

14 May 2003

Mr David Hatfield
Acting General Manager Regulatory Affairs - Gas
Australian Competition and Consumer Commission
PO Box 1199
Dickson ACT 2602

Dear Mr Hatfield

Moomba Sydney Pipeline Access Arrangement

We refer to the various correspondences between EAPL and the Commission regarding the process to be adopted by the Commission prior to determination of a Final Decision on the Moomba-Sydney Pipeline Access Arrangement (Access Arrangement).

In its letters of 20 September and 9 October 2002 EAPL has strongly argued that the Commission must ensure that due process is followed in progressing consideration of the Moomba-Sydney Pipeline Access Arrangement to a Final Decision. In the light of the matters addressed in those letters and recent developments, it is EAPL's view that such due process must now include the issue of a clear statement of the Commission's present position on all key matters for the Access Arrangement. Accordingly we request that the Commission issue a further Draft Decision and provide an opportunity for interested parties to comment on that Draft Decision prior to a Final Decision by the Commission. Should the Commission disagree with the concept of a further Draft Decision, then we consider that a Statement of Intent on outstanding matters is the minimum necessary to ensure due process.

EAPL's position is based on the history of the MSP Access Arrangement process. Since the original Access Arrangement was proposed, there has been considerable change in the circumstances affecting consideration of the proposals:

1. A Draft Decision was issued.
2. A Revised Access Arrangement was submitted, containing several matters with significantly different material to that in the original Access Arrangement, acknowledging the change of ownership of the pipeline, and not accepting the required amendments of the Draft Decision.
3. Submissions were received on that revised Access Arrangement.
4. Decision of the Western Australian Supreme Court in the matter of *Re Dr Ken Michael AM; Ex Parte Epic Energy (WA) Nominees* [2002] WASCA 231 (Epic Decision) was handed down, the most significant judicial interpretation of the proper meaning and operation of the Code to date.
5. EAPL suggested to the Commission that the Draft Decision should be quashed – the Commission did not agree with this approach and determined to consider submissions on the issue before deciding the process prior to moving to its Final Decision.

6. EAPL provided a submission on the impact of the Epic Decision on the Draft Decision.
7. The Commission produced an Issues Paper on the impact of the Epic Decision on the Draft Decision.
8. Submissions were received on that Issues Paper.
9. Significant revision of forecasts applicable to MSP, due to the announcement by AGL of a new portfolio of gas sources including AGL's determination of a lower commitment to the MSP.

The scheme of the Code is clear – a Draft Decision is issued to provide interested parties including the service provider with the opportunity to comment on the intention of the Regulator. Those comments must be taken into account by the Regulator in determining its Final Decision.

In the present situation, there are significant issues on which interested parties have no indication of the intention of the ACCC:

1. Revised Forecasts

On 12 May 2003, EAPL submitted revised forecasts to the Commission, arising out of the announcement by AGL of a new portfolio of gas sources including AGL's determination of a lower commitment to the MSP. Those revisions are substantial, representing a 35% reduction.

Interested parties will have no indication of the Commission's view of those revised forecasts prior to the Final Decision.

2. The impact of the revised forecasts on Reference Tariffs

The revised forecasts have considerable impact on the determination of Reference Tariffs. Interested parties have no indication of the Commission's intention in respect to impact of the forecasts submitted by EAPL, on Reference Tariffs.

This could be a crucial matter for EAPL in exercising its right under section 8.3 of the Code to determine the manner in which the Reference Tariff varies within the Access Arrangement Period through implementation of the Reference Tariff Policy.

Section 8.3 states:

“Subject to these requirements and to the Relevant Regulator being satisfied that it is consistent with the objectives contained in section 8.1, the manner in which a Reference Tariff may vary within an Access Arrangement Period through implementation of the Reference Tariff Policy *is within the discretion of the Service Provider.*” (emphasis added)

EAPL has submitted an NPV methodology to the design of Reference Tariffs in its Revised Access Arrangement. Should the Commission reject the forecasts submitted by EAPL and

substitute other forecasts, the commercial risk created by that decision would be unacceptable. In that event, EAPL will choose to either reduce the residual at the end of the Access Arrangement Period in line with that implied by the current forecast or implement the “cost of service” methodology to Reference Tariffs, as it has the right to do under the Code.

3. Impact of the revised forecasts on Optimised Replacement Cost

Forecasts are an element of the determination of the Optimised Replacement Cost (ORC). Should the Commission determine that the revised forecasts must be reflected in a revised ORC, both:

- (i) the decision to review the ORC – that is, whether the Code requires or indeed allows such a revision; and
- (ii) any revised ORC

would require scrutiny by interested parties.

4. Impact of the Epic Decision

As we have previously submitted, the impact of the Epic Decision on the Draft Decision is so great as to require a complete reassessment of the initial Capital Base (ICB) by the Commission, and as a consequence other significant matters in the Access Arrangement, most notably the price path. As the ICB is a fundamental element of the Access Arrangement which affects the majority of matters to be determined by the Commission, due process requires that EAPL and interested parties be given the opportunity to provide comment on the outcome of such a major reassessment.

In addition, this determination will be the first indication of the Commission’s view as to the impact of the Epic Decision. It is essential that interested parties are given the opportunity to consider and comment on the interpretation and application of that decision by the Commission, prior to the Commission reaching its Final Decision.

5. NPV DORC

5.1 The Epic Decision is Relevant

The Commission’s view of NPV DORC expressed in the Draft Decision, must be affected by the Epic Decision, and EAPL has made submissions to that effect.

