



TREASURY DEPARTMENT

SUBMISSION TO

**THE WESTERN AUSTRALIAN
INDEPENDENT GAS PIPELINES ACCESS REGULATOR**

ON

**ACCESS ARRANGEMENT AND
ACCESS ARRANGEMENT INFORMATION
FOR THE PARMELIA PIPELINE**

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INTRODUCTION

This submission relates to the document submitted by CMS Energy (CMS) to the Independent Gas Pipelines Access Regulator, headed "Parmelia Pipeline - Access Arrangement and Access Arrangement Information - submitted to the Independent Gas Access Regulator Western Australian - 7 May 1999".

This submission comments only on aspects of the proposal which could prevent access or cause it to be provided under onerous terms. Particular attention is paid to the:

- calculation of an appropriate rate of return;
- determination of Capital Base; and
- potential obstacles to seeking access.

CALCULATING THE RATE OF RETURN

The weighted average cost of capital (WACC) is an important determinant of reference tariffs for access arrangements and warrants detailed examination. CMS' access arrangement information proposes a real pre-tax WACC of 16 per cent.

Comparing other access arrangements

By contrast to CMS' proposed WACC of 16 per cent, the Office of the Regulator General (ORG) in Victoria has determined that an appropriate real pre-tax WACC is 7.75 per cent for some Victorian gas pipelines. In New South Wales there is currently debate about where it should be in the range 7.25 to 7.75 per cent.

The generally accepted estimate of the pre-tax WACC is therefore around half that estimated by CMS.

The CMS proposal does not explain why its WACC is so much higher than that in Victoria, but comments that there is no single correct way of calculating WACC, and that the different circumstances of Victoria make comparison meaningless. Given the substantial difference, clear identification of why the WACC for this pipeline is higher than that generally considered reasonable would appear necessary.

In order to ascertain the basis for the proposed WACC of 16 per cent, Treasury approximated the WACC using the typical parameter values shown in the CMS report (page 47). The parameter probability distributions used by CMS would indicate that such an approximation was valid. Using CMS' proposed parameter

values, Treasury estimated a WACC of 16 per cent, which concurs with the CMS estimate.

However, there are a number of aspects of the parameter values used in CMS's calculation of WACC that the Regulator should consider, namely the:

- risk and associated beta estimates;
- imputation parameter;
- debt equity ratio;

These matters are considered in turn.

Risk and associated beta estimates

CMS arrives at an asset beta of 1.6 by working out the weighted average beta estimates of selected companies, as reported in the Centre for Research in Finance's Risk Measurement Service (December 1998). Treasury has identified two shortcomings in the use of this beta:

- The betas quoted from the Risk Measurement Service (December 1998) are equity betas and are therefore not directly comparable with asset betas. CMS' use of this average as an asset beta results in a higher WACC than would otherwise be derived.
 - If an equity beta of 1.6 is used, as is comparable with those quoted by CMS which were derived from the Risk Measurement Service then the WACC would be reduced by 1.8 percentage points to 14.2 per cent.
- The companies that CMS uses as a yardstick to calculate its beta value are all exploration or gas extracting companies whose risk exposure would be considerably greater than that of the Parmelia Pipeline for two reasons:
 - Where a number of companies are extracting gas from a gas field, the risk of supply to a company such as CMS which relies on the gas field as a whole will always be lower than the risk faced by any one of the companies in its exploration of gas reserves.
 - The Parmelia Pipeline transports gas from other sources including the Dampier Bunbury Natural Gas Pipeline which is interconnected near the beginning of the Parmelia Pipeline. Therefore even if the Dongara field did not in future provide sufficient gas for the Parmelia Pipeline, gas could be transmitted from other sources.

If an equity beta of 1.2 is used, as used by the Australian Competition and Consumer Commission (ACCC) in its Final Decision in the Access Agreement Arrangement for Transmission Pipelines Australia Pty Ltd, then the WACC would be reduced by about 3.8 percentage points to about 12.2 per cent.

It is recommended that the Regulator should consider developing appropriate comparisons with industries which have similar risk exposure to the Parmelia Pipeline.

Imputation parameter

It would appear that the taxation imputation parameter has been set at zero, notwithstanding the high value of 0.6 being reported in the table on page 51 of the CMS proposal which outlines the assumptions used in the Monte Carlo simulation.

The submission also argues that the value of this parameter should be set at zero because of the foreign ownership of the pipeline. Treasury questions this position, as the appropriate treatment for accounting for taxation in such instances involves many other significant tax related matters not addressed in the argumentation. These could include the impact of foreign tax credit arrangements and the taxation and investment position of the overseas owner in the owner's home country.

Furthermore, allowing variations in methodology applied in determining a reference tariff to recognise owner-specific matters of this type would bring about the possibility of arbitrage through sale to an Australian owner. These matters have been raised by the ACCC in other similar situations, where it takes the view that modelling should be consistent with an (average) Australian owner assumption and that the imputation parameter should therefore be set towards the high end. In its Final Decision in the access agreement arrangement for Transmission Pipelines Australia Pty Ltd the ACCC set the imputation parameter at 0.5.

