response, the ERA introduced new arguments, in paragraphs 170 to 179 of the Final Decision, to support the continued use of the eight capital cities CPI. These arguments had not been made in the ERA’s Draft Decision and had not been disclosed to DBP by the ERA prior to the release of the Final Decision.

4.6. In paragraph 176 of the Final Decision, the ERA explained that, in the determination and application of reference tariffs, inflation is applied to shelter investors in the DBNGP, as far as is practicable, from the effects of inflation on the real value of their assets. Since the objective is preservation of the value of assets (which the ERA refers to as financial capital maintenance), the relevant measure of inflation is one which reflects the prices of the goods and services which those investors could purchase with distributions from the asset.

4.7. The investors in the DBNGP are, the ERA argues in paragraph 177, widely dispersed across Australia. In consequence, a national measure of inflation must be applied in:

(a) escalating the value of the capital base from one access arrangement period to the next;

(b) determining the rate of return;

(c) the annual adjustment of reference tariffs originally determined in real terms at commencement of the access arrangement period.

4.8. The ERA notes, in paragraph 178 of the Final Decision, that the matter of changes in the costs which are actually incurred by DBP is not a relevant consideration in application of the principle of financial capital maintenance. The ERA continues:

4.9. In the determination of reference tariffs, capital and operating expenditures are accounted for by forecasts of costs made in nominal terms that presumably include allowances for expected inflation in costs of specific expenditure line items.

4.10. In these circumstances, according to the ERA, DBP ultimately bears the risk that actual inflation will vary from the assumptions made in producing the forecasts. However, for capital expenditures, this risk will be small: capital expenditures are ultimately accounted for at their actual cost.

4.11. The ERA concludes these comments, in paragraph 178 of the Final Decision, with the observation that the objective, when indexing the asset base, is to protect as far as practicable, the financial value of the capital base to investors. In consequence, inflation as measured by the all groups, eight capital cities CPI is to be applied in financial calculations (Final Decision, paragraph 179).

DBP response to the Final Decision

4.12. These arguments by the ERA are misconstrued and not relevant to the current assessment process. They seem to indicate that the ERA does not fully understand the real pre-tax model which it has used to determine reference tariffs for the DBNGP.

4.13. DBP has proposed, and the ERA has accepted (consistent with its past practice), that reference tariffs for the DBNGP be determined using the real, pre-tax method of calculation of total revenue.

4.14. When the real, pre-tax method is used:

(a) the capital base is re-set, in real terms, at (or at a date close to) the start of the forthcoming access arrangement period;

(b) the projected capital base is calculated, for each year of the access arrangement period, by:

(i) adding capital expenditure forecast to be made during the access arrangement period, that capital expenditure being expressed in real terms at the prices prevailing at date the capital base is reset;

(ii) subtracting depreciation, expressed in real terms at the prices prevailing at date the capital base is reset;

(iii) subtracting, if appropriate, the values of redundant assets and asset disposals, those values being expressed in real terms at the prices prevailing at date the capital base is reset;

(c) the return component of total revenue is determined by applying a real pre-tax rate of return to the projected capital base; and

(d) forecast operating expenditure for the access arrangement period, and any increments or decrements for the year resulting from the operation of an incentive mechanism, are expressed in real terms at the prices prevailing at the date at which the capital base is reset.

4.15. In the ERA's Final Decision tariff model, the total revenue is expressed in real terms at the prices prevailing on 31 December 2010. DBP had, earlier, adopted this date for its own real, pre-tax total revenue determination and tariff modeling.

4.16. DBP could have used a nominal method for determination for total revenue and reference tariff determination. It could have proposed the nominal pre-tax method which the ERA has accepted for the Goldfields Gas Pipeline, or it could have proposed the nominal post-tax method favoured by the Australian Energy Regulator. In either case:

(a) the capital base would have been expressed in nominal terms;

(b) the projected capital base would have been calculated, for each year of the access arrangement period, by:

(i) adding capital expenditure forecast to be made during the access arrangement period, that capital expenditure being expressed in nominal terms;

(ii) subtracting depreciation, expressed in nominal terms;

(iii) subtracting, if appropriate, the values of redundant assets and asset disposals, those values being expressed in nominal terms;

(c) the return component of total revenue would have been determined by applying a nominal rate of return to the projected capital base; and

(d) forecast operating expenditure for the access arrangement period, and any increments or decrements for the year resulting from the operation of an incentive mechanism, would have been expressed in nominal terms.

4.17. If DBP had proposed, and the ERA had accepted, a nominal (pre-tax or post-tax) method of total revenue determination, a forecast of the rate of inflation over the forthcoming access arrangement period would have had to have been made to for the purpose of expressing its expenditure forecasts in nominal terms. In these circumstances, DBP may have borne the risk that actual inflation varies from the assumption made in producing the forecasts. In paragraph 178 of the Final Decision, the ERA seems to be of the view that DBP does bear this risk. However, this is not the case. DBP did not propose, and the ERA did not use for the purpose of making its Final Decision, a nominal method of total revenue determination. DBP proposed, and the ERA accepted, use of a real pre-tax method, with subsequent tariff adjustment for actual inflation.

4.18. Each of the three methods of total revenue determination – real pre-tax, nominal pre-tax and nominal post tax – when properly applied, returns to investors the investment which those investors have financed, plus returns on the investment at the rate of return allowed by the regulator. It is this return of investment which has been financed which is the operation of the principle of financial capital maintenance to which the ERA refers.

4.19. If each of the three methods of total revenue determination returns to investors the investment which those investors have financed, plus returns at the allowed rate, why choose one in preference to another? In particular, why choose the real pre-tax method

over one of the two nominal methods? The nominal methods are simple to apply: CAPEX is the number of dollars of the actually spent (assuming the capital expenditure criteria of the regulatory regime are satisfied), and the capital base is simply the accumulated CAPEX less accumulated depreciation (plus any adjustments for asset redundancy and disposal).

4.20. One reason for the choice of the real method is the absence of a complete history of actual capital expenditures from which a nominal capital base might be constructed. This was a problem for some recently privatized electricity and gas businesses when those businesses were first regulated. The data required to construct a nominal asset base – a depreciated actual cost (DAC) – were not available. For these businesses, the initial capital base was determined as a (depreciated) replacement cost, assessed at prices prevailing at or near the time they first became regulated.

4.21. This was not an issue for the regulator at the time, in the case of the DBNGP. As the Independent Gas Pipelines Access Regulator noted in paragraphs 114 and 115 of his May 2003 Final Decision on the proposed Access Arrangement for the pipeline:

> *I acknowledge the difficulty in accurately estimating the DAC value from incomplete information concerning the historical construction costs. However, I am of the view that I have sufficient information to adequately estimate the DAC value for the purposes of the Code.*
>
> *I find $874 million to be the value under section 8.10(a) of the Code.*

4.22. In 2003, the Independent Gas Pipelines Access Regulator gave considerable weight to the use of a depreciated optimized replacement cost (DORC) valuation of pipeline assets. The use of a replacement cost valuation of initial assets was seen as providing a basis for the setting of reference tariffs which were economically efficient. The then Regulator noted, at paragraph 139 of the Final Decision:

> *A DORC value is consistent with the forward-looking concept of efficiency, taking into account the costs of replacement assets with current technology and best practice, and being more consistent with the forward- looking costs of a Service Provider.*

4.23. At paragraph 139 the then Regulator advised:

> *A DORC valuation of assets would meet that part of the objective of section 8.1(b) that involves a forward- looking view of efficient costs. A DORC valuation of assets would replicate the tariff outcomes of a competitive market, on the reasonable presumption that Service Providers in a competitive market would be forced by competitive pressures to value assets on an optimised replacement cost basis and to depreciate those assets at the lowest rate consistent with recovering sufficient revenue to replace the assets as and when the need arises.*

4.24. DBP acknowledges that the initial capital base for the DBNGP was not the DORC value of the pipeline established at the time. The then Regulator was further guided, by the reasoning of the Full Bench of the Supreme Court of Western Australia in Re Dr Ken Michael AM; Ex Parte Epic Energy (WA) Nominees Pty Ltd & Anor [2002] WASCA 231, to set the initial capital base above the DORC value.

4.25. Nevertheless, the then Regulator sought to establish an initial capital base which was close to the replacement cost of the assets which comprised the DBNGP so as to provide the economically efficient tariff outcomes associated with a competitive market.

4.26. Through the use of a DORC for the initial capital base, the subsequent addition of (efficient) capital expenditures and subtraction of the depreciation, and the inflation of the capital base from one regulatory period to the next, tariff setting for the DBNGP continues to be based on a capital base which approximates the replacement value of the assets which form the pipeline system.

4.27. The periodic use of a real asset base which is, at least approximately, the replacement value of DBNGP assets allows the setting of reference tariffs which are seen as economically efficient. It allows the setting of tariffs which are considered to provide the correct signals for the allocation of scarce resources between the production of pipeline services, and the production of other goods and services.

4.28. As DBP advised in its Submission 49, the capital expenditures which it has made in the past, including the expenditures made during the period 2005 to 2010, were expenditures largely incurred in Western Australia for the purpose of providing natural gas services to consumers of natural gas in Western Australia. These capital expenditures were expenditures on labour, materials and services.

4.29. DBP's operations are in Western Australia, and all of DBP's labour costs, irrespective of whether they are capitalised or charged to operations, are incurred in Western Australia. If the capital base of the DBNGP is to be a replacement cost valuation of the assets which comprise the pipeline system, the capital base which was set in 2005, the capital expenditures during the period 2005 to 2010, and the amount of depreciation, must all be revalued at the prices at which those assets could be replaced. Those prices are prices in Western Australia, and not prices elsewhere. A suitable index of prices to be used for the purpose of revaluation is the CPI (All Groups, Perth). It is not a national measure of price change.

4.30. The issue here is the valuation of assets to provide the price signals required for efficient resource allocation. It is not the sheltering of investors in the DBNGP, as far as is practicable, from the effects of inflation on the real value of their assets, and allowing those investors, wherever they may be, to maintain the purchasing power of the distributions from the asset. In these circumstances, a Western Australian, and not a national, measure of inflation should be applied in escalating the capital base from one access arrangement period to the next.

4.31. In the calculations, required under Rule 87(2), which support rate of return determination, a nominal pre-tax weighted average cost of capital (WACC) is re-expressed as a real pre-tax WACC by removing the expected inflation from nominal equity and debt costs.

4.32. As DBP noted in Submission 49, precisely what expectations of inflation these nominal values include will depend on the way in which expectations are formed by participants in financial markets. A large body of economic research attests to the fact that this is not a straightforward matter. These expectations of inflation formed in financial markets are not conceptually the same as the past – actual – changes in the general level of prices, and are not conceptually the same as the rates of past price change which might be represented by any particular index. DBP, therefore, proposed a reasonable view of what inflation expectations might be for the purpose of carrying out its rate of return calculation. The issue of CPI, which is a measure of past inflation, is not relevant here. The ERA's conflation of inflation in the context of rate of return determination with escalation of the capital base is inappropriate.

4.33. An issue may, however, arise in the context of the annual adjustment of reference tariffs, originally determined in real terms at the commencement of an access arrangement period.

