

**Final Approval Request for the  
Proposed Natural Gas Pipeline to the  
Central Ranges Region of NSW**

**Decision**

**19 May 2004**

**INDEPENDENT PRICING AND REGULATORY TRIBUNAL  
OF NEW SOUTH WALES**



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**Gas 04-01**

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## **1 INTRODUCTION**

On 27 April 2004, the Central Ranges Natural Gas and Telecommunications Association Incorporated (CRNG&TAI) submitted a Final Approval Request (FAR) to the Independent Pricing and Regulatory Tribunal of NSW (the Tribunal) and the Australian Competition and Consumer Commission (ACCC).

The FAR seeks approval of the outcome of the CRNG&TAI's tender process which was designed to select an organisation to construct a transmission and distribution pipeline to supply natural gas to the Central Ranges region of NSW. It was also intended to determine the reference tariffs (and other related items) which will apply to the transportation of natural gas on these pipelines.

The FAR was submitted pursuant to section 3.29 of the *National Third Party Access Code for Natural Gas Pipeline Systems* (the Code). Under the Code, the Tribunal is responsible for regulating distribution pipelines in NSW, and the ACCC is responsible for regulating transmission pipelines.

Whilst the Tribunal and the ACCC have worked co-operatively to assess the FAR, including joint engagement of a consultant to assist in their assessments, each regulator has an obligation to make its own separate decision pursuant to the Code.

The Tribunal has given detailed consideration to whether the FAR meets the criteria set out in section 3.33 of the Code, all of which must be satisfied before a decision to approve may be made. It has decided that the CRNG&TAI's FAR does satisfy these criteria. **It therefore decided on 19 May 2004 to approve the FAR in relation to the proposed distribution pipeline**, pursuant to section 3.32 of the Code.

This document provides more detail on the decision-making process and the Tribunal's rationale for reaching its decision:

- Chapter 2 provides an overview of the regulatory framework within which the FAR has been submitted
- Chapter 3 outlines the process and criteria the Tribunal has used to assess the FAR, and its assessment of the extent to which the FAR meets each of the criteria it is required to consider.

Upon approval, the proposed distribution pipeline became a 'covered' pipeline subject to Code regulation. Within 90 days of becoming a covered pipeline, the Service Provider for the pipeline must lodge a proposed Access Arrangement (AA) with the Tribunal, which includes the tender-determined outcomes.

## 2 REGULATORY FRAMEWORK

The CRNG&TAI's FAR has been submitted pursuant to section 3.29 of the Code. The Code establishes a national regime under which third parties may access natural gas pipeline systems. Under this regime, the owner or operator of a pipeline considered to be covered by the Code is required to lodge an AA with the relevant regulator for approval. Once approved, the AA sets out the terms, conditions and policies under which third parties may access the pipeline, including reference tariffs for key services.

When a new pipeline is being proposed or built (as is the case for this FAR), the Code allows an alternative process – a competitive tender process – to be used to determine the reference tariffs and related items which are intended to form part of an AA for a new pipeline.<sup>1</sup> The CRNG&TAI is following this process, an overview of which is provided at Appendix 1.

As required under the Code, the CRNG&TAI sought approval of the Tribunal and ACCC to a tender process for the supply of natural gas to the Central Ranges region, to be conducted in accordance with the Code. This was submitted in the form of a Tender Approval Request (TAR).

In addition to selecting an organisation to construct pipelines to the Central Ranges region, the TAR proposed that the tender process would determine four key items to be included in the AA for the new pipelines. These items are:

- the reference tariffs to apply to the revisions commencement date
- the reference tariff policy (to the extent that it determines the manner in which tariffs change over the initial regulatory period)
- an additional revenue policy (ARP) (which determines how additional revenue generated when the actual quantity of gas transported exceeds a certain volume will be shared between the pipeline owner/operator and users)
- a revisions commencement date (which establishes the length of the initial regulatory period, or how long the initial AA will apply).

On 12 March 2003, the Tribunal approved the TAR that was submitted on 3 January 2003, and amended on 18 February 2003, by the CRNG&TAI.<sup>2</sup> The ACCC approved the TAR with respect to the proposed transmission pipeline.

During 2003, the CRNG&TAI conducted its tender process. From the two tenders received, it selected Europacific Consortium (Europacific) as the successful tenderer. The second tender which was received from Agility was found to be a non-conforming tender.

Where a person has obtained TAR approval, conducted a tender and selected a successful tender, the Code allows (but does not require) the person who conducted the tender to seek regulatory approval of the outcomes of its tender. The CRNG&TAI chose to submit, on 27 April 2004, a FAR with the Tribunal and the ACCC.

