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29 May 2009

Mr Lyndon Rowe
Chairman
Economic Regulation Authority
6th Floor
197 St. George's Terrace
PERTH WA 6000

Dear Mr Rowe

Goldfields Gas Pipeline - Response to Issues Paper dated 22 April 2009

I refer to the "Issues Paper on The Proposed Revisions to the Access Arrangement" published by the Authority 22 April 2009 (Issues Paper).

Please find attached GGT's public submission in response to certain paragraphs in the Issues Paper and GGT confirms that the submission may be placed on the Authority's website.

Yours faithfully

David King
General Manager

GOLDFIELDS GAS PIPELINE

Response to
"Issues Paper on the Proposed Revisions to the Access Arrangement" dated 22 April 2009

PUBLIC SUBMISSION

29 May 2009

Contents

1 Introduction

1.1 Preamble

This Submission is lodged by Goldfields Gas Transmission Pty Ltd ("GGT") in response to the "Issues Paper on the Proposed Revisions to the Access Arrangement" dated 22 April 2009 ("Issues Paper") published by the Economic Regulation Authority ("Authority") relating to the proposed revisions to the Access Arrangement ("Revised Access Arrangement") and Access Arrangement Information ("AAI") for the Goldfields Gas Pipeline ("GGP") lodged on 23 March 2009.

2 Comments

2.1 Paragraphs 40 and 45 – using covered assets to provide uncovered services

The Covered Pipeline, as defined in the National Third Party Access Code for Natural Gas Pipeline Systems ("Code"), is not used to provide services enabled by the construction of the (uncovered) second compressor set at Paraburdoo compressor station or Wyloo West compressor station.

Paragraph 40 of the Issues Paper states:

> "*Unless costs are correctly allocated to covered and uncovered capacity, this could lead to the situation where users of pipeline services under the access arrangement pay more for these services than should be the case based on a proper allocation of costs between covered and uncovered capacity*."

Paragraph 45 goes on to provide (in part):

> "*This election to exclude capacity has the effect of using covered assets to contribute to uncovered capacity*."

The Authority has sought submissions on the 'proposed treatment of covered and uncovered service in respect of the allocation of costs'.

The text in the Issues Paper appears to suggest that the Authority is investigating the possibility of allocating some of the costs of the Covered Pipeline to the services provided using the capacity provided by the uncovered expansions.

GGT submits that the Authority is not empowered to allocate any costs from the Total Revenue for the Covered Pipeline to services provided by means of the uncovered expanded capacity for the following reasons:

(a) as acknowledged in paragraph 33 of the Issues Paper, the Covered Pipeline does not include any expanded capacity unless this has been incorporated in the Covered Pipeline by operation of the extensions/expansions policy;

(b) having regard to the definition of 'Covered Pipeline' (which expressly includes a 'part of a Pipeline') and the provisions of sections 1.40 and 3.16 of the Code, the expanded capacity of 42 TJ/day is to be treated as separate from the Covered Pipeline for the purposes of the Code;

(c) it is only in relation to the Covered Pipeline that services must be offered in an access arrangement;

(d) under section 8.4 of the Code, the Total Revenue used for deriving tariffs must equal the costs of providing Services by means of the Covered Pipeline; and

