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Dear Mr Martin

## **GasNet Australia - Revised Access Arrangement**

### **1. Introduction**

You have asked whether the National Third Party Access Code for Natural Gas Pipelines Systems (**Code**), which applies in Victoria by virtue of the *Gas Pipelines Access (Victoria) Act 1998 (Act)*, permits GasNet Australia (Operations) Pty Ltd (**GasNet**), as owner of the Covered Pipeline known as the GasNet System (**GNS System**), to "rectify" the initial Capital Base applicable to the Pipeline with retroactive effect to 1 January 1998. The "rectification" would result in the initial Capital Base being increased from \$363.7m to \$399.5m.

### **2. Conclusion**

For the reasons set out below, it is our opinion that the Code does not permit the initial Capital Base to be changed in the manner contemplated by GasNet.

### **3. Reasons**

- 3.1 Once the initial Capital Base of a Covered Pipeline has been determined and the related Access Arrangement approved by the Relevant Regulator, the Code evinces the clear legislative intent that the determination cannot be re-opened. In order to ensure that the initial Capital Base is correctly determined, the Service Provider and interested parties are provided with the opportunities to make submissions and for administrative and judicial review as described in 3.10 below, in advance of final approval of the Access Arrangement or, if the Relevant Regulator drafts and approves its own Access Arrangement, after such approval.

Having set the initial Capital Base, it can only be adjusted by indexation and allowances for New Facilities Investment or Recoverable Portion, Depreciation and Redundant Capital (see 3.2 and 3.3 below). In the case of the GNS System, this position is expressly legislated by clause 9.2(a)(3) of the Reference Tariff Policy applicable to the System (see 3.11 below).

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- 3.2 In its Final Decision dated 6 October 1998 (**Final Determination**) regarding the Access Arrangement applicable to the GNS System, the Australian Competition and Consumer Commission (as Regulator) (**ACCC**) determined:

*"In terms of future regulatory period, however, the Commission notes that the Victorian Access Code requires that the Capital Base be determined mechanically, adjusted only for depreciation, new facilities investment and redundant capital (section 8.9). Therefore, in order for the methodology proposed by TPA to be consistent with requirements of the Victorian Access Code, the appropriate formula for determining the Capital Base at the commencement of the next access arrangement period is:*

$$\text{Capital base} = \text{initial capital base (indexed)} - \text{depreciation (indexed)} + \text{new facilities investment (indexed)} - \text{redundant capital}$$

*The Commission notes that the Victorian Access Code does not provide scope to revalue the existing assets outside of what is permitted by this formula."*

- 3.3 The equation in the preceding paragraph is an abridged formulation of section 8.9 of the Code which, in material part, provides:

*"8.9 ... Consistently with those principles, the Capital Base at the commencement of each Access Arrangement Period after the first, for the Cost of Service methodology is determined as follows:*

- (a) the Capital Base at the start of the immediately preceding Access Arrangement Period; plus*
- (b) the New Facilities Investment or Recoverable Portion (whichever is relevant) in the immediately preceding Access Arrangement Period (adjusted as relevant as a consequence of section 8.22 to allow for the differences between actual and Forecast New Facilities Investment); less*
- (c) Depreciation for the immediately preceding Access Arrangement Period; less*
- (d) Redundant Capital identified prior to the commencement of that Access Arrangement Period ...*

- 3.4 For the purposes of determining the initial Capital Base of the GNS System, the Energy Projects Division of the Victorian Department of Treasury and Finance (**EPD**) commissioned the engineering consulting firm, Gutteridge, Haskins and Davey (**GHD**) to undertake a valuation of the System. GHD's valuation included a number of assets which were subsequently excluded by EPD from the valuation used for tariff calculation purposes. Those assets were:

- (a) easements valued by GHD at approximately \$40m. In paragraph 5.5.1(a) of GasNet Access Arrangement – Submission dated 27 March 2002 (**GasNet's Submission**), GasNet records its understanding that a policy decision was undertaken by EPD to exclude the value of easements from the initial Capital Base "in order to meet the State Government's objectives of imposing maximum uniform tariffs"; and*

- (b) pipeline regulators and associated remote terminal units, which were valued by GHD at approximately \$1.9m. In paragraph 5.5.1(b) of GasNet's Submission, GasNet expresses the view that, on the basis of the GHD valuation, EPD incorrectly assumed that these assets were non-regulated and, hence, inappropriate for incorporation in the initial Capital Base.

Further, GasNet asserts that the Western Transmission System and the Lurgi Pipeline were included in the initial Capital Base at amounts respectively \$9m and \$1.2m below GHD's valuation. In paragraph 5.5.1(c) of GasNet's Submission, GasNet repeats that this was a policy decision taken by EPD *"in order to meet the State Government's objectives of imposing maximum uniform tariffs"*.