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<sup>1</sup> Section 3.21.

<sup>2</sup> Pursuant to section 3.25 of the Code.

The Code provides that if the Tribunal is satisfied that, among other things, a successful tender has been selected in accordance with the selection criteria, procedures and rules specified in an approved TAR, then the FAR may be approved, and the proposed pipeline becomes a covered pipeline, regulated pursuant to the Code.<sup>3</sup> The Tribunal must make its decision to approve or not approve the FAR within 28 calendar days of receiving all the information it requires to make its decision.<sup>4</sup>

If a FAR is approved, the intended Service Provider (which may be an owner and/or operator)<sup>5</sup> would then be required to lodge a proposed AA with the Tribunal within 90 days of the approval.<sup>6</sup> This AA would address items that were not determined by the competitive tender process.

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<sup>3</sup> Section 1.21 & 3.34.

<sup>4</sup> Section 3.32 of the Code.

<sup>5</sup> *Gas Pipelines Access (New South Wales) Act 1998*, Part 1, Clause 2, Definitions.

<sup>6</sup> Section 2.2 of the Code.

### 3 ASSESSMENT OF THE FAR AGAINST THE CODE CRITERIA

Section 3 of the Code<sup>7</sup> sets out the specific requirements that the Tribunal must consider when determining whether or not to approve a FAR. These requirements cover:

- provisions concerning minimum information requirements, permitted changes to the terms of the tender and the Tribunal's right to request further information and assistance, and
- the decision criteria for approving or not approving the FAR.

This chapter discusses each of these requirements in more detail.

#### 3.1 Preliminary provisions

##### 3.1.1 Minimum information requirements

Section 3.29 of the Code provides that a FAR must include a statement of which tender was selected and the reasons for that selection based on the selection criteria.

In its FAR, the CRNG&TAI indicates that it has selected the tender submitted by Europacific as the winning tender and listed the reasons for its decision by reference to the three stages of the selection criteria.<sup>8</sup> The CRNG&TAI also goes into greater detail in its assessment of section 3.33 criteria<sup>9</sup> on how the successful tenderer met the selection criteria.

*The Tribunal considers that the CRNG&TAI's FAR meets the minimum information requirements.*

##### 3.1.2 Permitted changes to tender terms that affect reference tariffs

Section 3.30 of the Code provides that, after the successful tenderer has been selected, the Relevant Regulator may permit the person who conducted the tender and the successful tenderer to agree to changes to the terms of the tender which result in minor changes to the Reference Tariffs proposed in the tender, provided the Relevant Regulator is satisfied that the changes are consistent with the requirements in s3.28(a) to (i).<sup>10</sup>

Following the selection of the successful tenderer, the CRNG&TAI requested that Europacific clarify the application of its proposed ARP and reference tariff policy. It included Europacific's response in the FAR.<sup>11</sup> The CRNG&TAI submits that these changes are merely 'clarifications' which do not affect the tariffs proposed in the tender.

*The Tribunal considers that the clarifications do not have a material effect on the reference tariffs proposed in Europacific's tender and therefore do not conflict with section 3.30.*

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<sup>7</sup> Specifically sections 3.29 - 3.34.

<sup>8</sup> FAR Attachment, p 4.

<sup>9</sup> FAR Attachment, pp 5-11.

<sup>10</sup> These Code provisions refer to the criteria that were applied in assessing the TAR.

<sup>11</sup> FAR Attachment, pp 24-26.

### **3.1.3 Tribunal’s right to request information or assistance prior to decision**

Section 3.31 of the Code provides that before it makes its decision to approve or not approve the FAR, the Relevant Regulator may require any assistance or information that it reasonably requires.

The Tribunal notes that, prior to lodgement of the FAR, the staff of the Tribunal and ACCC met with the CRNG&TAI about the nature of information that would be required to enable the regulators to make their decisions. Subsequent to the submission of the FAR, the CRNG&TAI and Europacific assisted the Tribunal and ACCC by providing additional information for clarification. There were, however, no formal requests for information or assistance after the submission of the FAR.

*The Tribunal considers that there is no matter requiring further resolution that would warrant a formal request for information or assistance.*

## **3.2 Assessing the FAR against the decision criteria of the Code**

The Tribunal has considered whether the FAR satisfies all the specific criteria contained in sections 3.33(a) to 3.33(e) of the Code.