4.34. The annual adjustment of reference tariffs, originally determined in real terms, serves the purpose of allowing DBP to recover its efficiently incurred costs. In the case of depreciation – which is the return of investment in the pipeline system represented by the capital base, and in the case of operating costs, if DBP is to have the opportunity to recover those costs, the annual tariff adjustment must be made in a way consistent with the way in which those costs have changed as a result of price change since they were first estimated at (or near the date of) the start of the access arrangement period. As DBP argued earlier, in Submission 49, those costs are costs incurred largely in Western Australia, and the proper adjustment is an adjustment for price changes which have occurred in Western Australia. An appropriate measure for price change is, in these circumstances, the CPI (All Groups, Perth). It is not a national measure of inflation as the ERA requires.

4.35. Ensuring that DBP recovers the actual cost of financing the investment represented by the capital base requires that DBP be compensated, through the annual inflation adjustment of reference tariffs, for the expected inflation which is, in fact incorporated in its costs of equity and debt (and which was removed in setting reference tariffs in real terms). Neither the CPI (All Groups, Eight Capital Cities), nor the CPI (All Groups, Perth), is entirely appropriate for this purpose. DBP is of the view that the CPI (All Groups, Perth) provides a reasonable estimate, consistent with its operations being in Western Australia and serving end users of gas in the State. Using the CPI (All Groups, Perth) has the added advantage that it allows use of a relative simple tariff variation mechanism.

4.36. Since an Access Arrangement for the pipeline was first developed, the setting of reference tariffs for the DBNGP has been governed by the regulatory requirements for tariffs with efficient structures and levels. These requirements are best achieved, when escalating the value of the capital base from one access arrangement period to the next, and when annually adjusting for inflation tariffs which were initially determined in real terms, by using the CPI (All Groups, Perth). This should have been recognized in Required Amendment 5 of the Final Decision; Required Amendment 5 should not have required the use of the CPI (All Groups, Eight Capital Cities).

5. CAPITAL EXPENDITURE FOR THE PERIOD 2005 – 2010

Project Management Retainer Fees (2008-2010)

5.1. Required Amendment 6 requires that the value of conforming capital expenditure of the 2005 to 2010 access arrangement period must be amended to values as indicated in Table 11 of the Final Decision.

5.2. The only amounts that have been required to be removed by the ERA as a result of Amendment 6 are:

(a) amounts for the payment of Project Management Retainer Fees (**PMR Fee**); and

(b) the inflation escalation adjustment for all capital expenditure incurred in 2005-2009 to convert it to real $2010 values. This issue is addressed in section 4 of this submission.

DBP's pre-draft decision submissions

5.3. In submission 1, DBP submitted that the payment of the PMR Fee is necessary to be able to contract project management services within the required time frame of 30 months for an expansion of the DBNGP where a shipper requests additional capacity under the terms of the standard shipper contract or "Aloca Exempt Contract".

ERA draft decision

5.4. The ERA determined in the draft decision that the amount of the PMR Fee does not satisfy the prudence and efficiency requirements of rule 79(1)(a) for reasons that:

(a) DBP had not provided information that satisfies the ERA that the payment of the PMR Fee is necessary to be able to contract for project management services within the required time frames for an expansion of the DBNGP;

(b) the ERA was not satisfied that the PMR Fee is a genuine fee for a service or facility to be provided by WestNet Energy Services Pty Ltd; given:

(i) a lack of a detailed specification in the Amended and Restated Operating Services Agreement of any relevant requirements to be met by WestNet Energy Services Pty Ltd in return for the fee;

(ii) a view of expert engineering advisors to the ERA that there is a lack of precedent to suggest that the nature and quantum of the PMR Fee are consistent with common industry practice; and

(iii) DBP has forecast no expansion of the DBNGP for the 2010 to 2015 access arrangement period;

(c) the ERA was concerned that the PMR Fee may represent a negotiated compensation to Alinta Asset Management and WestNet Energy Services Pty Ltd for the termination of a management fee under the Operating Services Agreement, rather than a fee for an additional service or obligation under the Amended and Restated Operating Service Agreement. (para 277)

5.5. In the draft decision the ERA required that the amount of this fee be removed from the capital expenditure. In the ERA's opinion, DBP had not provided a clear statement of the

value of the PMR Fee in specified nominal or real values. The ERA therefore estimated the amount of this fee for the three year period 2008 to 2010, based on the terms of the Operating Services Agreement, as an inflation-indexed amount of $2 million in 2004. The amounts deducted from the additions to the capital base (in dollar values of 31 December 2010) comprise $2.375 million in each of the three years. (paragraph 278)

DBP's response to the draft decision

5.6. In submission 53, DBP reiterated contentions made in submission 1 with the original access arrangement proposal that payment of the PMR Fee is necessary to be able to contract project management services within the required time frame of 30 months for an expansion of the DBNGP where a shipper requests additional capacity under the terms of the standard shipper contract or "Aloca Exempt Contract".

5.7. DBP also reiterated a contention made in a submission with the original access arrangement proposal that the value of the retainer fee would be significantly smaller than the additional costs that DBP is likely to incur in bringing a new project management team up to speed with the requirements of an expansion project for the DBNGP.

5.8. DBP maintained that the PMR Fee is a genuine fee for service and is efficient, evidenced by:

(a) in 2009 when the PMR Fee was initiated, there was a likelihood that the expansion programme for the DBNGP would not continue beyond Stage 5B, hence it was necessary to ensure that the project manager retained the relevant personnel so as to be able to commence any further project and complete it in accordance with the relatively compressed timetable for the provision of additional capacity as provided for in the shipper contracts;

(b) the Operating Services Agreement does provide that in consideration for the payment of the retainer fee, WestNet must retain the necessary personnel, corporate systems and procedures to maintain an ongoing capability to provide the Project Management Services irrespective of whether an Additional Capacity Expansion is being planned or undertaken;

(c) the PMR Fee covers an expansive range of services provided by WestNet under the OSA in relation to capacity expansions and capital works, including the retention of all project services, from conceptual design, through front-end engineering design (FEED) studies, planning, approvals, construction, commissioning and final delivery of the projects for operation (and all services to support these activities e.g. human resources management, and financial control); and

(d) PMR Fees are accepted industry practice in the construction industry.

5.9. DBP contended that, in addition to the above, the expense of the PMR Fee, as an expense incurred under the Operating Services Agreement, is an expense incurred by a prudent service provider acting efficiently given:

(a) it is prudent for the ownership consortium for the DBNGP to have relied on the resources and expertise of one of the members of that consortium to provide services relating to the operation and expansion of the pipeline;

(b) at acquisition, negotiations took place at arm's length and all parties had experience in negotiating major construction and operating contracts;

(c) Alcoa and DUET were commercially motivated to ensure that any fees charged by one member of the consortium were at reasonable levels;

(d) there was no reason for either DUET or Alcoa to have any commercial or other interest in WestNet deriving non-commercial fees for performing services under the Operating Services Agreement, or for the contractual arrangements to be of a nature that are neither efficient nor in accordance with good or accepted industry practice;

(e) the amount for the PMR Fee is efficient because it covers an expansive range of services provided by WestNet under the OSA; and

(f) DBP has a positive obligation to seek to minimise the capital costs of expansion of the DBNGP under the standard shipper contract.

5.10. DBP states that shippers on the DBNGP have, through the tariff adjustment mechanism under the standard shipper contract, agreed that fees such as the retainer fee can be included in the adjustment to the negotiated tariff.

ERA Final Decision

5.11. In the Final Decision, the ERA maintains its position from the Draft Decision that the amount of this fee does not satisfy the prudence and efficiency requirements of rule 79(1)(a).

5.12. The ERA suggests that in its revised access arrangement proposal and supporting submissions, DBP still does not provide a clear statement of the value of the PMR Fee during the 2005 to 2010 access arrangement period. DBP had, however, indicated a value of this fee in the forecast of capital expenditure for 2011 to 2015, with this value being a constant real value of $2.255 million per year in dollar values of 31 December 2010. The ERA therefore deducted this value from the value of stated capital expenditure for each of the years 2008 to 2010. (paragraph 290)

5.13. Final Decision does not deal with the submissions made by DBP in submission 53 other than to summarise DBP's contentions from submission 53. It then concludes that DBP has not provided adequate justification of the PMR Fee (paragraph 289).

DBP’s response to the Final Decision

5.14. DBP submits that there are a number of problems with the reasoning in the Final Decision surrounding the treatment of the PMR Fee.

5.15. The first problem relates to the years with respect to which, the ERA has removed amounts for the PMR Fee.

5.16. In calculating the conforming capital expenditure in the 2005-2010 Access Arrangement period, DBP included in the conforming expansion expenditure the following amounts as PMR Fees incurred pursuant to the Operating Services Agreement in 2009 and 2010:

Year	2005	2006	2007	2008	2009	2010
Amount	$0	$0	$0	$0	$0	$4,042,921.85

5.17. At paragraphs 278 and 290 the ERA states it has deducted the value of the PMR Fee for each of the years 2008, 2009 and 2010. DBP notes that this is what has been done in the tariff model that accompanied the Final Decision.

5.18. However, DBP had not, in its Revised AA Proposal, included the PMR Fee in its Conforming Capital Expenditure in the 2008 year, as the PMR Fee was not payable under the OSA until 2009, at which time, the OSA was amended (2009 OSA). The ERA appears to have made an error of fact in deducting any amount from the Conforming Capital Expenditure for the 2008 year.

5.19. The ERA also committed errors of fact in removing the particular amounts that it did (ie $2.255m - $31 December 2010 values) in 2009 and 2010.

5.20. For the 2009 year, while DBP's obligation to pay WestNet the PMR Fee commenced in February 2009 (as a result of the 2009 OSA), as shown above, DBP did not include (in its refiling following the draft decision) an amount in its Conforming Capital Expenditure for the 2009 calendar year.

5.21. For the 2010 year, the ERA removed an amount of $2.255m ($31 December 2010 values) from the Conforming Capital Expenditure.

5.22. However, DBP had incurred $4,431,505.07 in PMR Fees for the period from February 2009 to 31 December 2010 (Pre-2011 PMR Fees).

5.23. The audited capital expenditure for 2010, and the amount included by DBP as conforming capital expenditure in 2010 for the PMR Fee only included an amount of $4,042,921.85 - being effectively the amount of the PMR Fee payable since the PMR Fee became payable to WestNet in early 2009 (as confirmed by the audited accounts) until 31 October 2010 (being the date by which amounts were included in DBP's asset register for accounting purposes).

5.24. Accordingly, for the purposes of the access arrangement:

(a) An amount of $4,042,921.85 of the Pre-2011 PMR Fees was treated by DBP as having been brought to account in DBP's asset register and therefore was capitalised for the purposes of DBP's audited statutory accounts for the calendar year ending 31 December 2010. It was therefore to be rolled into the capital base as at 31 December 2010.

(b) The balance of the Pre-2011 PMR Fees (ie $388,583.22) was treated as capital works in progress for the purposes of DBP's audited statutory accounts. This was because it had not been brought to account in DBP's asset register by the time of the close of the financial accounts as at 31 December 2010. It was therefore to be rolled into the capital base as forecast conforming capital expenditure for the year ending 31 December 2011.

