

OFFICE OF ENERGY – WESTERN AUSTRALIA

SUBMISSION ON THE CMS ACCESS ARRANGEMENT: PARMELIA PIPELINE

The Office of Energy (OOE) submits the following comments in respect of the proposed Access Arrangement for the Parmelia Pipeline. The key arguments and assumptions of the access information are summarised below with comments made by the OOE presented in bold and italicised text.

It is noted that the purpose of the Access Arrangement Information is to permit interested parties to understand the derivation of the “elements” in the proposed Access Arrangement and to form an opinion as to the compliance of the Access Arrangement with provisions of the Code. In this regard, any person may request the Regulator to consider whether the Access Arrangement Information is sufficient in relation to any particular matter. It is from this perspective that the following comments are made.

Background

1. Characteristics of the Business and its Market

CMS asserts that the Parmelia pipeline operates under conditions of strong competition and therefore is not a natural monopoly. CMS argues that both the DBNGP and AlintaGas distribution system are direct and formidable competitors. CMS also asserts that the Parmelia is not part of a vertically integrated business since it does not produce gas or sell gas

Comments:
It could be considered that CMS does have some elements of a natural monopoly in relation to the limited ability of Perth basin gas producers to feasibly connect to an alternate pipeline such as the DBNGP, and are therefore a captive market of the Parmelia. Though CMS does not produce gas, it however owns the gas processing facilities and gas gathering system. This and the current more stringent gas quality specifications for the DBNGP limit the ability of current producers to readily connect to the DBNGP.

2. Capital Costs

CMS uses the Depreciated Optimised Replacement Cost (DORC) valuation to determine the Initial Capital Base and has argued on the basis of its future strategic intent and projected new contracts for the access period that the optimum size is the current size of 14 inch. Using both an industry rule of thumb and an engineering estimate, CMS estimates the Optimised Replacement Cost (ORC) for the pipeline to be in the range \$157 million to \$240 million. Including \$13 million of other capital assets and working capital, the total ORC value is estimated to fall in the range \$170 million to \$253 million, with CMS taking the typical (or mid) value to be \$210 million. CMS indicates that the Initial Capital Base used for determination of Reference Services tariffs is the depreciated value of this Optimised Replacement Cost.

CMS has used 60 years as the typical average asset life to cover all assets and indicates that asset life could be as short as 42 years (the term of the current pipeline licences), or could be as long as 80 years given continued high standards of operation and maintenance.

Future capital expenditure is anticipated on the basis that CMS is successful in accessing and securing new gas transport opportunities. This expenditure comprises capital costs associated with expanding the business and minor capital expenditure. Projected capital expenditure amounts to \$ 10.25 million over the five years of the access arrangement with 69% being spent in the first two years.

Comments:

In respect of the Replacement Cost estimate it is considered necessary for OffGAR to obtain more information as to what assets have been included in the estimate (such as compressor stations), clarify how the engineering determination of the Replacement Cost was undertaken, and obtain independent verification of the methodology and reasonableness of the engineering estimate.

OffGAR should also obtain and review the details of the other capital assets and the working capital and be satisfied with the reasonableness of the provisions for these assets. Projected capital expenditures should be reconciled with the Replacement Cost estimate to ensure there is no double counting (particularly in relation to the compressor stations).

OffGAR should also verify the projected capital expenditures in the context of the assumed expected and likely expansion of the CMS market and be satisfied with its reasonableness. It will need to ensure that the incremental investment is economic.

The Office of Energy considers that the asset life quoted in the Access Arrangement Information is merely the technical life and no substantiation had been made as to the economic life of the pipeline. This is particularly relevant in the context of the upstream, transport and downstream markets it faces, which are argued as the risk factors in the return desired. This is also significant in the light of the statement in the information document that “the total remaining volumes of gas and associated flow rates from currently producing Perth basin fields are insufficient to justify the construction of a new pipeline” and thus the availability of gas that could be transported from the Perth basin.

The economic asset life for establishing the Initial Capital Base of the existing pipeline is particularly important where the asset is relatively old. The longer the asset life assumed the higher the Initial Capital Base for the same level of depreciated life. For the particular tariff determination methodology (NPV) and the rate of return used, the resultant tariffs would be higher with longer asset lives.

