Regulatory Treatment of the Murray Valley Pipeline
Issues on its Inclusion in the GasNet Capital Base

Introduction

The Commission has advised GasNet that its proposed treatment of the Murray Valley pipeline in the revised Access Arrangement may not meet the requirements of the Code. Specifically, GasNet has included the Murray Valley pipeline in the Capital Base commencing 1/1/2003, on the basis that the pipeline was already in existence before the commencement of the current Access Arrangement in March 1999. As such, GasNet has not sought to justify the investment or the proposed tariff under the provisions of the Extensions and Expansions policy in section 5.7 of the GasNet Access Arrangement. Moreover, GasNet has allocated the pipeline costs for tariff purposes in the same way as other existing assets in the Initial Capital Base.

However, in recent discussions prior to the Draft Decision, the Commission has indicated that the Murray Valley pipeline might not be included in the Initial Capital Base, although the asset was commissioned in September 1998, before the commencement of the Access Arrangement. As such, the asset would be considered as an extension, and hence subject to the Extensions and Expansions policy.

Under these circumstances, the Murray Valley pipeline must meet the roll-in requirements set out in the Access Arrangement and the Code. This may also have implications for the tariff setting process, and for the treatment of this asset in the regulatory accounts.

GasNet's Proposal

In the event that it is determined that the Murray Valley pipeline is not already included in the GasNet Capital Base, and that it is classified as a New Facility under the provisions of the GasNet Access Arrangement, then it will be 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's preference would be to seek roll-in of the asset under 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. However, GasNet is concerned that the Reference Tariff on the Murray Valley pipeline should be set at a level which will encourage connections to gas by existing customers on alternative fuels. Hence GasNet's proposal is to set the Murray Valley pipeline tariff at a level which is just sufficient to pass the Economic Feasibility Test.

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). It is not clear that the Coverage clause in section 5.7.1 of the GasNet Access Arrangement applies to pipelines commissioned before the commencement of the Access Arrangement, or whether GasNet may propose a separate Access Arrangement.

The following discussion is contingent on the assumption that the Murray Valley pipeline is covered by the existing GasNet Access Arrangement.

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 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. An earlier tender by GTC for the Wimmera pipeline had been lost (this tender was won by Coastal Corporation which constructed and now owns the Wimmera pipeline).

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 100 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*8*$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 with 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 means:

> "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 proposed 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, which we believe is the correct methodology. However, for information purposes, the calculation is also done from 1998.