The Tribunal must decide to approve the FAR if satisfied of all the Code criteria and must decide not to approve the FAR if not satisfied of all the criteria.<sup>12</sup> The Tribunal finds that the FAR does satisfy each of the criteria for the reasons summarised below.

### **3.2.1 Section 3.33(a) – Tender selection**

Section 3.33(a) of the Code provides that the Relevant Regulator must be satisfied that the successful tender was selected in accordance with the selection criteria specified in the TAR approved by the Relevant Regulator under section 3.25.

The FAR refers to the three stages of the selection process as approved in the TAR. As an overall summary of the actual selection process, it compares how each tender has or has not addressed the tender requirements.<sup>13</sup>

Initially, the CRNG&TAI assessed the two tenders received against the criteria in Stage 1 and found that the Europacific tender had met the criteria to be considered a ‘conforming’ tender while the Agility tender had not. The Agility tender did not proceed to the second stage of assessment.

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<sup>12</sup> Section 3.33 of the Code.

<sup>13</sup> FAR Attachment, pp 8-11.

Then, the CRNG&TAI assessed the remaining tender from Europacific against the criteria in Stage 2 which required that the tender incorporate an appropriate ARP and demonstrate sufficient technical and prudential capacity.

- The CRNG&TAI considered that Europacific met the technical capacity requirements by virtue of the fact that Europacific member, Country Energy, is a licensed distributor. It also considered that the involvement of Colonial First State and Europacific Corporate Advisory Pty Ltd provided sufficient evidence of prudential capacity.<sup>14</sup>
- The CRNG&TAI found that Europacific's ARP is consistent with the overarching philosophy of the tender to maximise the gas supply area and minimise tariffs.<sup>15</sup> It did however seek clarification of the operation of the proposed ARP from Europacific. (For more detail on this policy see section 3.2.5 of this document.)

In the third stage, the CRNG&TAI assessed Europacific's proposed reference tariffs and associated policy as achieving the objectives of section 8.1 of the Code and the reference tariffs as containing or reflecting a fair and reasonable allocation of costs between users and services. (For more detail on cost allocation see section 3.2.3 of this document.) By virtue of the fact that it was the only remaining tender, the CRNG&TAI considered that Europacific's tender satisfied the primary criteria to provide the lowest sustainable distribution and transmission tariffs.<sup>16</sup> Consequently, Europacific was selected as the successful tenderer.

Throughout all of these stages, the CRNG&TAI's advisors, PricewaterhouseCoopers (PwC), assisted in evaluating the tenders and recommending the successful tender to the CRNG&TAI. Although not submitted as part of the FAR, the CRNG&TAI have provided a copy of PwC's evaluation and recommendation for the Tribunal's information.

#### *Tribunal's assessment*

The Tribunal notes that the approved tender documentation established 3 stages in the selection process<sup>17</sup>:

- Stage 1 – determined whether a tender is conforming or non-conforming. A tender would be considered non-conforming if it:
  - did not include a statement of reference tariffs and reference services
  - did not include an ARP
  - did not provide that the residual value would be based on depreciation
  - was otherwise inconsistent with section 4.2 of the tender specifications
  - was a conditional tender which does not meet specified requirements.

Non-conforming tenders would not proceed to Stage 2.

- Stage 2 – assessed conforming tenders against the following minimum criteria:
  - must incorporate ARPs that are appropriate for the transmission and distribution pipeline based on the proposed tariffs
  - must demonstrate sufficient technical and prudential capacity to own and operate gas transmission and distribution pipelines (generally if the tenderer – or

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<sup>14</sup> FAR Attachment, p 11.

<sup>15</sup> FAR Attachment, p 21.

<sup>16</sup> FAR Attachment, p 4.

<sup>17</sup> Schedule 2 of the Tender Specifications in the tender documentation.

a party to a tendering consortium - held an active distribution or transmission licence, it would automatically be considered to meet this criterion).

If any tender did not meet the minimum criteria it would not be considered further.

- Stage 3 – prior to ranking of tenders, tenders must have:
  - achieved the objectives of a reference tariff and reference tariff policy set out in section 8.1 of the Code; and
  - contained or reflected an allocation of costs between services and an allocation of costs between users which is fair and reasonable.

Complying tenders were then to be ranked, with non-conditional ranking over conditional.

The primary criteria for selecting the winning tender would be the ‘lowest sustainable tariffs’ taking into account the average combined distribution and transmission reference tariff and residual values. Secondary criteria would also be applied to differentiate similar priced tenders.