The depreciation of the Replacement Cost for the purpose of establishing the Initial Capital Base should be verified by OffGAR. As indicated by CMS, a Monte Carlo Simulation was used in establishing the Initial Capital Base and Residual Value of the pipeline. While the ORC value has been shown, the resulting DORC value was not provided and would need to be verified. The parameters used for the simulation particularly in relation to the probability distribution used also need to be verified.

*Using a deterministic calculation and the typical values of ORC and asset life (60 years) assumed by CMS, it would appear that the DORC value would be in the order of \$112 million (32/60*210M). Section 8.10 of the Code lists a number of factors that should be considered in establishing the Initial Capital Base. The factors include the depreciated actual cost of the pipeline (section 8.10a) and the price paid for any asset recently purchased by the Service Provider and the circumstances of that purchase*

(section 8.10j). The assessment of the Initial Capital Base needs to be considered in the light of what is understood to be CMS' effective purchase price for the pipeline of less than \$93 million and any goodwill that may have been paid. This figure is likely to reflect the prognosis at that time of the pipeline's market and risk into the future and thus the value of the pipeline. It is recognised that this needs to be assessed on the basis of changed circumstances, if any. Neither the purchase price nor the actual historical cost of the pipeline has been presented in the Access Information.

3. Operating, maintenance, marketing and overhead costs

CMS' projected operating and maintenance costs over the five years of the access arrangement amount to \$16.97 million spread about evenly over those years. This does not include System Usage Gas (the sum of compressor fuel and unaccounted for gas), which is to be proportioned across all pipeline users and charged to them periodically as an item separate from the transport tariff. Marketing and overhead costs are projected to amount to \$ 2.145 million spread equally over the five years of the access arrangement.

Comments:

It is considered necessary for OffGAR to obtain more information to verify the projected operating, maintenance, marketing and overhead costs, and be satisfied of their reasonableness.

Though the system usage gas costs are not part of the tariff determination, users would be charged for these on top of the tariff. Potential users would need to know and understand the level of the costs they are likely to face, which are affected by the projected throughput. OffGAR may wish to assess whether these additional charges to Users for System Usage Gas over and above a commodity tariff are reasonable and whether these costs should be regulated and included in the tariff. The Regulator may also wish to comment on the transparency of the arrangement for the commodity tariff and charges for System Usage Gas.

4. Pipeline Capacity and Throughput Projections

Taking into consideration gas heating value and operational factors, CMS's estimate of current firm plus interruptible capacity of the pipeline is approximately 86 TJ/d with a swing of 5 TJ/d either side. The firm capacity is 64 TJ/d with a potential 4 TJ/d variation. This is on the basis of the availability of installed but currently mothballed compression.

Existing contracts are projected by CMS to increase from 29 TJ/d to 30.2 TJ/d over the period of the access arrangement. Extended Term Reference Service capacity (firm and interruptible) is projected to fill the pipeline and is assumed to be 57 TJ/d in 1999 decreasing to 55.8 TJ/d by 2003.

Comments:

Section 8.2(e) of the Code specifies that "any forecasts required in setting the Reference Tariff represent best estimates arrived at on a reasonable basis". Though the confidentiality aspects of the forecast future contracts are recognised, it is considered that the reasonableness of the forecast has not been demonstrated and the Regulator would need to obtain and clarify the details of these forecasts to understand their basis and assess their reasonableness. This is particularly significant in the light

of the statement in the proposal that “the total remaining volumes of gas and associated flow rates from currently producing Perth basin fields are insufficient to justify the construction of a new pipeline”. This assessment would also provide an insight into the market risk that Parmelia faces. It would appear that the risk may be low considering the significant market increase that CMS projects.

It is recognised that CMS’s projection of filling the pipeline from the beginning of the access period has a potential downward impact on the determined tariffs. However, there are other factors related to this assumption (eg. capital expenditure) that will have an upward impact on tariffs and would have to be ascertained.

OffGAR needs to independently verify the determination of the pipeline capacity in the light of any change to the assumed forecast, capital expenditure and contractual obligations under existing contracts.

5. Pipeline Access Philosophy

CMS indicates that the reserves of current producers in the Perth Basin, the Parmelia Pipeline's 'natural' catchment area, have been substantially depleted. Therefore, the company's future survival is critically dependent on the development of new gas transport business.