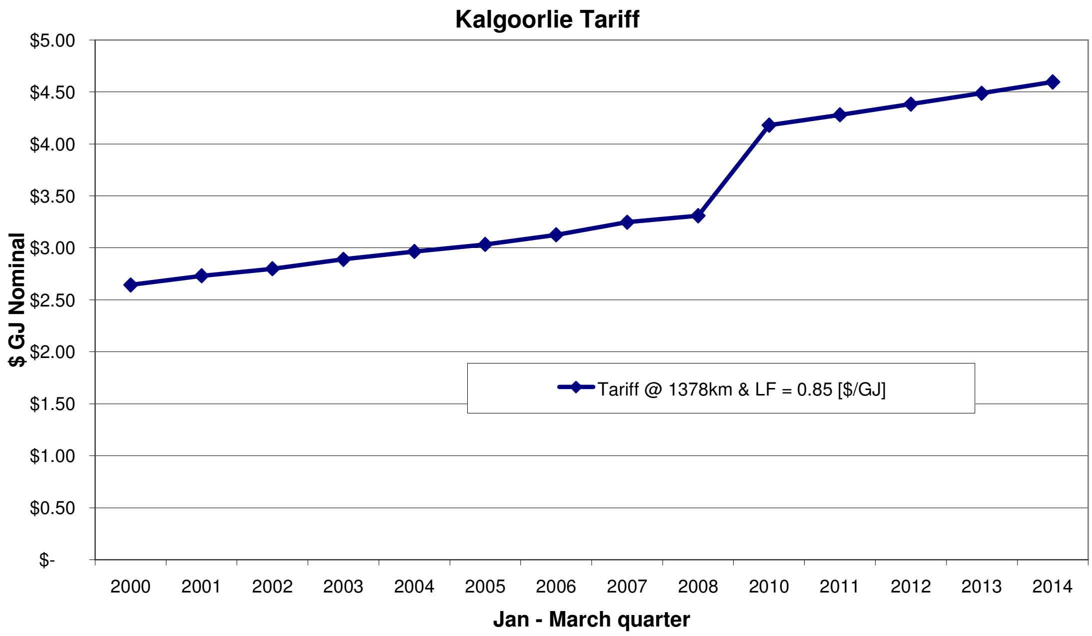
(e) there is no allowance in the Code for allocating any of the costs associated with Services provided by means of the Covered Pipeline to services provided by means of the non-covered capacity.

GGT considers that it is beyond the Authority's power to attempt to allocate any proportion of the costs associated with providing Covered services to the provision of non-covered services.

2.2 Paragraph 52 – chart demonstrating tariff progression

The chart associated with paragraph 52 of the Issues Paper identifies the tariff path from the current to forecast Access Arrangement. However, the graph omits the forecast 2009 tariff, implying an increase in average tariff greater than proposed by GGT.

The graph in the Issues Paper is shown below:

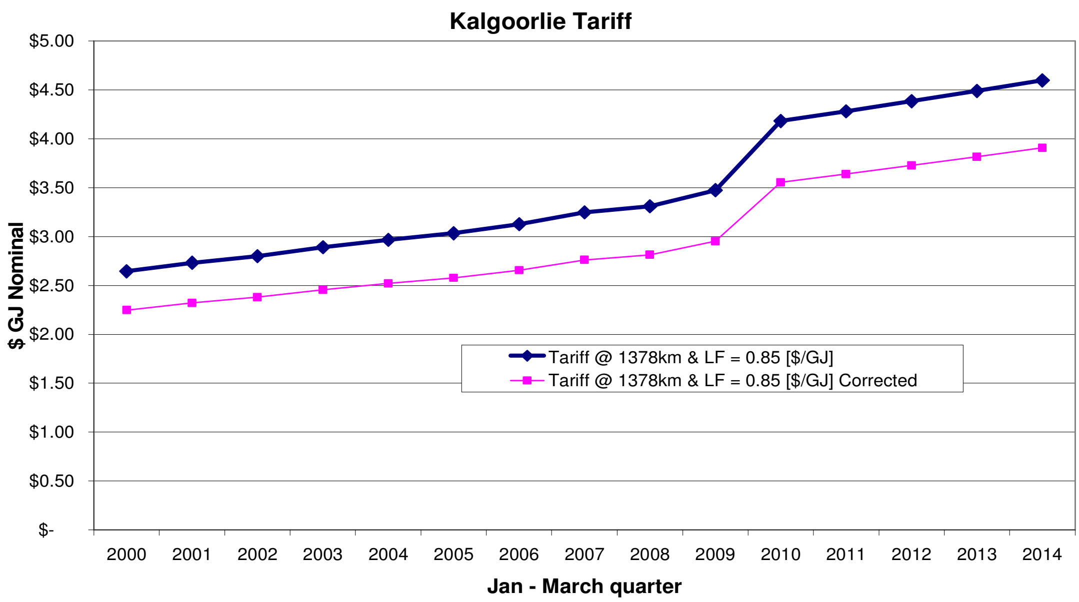


The load factor is a function of how much actual load is transported for a user compared with the reservation (or MDQ) by that user. The calculation of load factor is Throughput / MDQ. A load factor of 1 indicates that the throughput is the same as the MDQ (i.e., that the shipper takes its maximum quantity every day). A load factor of 0.85 means that the average throughput is 85% of the MDQ.

GGT understands that the Authority has calculated the above tariff based on a shipper being delivered 1 GJ, which means that at a load factor of 0.85 this shipper would need to reserve capacity of 1.18 GJ.

However, when looking at an average tariff for a shipper with a load factor of 0.85, it is convention that it should be calculated based on the shipper having to reserve capacity for 1 GJ. Therefore, throughput is calculated to be 0.85 GJ based on the load factor.

A corrected graph is presented below.



2.3 Paragraphs 54 and 55 - Weighted Average Cost of Capital (WACC)

Introduction

The Issues Paper briefly outlines GGT's position on WACC. This position is essentially accurately reflected.

Since the submission of the GGT's Supporting Information to Revised Access Arrangement dated 21 April 2009 ("Supporting Submission") and the release of the Authority's Issues Paper the Australian Energy Regulator ("AER") has released its Final Decision, which sets the values and methodologies to be used for WACC parameters for the revenue decisions for regulated east coast electricity assets. This review was discussed in some detail in the Supporting Submission.

The outcomes of this AER WACC review do not directly impact on the establishment of the WACC for the GGP, or any other gas asset. This is recognised by the AER which has stated[1]

> *The outcome of the AER's WACC review applies only to electricity determinations, and has no direct or formal applicability to gas access arrangements. The determination of the WACC for access arrangements is subject to requirements under the National Gas Law ("NGL") and National Gas Rules ("NGR"), which are not being considered in this review.* [Note the current GGP review is conducted under the Code not the NGL and NGR.]

[1] AER, 2009, Final decision: Electricity transmission and distribution network service providers Review of the weighted average cost of capital (WACC) parameters: May 2009 p6

As previously stated in the Supporting Submission, GGT believes that in the case of the GGP, the similarity of many of the issues is not great.

In particular when assessing WACC parameters, which relate to individual assets and the risks associated with these assets, such as equity beta and credit rating, the parameter values should be considered on their own merits, or by comparison to other relevant comparators, such as infrastructure serving mining markets, rather than by comparison to east coast electricity networks. As such GGT does not believe it is reasonable to consider the AER electricity WACC review findings in relation to these variables.

However, in the case of WACC parameters which relate to market wide factors and variables, such as the Market Risk Premium ("MRP"), GGT believes it is reasonable to consider the AER electricity WACC review while not being bound to its outcomes.

The financial crisis

As previously outlined in the Supporting Submission global capital markets have experienced some of the most challenging conditions in history, with significant increases in credit risk pricing and reductions in liquidity. These conditions are having a significant impact on the price of capital and access to capital markets.

As debt and equity providers are becoming more risk averse higher returns are being required for any risk. Any future investments will require higher returns to both debt and equity for them to be considered.

GGT believes that since the preparation of the Revised Access Arrangement in late March there has been no discernible change in conditions that would indicate either an improvement or worsening in financial markets' positions.

In considering issues relating to the financial crisis GGT believes the Authority should be aware that the AER WACC review outcomes apply to assets that will be having regulatory reviews in 2013-2014 and hence the outcomes of the current AER review will continue to be relevant until 2019. For this reason the AER may have sought to discount some issues relating to financial crisis given the extended time frame over which their decision applies. However the Authority's review of the GGP is effectively in place from 2010 to 2014. As such GGT believes the financial crisis should figure more prominently in the Authority's decision than it appears to have figured in the AER decision.