The Tribunal has considered both of the tenders that were included in the FAR<sup>18</sup> and statements in the FAR concerning the selection process, against the approved selection criteria in the TAR.

The Tribunal is satisfied that the FAR demonstrates that the selection of the successful tender was based upon an application of the selection criteria in accordance with those specified in the approved TAR. It notes that because only one tender proceeded to Stages 2 and 3, the application of secondary non-price criteria or ranking of tenders became redundant.

*The Tribunal is satisfied that the FAR meets the requirements of section 3.33(a) of the Code.*

### **3.2.2 Section 3.33(b) – Tender process**

Section 3.33(b) of the Code provides that the Relevant Regulator must be satisfied that the tender process was conducted in accordance with the procedures and rules specified in the TAR approved by the Relevant Regulator under section 3.25.

In its FAR, the CRNG&TAI identifies the following procedures and rules from the approved tender documentation (as contained in the TAR):

- Section 3 - lodgement of tenders
- Section 4 - information in tenders
- Section 7 - probity.

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<sup>18</sup> The Agility submission was lodged as a confidential attachment to the FAR.

To describe the actual tender process, the FAR includes a flowchart of the key steps<sup>19</sup>, and notes that:

- a four-week extension to the tender closing date was provided as a result of changes to a major customer's forecast load and uncertainty over Commonwealth Government policy on excise arrangements for biofuels
- the accessibility of intellectual property, belonging to the Australian Pipeline Trust (APT) and Agility, to all potential tenderers maintained a level playing field
- the tender was advertised widely through local press and electronic media
- tender documentation was sent to 20 potential tenderers
- the CRNG&TAI and PwC were involved in the evaluation of tenders received.<sup>20</sup>

The FAR includes copies of correspondence, media releases and other material to attest to the process followed, and a statutory declaration signed by the CRNG&TAI to the effect that the process undertaken was in accordance with the approved tender process.

#### *Tribunal's assessment*

The Tribunal has considered the tender process undertaken by the CRNG&TAI against the procedures and rules specified in the approved TAR.

In addition to the sections identified by the CRNG&TAI in the FAR, the Tribunal considered whether processes identified in the following sections of the tender documentation were conducted in accordance with the TAR:

- Section 2 - tender clarification, briefings and timeframes
- Section 5 - evaluation of tenders
- Section 6 - notification to winning tenderer
- Section 7 of the Background - availability of APT/Agility information.

The Tribunal notes that the actual deadline for tenders was later than the closing time for tenders in the approved tender documentation. However, the tender specifications provide for the CRNG&TAI to vary tender timeframes at its absolute and sole discretion.<sup>21</sup> The CRNG&TAI consulted the ACCC and Tribunal before making this variation and consistent with the tender specifications, it advised affected parties of this change.

With respect to the other tender processes, the Tribunal considers that the CRNG&TAI has provided sufficient material (such as relevant correspondence, media releases and reports) for it to be satisfied that the tender was conducted in accordance with the key steps of the tender process. It also notes that the CRNG&TAI provided a statutory declaration to that effect and it is not aware of any claims from potential tenderers or stakeholders that tender procedures and rules were not followed.

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<sup>19</sup> FAR Attachment, p 13.

<sup>20</sup> FAR Attachment, pp 12-15.

<sup>21</sup> Section 2.4 of Tender Specifications, p 30.

While noting that only two tenders were received, the Tribunal had foreshadowed in its TAR decision that it would be reasonable to expect that a small number of tenderers would be involved in this type of project, but this does not of itself indicate a less than competitive outcome.<sup>22</sup>

The Tribunal is satisfied that the tender was conducted in accordance with the approved procedures and rules.

*The Tribunal is satisfied that the FAR meets the requirements of section 3.33(b) of the Code.*

### **3.2.3 Section 3.33(c) – Reference tariffs**

Section 3.33(c) of the Code provides that the Relevant Regulator must be satisfied that the Reference Tariffs determined in accordance with the tender process:

- (i) achieve the objectives in section 8.1; and
- (ii) contain or reflect an allocation of costs between Services and an allocation of costs between Users which is fair and reasonable.

The objectives in section 8.1 are as follows:

- (a) providing the Service Provider with the opportunity to earn a stream of revenue that recovers the efficient costs of delivering the Reference Service over the expected life of the assets used in delivering that Service;
- (b) replicating the outcome of a competitive market;
- (c) ensuring the safe and reliable operation of the Pipeline;
- (d) not distorting investment decisions in Pipeline transportation systems or in upstream and downstream industries;
- (e) efficiency in the level and structure of the Reference Tariff; and
- (f) providing an incentive to the Service Provider to reduce costs and to develop the market for Reference and other Services.