5.25. So, for the 2011 year of the proposed access arrangement period, the ERA also needs to allow as conforming forecast capital expenditure for the PMR Fee for the 2011 year. The amount to be allowed for the PMR Fee must be $2,372,766.59, being the sum of the following amounts:

(a) an amount of $388,583.22, because that was part of the Construction Works in Progress (CWIP) amounts at year end 2010 that were carried over until 2011.

(b) an amount of $1,984,183.37, being the amount of PMR Fees to be paid from 1 January 2011 until August 2011.

5.26. The ERA has not done this. Instead it has removed an amount of $2.255m in 2011.

5.27. Following are the reasons why the ERA needs to include, as forecast conforming capital expenditure for 2011, an amount of $1,984,183.37, being the amount of PMR Fees to be paid from 1 January 2011 until August 2011:

(a) In July 2011, DBP and WestNet agreed to further changes to the OSA that was amended in 2009 (**2011 OSA**). The key changes were as follows:

(i) WestNet would cease providing expansion project management services to DBP.

(ii) DBP would cease paying the PMR Fee from August 2011.

(iii) WestNet would novate its rights and obligations under the amended OSA to ATCO IT Australia Pty Ltd.

(b) Until the 2011 OSA, the stage 5B expansion project was still ongoing. DBP incurred an additional amount of PMR Fees for the period 1 January 2011 to 31 July 2011. The additional amount is $1,984,183.37, being the amount of PMR Fees to be paid until August 2011.

(c) This amount is to be added to the capital base as projected conforming capital expenditure in the 2011 calendar year.

5.28. In summary, the following table outlines what the ERA has done in the Final Decision and what DBP submits it should have done in relation to the treatment of the PMR Fee for the period 2008 to 2011:

Year	**2008**	**2009**	**2010**	**2011**
Amount ERA should have included in the capital base as conforming capital expenditure for PMR Fees	$0	$0	$4,042,921.85	$2,372,766.59
Amount ERA has removed from the capital base	$2.255m	$2.255m	$2.255m	$2.255m

Note: All figures are in $31 December 2010 values

5.29. Given the PMR Fee is no longer payable by DBP under the 2011 OSA, DBP does not disagree with the ERA's removal of amounts from forecast conforming capital expenditure for the PMR Fee in each of the 2012 to 2015 years.

6. RATE OF RETURN

6.1. In its Final Decision, the ERA rejected DBP's revised real pre-tax rate of return of 10.03% (Final Decision, paragraph 422). The ERA found that:

(a) DBP's revised rate of return was not commensurate with prevailing conditions in the market for funds and the risks involved in providing reference services; and

(b) a real pre-tax rate of return of 5.74% was commensurate with prevailing conditions in the market for funds and the risks involved in providing the reference services.

6.2. The ERA identified, in paragraph 423 of the Final Decision, what it saw as being the key issues in setting the rate of return. These were:

(a) the input parameters for the weighted average cost of capital (WACC); and

(b) matters raised in DBP's submissions in response to the ERA's March 2011 Draft Decision, being principally those regarding:

(i) the cost of equity;

(ii) the cost of debt;

(iii) the market risk premium;

(iv) the value to be attributed to imputation credits (gamma); and

(v) the nominal risk free rate of return.

6.3. The ERA's key issues did not include consideration of what was required by Rule 87, which governs the setting of the rate of return. Certainly, Rule 87 was restated in paragraphs 427 and 428 of the Final Decision. However, its specific requirements had little bearing on the way in which the ERA formed its view that a real pre-tax rate of 5.74% was the required rate of return. As it did for its Draft Decision, the ERA ascertained, for the Final Decision:

(a) that the rate of return that meets the requirements of Rule 87 was to be determined solely by using the WACC approach adopted in the Draft Decision, which approach involved the cost of equity being determined solely by the application of the Sharpe-Lintner CAPM and the cost of debt being set by adding the risk free rate of return with the debt risk premium, the latter being set solely by use of a methodology used in the Draft Decision and which the ERA called the "bond-yield approach";

(b) what it considered to be appropriate parameter estimates for the CAPM, and the debt risk premium and for the calculation of a real pre-tax WACC.

6.4. The ERA then calculated that WACC (5.74%), and – in paragraph 623 of the Final Decision – identified that WACC as the rate of return required by Rule 87.

6.5. Although the interpretation of Rule 87, and of the provisions of the NGL relating to the rate of return, had been set out in Submissions which DBP made following the ERA's Draft Decision (Submissions 55 and 67), the ERA took no account of the specific requirements of Rule 87 and, in particular, of the requirements of Rule 87(1) in its Final Decision. More generally, the ERA failed to consider all of the requirements of the NGL which pertain to the rate of return.

6.6. Contrary to its assertion in paragraph 422, the ERA did not, in its Final Decision, establish that its real pre-tax WACC of 5.74% was commensurate with prevailing conditions in the market for funds and the risks involved in providing the reference services.

6.7. Rather, the ERA applied its formulaic approach and models for cost of equity and cost of debt and concluded, without seeking to justify how, that the resultant value was compliant with Rule 87.

Cost of equity

6.8. In paragraph 438 of the Final Decision, the ERA advised that DBP was of the view that the cost of equity should be determined from:

(a) the results obtained from a well-accepted financial model, being the Sharpe-Lintner CAPM;

(b) the results obtained from three other well accepted financial models; and

(c) an examination of equity analysts' dividend yield forecasts for the period 2010 to 2012 for comparable Australian infrastructure businesses.

6.9. This is not correct. In responding to the ERA's Draft Decision, DBP did not propose that the cost of equity be determined from the Sharpe-Lintner CAPM, three other well accepted financial models, and an examination of equity analysts' dividend yield forecasts for comparable businesses. DBP proposed that the cost of equity be estimated using the Sharpe-Lintner CAPM, which Rule 87(2) designates a well accepted financial model. DBP's estimate of the cost of equity, 10.91%, was obtained using, with the Sharpe-Lintner CAPM, an estimate of the nominal risk free rate of 5.71%, an estimate of the equity beta of 0.8, and an estimate of the market risk premium of 6.5%.

6.10. DBP used, in estimating the cost of equity, the same estimate of the equity beta which the ERA used in its Final Decision (0.8 at a gearing of 60% debt to total assets; Final Decision, paragraph 617).

6.11. For the purpose of estimating the cost of equity using the CAPM, DBP estimated the nominal risk free rate of return as the average of daily yields, reported by the Reserve Bank of Australia, on Australian Government bonds with terms to maturity of 10 years. The average was calculated for a period of 20 trading days. For its Final Decision, the ERA similarly used an average of daily yields on Australian Government bonds, and calculated the average for a period of 20 trading days (although the ERA's 20 trading days were different from those used by DBP, the ERA's 20 trading days being chosen closer to the date on which the regulator issued its Final Decision). The ERA did not, however, average the yields on Australian Government bonds with terms to maturity of 10 years. It averaged the yields on bonds with terms to maturity of 5 years (Final Decision, paragraph 618).

6.12. No consideration was given, by the ERA, to the issue raised by DBP in its response to the Draft Decision, that, although a nominal risk free rate estimated from yields on bonds with terms of maturity of 5 years may have been consistent with the regulator's assumptions in estimating the debt risk premium, it was inconsistent with the estimate of the market risk premium which the regulator sought to apply. That estimate, 6.0%, was based on work for the AER in which the market risk premium was estimated as a long term average of historical excess returns relative to Australian Government bonds with terms to maturity of 10 years.

6.13. Consistency requirements, accepted elsewhere by the ERA, require a nominal risk free rate estimated as an average of yields on Australian Government bonds with terms to maturity of 10 years.

6.14. The appropriate estimate of the market risk premium to be used in estimating the cost of equity is considered below.

6.15. In its Draft Decision (paragraphs 362 to 482), the ERA rejected use of asset pricing models other than the Sharpe-Lintner CAPM because:

(a) Black's Capital Asset Pricing Model and the Fama-French three factor model were not well accepted financial models; and

(b) DBP had ignored the results, not only from the Sharpe-Lintner CAPM, but also from the other asset pricing models which it put forward, and adopted, instead, an estimate of the cost of equity, made by SFG, and based on dividend yield forecasts.

6.16. In its Final Decision (paragraph 601), the ERA advised that the rationale for its rejection of the other asset pricing models, and for its rejection of the work by SFG to estimate costs of equity from equity analysts' reports, had been discussed at length in the Draft Decision. In responding to the Draft Decision, DBP had not, according to the ERA, put forward new or convincing evidence or arguments on the regulator's reasons for rejecting the models and the SFG work.

6.17. In responding to the Draft Decision, DBP provided further reports by NERA (on the use of the other asset pricing models) and by SFG (on the use of equity analysts' assessments of the dividend yields of businesses comparable to DBP). These reports addressed specific errors in the ERA's reasoning in the Draft Decision. The report from NERA was not prepared and submitted to provide new evidence or arguments on whether Black's Capital Asset Pricing Model and the Fama-French three factor model were well accepted financial models. The report from SFG was not prepared and submitted to provide new evidence or arguments on the use of dividend yields in establishing the cost of equity.

6.18. DBP maintains that Black's Capital Asset Pricing Model and the Fama-French three factor model are well established financial models which address specific problems with the Sharpe-Lintner CAPM. DBP's reasons for this were set out in its Submissions 8 and 55. These models, and the SFG estimates of the cost of equity from the equity analysts' reports, provided evidence on whether an estimate of the cost of equity obtained using the Sharpe-Lintner CAPM was commensurate with prevailing conditions in the market for funds and the risks involved in providing reference services. The other asset pricing models were not put forward as alternatives to the Sharpe-Lintner CAPM for the purpose of applying Rule 87(2), and DBP did not adopt an estimate of the cost of equity made by SFG and based on dividend yields.

6.19. The ERA's conclusion in paragraph 601 of the Final Decision is incorrect.

6.20. Although the ERA concluded, in paragraph 601, that DBP had not put forward new or convincing evidence and arguments on the other asst pricing models, paragraphs 602 to 608 of the Final Decision further questioned aspects of NERA's statistical estimation of the Fama-French three factor model and the zero beta version of that model. The issues raised by the ERA have been addressed by NERA in its report for DBP DBNGP final decision – Response which is Attachment 1 to this submission.

6.21. DBP maintains that the Fama-French three factor model, and the zero beta version of that model, as well as Black's Capital Asset Pricing Model, provided evidence that its estimate of the cost of equity obtained using the Sharpe-Lintner CAPM was not commensurate with prevailing conditions in the market for funds and the risks involved in providing reference services.

6.22. In paragraphs 613 of the Final Decision, the ERA concluded that the two SFG approaches to estimating the cost of equity were not appropriate. DBP notes that it did not persist with the second of the approaches – the residual income model – in its response to the ERA's Draft Decision (in DBP's Submission 55).

6.23. DBP did, however, continue to use (for the purpose of ensuring that the requirements of Rule 87(1) were satisfied) the evidence on the cost of equity provided by the dividend yields reported in equity analysts' reports.

6.24. The ERA questioned the use of dividend yield forecasts in paragraphs 610 and 611 of the Final Decision. Its concerns – and rejection of the evidence which the equity analysts' reports provided on the cost of equity – are unfounded.