Comments:

The assessment of CMS’s development of new gas transport business is important from the perspective of establishing the market risk that the pipeline faces, the economic asset life, the future level and timing of capital expenditures, and future O&M costs.

6. Cost Allocation

CMS argues that the Parmelia Pipeline offers gas transport services on a non-discriminatory basis. Therefore, the basic cost allocation philosophy adopted for the Parmelia Pipeline is that costs are distributed reasonably over all gas transport services and all users. Expenditures and revenues related to the operation of facilities not covered by the Code have been excluded from costs assigned to the Parmelia Pipeline.

Comments:

The statement of CMS in relation to cost allocation does not demonstrate that costs have been allocated on a fair and reasonable basis. The philosophy of non-discrimination is paying the same tariff for the same type of service. On the basis that tariffs are cost reflective then it should reflect the cost imposed by the service that a user utilises. The cost imposition of the services provided by the Parmelia to all types of contract, particularly in respect of existing and reference services, should be ascertained by OffGAR to ensure fair and reasonable cost allocation consistent with the principles of section 8.38 of the Code.

One difference in the service that should be noted is the interruptibility and curtailment condition of the proposed access arrangement, which provides that existing contracts would be the last to be interrupted or curtailed.

It appears from the description of the tariff determination that the revenue obtained from existing contracts has been utilised in the NPV calculation to determine the

revenue (and thus the tariffs) to be recovered from the reference services, rather than using the existing contracted quantities and determining an average tariff. Given that the average transport charge to existing contracts is about \$0.64/GJ (calculated from throughput and revenue presented in the access information) compared to the calculated tariff for reference services of \$0.83/GJ, it would appear that reference services have borne a larger proportion of the costs in the NPV calculation. Though it is recognised that additional capital costs could be imposed by expanding its business, whether the calculated tariffs reflect costs imposed by the reference services would need to be ascertained.

If indeed the tariff determination was undertaken on the understanding above and on the basis of OffGAR's review of the cost allocation, OffGAR would have to ascertain whether discounts have effectively been given to existing contracts and consider whether these are prudent discounts for purposes of the Code and are to be passed on to other Users.

7. Tariff Determination Methodology

The NPV methodology was coupled with a Monte Carlo Simulation to determine tariffs.

The NPV tariff setting approach used yields a 'levelised' tariff. The impacts of significant non-routine expenditures, such as gas turbine overhauls, are spread over the duration of the Access Arrangement, thus eliminating price shocks. Further, the adoption of a longer time horizon for tariff setting ensures that future activities are anticipated and planned prudently.

Comments:

If the capital expenditure is not scrutinised closely, not only from the perspective of the level of expenditure but also in terms of required timing, it is possible that expenditures are projected to occur early in the period, with the result of increasing the tariff. This is particularly relevant to expenditure that has some degree of discretion and dependent on projected new contracts.

It is considered necessary for OffGAR to verify the NPV Financial Modelling and the application of the Monte Carlo Simulation to ensure that it has been applied correctly.

For instance it is not clear whether the NPV analysis was undertaken on a real or nominal basis. Consistency in the treatment of input variables from this perspective would have to be ascertained.

Inputs to Weighted Average Cost of Capital (WACC)

8. Cost of Debt

Financial analysts in Australia have recently estimated the debt premium above the risk free rate for gas transport projects to be in the range 0.75 percent (Macquarie Risk Advisory Services 1998: 28) to 1.50 percent (Texas Utilities Australia / Eastern Energy 1998: 9). CMS concludes that the 'typical' debt premium above the risk free rate is of the order of 1.2 percent.

Comments:

The typical value of the debt premium utilised by CMS of 1.2% is the same as that used in the determination of the Victorian gas access arrangements by the ACCC and ORG. However, the Office of Energy notes that CMS has not substantiated this figure from the perspective of the type of business it currently undertakes in Western Australia, and in the context of its argument relating to its proposed typical debt gearing and associated risk. OffGAR needs to undertake a review of the debt premium being proposed.

9. Capital Structure

CMS Energy Corporation's prevailing debt to equity ratio is 52:48. A substantial proportion of its assets comprise comparatively 'safe' distribution utilities. As gearing levels as accepted by lenders are generally inversely proportional to risk, it is appropriate to assume a gearing level for the Parmelia Pipeline which is lower than that for the entire corporation.