- 3.5 In paragraph 2.3.1 of its Issues Paper dated 19 April 2002, the ACCC states:

*"As envisaged by section 8.9 of the Code, GasNet proposes to roll forward its inflation adjusted initial Capital Base by adding new facilities investment and subtracting depreciation and redundant capital. However, GasNet also proposes to reopen the asset base (mainly to recognise the value of easements) and adjust it upwards by \$35.8m (to a January 1998 value of \$399.5m). It is the Commission's understanding that the Code does not allow for such an adjustment."*

- 3.6 Section 8.10 of the Code prescribes the factors to be considered in establishing the initial Capital Base of a Covered Pipeline. Those factors include comparing depreciated actual costs (**DAC**), depreciated optimised replacement cost (**DORC**) and "other well recognised asset valuation methodologies in valuing the Covered Pipeline."

In Part 1 of Schedule 1 to the *Gas Pipelines Access (South Australia) Act 1997 (Act)* (which, by virtue of section 7 of the Act, forms part of the Gas Pipelines Access (Victoria) Law) "Pipeline" is defined to mean *"a pipe or system of pipes, or part of a pipe, or system of pipes, for transporting natural gas, and any tanks, reservoirs, machinery or equipment directly attached to the pipe, or system of pipes"*.

Given the limited nature of this definition and the nature of the valuation methodologies referred to above, there is a strong inference that the value of easements should not be included in the initial Capital Base of a Covered Pipeline.

Further, it is understood that it is not Australian regulatory practice for land or easements to be included as part of the asset base, either in the case of Covered Pipelines or gas distribution systems.

- 3.7 Section 8.14 of the Code provides:

*"Where an Access Arrangement has expired, the initial Capital Base at the time a new Access Arrangement is approved is the Capital Base applying at the expiry of the previous Access Arrangement adjusted to account for the New Facilities Investment or the Recoverable Portion (whichever is relevant), Depreciation And Redundant Capital (as described in section 8.9) as if the previous Access Arrangement has remained in force."*

This section clearly evidences the legislative intent that the initial Capital Base is not to be recalculated *de novo* at the expiration of the term of each Access Arrangement.

In paragraph 5.5.1 of GasNet's Submission, GasNet acknowledges that *"The Code does not permit the Commission to undertake a revaluation of the initial GasNet Capital Base"* .

- 3.8 In paragraph 5.5.3(e) of GasNet's Submission, GasNet relies upon section 2.24 of the Code as support for the proposition that, even though the ACCC is not entitled to re-calculate the initial Capital Base for the purposes of the Second Access Arrangement Period, the ACCC was required in approving the first Access Arrangement to take into account *"the Service Provider's legitimate business interests and investment in the Covered Pipeline"* (see section 2.24(a)) but, by reason of the exclusions and adjustments referred to in 3.4, did not do so. There are at least two points to be made in response to this proposition:

First, it would appear that the ACCC did take the exclusions and adjustments into account in settling the initial Capital Base. In paragraph 3.2.2 of its Final Determination the ACCC states:

*"Depreciation reduced the optimised asset valuation further to \$357million. EPD made a policy decision to reduce this valuation further, mainly in respect of assets on the WTS to limit what it considered undesirable network price differentials. In essence EPD considered tariffs would be unacceptably high using the proposed tariff setting procedure in conjunction with the initial DORC valuations for WTS assets. Reducing the DORC valuations was the mechanism used to achieve the desired tariff level without compromising the overall approach to the establishment of tariffs. Further aspects of this adjustment are discussed in section 3.7 below."*

Secondly, had Transmission Pipelines Australia Pty Ltd and Transmission Pipelines Australia (Assets) Pty Ltd (collectively *TPA*), being GasNet's predecessors in title to the GNS System, been dissatisfied with the ACCC's determination of the initial Capital Base, they had at their disposal the opportunities and remedies described in 3.10 with which to contest that determination.

- 3.9 As noted above, the ACCC's Final Determination was published on 6 October 1998. The Access Arrangement currently applicable to the GNS System was approved by the ACCC on 16 December 1998.

GasNet purchased the GNS System from the Victorian Government in May 1999 under a competitive bidding arrangement. When it did so, GasNet was aware of the initial Capital Base, the Reference Tariff Policy and the approved Access Arrangement applicable to the GNS System. In setting its offer price, GasNet no doubt had regard to those factors, as would have competitive bidders. To re-open the initial Capital Base and adjust it to GasNet's advantage, even if that were permissible under the Code, would be to impugn the integrity of that competitive bidding process.

- 3.10 There is no provision in the Code which would allow the ACCC to circumvent the clear intent of sections 8.9 and 8.14 and recalculate the initial Capital Base once finally determined. This can be explained by the scheme of checks and balances set out in the Code.