6.25. These concerns, and the ERA's rejection of the evidence, are examined and dismissed, in a further report from SFG, Response to the DBP Final Decision, which is Attachment 2 to this submission.

6.26. In paragraph 619 of the Final Decision, the ERA noted that:

> *It was aware that mature infrastructure assets, such as mature toll roads, mature power generation, regulated utilities, gas and electricity distribution, and mature transmission assets have ranked low in UBS's infrastructure asset risk-return spectrum.*

6.27. No conclusion was drawn from this "awareness", and the relevance of the views expressed to the setting of the rate of return for the DBNGP is not clear. Did the ERA intend that paragraph 619 be a belated recognition that the criteria – the "market tests" – of Rule 87(1) do, in fact, have a role to play in rate of return determination? If this were the case, it is inadequate. The ERA did not seek to show that the cost of equity (11.10% nominal pre-tax) which it had used in calculating a real pre-tax WACC of 5.74% could have produced a rate of return commensurate with prevailing conditions in the market for funds and the risks involved in providing reference services. In using this cost of equity, the ERA did not give consideration to the requirements of the revenue and pricing principles of section 24 of the NGL. In particular, the regulator did not consider whether the reference tariff which resulted from the application of a rate of return established using a cost of equity of 11.10% would allow a return commensurate with the regulatory and commercial risks involved in providing the reference service to which that tariff related (NGL, section 24(5)).

Cost of debt

6.28. Paragraph 443 of the Final Decision advised that DBP was of the view that the cost of debt should be determined from:

(a) the results obtained by applying the methodology adopted by the Australian Energy Regulator (AER) in its October 2010 Final Decision for the Victorian electricity distribution businesses; and

(b) advice obtained from a senior debt advisor, AMP Capital Investors (AMPCI).

6.29. This is not correct. In responding to the ERA's Draft Decision, DBP did not propose that the cost of debt be determined from application of the methodology adopted by the AER in its October 2010 Final Decision, and from advice obtained from a senior debt advisor. DBP proposed that the cost of debt be estimated as the sum of the risk free rate of return and a debt risk premium. This was the approach used by the ERA and the AER. Furthermore, DBP proposed that the debt risk premium be estimated in the way in which the AER had estimated that premium in its October 2010 Final Decision for the Victorian electricity distribution businesses.

6.30. The ERA gave no consideration to DBP's estimation of the cost of debt as the sum of the risk free rate of return and the debt risk premium. Instead, it focused solely on the advice which DBP had obtained from AMPCI. That advice was provided for the purpose of assessing whether the cost of debt, estimated as the sum of the risk free rate and the debt risk premium, satisfied the criteria of Rule 87(1). The ERA did not view the AMPCI advice in the context in which it was presented by DBP.

6.31. The ERA noted, in paragraph 551 of the Final Decision, that AMPCI was of the view that the ERA's bond-yield approach, which used a Standard and Poor credit rating as the key determinant of assessing the appropriateness of the peer group, was an overly simplistic assessment of credit risk. The ERA did not reject this view. The regulator advised only that it was of the view that there was no better alternative approach, which is as simple, independent, and transparent as the Standard and Poor method of assessing credit risk.

6.32. There are many ways of making a forecast which could be described as simple, independent and transparent. Simplicity, independence and transparency are not, however, the criteria of the NGL and the NGR. The regulator must, among other things, provide the service provider with a reasonable opportunity to recover at least the efficient costs the service provider incurs in (a) providing reference services, and (b) complying with a regulatory obligation. If the service provider is to be given the opportunity of recovering the efficient cost incurred in financing a pipeline system, it must be provided with a rate of return which is commensurate with prevailing conditions in the market for funds and the risks involved in providing the reference services. The use of a method which is simple, independent and transparent, and which is also overly simplistic – the use of a method which cannot produce the right result – cannot provide the service provider with the opportunity to recover its efficiently incurred financing costs. It cannot provide a rate of return which is commensurate with prevailing conditions in the market for funds and the risks involved in providing the reference services. It has no place in the scheme of regulation imposed by the NGL and the NGR.

6.33. Paragraphs 552 to 560 of the Final Decision defend the ERA's use of its Standard and Poor "benchmark". However, DBP's fundamental concern – that the credit rating is an inadequate characterisation of service provider risk, and must lead to an inappropriate rate of return – remains. DBP articulated this concern in its Submissions 55, and in its earlier (January 2011) response to the ERA's consultation on its then proposed bond-yield approach. AMPCI has reinforced DBP's concern in its Response to the ERA Final Decision (which is Attachment 3 to this submission).

6.34. That the bond-yield approach did not provide a reasonable measure of the debt risk premium should have been obvious to the ERA. The companies included in its "benchmark sample" bear no resemblance, from a risk perspective, to a gas pipeline business.

6.35. The appearance, in the company samples shown in Tables 35 and 36 of the Final Decision, of entities with risks very different from gas pipeline service providers –

industrial packaging and office products distributor Nexus Australia, motor vehicle supplier Mercede-Benz Australia, property groups Dexus and Goodman Australia, fleet manager Leaseplan Australia, property developer Mirvac, and the financing vehicles for the Dalrymple Bay Coal Terminal, project management and contracting services group Leighton Holdings, oil and gas explorer and producer Santos, and Sydney Airport – should have alerted the ERA to the fact that the bond-yield approach did not provide an estimate of the debt risk premium which reflected best practice for those service providers. The bond-yield approach could not provide a result which accorded with the requirements of Rule 87(2).

6.36. In paragraphs 561 to 570 of the Final Decision, the ERA presents the results from its current application of the bond-yield approach. In applying the bond-yield approach, the ERA subtracted the nominal risk free rate from observed debt yields for BBB-/BBB/BBB+ Australian corporate bonds to obtain a series of risk premiums. The nominal risk free rate was estimated from yields on Australian Government bonds with terms to maturity of 5 years, albeit with adjustment to reflect the fact that bonds in the "benchmark" sample had terms to maturity longer or shorter than 5 years. This use of yields on Australian Government bonds with terms to maturity of 5 years in the estimation of the nominal risk free rate is discussed in section 0 below.

6.37. The ERA's failure to examine the requirements of Rule 87 also led to confusion on the issue of debt raising costs in the Final Decision (paragraphs 571 to 579).

6.38. In estimating, the cost of debt for the purpose of applying Rule 87(2) (as the sum of the risk free rate and a debt risk premium) for its response to the ERA's Draft Decision, DBP did not make any allowance for debt raising costs.

6.39. As noted above, DBP sought advice from an experienced capital markets advisor – AMPCI – for the purpose of assessing whether its estimate of the cost of debt (sum of the risk free rate and debt risk premium) satisfied the criteria of Rule 87(1). AMPCI established a cost of debt for DBP using the approach which would be taken by a provider of debt. AMPCI used its knowledge and experience to build up the costs of borrowing as a series of explicitly identified costs to be added to the lender's base rate (a bank bill swap rate, a rate not to be confused with the theoretical risk free rate of the regulator's debt model).

6.40. These explicitly identified costs of borrowing were not generic allowances of the type which the ERA and other Australian regulators have applied in their estimations of the cost of debt. Furthermore, they were indicative of current market conditions. This was the reason for the decline in the estimates between April 2010 and April 2011 to which the ERA drew attention in paragraphs 576 and 577 of the Final Decision.

6.41. As AMPCI noted in its reports which were an attachment to DBP's April 2010 Submission 8, and Attachment 8 to DBP's May 2011 Submission 55, the costs of borrowing have changed very significantly during and since the Global Financial Crisis. The 2004 Allen Consulting Group study on which the ERA relied for its allowance of 0.125% for debt raising costs is now obsolete. (The ERA's reference to advice which Associate Professor Handley provided to the AER in April 2010 on the "completion method" does not change this.)

6.42. In these circumstances, the ERA's conclusion, in paragraph 579 of the Final Decision, that 12.5 basis points is an appropriate allowance for debt raising costs, is not sustained. If the ERA were concerned with the veracity of AMPCI's views as an experienced debt markets advisor, it should have sought further advice, either from DBP, or directly from the

market. Stating that 12.5 basis points is ordinarily appropriate and provided for by Australian regulators is irrelevant. The regulator must be guided by the requirement of section 24(2) of the NGL: the service provider should be provided with the opportunity to recover its efficiently incurred financing costs through an appropriate allowance for debt raising costs.

6.43. Moreover, the service provider should be provided with the opportunity to recover its efficiently incurred financing costs through the setting of a rate of return established using an appropriate cost of debt. However, the ERA did not seek to show that the cost of debt 7.01% nominal) which it had used in calculating a real pre-tax WACC of 5.74% could have produced a rate of return commensurate with prevailing conditions in the market for funds and the risks involved in providing reference services. In using this cost of debt, the ERA did not give consideration to the requirements of the revenue and pricing principles of section 24 of the NGL. In particular, the regulator did not consider whether the reference tariff which resulted from the application of a rate of return established using a cost of debt of 7.01% would allow a return commensurate with the regulatory and commercial risks involved in providing the reference service to which that tariff related (NGL, section 24(5)).

Market risk premium

6.44. DBP proposed an estimate of 6.5% for the market risk premium used in estimating the cost of equity. This was rejected by the ERA. The ERA considered that there was no persuasive evidence to depart from the previously adopted methods, and the estimate of 6.0%, which had been used in all of the regulator's previous decisions.

6.45. In this matter, the ERA was in error. The test which the ERA applied in deciding that 6.5% was not an appropriate estimate of the market risk premium was not the test required by Rule 87. It was the test which is to be found in the rate of return provisions of Chapter 6A of the National Electricity Rules.

6.46. The ERA noted, in paragraph 488 of the Final Decision, that the implied volatility of the prices of options on the ASX 200 index had recently increased, but:

(a) found that the current level of the implied volatility was still substantially below the level during the Global Financial Crisis in 2008 and 2009; and

(b) advised that the ERA was not aware of any reliable framework on which the market risk premium can be directly estimated from the implied volatility for a long term horizon.

6.47. Furthermore, the ERA found that recent surveys of market practitioners were supporting a view that the market risk premium was approximately 6% (Final Decision, paragraph 489).

6.48. The ERA also advanced what it called a "new economic outlook", referring to the Reserve Bank's Statement on Monetary Policy in August 2011, and continuing to refer to earlier (October 2010) views of the International Monetary Fund (Final Decision, paragraphs 505 to 510).

6.49. That the current level of implied volatility might be substantially below the level during the Global Financial Crisis in 2008 and 2009 is not surprising. However, it says nothing about the current level of the market risk premium.

6.50. In further advice provided to DBP, and set out in its Commentary on Market Risk Premium which is Attachment 4 to this submission, Value Advisor Associates directed attention to the recent publication of its implied volatility approach in Bishop, S., M. Fitzsimmons and

B. Officer, "Adjusting the market risk premium to reflect the global financial crisis", JASSA (The Finsia Journal of Applied Finance), Issue 1, 2011: 8-14. The implied volatility framework is a "reliable framework".

6.51. The inadequacy of survey methods in the estimation of financial market parameters is noted in the further advice provided by Value Advisor Associates in its Commentary on Market Risk Premium. Value Advisor Associates also noted that practitioners might continue to claim that the market risk premium is 6.0%, while adjusting the cost of equity estimated using that premium for current market conditions. Survey results are not a substitute for market data.