Therefore, a debt to equity ratio of 50:50 is used as a typical value for the determination of WACC.

A gearing ratio of 40:60 is used as a minimum reflecting AGL's reported gearing ratio (Macquarie Risk Advisory Services).

A gearing ratio of 60:40 is used as a maximum reflecting ACCC's determination for TPA and VENCORP.

Comments:

The standard debt to equity ratio for this industry is considered to be 60/40. This is reflected by the ACCC's determination for TPA and VENCORP. The Office of Energy notes that CMS's argument on the linkage between the debt premium it adopts and its assumed gearing ratio has not been substantiated and that this should be reviewed.

The Office of Energy considers that the existing financial structure should not impact on the WACC and that the standard debt to equity ratio for this industry of 60/40 should be adopted.

10. Dividend Imputation

CMS argues that its parent company is a foreign investor and it does not benefit from dividend imputation. Further to this, CMS argues the proposition that the effects of dividend imputation will be factored into the market risk premium in an efficient market (Kolhatkar, 1998:3) and this is the reason why the Australian market risk premium is lower than in the United States. Therefore, a gamma value of zero is appropriate for the determination of WACC.

Comments:

As provided for by section 8.31 of the Code, "in general, the weighted average of the return on funds should be calculated by reference to a financing structure that reflects standard industry structures for a going concern and best practice". It is from this perspective that OffGAR would have to decide whether or not dividend imputation is to be included.

In respect of its ownership argument, it should be noted that Western Power, which is an unlisted Government owned corporation is also unable to make use of imputation credits. Yet from the perspective of reflecting standard industry practice and competitive neutrality, dividend imputation is incorporated in the determination of its WACC.

It is not considered a competitive outcome if the charges approved for Service Providers differ because of their specific ownership. As noted above, the financing structure should reflect standard industry structure and in this particular case a structure that reflects Australian and Western Australian conditions.

In respect of the second argument (dividend imputation being already reflected in the market risk premium), this is a matter for OffGAR to assess, noting that its view on this matter may set a precedent. The Office of Energy believes that the inclusion of dividend imputation is the standard industry practice in Australia. This has been adopted for electricity access arrangements in Western Australia and has been the recommended approach for past gas distribution access arrangements in Western Australia. It is also consistent with the ACCC's recent determination for the Victorian gas transmission access arrangements. The Office of Energy considers that an appropriate value for the gamma factor is 0.5 based on dividend imputation that has been applied in the cases noted above.

Cost of Equity

11. Risk Free Rate

CMS proposes that a proxy risk free rate should be determined somewhere between a risk free rate of 8.0 percent (as *proposed* in the recent Victorian Access Arrangements) and the 10 year bond rate of 5.51 percent (quoted as at 3 May 1999). On this basis and with comparative stability in interest rates predicted in the medium term, a nominal risk free rate of 6.5 percent has been chosen as a typical value for the determination of the WACC.

Comments:

CMS has not effectively substantiated and established a principle for the risk free rate it proposes. As a typical value, it assumes a point somewhere between a proposed risk free rate (which was not accepted) and the 10 year bond rate quoted on 3 May 1999.

It is considered acceptable practice to use the point estimate of the ten year Commonwealth bond rate (in accordance with the Capital Asset Pricing Model) or to use an average over a shorter period eg. 20 business days as used recently by IPART and supported by OOE for Western Power's 1998/99 electricity access price redetermination. Recent spot rates have averaged around 5.9% for the month of May and the latest spot rate at 8 June 1999 is 6.16%. This indicates that the CMS risk free rate may be a little high.

12. Beta Value

CMS Gas Transmission Australia is not a public company, therefore a proxy value for the firm's asset beta must be established.

CMS concluded that the asset beta for AGL of 0.8 (Risk Measurement Service 1998) represented a low asset beta and that a value of 1.6 calculated from an average of five selected companies represented a high value asset beta. Acknowledging the uncertainty for calculating the asset beta, a conservative typical asset beta value of 1.2, halfway between the high and low values, is used.