The Code requires that the cost of capital provide a return commensurate with prevailing conditions in the market for funds, and the financial crisis is currently the most important prevailing condition in the market for funds.

Comments on cost of capital parameters

Nominal risk free rate of return – GGT notes that the risk free rate methodology to be used by the AER following its review is essentially the methodology previously used by the Authority and proposed for use by the GGT at this Access Arrangement review.

Debt to equity ratio - GGT notes that 60% debt funding parameter to be used by the AER is the value previously used by the Authority and proposed for use by the GGT at this Access Arrangement review.

Credit rating - The AER is to use a credit rating of BBB+ for electricity assets serving broadly based, stable markets with a necessary commodity.

GGT use a credit rating for the GGP of BBB- for a gas pipeline serving mining markets in remote locations which often have access to alternative fuels. The credit rating used by GGT is based on an independent report. GGT has no reason to alter this credit rating following the AER review.

Equity Beta – The AER is to use an equity beta of 0.8 for electricity assets serving broadly based, stable markets with a necessary commodity.

GGT use an equity beta of 1.0 -1.8 for a gas pipeline serving mining markets in remote locations which often have access to alternative fuels. The equity beta used by GGT is based on an independent report. GGT has no reason to alter this equity beta following the AER review.

Market risk premium – The AER is to use an MRP of 6.5%, this has increased from the previously accepted regulatory value of 6%. The fact that the AER increased the value of the MRP variable, which is a market wide variable, indicates that the MRP variable should be increased when assessing the MRP applicable for the GGP.

GGT propose an MRP value of 7%.

As previously outlined in the Supporting Submission this position is based on the extensive work undertaken by the energy infrastructure industry and consultants to support the Joint Industry Associations ("JIA")[2] submission to the AER WACC Review[3]. The current economic environment is one where the forward looking MRP over the period until the next GGP Access Arrangement Revision is likely to be well above 7%, given the financial crisis and the need for higher equity returns.

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[2] The industry associations involved in the JIA are the Energy Networks Association ("ENA"), the Australian Pipeline Industry Association ("APIA") and Grid Australia

[3] The work referred to includes:

- JIA, 2008, Network Industry Submission AER Issues Paper Review of the Weighted Average Cost of Capital (WACC) parameters for electricity transmission and distribution September 2008 in particular chapter 5 pp78-97 and Appendix G Market Risk Premium Value Adviser Associates This can found at this website:

http://www.aer.gov.au/content/index.phtml/itemId/722310

- JIA, 2009, Network Industry Submission AER Proposed Determination Review of the Weighted Average Cost of Capital (WACC) parameters for electricity transmission and distribution February 2009, particularly Chapter pp79 -96 and Attachment J Value Adviser Associates, Market Risk Premium, January 2009. This can be found at this website:

http://www.aer.gov.au/content/index.phtml/itemId/726694

In considering issues relating to the MRP it should be recognised that the AER WACC review outcomes apply to assets that will be having regulatory reviews in 2013-2014 and hence the outcomes of the current AER review will continue to be relevant until 2019. For this reason the AER may have sought to discount some of the shorter term issues relating to financial crisis driving higher MRPs given the extended time frame over which their decision applies. However the Authority's review of the GGP is effectively in place from 2010 to 2014 and as such these longer term considerations do not apply to the GGP review.

GGT believes an MRP of 7% best reflects the long term forward looking MRP. However, the current economic climate is one where the forward looking MRP over the period until the next GGP Access Arrangement review is likely to be well above 7%.

GGT believes the AER review strengthens the view that the MRP should be 7%.

Valuation of imputation credits (also known as gamma) - The AER is to use a gamma of 65%, this has increased from the previously accepted regulatory value of 50%.