6.52. Market data continue to show a market risk premium above 6%. In their further advice to DBP, Value Advisor Associates continue to see the current data as supporting the view that 6.5% is a better representation of the market risk premium than 6.0%.

6.53. In advice on estimation of the market risk premium prepared for DBP, and which was provided as Attachment 2 to DBP's Submission 55, Value Advisor Associates provided evidence that the risk spreads on investment grade debt were well above the more stable spreads which prevailed prior to the Global Financial Crisis. Since there were no impediments to investment funds flowing between debt and equity markets, Value Advisor Associates reasoned that the higher risk spreads on debt should be reflected in higher spreads in the equity market. Elevated risk spreads in the debt market should, then, be reflected in an elevated market risk premium. Value Advisor Associates interpreted this result as being consistent with the theoretical argument of Professor Bruce Grundy that the equity risk premium should be at least 2.67 times the debt risk premium.

6.54. In paragraphs 493 to 504 of the Final Decision, the ERA purported to address the conclusion which Value Advisor Associates drew from the relationship between the cost of debt and the cost of equity. However, instead of addressing the main point raised by Value Advisor Associates – that elevated risk spreads in the debt market should be reflected in an elevated market risk premium – the ERA proceeded to question the logic of the Grundy argument and its use of the Modigliani-Miller theorem. The ERA concluded, in paragraph 504 of the Final Decision, that the Value Advisor Associates argument based on Grundy's estimation could not be relied upon. This "missed the point".

6.55. Value Advisor Associates main point was simply ignored by the ERA. Value Advisor Associates has now provided further evidence supporting its view that elevated risk spreads in the debt market should be reflected in an elevated market risk premium, and further supporting an estimate of the market risk premium of at least 6.50%.

6.56. The ERA's "new economic outlook" does not add to views which the regulator put forward in the Draft Decision, and which were addressed in Attachment 1 to DBP's Submission 55. Those views – broad statements about economic outlook – say little about investor expectations as to the premium (above the risk free rate) which might now be required to induce investors to invest in equities.

6.57. The ERA's view that 6.0% is an appropriate estimate of the market risk premium is no longer tenable. This would have been apparent to the ERA if it had sought to show that its real pre-tax WACC of 5.74% produced a rate of return commensurate with prevailing conditions in the market for funds and the risks involved in providing reference services. However, the ERA did not. Moreover, the regulator did not give consideration to the requirements of the revenue and pricing principles of section 24 of the NGL. In particular, the ERA did not consider whether the reference tariff which resulted from the application of a rate of return established using a market risk premium of 6.0% would allow a return

commensurate with the regulatory and commercial risks involved in providing the reference service to which that tariff related (NGL, section 24(5)).

The value to be attributed to imputation credits (gamma)

6.58. In paragraph 447 of the Final Decision, the ERA advised that DBP submitted that the value to be attributed to imputation credits – gamma – be set to zero because this was consistent with setting the value of cash dividends at one for the purpose of estimating the required rate of return on equity, and was also consistent with market practice.

6.59. This is correct.

6.60. However, the ERA rejected DBP's estimate of zero for gamma and concluded that an estimate of 0.25 was reasonable. It was an estimate consistent with the recent finding on gamma by the Australian Competition Tribunal (Final Decision, paragraph 538).

6.61. In the Final Decision, the ERA's reasons for rejecting DBP's estimate of zero for gamma, and for requiring use of an estimate of 0.25, are not clear. No consideration seems to have been given, by the ERA, to the issue of consistency with the assumptions made when using asset pricing models (including the Sharpe-Lintner CAPM) that cash dividends are valued at 100 cents in the dollar. This is surprising: elsewhere, consistency looms large in the regulator's decision making.

6.62. When this consistency issue is properly addressed, the evidence on which the Australian Competition Tribunal relied for its finding on gamma should have been interpreted as implying a value of zero was permissible for the parameter theta and, hence, a value of zero for gamma was permissible and, indeed required, when cash dividends were valued at 100 cents in the dollar.

6.63. These issues were addressed by DBP in its Submission 55 which responded to rate of return issues in the ERA's Draft Decision, and in the further report from SFG which was Attachment 3 to Submission 55.

6.64. The ERA was incorrect in finding that an estimate of 0.25 for gamma was reasonable when the correct estimate was zero.

6.65. That an estimate of gamma of 0.25 was not reasonable would have been apparent to the ERA if it had sought to show that its real pre-tax WACC of 5.74% produced a rate of return commensurate with prevailing conditions in the market for funds and the risks involved in providing reference services. However, the ERA did not. Moreover, the regulator did not give consideration to the requirements of the revenue and pricing principles of section 24 of the NGL. In particular, the ERA did not consider whether the reference tariff which resulted from the application of a rate of return established using an estimate of gamma would allow a return commensurate with the regulatory and commercial risks involved in providing the reference service to which that tariff related (NGL, section 24(5)).

Nominal risk free rate of return

6.66. The ERA's rationale for estimating the nominal risk free rate from yields on Australian Government bonds with terms to maturity of 5 years was set out in paragraphs 468 to 475 of the Final Decision.

6.67. The ERA examined debt profiles for privately owned and government owned energy network businesses, and concluded that the average term to maturity of the debt issued by those businesses was less than 5 years.

6.68. The ERA also examined the trading of Commonwealth Treasury Bond futures contracts for maturities of 3 years and 10 years. The regulator acknowledged that both bond futures were actively traded, but investors showed a preference for contracts for the shorter tenor.

6.69. From the results of its examination of the average term to maturity of debt issued by energy network businesses, and from its observation on volumes of futures contracts traded, the ERA concluded that the nominal risk free rate should be calculated using daily yields on Australian Government bonds with terms to maturity of 5 years (Final Decision, paragraph 475). Given the evidence, the regulator could not approve DBP's use of daily yields on Australian Government bonds with terms to maturity of 10 years (Final Decision, paragraph 474).

6.70. AMPCI reviewed, for DBP, the data on the average term to maturity of debt issued by energy network businesses, and on the volumes of futures contracts traded. The results of the review are set out in AMPCI's Response to the ERA Final Decision.

6.71. When the data on terms to maturity are properly interpreted, they clearly indicate that the energy network businesses issue debt with terms to maturity longer than 5 years.

6.72. The data on the volumes of futures contracts traded indicate that 3 years bond futures have higher traded volumes than 10 years futures. However, this does not imply that a term to maturity of 5 years is more appropriate than a term of 10 years when estimating the nominal risk free rate. All that can be inferred is that the volumes of trading of both 3 years and 5 years contracts imply an efficient market with competitive pricing at each of these tenors.

6.73. Other criteria must then be adopted to decide on whether a 5 years or a 10 years term to maturity should be used in establishing the risk free rate of return. As AMPCI indicated in its April 2010 report (which was an attachment to DBP's Submission 8), adoption of the 10 years term to maturity allows "looking through" the variability in short term rates attributable to the economic cycle and monetary policy settings to a more stable risk free rate. This is why an average of yields on bonds with terms to maturity of 10 years is favoured by economists and financial market analysts. Use of a 10 years horizon, based on the term to maturity of the longest Australian Government bond issue is also an appropriate choice for assets, like the assets which comprise the DBNGP, which have relatively long remaining lives.

6.74. Furthermore, when the cost of equity is estimated using the Sharpe-Linter CAPM and an estimate of the market risk premium which has been made by reference to yields on Australian Government bonds with terms to maturity of 10 years, consistency and accuracy in the result require that the nominal risk free rate be estimated from yields on bonds with terms to maturity of 10 years (see paragraphs 6.11 and 6.12 above.

6.75. The ERA was incorrect in making its estimate of the nominal risk free rate from daily yields on Australian Government bonds with terms to maturity of 5 years.

Expected inflation

6.76. The real pre-tax WACC of 5.74%, which the ERA calculated and identified as the rate of return on capital, was calculated by removing the expectations on inflation embedded in a nominal pre-tax WACC.

6.77. DBP had proposed that an estimate of expected inflation be calculated as the geometric mean of the inflation forecasts made by the Reserve Bank of Australia and published periodically in the Bank's Statement on Monetary Policy. The geometric mean was to be calculated for a period of 10 years.

6.78. The ERA accepted DBP's proposal as being consistent with its own past practice, but required that the geometric mean be calculated for a period of 5 years (Final Decision, paragraphs 580 and 585). In the Final Decision (paragraph 585), the ERA pointed to its reasoning in the Draft Decision. In the Draft Decision (paragraph 721), the ERA had stated that, for consistency with the way in which it estimated the debt risk premium and the nominal risk free rate, the geometric mean of inflation forecasts should be calculated over a period of five years.

6.79. Unlike the debt risk premium and the nominal risk free rate of return, expected inflation is not estimated from the attributes of specific financial instruments. There is, then, no reason, other than for appearance, to require the use of a geometric mean of inflation forecasts calculated for a period of five years in place of a geometric mean of inflation forecasts calculated for a period of 10 years.

6.80. Expected inflation should be forecast as the geometric mean of the inflation forecasts made by the Reserve Bank of Australia and published periodically in the Bank's Statement on Monetary Policy, the mean being calculated for a period of 10 years as DBP proposed.

Incorrect values used in determining rate of return

6.81. Irrespective of whether a rate of return is, as the ERA contends, to be determined by estimating the cost of equity and debt solely by WACC and CAPM without adjustment, the ERA's calculation of a real pre-tax WACC (and, hence, real pre-tax rate of return on capital) of 5.74% was incorrect.

6.82. The real pre-tax WACC of 5.74%, which the ERA calculated and identified as the rate of return on capital, was calculated using the Sharpe-Lintner CAPM and an estimate of the market risk premium of 6.0%. DBP provided evidence (noted in section 0 above), including reports from Value Advisor Associates, which showed that a higher, rather than a lower, estimate of the market risk premium was appropriate: financial markets have not returned to "normal" conditions following the Global Financial Crisis, and market data continue to support a view that the market risk premium is around 7%, and that 6.5% is a better estimate of the risk premium than an estimate of 6.0%.

6.83. If the cost of debt is estimated solely as the sum of the risk free rate of return and a debt risk premium, and solely by the calculation of a real pre-tax WACC, then the estimate of the market risk premium to be used in estimating the cost of equity is 6.5%.

6.84. The real pre-tax WACC of 5.74%, which the ERA calculated and identified as the rate of return on capital, was calculated by estimating the cost of debt as the sum of:

(a) the risk free rate of return;

(b) a debt risk premium; and

(c) an allowance for debt raising costs.

6.85. The estimate of the debt risk premium used by the ERA was incorrect: the ERA's bond-yield approach incorrectly estimated the debt risk premium, and the ERA incorrectly estimated the allowance for debt raising costs (see above).

6.86. That the bond-yield approach did not provide the correct estimate of the debt risk premium should have been apparent to the ERA from the company samples shown in Tables 35 and 36 of the Final Decision. Those samples should have alerted the ERA to the fact that the bond-yield approach did not provide an estimate of the debt risk premium which reflected best practice for pipeline service providers.

6.87. The ERA provided no evidence that, despite the obvious appearance to the contrary, the bond-yield approach provided an estimate of the debt risk premium which reflected best practice for gas network service providers.