CMS also argues that the Parmelia Pipeline holds a small (less than 10 percent) share of the Western Australian gas transport market sector in which it competes and that the Parmelia Pipeline does not currently hold transport contracts which may be expected to endure in the long (e.g. 20 year) term. This is because all currently producing gas fields in the Perth Basin are in decline. These factors further compound the increase in business risk and hence beta.

Comments:

The Office of Energy considers that the typical asset beta of 1.2 assumed by CMS is too high. This value would mean a typical equity beta of 1.97%, implying a substantial commercial risk for the pipeline. As a comparison, this value is significantly higher than that used in the determination of the Victorian gas transmission and distribution access arrangements and in past Western Australian gas transmission and distribution access arrangements. OffGAR needs to review and assess this in greater detail and the factors being argued as impacting on its risk. The significant risk being implied by the assumed asset beta does not appear to be consistent with the following:

- ***the growth being experienced in and increased market opportunities resulting from full deregulation of the gas market in Western Australia;***
- ***the likelihood of an interconnection with the AlintaGas distribution system and thus access to a greater market for gas transported through the Parmelia without the need for additional capital investment;***
- ***the current transport of gas through the Parmelia from the DBNGP (and thus Carnarvon basin gas) despite the difference in gas quality specifications between the two pipelines, which alleviates what CMS asserts as a limited and risky upstream market that it faces;***
- ***the longer term resolution of interconnection issues with the DBNGP particularly related to gas quality; and***
- ***CMS' projection of the expected full utilisation of the pipeline over the access period.***

All of the above point to a lower level of associated risk. This should be taken into consideration by OffGAR.

The assumed asset beta and the resultant equity beta have the greatest impact on the calculated WACC given its significant deviation from what has been used in other recent determinations. The Office of Energy considers that the beta value should be brought down to a level that is more consistent with values that have been utilised for other regulatory determinations in Western Australia and Australia.

13. Market Risk Premium

CMS points out that rates of return to Australian shares and bond yields [Officer (1989)], over the 105 year period 1882 to 1987, shows that the equity premium over bond yields was 7.94 percent. For the 10 year period 1978 to 1987, the premium was 11.87 percent. Given that a pipeline project has a life of 50 years or more, CMS concludes that a value of $(R_m - R_f)$ of around 8 percent could be used.

CMS notes that the ORG and the ACCC mandated a market risk premium of 6.0 in their recent Victorian decisions. It also points out a value of 6.5 percent currently has wide acceptance in the Australian finance industry for the market risk premium (Commonwealth Bank of Australia 1998: 2; Davis 1998: 14; Macquarie Risk Advisory Services 1998: 17; Texas Utilities Australia / Eastern Energy 1998: 9). On the basis of the above CMS concludes that a typical value would be 6.5, with a low of 6.0 and a high of 8.0.

Comments:

The assumed typical market risk premium appear to be consistent with accepted industry values, though higher than the regulatory decisions for the Victorian gas transmission and distribution access arrangements. OffGAR needs to be satisfied that there is indeed wide acceptance of 6.5% as argued by CMS.

14. Inflation rate

The Consumer Price Index has exhibited increases of between 0 percent and 4 percent per year in recent times. For the purposes of tariff determination, a CPI rate of increase of 2.5 percent is used.

Comments:

The inflation rate assumed of 2.5% differs from the recent Commonwealth Treasury forecast contained in the budget of 2.25%. The maximum inflation assumption of 4% for the access period appears to be high. Nonetheless, there is a need for OffGAR to consider the potential impact of GST either as part of the determination or as an adjustment to inflation and the tariffs at the appropriate time.

15. Calculation of the WACC

CMS uses a Monte Carlo Simulation and the following table of inputs. This results in the real before tax Weighted Average Cost of Capital for the Parmelia Pipeline to be 16.0 percent.

WACC Calculation Input Variable	Minimum	Typical	Maximum
debt premium above risk free rate (%)	0.75	1.2	1.5
debt to equity ratio	40 : 60	50 : 50	60 : 40
dividend imputation factor gamma (%)	0	0	60
risk free rate (%)	5.5	6.5	8.0
asset beta value	0.8	1.2	1.6
market risk premium (%)	6.0	6.5	8.0
inflation rate (%)	0	2.5	4.0

Comments:

Using the typical input values quoted and using a deterministic model for the WACC formula gives an outcome for the real pre tax WACC of 16.02%. This compares with the CMS real pre tax WACC result of 16%. The CMS outcome should be confirmed by reviewing the detailed structure and inputs of the CMS Monte Carlo simulation, i.e. the range of input values and their associated probabilistic distributions, and the integrity of the model. The Office of Energy considers it is questionable whether there is any benefit from the use of the Monte Carlo simulation, particularly from the perspective of understanding the derivation of the WACC. OffGAR needs to undertake a full review.