Having received the proposed Access Arrangement and the Access Arrangement information from the Service Provider, the Relevant Regulator (in the case of the GNS

System, being the ACCC) must invite public submissions under section 2.10 and consider those submissions under section 2.12. Having considered those submissions, the Relevant Regulator must issue a draft decision under section 2.13 which either proposes to approve the Access Arrangement or proposes not to approve the Access Arrangement and states the amendments (or nature of the amendments) which would have to be made to the Access Arrangement in order for it to receive the Relevant Regulator's approval.

Having considered any submissions which may be received in relation to its draft decision, the Relevant Regulator is required by section 2.16 to issue a final decision which:

- (a) approves the Access Arrangement; or
- (b) does not approve the Access Arrangement and states the amendment (or nature of the amendments) which would have to be made to the Access Arrangement in order for the Regulator to approve it and the date by which a revised Access Arrangement must be resubmitted by the Service Provider; or
- (c) approve a revised Access Arrangement submitted by the Service Provider which the Regulator is satisfied incorporates the amendments specified by the Regulator in its draft decision.

If, in accordance with section 2.16(b), the Regulator does not approve the Access Arrangement and sets a date by which revised Access Arrangement must be resubmitted, and if either the Service Provider does not submit a revised Access Arrangement by the date specified, or does submit a revised Access Arrangement which the Regulator is not satisfied incorporates the required amendments, the Regulator must draft and approve its own Access Arrangement instead of the Access Arrangement provided by the Service Provider (section 2.20). The Regulator's final decision must be issued within 6 months of receiving the proposed Access Arrangement (section 2.21), although that time can be extended by Regulator for 2 months one or more times.

A decision by the Relevant Regulator to draft and approve its own Access Arrangement is subject to review by the relevant Appeals Body (being, in this case, the Australian Competition Tribunal) under the Gas Pipelines Access (Victoria) Law (section 2.26 of the Code). Under section 39 of the Law, the Service Provider may apply for a review of the merits of the Relevant Regulator's decision on the grounds:

- (i) of an error in the Regulator's finding of facts;
- (ii) that the exercise of the Regulator's discretion was incorrect or was unreasonable, having regard to all the circumstances; or
- (iii) that the occasion for exercising the discretion did not arise.

By virtue of section 20 of the Act, decisions of the Australian Competition Tribunal are subject to the *Administration Decisions (Judicial Review) Act 1997 (Cth)* and section 18 of the Act confers jurisdiction on the Federal Court of Australia, with respect to applications made to that Court under the *Administration Decisions (Judicial Review) Act*.

The procedures described at some length above provided TPA with ample opportunity to challenge determination of the initial Capital Base, had they been inclined to do so. Their

decision not to do so has left GasNet bound by the ACCC's determination of the initial Capital Base.

- 3.11 Section 3.5 of the Code prescribes that an Access Arrangement must include a Reference Tariff Policy. Clause 5.3.2 of the Access Arrangement currently applicable to the GNS System provides that the reference tariffs applicable to the System are those described in the Victorian Gas Industry Tariff Order 1998 (**Tariff Order**). Clause 5.3.4 of the Access Arrangement provides (in part):

*"Chapter 9 of the Tariff Order provides a mechanism whereby certain principles in the Tariff Order, and therefore by definition, the Reference Tariff Policy, cannot be changed at the 1 January 2003 review of reference tariffs."*

Clause 9.2(a)(3) of the Tariff Order provides:

- "(a) In making a price determination in relation to tariffed transmission services for the subsequent access arrangement period, the Regulator is to adopt the following fixed principles:*

*... ..*

- (3) Use the capital base for the TPA at the start of the initial regulatory period, adjusted to take account of inflation since 1 January 1998, depreciation, wholly or partially redundant assets and additions and disposals in the ordinary course of business since 1 January 1998, other than a disposal of:*
- (A) all of the assets and liabilities of TPA;*
  - (B) assets interdependent with a transaction pursuant to which all the issued shares in or the assets and business of TPA cease to be held by or on behalf of the State of Victoria or a statutory authority;*  
*or*
  - (C) assets pursuant to which the assets of TPA are sold and leased back to TPA; "*

Accordingly, it is one of the fixed principles of the Reference Tariff Policy incorporated in the current Access Arrangement that the initial Capital Base cannot be changed for the subsequent Access Arrangement period.

Section 8.47 of the Code provides that where, under a Reference Tariff Policy, certain principles are fixed for a specified period, they cannot be changed without the consent of the Service Provider. In paragraph 5.2.4(e)(iv) of GasNet's Submission, GasNet purports to consent to the change of the Reference Tariff Policy for the purpose of enabling its revised initial Capital Base to be adopted. However, this confuses the purpose of section 8.47 of the Code. That section prevents the Relevant Regulator, in approving a subsequent Access Arrangement, from departing from the principles fixed under a Reference Tariff Policy during the specified period without the Service Provider's consent. It does not enable a Service Provider to initiate a change to the Reference Tariff Policy and then consent to its own change.

I trust the foregoing addresses adequately the issues you have raised.

With kind regards

Yours sincerely



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