6.88. The ERA's bond-yield approach to estimation of the debt risk premium used risk premiums from a large sample of companies, all of which had credit ratings in the range BBB+/BBB/BBB-. The ERA believed that a large sample would yield a more reliable estimate of the debt risk premium (Draft Decision, paragraph 579). This might have been the case if credit ratings were precise indicators of the default risk for which lenders are to be compensated through the debt risk premium. However, they are not. DBP provided evidence that credit ratings are, themselves, an incomplete and imprecise measure of default risk (in DBP's January 2011 response to the ERA's consultation on its then proposed bond-yield approach, and in Submission 55).

6.89. The ERA acknowledged that the bond-yield approach was an overly simplistic assessment of credit risk (Final Decision, paragraph 551). The bond-yield approach could not, therefore, provide the correct estimate of the debt risk premium, but the ERA was of the view that there was no better alternative approach.

6.90. The ERA assumed an allowance for debt raising costs of 0.125%. The ERA's allowance was based on the results of a study undertaken by the Allen Consulting Group for the Australian Competition and Consumer Commission in December 2004, on advice provided by Melbourne University Associate Professor John Handley to the AER in April 2010, and on the ERA's view that an allowance of 0.125% provided certainty given that this estimate of debt raising costs had been widely used by Australian regulators.

6.91. DBP provided evidence, in a report from capital markets advisor AMPCI, that debt issuing costs had changed significantly since the Global Financial Crisis. Furthermore, AMPCI advised that the Allen Consulting Group report on which the ERA had relied was obsolete, and the Hanley advice to the AER did not remedy the situation (see paragraph 6.41 above).

6.92. DBP provided, in the form of advice from AMPCI, an alternative approach to estimation of the cost of debt which avoided the problems with the ERA's bond-yield approach to estimating the debt risk premium, and which incorporated the current costs of issuing debt. DBP's alternative approach indicated a debt risk premium (cost of debt, including allowance for debt raising costs, less the risk free rate of return) of 3.81% (= 9.52% - 5.71%).

6.93. Accordingly, the estimate of the debt risk premium to be used in estimating the cost of debt for the purposes of calculating real pre-tax WACC is 3.81%. This estimate includes allowances for debt raising costs.

6.94. The real pre-tax WACC of 5.74%, which the ERA calculated and identified as the rate of return on capital, was calculated using an estimate of gamma, the value of imputation credits (franking credits), of 0.25. The ERA correctly estimated the value of gamma as the product of the distribution or payout ratio (denoted by F) and the utilisation rate (denoted by theta), and correctly assumed that F was 0.70. However, the ERA incorrectly concluded that the value of theta was 0.35, implying that gamma, the product of F and theta, was 0.25 (= 0.70 x 0.35).

6.95. The ERA incorrectly concluded that there was no inconsistency between an estimate of the value of cash dividends of 75 to 80 cents per dollar which was made jointly with an estimate of theta of 0.35, and an estimate of the value of cash dividends of 100 cents per dollar when the cost of equity was estimated using the CAPM (Final Decision paragraph. 528, and Draft Decision paragraph 657). The ERA ought to have found that there was inconsistency and that, when cash dividends are valued at 100 cents per dollar, as they are when estimating the cost of equity using the CAPM, those cash dividends should also be valued at 100 cents per dollar when estimating theta (see paragraph 6.62 above).

6.96. DBP provided evidence that when cash dividends were valued at 100 cents in the dollar in the estimation of theta, the resulting estimate of theta was zero (see paragraph 6.63 above).

6.97. The ERA, then, incorrectly found that the estimate of gamma to be used in calculating a real pre-tax WACC was 0.25, when that estimate should have been zero (= 0.70 x 0).

6.98. The real pre-tax WACC of 5.74%, which the ERA calculated and identified as the rate of return on capital, was calculated by removing the expectations on inflation embedded in a nominal pre-tax WACC.

6.99. DBP had proposed that an estimate of expected inflation be calculated as the geometric mean of the inflation forecasts made by the Reserve Bank of Australia and published periodically in the Bank's Statement on Monetary Policy. The geometric mean was to be calculated for a period of 10 years.

6.100. The ERA accepted DBP's proposal as being consistent with its own past practice, but required that the geometric mean be calculated for a period of five years (Final Decision, paragraphs 580 and 585). In the Final Decision (paragraph 585), the ERA pointed to its reasoning in the Draft Decision. In the Draft Decision (paragraph 721), the ERA had stated that, for consistency with the way in which it estimated the debt risk premium and the nominal risk free rate, the geometric mean of inflation forecasts should be calculated over a period of five years.

6.101. Unlike the debt risk premium and the nominal risk free rate of return, expected inflation is not estimated from the attributes of specific financial instruments. There is, then, no reason, other than for appearance, to require the use of a geometric mean of inflation forecasts calculated for a period of five years in place of a geometric mean of inflation forecasts calculated for a period of 10 years.

6.102. Accordingly, the real pre-tax WACC should be calculated using an estimate of expected inflation determined as the geometric mean of the inflation forecasts made by

the Reserve Bank of Australia and published periodically in the Bank's Statement on Monetary Policy, the mean being calculated for a period of 10 years.

7. FORECAST OPERATING EXPENDITURE – REGULATORY COSTS

7.1. Amendment 14 of the Final Decision requires that the revised access arrangement proposal should be amended such that the forecast of operating expenditure for the 2011 to 2015 access arrangement period is as indicated in Table 55 of the Final Decision.

7.2. Relevantly, this includes an amendment to the forecast expenditure that DBP had proposed to remove some of the regulatory costs DBP had proposed.

DBP's pre-draft decision submissions

7.3. In its Submission 12, DBP described the regulatory expenses as costs which DBP expected to incur during the period.

ERA draft decision

7.4. The ERA's determination at the draft decision regarding DBP's proposed regulatory costs is made in paragraphs 902 to 908 of its decision.

DBP's response to the draft decision

7.5. DBP's response in Submission #54 (20 May 2011 at page 27) was to maintain that its forecast was arrived at on a reasonable basis.

ERA Final Decision

7.6. The ERA determined that DBP's forecast of regulatory expenses over the 2011 to 2015 period did not satisfy the requirements of Rule 91 (Final Decision at paragraph 688). The ERA has forecast a total value of $1.157 million ($2010) for regulatory costs over that period, compared with $1.359 million proposed by DBP ($2010)(Final Decision at paragraph 718).

7.7. In particular, whilst the ERA and DBP have the same position on the regulatory expenses for the years 2011 to 2013 inclusive ($49,000 per year, $2010), there is a $100,000 discrepancy in each of 2014 and 2015, being the years in which DBP says that it will be required to incur substantial further costs as part of the next access arrangement approvals process.

7.8. The table below summarises DBP's position versus that of the regulator in the Final Decision:

	2011-2013	2014 & 2015	Total Forecast 2011-2015 ($2010)	Total Forecast 2011- 2015 (indexed)
DBP's Position (in its response to the Final Decision of 18 April 2011)	**$147,000**($2010) ($2010) [i.e. $49,000 per year]	**$1.21 million** ($2010)	**$1.359 million** ($2010)	**$1.506 million** (indexed and rounded)
Regulator's Final Decision	**$147,000** [i.e. $49,000 per year]	**$1.01 million** ($2010) [comprising $913,000 ($2010) plus the annual allowance of $49,000 per year]	**$1.157 million** ($2010)	**$1.306 million** (indexed and rounded)

7.9. The ERA's Final Decision was based on what it determined was a failure by DBP to submit any evidence justifying its forecasts cost increases for years 2014 and 2015. Instead, the ERA:

(a) purported to base its forecasts for 2014 and 2015 on DBP's own forecast for the corresponding years of the current access arrangement review (Final Decision at para 718), which were $800,000 per year (DBP's pre-draft submission, Submission #12 dated 18 April 2010, page 21), although the ERA in fact used the slightly higher sum of $913,000, being the allowance for the corresponding period of the existing access regime, as the base figure for 2014 and 2015 (Draft Decision at para 908);

(b) concluded that, in light of DBP's failure to provide any further evidence justifying the forecast of costs for those years, DBP's forecasts for regulatory expenses for those years did not meet the prudence and efficiency criteria of rule 91 (Final Decision at para 677, read with para 721; para 735); and

(c) accordingly, decreased the amounts allowed for regulatory expense in each of 2014 and 2015 by $100,000pa.

DBP's response to the Final Decision

7.10. DBP believes that ERA was wrong, in the Final Decision, to have removed these amounts of regulatory expenses in 2014 and 2015 for the following reasons:

(a) in using DBP's previous forecast of $800,000 as the basis for its forecast for 2014 and 2015 (although using $913,000 as the base figure), the Final Decision does not deal with the subsequent submission of DBP, following the Draft Decision, that DBP had already incurred more costs for the current access arrangement approvals process than it had originally forecast (Submission #54

dated 20 May 2011, page 27) and that the next access arrangement review process in 2015 was likely to be more contentious (because of DBP's contractual position with most of its shippers) and therefore was likely to require more expenditure;

(b) The ERA has not demonstrated how DBP's proposal was inconsistent with the criteria for operating expenditure and the revenue and pricing principles.

(c) The ERA was wrong to have dismissed DBP's forecast for 2014/2015 on the basis that there was no evidence as to the forecasts' reasonableness in circumstances where:

(i) the matter involves a forecast, which only needs to be, in accordance with NGR rule 74(2), arrived at on a reasonable basis and the best possible forecast in the circumstances;

(ii) the increase is not materially significant from the amounts allowed for the review of the current access arrangement ($100,000 per year);

(iii) DBP actually did make submissions to the ERA as to why the costs were likely to be more in 2014/15 than in the corresponding period of the current access arrangement period (ie 2009/10) and why the forecast costs for these year were reasonable and met the criteria for operating expenditure - that there is likely to be a significant increase in interest from stakeholders in the access arrangement review process in 2014/2015, thereby requiring DBP to spend more time reviewing and responding to submissions and reviewing decisions from the ERA which will be more detailed if there is a greater shipper involvement in the process than there has been to date.

(iv) the current proposals being considered by the Australian Energy Market Commission to change the rate of return provisions of the NGR (in particular, to change the methodology and criteria in the determination of the rate of return), will, if accepted by the AEMC, mean that DBP has to participate in two additional regulatory approvals processes – one being the statement on the cost of capital (SOCC) process to be run in 2014 by the AER and the other, also being a SOCC process, being required to be undertaken by the ERA. These will sit outside the access arrangement approvals process and are likely to require significant external support and require significantly more expenditure than has been forecast.

(d) further, the decision ignores the conclusion in the Draft Report of Halcrow Zincara (March 2011 at page 218) (Halcrow Report), that DBP's forecast for regulatory expenses meets the prudence and efficiency criteria

8. TARIFF VARIATION MECHANISMS

8.1. Amendment 16 requires the definition of "CPI" in the reference tariff variation mechanisms to "CPI means the Consumer Price Index, all groups, eight capital cities".

8.2. Amendment 17 requires the proposed revised access arrangement should be amended so that the variation of reference tariffs by way of a Tax Change Variation:

(a) is limited to costs of tax changes that satisfy the criteria governing operating expenditure set out in rule 91 of the NGR; and

(b) is subject to the ERA's approval of the variation.