GGT cannot reconcile the AER position with the information before the AER. GGT believes a more reasonable value for gamma is 20%. This position is based on the extensive work undertaken by the energy infrastructure industry and consultants to support the JIA submission to the AER WACC Review[4]. In developing its submission and its position of gamma the JIA sought advice from recognised experts who examined both the latest empirical evidence and the underlying economic and finance theory relevant to determining a benchmark value of imputation credits.

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[4] The work referred to includes:

- JIA, 2008, Network Industry Submission AER Issues Paper Review of the Weighted Average Cost of Capital (WACC) parameters for electricity transmission and distribution September 2008 in particular chapter 5 pp149-182 and Appendix K The Valuation of Imputation Credits NERA Economic Consulting and Appendix L The impact of franking credits on the cost of capital of Australian firms SFG Consulting . This can found at this website:
  http://www.aer.gov.au/content/index.phtml/itemId/722310
- JIA, 2009, Network Industry Submission AER Proposed Determination Review of the Weighted Average Cost of Capital (WACC) parameters for electricity transmission and distribution February 2009, particularly Chapter pp140-156 and Attachment P Strategic Finance Group Consulting, Market practice in relation to franking credits and WACC, Attachment Q NERA Economic Consulting, AER's Proposed WACC Statement – Gamma, Attachment R Strategic Finance Group Consulting, Using redemption rates to estimate theta, Attachment S Strategic Finance Group Consulting, The value imputation credits as implied by the methodology of Beggs and Skeels (2006), Attachment T Strategic Finance Group Consulting, The consistency of estimates of the value of cash dividends
- This can be found at these websites:
  http://www.aer.gov.au/content/index.phtml/itemId/726694
  http://www.aer.gov.au/content/index.phtml/itemId/726698

Failing the use of 20% the use of 50% would seem understandable to the extent that this was the previous value, and if no evidence is persuasive then the previous value is to be used under the relevant national electricity rules.

Overall the JIA strongly argued that the AER has given insufficient regard to theoretical arguments, empirical studies and market practices in arriving at a value for gamma in its draft decision. The JIA presents persuasive evidence that suggests that the value of gamma is between 0% and 20%.

GGT believes that given the information available a 20% value for gamma should be used. Failing this, the continuing use of a figure of 50% is defensible to the extent that current evidence is deemed unpersuasive.

Conclusion

The cost of capital selected for the GGT is a pre tax nominal WACC of 13.5%.

Following the AER electricity WACC review GGT continues to believe the cost of capital range and cost of capital parameter value selected are consistent with the Reference Tariff principles, and that the Cost of Capital parameter selected falls within the range of rates commensurate with the prevailing market conditions and the relevant risk.

2.4 Paragraph 63 – development of Initial Capital Base

GGT is concerned with the extent of discussion included in the Issues Paper relating to the establishment of the Initial Capital Base, on three counts.

- This was a matter for the 2005 AA Determination

  The discussion of the methodology applied for setting the Initial Capital Base was an issue for the Determination in which that Initial Capital Base was set. As that process was exhaustively documented in the 2005 Final Decision, it does not appear to be helpful to cover that ground again here.

- Once the ICB is set, the basis of its setting is not relevant to future revisions to the AA.

  Within the context of the Cost of Service methodology, there do not appear to be any provisions in the Code that operate differently depending on the approach used to establish the Initial Capital Base. It is not clear how the discussion of the process used to establish the Initial Capital Base is relevant to the current review of the proposed Revisions to the Access Arrangement.

- Once the ICB is set, it is not in the Regulator's powers to amend it.

  The Code does not include provisions for amending the Initial Capital Base once it is set. Section 8 of the Code provides a process for rolling the Capital Base forward from one year to the next, but does not provide scope to amend the Initial Capital Base.