The Office of Energy considers that a real pre tax WACC of 16% is too high and should be significantly reduced.

16. Tariff Calculation

A Monte Carlo Simulation was utilised in calculating the tariff.

The Interruptible Extended service is allocated a tariff which is 90 percent of that for the Firm Extended service.

For both Firm Extended and Interruptible Extended Reference Services, the ratio of Reservation Tariff to Commodity Tariff is 80 : 20.

The transport tariffs for Firm Spot and Interruptible Spot Reference Services are to be established by users engaging in a competitive bidding process (on a daily basis) for access to those services.

The Reference Tariff determination for the Parmelia Pipeline considers earnings before interest and tax.

For the purposes of determining tariffs for Reference Services, it has been conservatively assumed that all unused pipeline capacity is assigned to Reference Services, and that revenues are derived from all of this capacity for the entire life of the Access Arrangement.

A load factor of 0.90 (where load factor is defined as average throughput divided by maximum throughput) has been assumed for the purposes of Reference Services tariff determination.

Spot services have been assumed to operate to take advantage of reserved but unused capacity.

Tariffs are calculated on the basis of a 'full' pipeline, notwithstanding the fact that the Parmelia Pipeline is currently operating significantly under capacity.

For the purposes at hand, existing contracts throughputs and consequent revenues are assigned deterministic values.

In respect of future capital expenditures and operating expenditures for the Parmelia Pipeline during the Access Arrangement period, typical values were presented and to facilitate probabilistic tariff determination, low and high range values of plus and minus 25 percent respectively are assigned to these expenditures.

Given the ranges of the ORC and the asset life estimates, the DORC and the Residual Value are also probabilistic estimates.

The range for WACC consists of a typical value of 16.0 percent (the mean of the Monte Carlo simulation), and minimum and maximum range values of 13.5 percent and 18.6 percent respectively.

The assumptions for inflation are 2.5 percent typical, 0 percent minimum, 4 percent maximum.

Each uncertain input variable to the Reference Services tariff calculation is assigned a triangular probability distribution defined by the low, typical, and high values.

On the basis of the simulation, the Firm Extended Reference Service Tariff for the Parmelia Pipeline has a (probabilistically calculated) mean value of A\$ 0.83 per gigajoule.

On the basis of the 80 : 20 split described above, this translates to a Reservation Tariff for the Firm Extended Reference Service of A\$ 0.664 per gigajoule, and a Commodity Tariff for the Firm Extended Reference Service of A\$ 0.166 per gigajoule.

On the basis of the relativity between Firm and Interruptible tariffs described above, the Reservation Tariff for the Interruptible Extended Reference Service is A\$ 0.5976 per gigajoule, and a Commodity Tariff for the Interruptible Extended Reference Service is A\$ 0.1494 per gigajoule.

Reference Services Calculation Input Variable	Minimum	Typical	Maximum
pipeline capacity firm+interruptible (TJ/d)	80	86	91
pipeline capacity firm (TJ/d)	60	64	68
Spot services capacity if available (TJ/d)	0	5	15
Spot tariff (competitively bid) (A\$/GJ)	0.15	0.25	0.50
capital expenditure: percent of projected	75	100	125
operating costs: percent of projected	75	100	125
pipeline Optimised Replacement Cost (A\$M)	170	210	253
pipeline life (years)	42	60	80
Weighted Average Cost of Capital (%)	13.5	16.0	18.6
inflation rate (%)	0	2.5	4

Comments:

OffGAR needs to review and ascertain the integrity of the Monte Carlo simulation modeling and clarify and assess the reasonableness of the assumptions as listed above and further commented on below as appropriate.

In the light of the probabilistic calculation of WACC, the basis for the assumed minimum and maximum WACC is not made clear in the information document.

