

Murray Valley Tariff - Revised Proposal

24/10/2002

The ACCC has determined that the Murray Valley pipeline is not part of the Initial Capital Base, and is therefore an element of capital expenditure within the current Access Arrangement period. As such, the pipeline must satisfy the tests of section 8.16, and the tests of section 5.7.2 of the GasNet Access Arrangement, which is demonstrated in below.

GasNet proposes to treat the Murray Valley pipeline as an incremental asset, with a separate tariff calculation on the incremental costs associated with the pipeline. The tariff at the entrance to the Murray Valley pipeline at Chiltern Valley will be calculated using the standard methodology, and will be allocated its share of direct and indirect costs according to the standard cost allocation method, and the flows through Chiltern Valley into the Murray Valley pipeline. Hence the final tariff at each off-take on the Murray Valley pipeline will be the sum of the Chiltern Valley and Murray Valley pipeline tariffs.

The incremental tariff on the Murray Valley pipeline will be set to recover the forecast revenue requirement over each Access Arrangement period from the forecast volumes over the period. Furthermore, GasNet proposes to retain the current cost allocation methodology on the Murray Valley pipeline itself, in order to minimise tariff shock. This is particularly relevant to this pipeline since the Murray Valley pipeline currently has the highest withdrawal tariffs on the system, and therefore is most sensitive to tariff shock. Hence, on the Murray Valley pipeline, the incremental capital costs will be allocated to forecast peak flows, and the incremental operating costs will be allocated to forecast annual flows.

Murray Valley pipeline Roll-in

The Murray Valley pipeline has been classified as a New Facility under the provisions of the GasNet Access Arrangement. Hence it is necessary to demonstrate that the pipeline passes the tests of section 8.16 of the Code, and the tests of section 5.7.2 of the GasNet Access Arrangement. Provided these tests are passed, the New Facilities Investment can be included in the Capital Base commencing 1/1/2003.

GasNet believes that the Murray Valley pipeline satisfies the Economic Feasibility Test from section 5.7.2 (a) of the Access Arrangement, which is equivalent to the test in section 8.16 (b)(i) of the Code.

The effect of the Economic Feasibility Test is to impose restrictions on the Reference Tariff that can be applied to the Murray Valley pipeline in the future. These restrictions have the effect of requiring that the incremental costs of the Murray Valley pipeline must be kept separate from the averaging processes used to derive the Reference Tariff on other parts of the system. This requirement is achieved by isolating the direct costs of the Murray Valley pipeline and ensuring that these costs are always recovered from the forecast flows on the pipeline.

New Facility

The Murray Valley pipeline was commissioned on 1st September 1998. It was connected to the existing GasNet system at Chiltern Valley, near Wodonga, and was laid in a westerly direction connecting to four towns in the Murray Valley region. As such the Murray Valley pipeline is an extension to the GasNet system.

The Murray Valley pipeline is listed in Schedule A of the Code, and hence it is covered by the Code. Furthermore, section 5.7.1 of the GasNet Access Arrangement states that any extension of

the PTS is covered by this Access Arrangement, subject to notification not being given under section 5.7.1(c) (and no such notification was made).

Capital Base

The value that GasNet seeks to include in the Capital Base for 1/1/2003 is the New Facilities Investment, which is the *actual capital investment*. If this passes the tests in the Access Arrangement and the Code, then this amount may be included in the Capital Base, escalated for inflation between the commissioning date and the 1/1/2003, as provided for in section 8.9 of the Code. The specific depreciation attributable to this pipeline is not directly relevant, as the value of the Capital Base is written-down at 1/1/2003 by the forecast depreciation used to derive the GasNet Reference Tariffs 1999-2002.

The actual capital cost of the Murray Valley pipeline was \$15.63 million. The commissioning date was 1/9/1998.

Economic Feasibility Test

GasNet intends to apply the Economic Feasibility Test, as described in section 5.7.2 of the GasNet Access Arrangement, to justify the inclusion of the New Facilities Investment in the Capital Base. In addition GasNet must satisfy the provisions of section 8.16 of the Code. This has the effect that GasNet must demonstrate that the Murray Valley pipeline passes the tests of section 8.16 (a) and 8.16 (b)(i) of the Code.