If the imputation parameter was set at 0.5 this would reduce the WACC estimate by 2.4 percentage points compared with that based upon a zero value for the parameter.

Debt equity ratio

The WACC formulation is sensitive to the debt equity ratio assumptions used. Treasury notes that the CMS model assumes an expected debt equity ratio of 50 per cent. This is lower than the 60 per cent debt equity ratio normally used in deriving WACC in other gas access regimes. The lower debt equity ratio increases the WACC estimate. It is suggested that a debt equity ratio of at least 60 per cent be assumed in line with other studies. This change would reduce the WACC by more than 0.5 percentage points.

DETERMINATION OF THE CAPITAL BASE

While it is not unusual for owner submissions in respect of access arrangements to focus heavily on presenting the depreciated optimised replacement cost (DORC) valuation of the capital in question, this is significantly higher than the depreciated current cost (DCC) valuation in the case in question. As a result the potential for significant under-utilisation of the infrastructure from an economic perspective arises unless the reference tariff is based upon a lesser valuation than the DORC.

It is recognised that one of the considerations in respect of how the reference tariff is struck is the avoidance of any sudden spikes in reference tariffs as new capacity comes on stream. In this instance, however there does appear to be a significant amount of unused capacity in the current infrastructure.

ACCESS ARRANGEMENT CLAUSES OF CONCERN

This section deals with those clauses of the proposed Access Arrangement that pose potential obstacles or may be unduly onerous for access seekers. The access provisions in Part 6 of the proposed arrangement should offer a practical mechanism for negotiating access, one that will be easily understood and used by access seekers.

Clause 6.8 allows CMS to require a Prospective User to provide Additional Information at its discretion. CMS' ability to do so should be limited, in order to overcome the possibility that CMS might unduly delay or even defeat an application by making unreasonable demands for additional information. The Regulator should consider whether CMS should only be able to require information:

- that relates directly to a matter listed in 6.1, 6.2 or 6.4;
- where it is reasonable to do so; and
- if CMS clearly describes what further information is required.

Clause 6.13 allows CMS to reject outright an Access Request it considers anti-competitive. It is not clear what criteria CMS might apply to reach this view. The Regulator may like to review whether this power should be clarified or removed.

Clause 6.15 provides among other things that where CMS accepts an Access Request Offer but conditions precedent have not been satisfied within one month, the Access Request lapses. This is inappropriate because conditions precedent under 7.3 could include matters that in the ordinary course of events would take longer than one month. An Access Request should be deemed to lapse only where there is clear evidence that the access seeker's proposal or behaviour is commercially untenable.

Clause 6.16 provides for an application fee of \$10,000, refundable at CMS' discretion. The Regulator should ascertain whether such a discretionary fee is standard within the industry, and if not, require deletion of the provision or clarification of the circumstances when the fee is not refundable.

Clauses 6 & 7: Entering Into A Service Agreement

The proposed arrangement should provide certainty to a Prospective User as to how and when an enforceable contract for pipeline access comes into being. The proposed arrangement contains a number of interacting provisions determining how a contract is made, including at clauses 6.6, 6.10, 6.12, 7.3 and 7.4. Clause 2 of the General Terms and Conditions also purports to have binding effect.

The provisions appear a somewhat convoluted mechanism for entering into an agreement to provide access. This is at least partially inevitable, given the requirement that an access regime offer certainty of outcome rather than a framework for negotiation.

It is appropriate that the proposed arrangement envisages how a contract might emerge in a range of circumstances. Nevertheless, it would be preferable to streamline and simplify the provisions as far as practical.

The Regulator should also be satisfied that the provisions are internally consistent and cover all contingencies.

The Regulator should carefully analyse the circumstances where CMS is able to use an "escape clause" to avoid entering into a contract. There will on occasion be legitimate reasons for CMS not wanting to enter into a contract, eg access seeker's failure to prove creditworthiness, negotiate in good faith or provide timely information. However, CMS's power to invoke an escape clause should be strictly limited to clearly defined and commercially realistic circumstances.

Clause 11 Extensions / Expansions Policy

Clause 11.2(a) provides that CMS will undertake investigations into building Enhanced Facilities to provide Developable Capacity.

However, the proposed arrangement does not contain any undertaking to actually provide Enhanced Facilities. The Regulator may consider requiring CMS to undertake such works if listed criteria are met, including criteria upon which CMS will make a decision of this nature.

A second issue raised by clause 11 is that CMS will only undertake such investigations where a Prospective User makes an "agreed contribution" to the cost of any Enhanced Facilities. This appears to leave it open to CMS to fail to

agree on a contribution and thereby avoid having to make any investigations. It is also unclear how the agreed contribution will be collected by CMS, which could lead to difficulties if, for instance, considerable preliminary work were done on a proposed extension/expansion that did not proceed for whatever reason.

There is a risk that access seekers would regard the clause as creating uncertainty and giving CMS an inequitable degree of leverage. The provision should be reconsidered, in this light, by the Regulator.

General Terms and Conditions

The Regulator should ensure that the General Terms and Conditions are reasonably equitable to a Prospective User and broadly in line with industry standards.

Treasury Department
Western Australia

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