The basis of the assumed spot capacity tariffs has not been specified and how spot capacity is treated in the simulation, i.e. the interplay between available capacity, existing contracts, extended reference services and spot reference services needs to be reviewed and understood.

As commented on previously, it should be ascertained whether discounts have effectively been given to existing contracts in the modelling and whether these are prudent discounts for purposes of the Code and are to be passed on to other Users.

17. Incentive Structure

CMS argues that the approach taken in the determination of tariffs for Reference Services is based on a "price path" philosophy (Code section 8.3(a)), whereby tariffs are set in advance for the entire Access Arrangement period on the basis of anticipated revenues and costs. These revenues and costs constitute a benchmark of performance for the Parmelia Pipeline. If CMS is able to reduce costs, through improvements in operating efficiency, it stands to generate returns above those predicted at the time of determination of tariffs. Conversely, if CMS incurs costs which are greater than those predicted, returns will be lower. Thus, incentives are inherent in the "price path" approach, particularly given the assumptions made regarding revenues generated from currently unused pipeline capacity.

Comments:

Only a very detailed review and assessment of the parameters used in the tariff determination would reveal whether there is indeed a reasonable level of incentive for performance improvement in the assumed tariff path.

18. Review

A review of this Access Arrangement by CMS may be conducted at any time. CMS may conduct a review of this Access Arrangement if the goods and services tax (GST), when it is introduced, or its application or effect is different from what was understood at the Effective Date. Section 21.6 of the General Terms and Conditions allows CMS to pass on as part of its charges the amount of any GST levied upon CMS.

Comments:

Given the significance and complexities of the GST, it may be more appropriate for a review and adjustment of charges to be undertaken only with the prior agreement of the Regulator. The GST should serve as an Access Arrangement review trigger event as provided for under the Code.

19. Appendix 1 - Definitions

Grandfathered Contracts means all contracts entered into before the latest date for complying with the ring-fencing provisions of the Code.

Comments:

According to the Code this date is six months after the pipeline becomes effectively covered by the Code i.e. 9 August 1999 (the Code was implemented on 9 February 1999). It should be noted that under the Code, the Regulator must grandfather contracts only if these are signed before the date of submittal of the proposed Access Arrangement, in this case 8 May 1999.

20. General Terms and Conditions

Section 3.6 of the General Terms and Conditions allows CMS to consider if a dispute resolution matter is a bona fide dispute.

Section 25, Technical and Commercial Dispute Resolution Procedures and sections 26, 27 provide for dispute resolution procedures and the appointment of an arbitrator or an expert as defined therein.

Comments:

The Code provides for matters of dispute resolution and it is ultimately the prerogative of the independent Arbitrator to decide on these matters.

In relation to certain disputes the provisions of section 25 will be conflicting with the Code dispute resolution mechanism. This could be especially important in relation to existing users seeking additional services. Although it may be true that the Code would not cover disputes in relation to aspects of already signed contracts, it may be appropriate for the independent Arbitrator, established in Western Australia for the purposes of the Code, to hear all access disputes in relation to covered gas pipelines and distribution systems. This will provide for consistency in dispute resolution and enable information to flow back to the Regulator. Application of the Code Arbitrator to all disputes in relation to this pipeline could be achieved by reference in the CMS Access Arrangement.

If CMS considers it undesirable to have the Code Arbitrator hearing all disputes then it may be appropriate in section 25 to include an explicit reference to the Code Arbitration mechanism and the disputes that are necessary to be lodged with the Code Arbitrator. It may also make reference to the appropriate procedures for lodging such disputes.

Section 4.4 of the General Terms and Conditions requires a contract to have a duration of not less than ten years.

Comments:

Given the current Access Arrangement is to last for five years it may be appropriate to allow contracts to have a five year duration unless both parties agree otherwise.

As provided for by section 4.11 of the terms and conditions of the access arrangement, a Reference Service may have only one Receipt Point and one Delivery Point

Comments:

In the context of a connection with the AlintaGas distribution system in the future, there may be a need for multiple outlet contracts to provide the flexibility of nominating at various connection points to the distribution system.

Section 19.6 requires Users to take out insurance of not less than \$5 million.

Comments:

OffGAR may wish to consider whether an insurance amount of \$5 million is a reasonable insurance amount which does not act as a barrier to entry and prevent some smaller customers from gaining access.