Section 8.16 of the Code states:

- 8.16 The amount by which the Capital Base may be increased is the amount of the actual capital cost incurred (*New Facilities Investment*) provided that:
- (a) that amount does not exceed the amount that would be invested by a prudent Service Provider acting efficiently, in accordance with accepted good industry practice, and to achieve the lowest sustainable cost of delivering Services; and
 - (b) one of the following conditions is satisfied:
 - (i) the Anticipated Incremental Revenue generated by the New Facility exceeds the New Facilities Investment; or
 - (ii) the Service Provider and/or Users satisfy the Relevant Regulator that the New Facility has system-wide benefits that, in the Relevant Regulator's opinion, justify the approval of a higher Reference Tariff for all Users; or
 - (iii) the New Facility is necessary to maintain the safety, integrity or Contracted Capacity of Services.

Prudent Service Provider Test (section 8.16(a))

GasNet must demonstrate that the New Facilities Investment associated with the Murray Valley pipeline “does not exceed the amount that would be invested by a prudent Service Provider acting efficiently, in accordance with accepted good industry practice, and to achieve the lowest sustainable cost of delivering Services”.

The construction of the Murray Valley pipeline was awarded to GasNet' predecessor GTC as the result of a competitive tender process. GasNet believes that the cost of the Murray Valley pipeline is consistent with generally accepted benchmarks for the capital cost of a pipeline.

The Murray Valley pipeline has a diameter of 8" and a length of 104 km. It operates at a MAOP of 7000 kPa.

A reasonable benchmark for this pipeline is \$20,000/in/km for 1998 (see the GasNet Revision Application for the SWP Schedule 5 for a justification of this benchmark). The corresponding cost for the Murray Valley pipeline is $100 \times 8 \times \$20,000 = \16 million. Hence this pipeline was constructed at below the benchmark cost.

The diameter of 8" was selected in order to allow for future growth. A diameter of 6" would have saved no more than 20% of the capital cost, but it would have led to a capacity reduction of 50%, which would have been inadequate to supply the anticipated long-term volume of over 3 PJ/annum. The addition of a compressor to a smaller diameter pipeline would have been uneconomic since a compressor would require a duplicate redundant unit, and would have cost of at least \$8 million.

Economic Feasibility Test

The amount of the New Facilities Investment that can be rolled-in to the Capital Base is the lesser of the Anticipated Incremental Revenue generated by the New Facility, and the New Facilities Investment.

The Anticipated Incremental Revenue is defined as:

“the present value (calculated at the Rate of Return) of the reasonably anticipated future revenue from the sale of Services at the Prevailing Tariffs which would not have been generated without the Incremental Capacity, minus the present value (calculated at the Rate of Return) of the best reasonable forecast of the increase in Non Capital Costs directly attributable to the sale of those Services.”

GasNet considers that the test is a forward looking test. In particular, the test refers to “anticipated incremental revenue” and “anticipated future revenue” which suggests that a forward looking approach should be adopted. This forward looking approach is also consistent with GasNet's treatment of depreciation on capital expenditure, which was calculated by reference to the forecast capital expenditure and not actual capital expenditure.

On this basis GasNet has performed its calculations in the following manner.

1. The calculation is performed from the date of the proposed roll-in , and aims to show that the Present Value of future revenues (less the Present Value of incremental operating costs), is equal to the actual capital cost at construction.
2. The calculation is performed using the reasonably anticipated future revenues rather than historical revenues. The anticipated revenues for the period beyond 1/1/2003 will be based on the proposed tariffs and demand forecast for the forthcoming Access Arrangement period.
3. The incremental revenues post 2007 cannot be determined since there is no Reference Tariff for this period. In order to remove this uncertainty, GasNet will demonstrate that the revenues earned between 2003 and 2007 inclusive, are sufficient to recover the incremental capital cost (depreciation and return to capital) for the period 2003 to 2007. The recovery of the incremental capital cost beyond 2007 is assured by imposing a requirement on the future

Reference Tariff (2007+) that the tariff on the Murray Valley pipeline will be set so as to recover the remaining un-recovered incremental capital costs.

4. All Present Value calculations are done at the estimated final pre-tax WACC for the forthcoming Access Arrangement period.

Calculation

The Anticipated Incremental Revenue for 2003 to 2007 is equal to:

- the forecast Murray Valley pipeline revenues 2003 to 2007 (inclusive), less
- the incremental Non-Capital Costs 2003 to 2007 (inclusive).

The Economic Feasibility Test is passed if the present value of this revenue exceeds the present value of the depreciation and return to capital applying to the New Facilities Investment for the same period.

The incremental Non-Capital Costs 2003 to 2007 consists of the additional O&M costs required to operate the additional pipeline assets. Additional passive linepack required to commission the pipeline is included in the capital costs. The incremental O&M is estimated to be approximately \$1000/km.

The calculations of each component are shown in the attached Excel model. The model applies the roll-in test from 2003, and for information purposes, the calculation is also performed from the commissioning date in 1998.