5.2 Commission’s Amadeus Basin Darwin Pipeline Final Decision

In addition, the Commission, in the Draft Decision, determined DORC by reference to other factors that may be relevant to the ICB, dismissing the use of NPV DORC in the process. The Commission appears now to have accepted the view that it is incorrect to determine

DORC in that way. The Commission's Amadeus Basin Darwin Pipeline Final Decision states:

“In assessing the various DORC and DORC-based valuations, the Commission has been guided by the advice of SKM that concluded that DORC should be determined based solely upon the economic principles that underpin it, resulting in a stand-alone and independently reproducible valuation that excludes other factors that the regulator may take into account when establishing an ICB (p.33 ABDP Final Decision).

and

“The Commission acknowledges that reflecting too many issues within a single instrument such as DORC, reduces the transparency of the ICB setting process and it is therefore desirable to determine DORC as a stand-alone value with other factors considered separately when determining the ICB. It is the Commission’s view that the approaches to the determination of DORC that depart from the economically sound derivation of DORC are therefore contrary to good regulatory practice.” (p.33 ABDP Final Decision).

If DORC is to be determined as a stand alone value based on economic principles, then the principal arguments relied on by the Commission to justify the value of DORC in the Draft Decision, and the related decision to disregard NPV DORC, are no longer valid.

5.3 Consultants’ reports obtained by the Commission

The Commission obtained, in the context of the MSP Access Arrangement, a report from SKM on the subject of depreciation within DORC valuations (February 2002). The Commission subsequently obtained a report from NERA (September 2002) which states that:

“The Commission now wishes to resolve this debate [between the continued use of the conventional straight line approach as recommended by SKM, and Agility’s NPV DORC approach] and has engaged NERA to assess the economic merits of the two approaches and provide a clear set of economic logic as to why one approach should be preferred over the other.”

NERA’s report provides little if any support for the continued use of straight line depreciation as recommended by SKM. With some difference of opinion on whether DORC should be assessed by reference to the NPV of cost streams or revenue streams, NERA supports the use of an NPV methodology.

There has been no indication of how the Commission proposes to resolve the differences between what are now three positions: SKM who advocate continued use of the conventional straight line approach; NERA who support a NPV approach based on costs; and the Agility NPV DORC based on revenues.

The issue of the correct determination of DORC is crucial in the determination of the ICB, and it is EAPL’s view that the Commission must establish a definitive DORC methodology

that is economically sound and consistent with the Code, as soon as practicable and certainly prior to issuing a Final Decision on the Access Arrangement.

6. Operating Costs

In the original Access Arrangement and the Draft Decision, the forecast operating costs were approx \$12-13m per annum. In the revised Access Arrangement, the forecast operating costs were approx \$23m per annum, reflecting costs arising out of the change in ownership to a stand alone listed company, insurance costs and asset sales.

While EAPL believes the revised costs are well supported and compare favourably with comparable Australian pipelines, there has been no indication of ACCC's view of this quantum of operating costs.

7. Tax Treatment

The Commission proposed in the Draft Decision to adjust the value of the capital base downward by the value of EAPL's accumulated deferred company tax liabilities. The Commission considered that the deferred tax liabilities represented a pre-compensation of future tax liabilities and as such constitute a return of capital. Therefore, the capital base should be reduced by the value of accumulated deferred tax liabilities. The Commission calculated the adjustment to the capital base to take account of deferred tax liabilities at \$37.4 million, which includes adjustments for the value of imputation credits and changes in the statutory tax rate. The Commission proposed a value for the initial capital base of \$502.1 million, comprised of DORC of \$539.5 million less the value of accumulated deferred taxes of \$37.4 million.

In its September 2002 submission to the NCC on the EAPL Revocation of Coverage Application, the ACCC stated:

“NECG argues that the Commission is inconsistent in its decisions with respect to the treatment of deferred tax liabilities. NECG notes that the value of deferred tax liabilities is deducted from the value of the asset base in the MSP Draft Decision, but is not deducted from the asset base in the Moomba to Adelaide Pipeline System (MAPS) Final Decision.

The Commission reviewed its position between the MAPS draft and final decisions and decided not to deduct the amount of deferred tax liabilities from the asset base in that case. The MAPS Final Decision was released in September 2001.

In the case of the MSP Draft Decision, adding back the value of deferred tax liabilities of \$37 million to the asset base would add only about \$0.03 to reference tariffs.”

The reference to the change in the Commission's position by September 2001 on the MAPS Access Arrangement suggests that the Commission may have a similar change in position in respect to the MSP. However, interested parties have no certainty as to the Commission's position.

8. Laterals

In the Revised Access Arrangement, EAPL changed the treatment of the regional laterals. The main elements of change were the structure of tariffs for the laterals including the removal of the 100km cap and escalation of tariffs at rates different to those of the mainline.

There has been no indication of the Commission's view about these changes.

Conclusion

Whilst these factors have various degrees of significance as stand alone items – the impact of the forecasts and the Epic Decision clearly having considerable importance – it is the combined impact of these many unknown factors which results in the position that the scheme of the Code cannot be followed – that is, interested parties will not have an opportunity to understand and comment upon the intention of the Commission prior to the Final Decision.

EAPL submits that due process requires that the Commission issue a further Draft Decision, or Statement of Intent, addressing each of these matters, and providing interested parties with an opportunity to comment, prior to moving to a Final Decision.

EAPL understands that the Commission intends to consider a Final Decision, without necessarily issuing a further Draft Decision. EAPL requests that the Commission give full consideration to adopting a process of issuing a further Draft Decision, and receiving comments on that decision, prior to moving to a Final Decision. To enable us to consider our legal options to secure appropriate process, EAPL requests that the Commission advise us of its intended course of action as soon as possible.

Yours sincerely

Michael McCormack
General Manager Commercial