8.3. Amendment 18 requires the new costs pass through variation mechanism to be amended as follows:

(a) It must exclude provision for a new costs pass through variation in respect of a change in cost of system use gas

(b) It must be limited to costs that satisfy the criteria governing operating expenditure as set out in rule 91 of the NGR;

(c) Any variation must be subject to the ERA's approval;

(d) It must provide for an adjustment of reference tariffs for either an increase or decrease in costs arising from the occurrence of a defined event;

(e) It must provide for a cost pass through notice to be issued 30 business days before a variation to the reference tariff commences to have effect.

DBP pre-draft decision submissions

8.4. Clause 11 of the proposed access arrangement sets out three reference tariff variation mechanisms proposed by DBP. Relevant to this Amendment 17, there are two proposed reference tariff variation mechanisms:

(a) Clause 11.3 provides for "Pass through of changes in taxation costs and carbon costs:, which include any costs arising in relation to the management of and complying with any obligations or liabilities that may arise under any law in relation to greenhouse emissions in so far as the obligations or liability is connected to the DBNGP" (**pass through of tax changes variation mechanism**).

(b) Clause 11.4 provides for a "**new costs pass through variation mechanism**".

ERA draft decision

8.5. The ERA makes its determination on DBP proposed tariff variation mechanisms at paragraphs 965 to 974 of the Draft Decision. Importantly, it required:

(a) as draft decision amendment 14, the same amendment in relation to the pass through of tax changes variation mechanism as in Final Decision Amendment 17; and

(b) as draft decision amendment 15, the amendment of the access arrangement to remove provision for a new costs pass through variation mechanism.

ERA Final Decision

8.6. In relation to the structure of the pass through of tax changes variation mechanism, the Final Decision Amendment 17 is justified by the ERA by reference to the following reasons:

(a) For some taxes faced by DBP – in particular the carbon tax - DBP's tax liability is affected by decisions and practices of DBP in operation of the DBNGP (para 816). Accordingly, the scope in the reference tariff variation mechanism for the pass through of costs must be constrained and, in particular, should be subject to the same regulatory assessment and approval as for forecasts of costs in the normal process of approval of proposed revisions to the access arrangement, namely the "prudence and efficiency criteria" in NGR Rule 91;

(b) A requirement for any tax pass through to be approved by the ERA is consistent with the process for approval of revisions to the access arrangement, which involves consideration of taxes, rates and charges as an element of operating expenditure.

(c) although only expressed in the Draft Decision (paragraph 973), such an arrangement is consistent with the oversight and authorisation powers set out in NGR Rule 97(4).

8.7. In relation to the new costs pass through variation mechanism, the Final Decision Amendment 18 is justified by the ERA by reference to the following reasons:

(a) An increase in system use gas costs is not a reasonable cost pass through event because it should only apply to cost items that are unilaterally imposed on DBP, such as changes in taxation.

(b) While a change in costs for land access under the access right granted under the DBP Act is a reasonable cost pass through event, the mechanism should allow for increases and decreases in these costs to be passed through.

(c) The ERA should have a minimum of 30 business days to assess and approve a proposal for a new costs pass through variation because a minimum 15 business day period is inadequate.

DBP's response to the Final Decision Amendment 16

8.8. DBP refers to its submissions made in section 4 of this submission as to why it is wrong for the ERA to require Final Decision Amendment 16.

DBP's response to the Final Decision Amendment 17

8.9. DBP submits that there are a number of reasons for why the ERA has erred in requiring Final Decision Amendment 17.

8.10. Firstly, the ERA did not have regard to the factors that the ERA must have regard to in deciding whether a particular tariff variation mechanism is appropriate to a particular access arrangement (as required by Rule 97(3). If it had, the ERA would not have required Final Decision Amendment 17.

8.11. In particular, the mechanism proposed by the ERA will not lead to an efficient tariff structure because given the quantum of the carbon costs that DBP is likely to incur, it could lead to a 10% increase in the level of the reference tariff, whereas DBP's proposal would have created a smoother tariff path with only minor adjustments to be made should the actual costs differ from the amounts included in the forecast operating expenditure. A smoother tariff path is more efficient for shippers.

8.12. The ERA has created a significant risk for DBP in that it will not allow DBP to pass through the carbon tax in any tariff variation mechanism that requires the regulator to assess the variation against the prudency and efficiency criteria because the ERA has already pre-determined that this tax is not prudent and efficient (Final Decision paragraph 710).

8.13. The ERA's mechanism that requires ERA approval of any variation proposal would significantly increase the ERA's administrative costs. This would, in turn (because of the statutory funding arrangements that exist for the funding of the ERA in Western Australia – ie service providers are required to fund the ERA through service and standing charges), lead to increased costs for service providers. This is particularly the case if DBP seeks to pass through these costs frequently in the year because of cash flow requirements. These increased costs have not been provided for in the forecast operating expenditure proposed by DBP or allowed by the ERA in the Final Decision. DBP would therefore be deprived of the opportunity to recover these costs.

8.14. Secondly, the ERA's proposal gives DBP insufficient certainty that it will be able to pass on all carbon costs on to the shippers and, in particular:

(a) any tax is mandated on DBP by law and DBP therefore has no control over the prudence or efficiency of that tax and may be unable to recover costs incurred as a result of a tax which is imprudent or inefficient (Submission #56 dated 20 May 2011 at paragraph 4.3);

(b) in a competitive environment, all taxes are passed through to the end customer (Submission #56 dated 20 May 2011 at paragraph 4.4);

(c) the shippers have already agreed to a mechanism for passing through the effect of new tax changes without the regulator's involvement (Submission #56 dated 20 May 2011 at paragraph 4.5(a));

(d) in the absence of a time limit, DBP is exposed to the financial consequences of an unnecessary or protracted deliberation by the regulator (Submission #56 dated 20 May 2011 at paragraph 4.5(b)).

8.15. Thirdly, it is wrong to require ERA to have oversight for the reason that DBP's tax liability is affected by decisions and practices of DBP in operation of the DBNGP. DBP's tax liability will be determined by the product of the carbon tax and DBP's emissions. In relation to the carbon tax, for the period until 30 June 2015, the tax will be a fixed price. So, there is no ability for DBP to affect this amount. In relation to the amount of DBP's emissions, while it is correct that the amount of DBP's emissions will be affected by DBP's decisions and practices in the operation of the DBNGP, the major source of these emissions will be from the use of system use gas in the operation of compressors (in fact, over 93% of DBP's emissions will be as a result of the use of SUG in the operation of the compressors). The ERA already assesses the prudency of DBP's forecast system use gas requirements as part of its assessment of forecast operating expenditure. It will therefore be unnecessary for the ERA to have another right of review.

8.16. Fourthly, the variation mechanism proposed by DBP is consistent with the mechanism that is included in the terms and conditions of the SSC for new tax changes. This mechanism has been accepted by all shippers on the DBNGP.

8.17. Alternatively, if it is determined that the regulator must oversee and/or approve the pass through of tax changes tariff variation mechanism, then there should be limits imposed on that oversight, including time limits, and DBP should be allowed to pass through the costs of the approval process.

DBP's response to the Final Decision Amendment 18

8.18. In relation to the ERA's reason that an increase in system use gas costs is not a reasonable cost pass through event because it should only apply to cost items that are unilaterally imposed on DBP, such as changes in taxation, DBP submits that there is nothing in the NGR which limits "cost pass through events" to only those which are unilaterally imposed on DBP.

8.19. DBP has previously outlined the reasons for requiring this as a new costs pass through event. These are still valid reasons.

8.20. In relation to the ERA's reason that, for a change in costs for land access under the access right granted under the DBP Act, the mechanism should allow for increases and decreases in these costs to be passed through. DBP does not disagree and in fact proposed such a mechanism.

8.21. In relation to the reason that the ERA should have a minimum of 30 business days to assess and approve a proposal for a new costs pass through variation because a minimum 15 business day period is inadequate, DBP submits that this does not address DBP's concerns as to the ERA not being bound by any timetable for approval.

8.22. It is noted that the ERA's Amendment 18 also requires that the ERA have the power to approve a variation and that the variation must satisfy the criteria governing opex in Rule 91 of the NGR. While there is no express reasoning given to require this part of the amendment, DBP repeats its arguments in paragraphs 8.10 to 8.13 of this submission.

9. FORECAST OPERATING EXPENDITURE – CARBON COSTS

9.1. Final Decision Amendment 14 required that the revised access arrangement proposal should be amended such that the forecast of operating expenditure for the 2011 to 2015 access arrangement period is as indicated in Table 55 of the Final Decision. This required the removal of forecast costs associated with the carbon tax.

9.2. Since the Final Decision, the ERA issued the FD Amendment Notice advising of its intention to make changes to Amendment 14 of the Final Decision so as to allow, as part of the forecast operating expenditure for the access arrangement period, an amount for forecast costs arising from the carbon tax.

9.3. The following submissions argue why the Final Decision Amendment 14 should not be allowed in so far as it proposes to remove carbon tax related costs and why the amendment to Final Decision Amendment 14 as proposed in the FD Amendment Notice should be made.

ERA's Final Decision

9.4. The ERA rejected DBP proposal on the issue of whether Carbon Costs should be included in the forecast operating expenditure, the regulator's finding in the Final Decision is based solely on the reasoning that the costs attributed to a proposed tax is not consistent with the prudence and efficiency criteria of rule 91 (para 710 FD). The ERA appears (although it is not explicit in the Final Decision) to have formed this view because of two reasons:

(a) firstly, the fact that, at the time of the Final Decision, there was no legislation to give effect to the obligation to pay a carbon tax or purchase carbon permits. Therefore, it is too uncertain for an estimate of Carbon Costs to be included. Certainly, this was the basis for the regulator concluding, in the draft decision, to not allow Carbon Costs in the forecast operating expenditure.

(b) Secondly, if legislation is passed which imposes on DBP the obligation to pay a carbon tax and to purchase carbon permits during the regulatory period, it is reasonable to recover the costs associated with this legislation through reference tariffs but, by way of a reference tariff variation mechanism.

DBP's response to the Final Decision and FD Amendment Notice

9.5. DBP contends that the ERA was incorrect to require the removal of the Carbon Costs from DBP's forecast operating expenditure in the Final Decision for the following reasons:

(a) There was significant certainty at the time of both the Final Decision and the draft decision that there would be legislation to give effect to the obligation to pay a carbon tax and purchase carbon permits. Before the time of the Final Decision, the legislation to give effect to the carbon tax had passed the lower house of the parliament (this occurred on 12 October 2011) and in fact, received royal assent less than 3 weeks after the Final Decision. DBP notes that the ERA's FD Amendment Notice acknowledges this.

(b) DBP's proposal was efficient and prudent given the structure of the legislative regime (ie with a fixed price arrangement until 30 June 2015) and the fact that DBP's Carbon Costs assumed a price for each permit ($20) which was lower than the price prescribed in the regime (starting at $23 in 2012). This means that, under DBP's proposal:

(i) DBP would never over recover its actual carbon costs;

(ii) even if it did over recover, when combined with DBP's proposed new tax change tariff variation mechanism, DBP would be obliged to refund to shippers any such over recovery; and

(iii) DBP would never be fully out of pocket for the costs of complying with the regime and to the extent that it is out of pocket, DBP would be able to determine the duration for which it remains out of pocket.