2.5 Paragraph 68 - Tariff Adjustment Mechanism

Through discussions with the Authority, it became clear that three errors had been made in the Tariff Adjustment Mechanism filed with the Revised Access Arrangement:

- the Tariff Adjustment Mechanism was not clear that the movement in individual tariff components is subject to the overall limitation on the movement in total revenue;
- the Tariff Adjustment Mechanism was not clear that the annual adjustment featuring the adjustments for regulatory costs and the relative levels of tariff components was to occur for the January price change in lieu of the quarterly CPI adjustment proposed in section 5.3(a) of the proposed Access Arrangement; and
- the regulatory cost component of the Tariff Adjustment Mechanism incorrectly included an inflation adjustment. This adjustment is not required, as the GGT nominal opex forecasts, will be in the same "dollars of the day" as the actual costs when they are incurred.

A revised Tariff Adjustment Mechanism has been provided as Schedule 1 to this submission.

GGT acknowledges that, notwithstanding that this matter was raised and clarified at the officer level through discussions, the Authority will be required to issue a Required Amendment in its draft decision on the proposed revisions to the Access Arrangement.

SCHEDULE 1 – Reference Tariff Adjustment Mechanism

Variation of Reference Tariffs

GGT has adopted a 'tariff basket price cap' approach as the manner in which Reference Tariff Components (as described in Clause 5.2(c)(4)) ("**Tariff Components**") may vary within this Access Arrangement Period. For GGT, this formula applies as some tariffs are specified as a price per "TJkm". In this case the tariff components would apply for a given number of TJ capacity reservation to an outlet that is a given number of km from the Inlet Facilities.

GGT will vary Tariff Components annually in accordance with the process described below. Subject to the limit on the varied Tariff Components and the limitation on movement of the weighted average price basket described below, GGT may in its discretion vary any Tariff Component for each Variation Year.

The following adjustments relate to tariff changes effective 1 January of each year and are conducted in lieu of the CPI adjustment specified in clause 9.8 of the General Terms and Conditions:

Limit on movement of the weighted average price basket and varied Tariff Components

For each January tariff change, the limitation on movement of the January-on-January weighted average price basket is determined as follows:

$$\frac{\sum_{j=1}^{m} p_t^{ij} * q_{t-2}^{ij}}{\sum_{j=1}^{m} p_{t-1}^{ij} * q_{t-2}^{ij}}, i=1,...n \quad \leq \quad \frac{SepCPI_{t-1}}{SepCPI_{t-2}} * (1\text{-}x) * (1+R_t)$$

And, subject to the limitation on movement of the weighted average price basket, a Tariff Component variation must be in accordance with the following:

$$p_t^{ij} \leq p_{t-1}^{ij} * \frac{SepCPI_{t-1}}{SepCPI_{t-2}} * (1\text{-}x) * (1+R_t) * (1+Y)$$

where:

p^{ij}_t is the proposed value for Tariff Component j of Reference Tariff i in calendar Year t;

p^{ij}_{t-1}	is the value for Tariff Component j of Reference Tariff i in calendar Year t-1;
q^{ij}_{t-2}	is the quantity of Tariff Component j of Reference Tariff i that was sold in calendar Year t-2;
x	is 0;
Y	is positive 0.02;
R_t	is the Regulatory Costs factor for calendar Year *t* and is calculated in accordance with the process described below;
$SepCPI_{t-1}$	is the September quarter CPI for Year *t-1*;
$SepCPI_{t-2}$	is the September quarter CPI for Year *t-2*; and
t	is the Variation Year.

The Regulatory Costs factor R_t is calculated as follows:

(a) for Variation Year 2011:

$$R_t = \frac{1 + \dfrac{Drc_{t-1} * (1 + WACC)}{Rrev_t}}{1} - 1$$

and

(b) for each Variation Year other than 2011:

$$R_t = \frac{1 + \dfrac{Drc_{t-1} * (1 + WACC)}{Rrev_t}}{1 + \dfrac{Drc_{t-2} * (1 + WACC)}{Rrev_{t-1}}} - 1$$

where:

Drc_{t-1}	is the actual Regulatory Costs minus the forecast Regulatory Costs for Year *t-1*, and is calculated as follows:

$$Drc_{t-1} = (Arc_{t-1} - Frc_{t-1})$$

where:

Arc_{t-1}	is the actual Regulatory Costs for Year *t-1*;
Frc_{t-1}	is the forecast Regulatory Costs for Year *t-1*; and
Drc_{t-2}	is the actual Regulatory Costs minus the forecast Regulatory Costs for Year *t-2* and is calculated as follows:

$$Drc_{t-2} = \quad (Arc_{t-2} - Frc_{t-2})$$

where:

Arc_{t-2}	is the actual Regulatory Costs for Year *t-2*;
Frc_{t-2}	is the forecast Regulatory Costs for Year *t-2*;
WACC	is the nominal pre-tax Weighted Average Cost of Capital used in the determination of the Total Revenue;
$Rrev_t$	is the Total Revenue applicable to the Covered Pipeline for *Year t;*
$Rrev_{t-1}$	is the Total Revenue applicable to the Covered Pipeline for *Year t-1;*
$Rrev_{t-2}$	is the Total Revenue applicable to the Covered Pipeline for *Year t-2; and*
Drc_{t-1} , Drc_{t-2}	are each subject to a “deadband” materiality threshold of plus or minus 0.5% of Total Revenue for the Covered Pipeline for the relevant year.

GGT’s Regulatory Costs are defined as:

For the purpose of this Tariff Adjustment Mechanism, **Regulatory Costs** means a cost connected to or associated with:

(a) GGT’s compliance with new or revised requirements or procedures under the *Petroleum Pipelines Act 1969*, Pipeline Licence 24, the *Energy Coordination Act 1994 (WA),* the *Gas Standards Act 1972 (WA),* the *Energy Operators (Powers) Act 1979*, *Environmental Protection Act 1986 (WA)* and all other applicable Laws which affect the operation of the Covered Pipeline or the provision of Services;

(b) GGT’s participation in regulatory policy or regulatory reform consultation processes;

(c) the pro rata portion of the Emissions Costs;

(d) changes to the GGP Act, GGP Agreement, *Gas Pipelines Access (Western Australia) Act 1998 (WA),* the Code or the *Economic Regulation Authority Act 2003 (WA);* and

(e) the introduction of new or revised requirements under the Code which are more complex or extensive than those applying at 31 December 2008 including the introduction of the *National Gas Access (Western Australia) Act 2008.*

In this Schedule 1, the following definitions apply:

Direct Costs – see definition of "Enterprise Costs";

Emissions Costs means the Enterprise Costs in respect of:

(a) the services provided by GGT under the Service Agreement; and
(b) GGT's business operations, to the extent they relate to those services;

Emissions Permit means a tradeable certificate, credit, permit or similar right or instrument (however described) required to be held, used or surrendered to satisfy a liability of GGT or the Owners under a Greenhouse Gas Law;

Enterprise Costs means

(a) the value of Emissions Permits required to be held, used or surrendered (the Direct Costs); and
(b) all other reasonable costs, charges and expenses (including, without limitation, taxes and internal and external compliance costs) incurred (the **Indirect Costs**),

from time to time by GGT or the Owners or a related body corporate under or in respect of a Greenhouse Gas Law;

Greenhouse Gases means carbon dioxide (CO2) and may also include any one or more of methane (CH4), nitrous oxide (N20), hydrofluorocarbons (HFCs), perfluorocarbons (PFCs), sulphur hexafluoride (SF6) and other atmospheric gases recognised as being responsible for causing or contributing to global warming or climate change under the United Nations Framework Convention on Climate Change;

Greenhouse Gas Law means a law relating to any scheme designed to encourage, directly or indirectly, reductions in the emissions of Greenhouse Gases (including laws requiring the reporting as to Greenhouse Gas emissions in respect of or in anticipation of any such scheme) including the NGER Act and the Carbon Pollution Reduction Scheme Bill 2009;

Indirect Costs – see definition of "**Enterprise Costs**"; and

NGER Act means the *National Greenhouse and Energy Reporting Act 2007* (Cth) as amended.