(c) Including an amount of Carbon Costs in the forecast operating expenditure would not disincentivise DBP to maintain its use of fuel gas (and therefore the primary source of its greenhouse gas emissions) to an efficient level because fuel gas usage and expenditure is separately assessed by the regulator against the rule 91 NGR criteria.

(d) DBP's proposal removes a significant part of the administrative burden of a tariff variation mechanism – i.e. the regulatory sign off of all of the costs

(e) DBP's proposal gives DBP the ability to purchase credits at the right time of the market for the period following 30 June 2015, when the regime moves to a market derived pricing mechanism (ie it will have been paid in advance (through the payment of charges by shippers) to fund purchases when the pricing is right).

9.6. DBP contends that the ERA is therefore correct to have reinstated, in DBP's forecast operating expenditure, an amount for carbon costs and that the amount proposed by the ERA is arrived at on a reasonable basis and represents the best forecast or estimate for these costs possible in the circumstances for the following reasons:

(a) The cost of permits under the Clean Energy Act (2011) over the regulatory period is known commencing at $23 from 1 July 2012.

(b) The ERA has assessed DBP's proposed system use gas requirement for prudency and efficiency under rule 91 of the NGR.

(c) DBP's proposal includes a 'wash-up' mechanism that would otherwise be implemented under the tariff variation mechanism.

10. CONSEQUENTIAL AMENDMENT FOR CARBON COSTS - TARIFF VARIATION MECHANISM

10.1. It is noted that the ERA's FD Amendment Notice outlines an intention on the part of the ERA to include carbon costs as part of the forecast operating expenditure. Section 9 of this submission outlines why it is appropriate to change this aspect of the Final Decision.

10.2. DBP also submits that if the ERA makes this decision and seeks to make Amendment 17 and make changes to the pass through of tax changes tariff variation mechanism, a consequential change also needs to be made to the pass through of tax changes tariff variation mechanism.

10.3. It would be inappropriate for the ERA to include the costs for the carbon tax in DBP's forecast operating expenditure but then to allow itself to decide, through the pass through of tax changes tariff variation mechanism, not to pass through these costs because, at the time of assessing whether the costs to be passed through meet the criteria under Rule 91, the ERA decides that they are not prudent and efficient.

10.4. The mechanism should only operate to vary the tariff by the difference between the amount for carbon costs included in forecast operating expenditure and the actual carbon costs incurred by DBP. This is what DBP originally proposed.

11. EXTENSION & EXPANSION REQUIREMENTS

11.1. By a notice dated 1 December 2011 headed "*Proposed Amendment to Final Decision*" (**Notice**), the ERA proposed to amend its Final Decision dated 31 October 2011 on DBP's proposed revisions to the access arrangement on the DBNGP.

11.2. Materially, in the Notice the ERA sought to amend the extension and expansion requirements in the proposed revised access arrangement. The ERA's proposed amendment, and its basis for requiring the amendment, is set out at paragraphs 19 to 22 of the Notice.

11.3. Broadly, there are two deficiencies in the approach proposed by the ERA:

(a) First, it has sought to effectively make a determination which can only be made by the National Competition Council (NCC) and is, accordingly, beyond the jurisdiction of the ERA. Further, in seeking to impose "automatic coverage" in respect of any extension or expansion, the ERA's determination is contrary to the policy and the manifest intent of the NGL and NGR;

(b) Secondly, even if the ERA could make such a determination, the proposed determination is based on speculation and a number of erroneous assumptions as to the course which may be adopted by DBP in the event that it extends or expands the DBNGP during the access period. Moreover, the ERA has not justified its rejection of the extension and expansion requirements proposed by DBP by identifying how they are inconsistent with the factors that the ERA must take into account on deciding whether to accept the extension and expansion requirements proposed by DBP.

The jurisdiction of the NCC and compliance with the NGL and NGR

11.4. As to the first matter, unless the service provider agrees otherwise, it is within the jurisdiction of the NCC, and not the ERA, to determine whether pipelines, and extensions or expansions of those pipelines, should be subject to coverage. Both the NGR and the NGL (WA) set out procedures which allow for the determination of coverage issues. By giving effect to this Notice in the revisions to the DBNGP access arrangement, the ERA will have purported to deem *any* extensions or expansions which DBP may make during the access period to be covered.

11.5. In this instance the ERA will by implementing this notice have determined (and, it is noted, not by reference to any objective criteria), that any extension or expansion will be a covered pipeline unless DBP can demonstrate to the ERA's satisfaction that the increment should not be covered. The determination is unlawful, since the ERA does not have jurisdiction over coverage related matters. It is clear from the NGL and NGR that this is the domain of the NCC.

11.6. Further, there is no justification for the ERA to effectively reverse the onus onto DBP such that an extension is covered until determined otherwise. It is not to the point that DBP can seek to apply for revocation under relevant provisions of the NGL (WA). The revocation provisions are intended to apply where it has first been determined- lawfully- that the relevant pipeline is a covered pipeline (see sections 102 to 108 of the NGL (WA)).

11.7. The ERA's intention to determine that any extensions will be automatically covered is also contrary to the policy reflected in the NGL and NGR that expansions or extensions are not automatically considered to be part of the covered pipeline. This is apparent from:

(a) the definition of extension and expansion requirements in Section 2 of the NGL and the inclusion of Section18 of the NGL, which clearly contemplate that not all extensions or expansions will form part of a covered pipeline; and

(b) rule 104 of the NGR, which provides that extension and expansion requirements may state whether the access arrangement will apply to incremental services to be provided as part of an extension to, or expansion of the capacity of, the pipeline or may allow for later resolution of that question on a basis stated in the requirements.

11.8. The ERA's Notice which if implemented, effectively amounts to an automatic determination of coverage in respect of future extensions or expansions, is clearly inconsistent with the policy and intent of the NGL and NGR. By contrast, the proposal set out in DBP's proposed revisions to the access arrangement are consistent with the requirements of the NGL and NGR.

Erroneous assumptions

11.9. Even if the ERA can, as it has foreshadowed, make a determination of automatic coverage, there is no proper basis for doing so.

11.10. The requirement at paragraph 23 of the Notice appears to be premised on at least three erroneous assumptions, namely:

(a) DBP's commercial interests will inevitably favour the exclusion of an extension or expansion from the covered pipeline;

(b) DBP will not comply with National Gas Objective and the coverage criteria under section 15 of the NGL (WA) by electing not to include an expansion of the capacity of the DBNGP;

(c) the next significant expansion of the capacity of the DBNGP is likely to be achieved by the completion of looping of the pipeline between compressor stations and that there is likely to be a decrease in the average cost of gas transmission when the increment to capacity becomes fully utilised. If the expansion does not form a part of the covered pipeline, there is a risk that the benefits of the expansion (reduced average cost of gas transmission) will not be passed on to all pipeline users.

11.11. The assumption as to DBP's commercial interests is pure speculation. In this regard, DBP notes the following:

(a) it may be that commercial imperatives exist which make it beneficial for any extension or expansion to be covered. Such imperatives have existed in the past. Over the previous five years DBP has a demonstrated track record of expanding the pipeline to meet the customers' requirements, ahead of when each customer has actually needed the capacity for its downstream operations. DBP has invested over $1.7billion since 2005 in expanding the capacity of the DBNGP. To date, DBP has been incentivised to roll all expansions (stages 4-5B) and extensions (eg Kemerton Lateral) into the covered pipeline because it enhances the capital base which helps DBP meet its financing covenant of debt to Capital Base. DBP has no present apprehension that this wil change as it remains a financing covenant.

(b) the decision as to whether an expansion forms part of the covered pipeline or not will not determine whether DBP funds an expansion of the capacity of the pipeline:

(i) regardless of whether the average cost of transmission will increase or reduce, for DBP to fund a future expansion of the pipeline, it will not be economic for it to be funded based on the reference tariff proposed by the ERA or even at a reference tariff calculated using the rate of return proposed in the Final Decision. It will only be economic for DBP to fund an expansion at a higher tariff and higher rate of return then allowed by the ERA;

(ii) moreover, DBP would only contemplate funding an expansion of the pipeline on the following bases:

- All of the additional capacity will be fully contracted; and
- the contracts will be long term contracts for at least 15-20 years.

11.12. Insofar as the assumption that DBP will not comply with National Gas Objective and the coverage criteria under section 15 of the NGL (WA) by electing not to include an expansion of the capacity of the DBNGP is concerned, the ERA could have simply required DBP to include in cl. 7.4 of the proposed revised access arrangement (for example), a requirement that DBP must have regard to the National Gas Objective and section 15 of the NGL (WA). The ERA has not sought to do so. In any event, it is entirely unclear why the ERA contends that some (hypothetical) election by DBP not to include an expansion of the capacity of the DBNGP would likely be contrary to the National Gas Objective and the coverage criteria in section 15 of the NGL (WA). Certainly, the ERA has not referred to any evidence of such a likelihood and, in DBP's submission, none exists.

11.13. Finally, the ERA's assumption that the next significant expansion of the capacity of the DBNGP is likely to be achieved by the completion of looping of the pipeline between compressor stations and that there is likely to be a decrease in the average cost of gas transmission when the increment to capacity becomes fully utilised, is without foundation. In particular:

(a) The size of the next expansion and the configuration of that expansion will depend on a number of factors including (but not limited to):

(i) the amount of capacity sought by customers

(ii) whether these customers are full haul or part haul;

(iii) the price of system use gas (SUG). If DBP expands using compression, then it would be exposed to a significant increase in not only the amount of system use gas that we would require but also in the price for that SUG beyond 2015 and its carbon liability. It may, be that is preferable to expand by looping rather than by compression;

(iv) the unit costs of key inputs such as steel pipe, which are variable;

(v) the availability of key items of plant and equipment, which are variable; and

(vi) the safety regulator's view on increasing the allowable operating pressure of the pipe.

11.14. The average cost of transmission increases or decrease will likewise depend on the above factors.

11.15. Put simply, an expansion or extension will only occur if contracted demand necessitates it. It will not be built on a speculative basis. At present, it is impossible to conclude with any certainty when the next expansion will occur, the size of the expansion or how it will be configured. Similarly, it is impossible to say what an extension or expansion may do to the average cost of transmission.

12. CONFIDENTIALITY

12.1. This submission is provided to the ERA to assist it in its assessment of the Proposed Revised Access Arrangement.

12.2. Information contained in the submission is confidential and commercially sensitive.

12.3. It is provided to the ERA on the following conditions:

(a) it is to be used by the ERA solely for the purposes of assessing the proposed revisions to the DBNGP Access Arrangement;

(b) it is not to be disclosed to any person other than the following without DBP's prior written approval:

- those staff of the ERA who are involved in assisting the ERA in its assessment process; and
- those of the ERA's consultants who are involved in assisting the ERA in its assessment process and who have appropriate confidentiality undertakings in place.

13. ATTACHMENTS

Attachment 1: NERA DBNGP Final Decision – Response

Attachment 2: SFG Response to the DBP Final Decision

Attachment 3: AMP Capital Response to ERA Final Decision

Attachment 4: VAA Commentary on Market Risk Premium