#### **(i) Objectives in section 8.1**

The CRNG&TAI's key reasoning for concluding that section 8.1 objectives have been achieved is that the proposed reference tariffs have been determined through an open and competitive tender process. It concludes that the proposed reference tariffs:

- will permit recovery of efficient costs - s8.1(a), and
- will replicate the outcome of a competitive market - s8.1(b).<sup>23</sup>

The CRNG&TAI states that it saw no reason to suggest that the proposed reference tariffs would:

- not ensure safe and reliable operation of the pipeline - s8.1(c), or
- distort investment decisions in pipeline transportation systems or in upstream and downstream industries - s8.1(d).<sup>24</sup>

The CRNG&TAI also notes that the:

- proposal to capitalise any under-recoveries is consistent with other greenfield pipelines
- tariff categories are consistent with those that exist elsewhere in gas industry, and

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<sup>22</sup> TAR Decision, p 8.

<sup>23</sup> FAR Attachment, p 16.

<sup>24</sup> FAR Attachment, p 16.

- tariff structure provides an incentive for Europacific to reduce costs and develop services.<sup>25</sup>

Although not specifically expressed, these appear to be references to objectives (a), (e) and (f) in section 8.1 of the Code.

*Tribunal's assessment of s3.33(c)(i)*

**(i) Objectives in section 8.1**

In making its decision on the TAR, the Tribunal commented that provided the tender is conducted in accordance with the process outlined in the TAR, the objectives of section 8.1 are likely to be met.<sup>26</sup> This is consistent with the stated policy of the Code which contends that by using a competitive tender process, reference tariffs will have been set in a competitive market, and will naturally achieve the objectives in section 8.1.<sup>27</sup>

Although the Tribunal considers that the tender process was conducted in accordance with the TAR, it had foreshadowed its intention in its TAR decision to fully consider section 8.1 factors pursuant to section 3.33(c) of the Code.<sup>28</sup>

Given the short timeframe within which to make a decision on the FAR, the Tribunal and ACCC jointly engaged McLennan Magasanik & Associates (MMA) to assist with a review of the key tariff-related parameters underpinning the successful tenderer's bid, including:

- forecasts of gas demand
- estimates of costs (including capital and non-capital costs), and
- cost allocation methodology.

MMA was required to review the fairness and reasonableness of demand and cost estimates, and the cost allocation methodology having regard to the section 8.1 objectives of the Code. The Tribunal notes that MMA considered the information in the FAR, sought further information from the successful tenderer, held discussions with a major foundation load customer named in the FAR, and applied its own industry knowledge and modelling expertise. The Tribunal has considered MMA's findings in the following assessment of the proposed reference tariffs against the section 8.1 objectives.

- **Section 8.1(a)** – *provide the Service Provider with the opportunity to earn a stream of revenue that recovers the efficient costs of delivering the Reference Service over the expected life of the assets used in delivering the Service*

Europacific has proposed a total of \$22.1m in capital costs and \$0.2m per annum in operating costs (July 2003 dollars) over the initial AA period to 1 July 2019 for the proposed distribution pipeline. The Tribunal notes the assessment by MMA that the costs proposed in the Europacific tender are within a reasonable range. MMA has suggested that payments to Europacific members for services such as project management, and which form part of capital costs, should be set transparently to avoid the potential for cost shifting. The Tribunal however, does not consider that this indicates excessive costs.

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<sup>25</sup> FAR Attachment, pp 15-16.

<sup>26</sup> TAR Decision, p 7.

<sup>27</sup> Italicised introduction to section 3 of Code.

<sup>28</sup> TAR Decision, footnote 16, p 7.

The Tribunal notes that Europacific's tender is based upon supplying gas to a range of large and small customers in Tamworth and Gunnedah, with demand expected to gradually increase from 1.5PJ in 2004/05 to 2.8PJ in 2018/19. The most significant customer is expected to be an ethanol plant in Gunnedah with an estimated load of 1.2PJ. Less significant, but increasing, demand is expected from industrial, residential and business customers in these two towns. It is anticipated that other towns in the region will be reticulated once assessed to be commercially viable. MMA advised that overall the demand estimates and the underlying methodology are reasonable, and consistent with a 'high' marketing effort.

The Tribunal considers that given the tariffs will be fixed over the initial AA period, Europacific would have an incentive to maximise throughput and minimise costs, therefore this should ensure that actual costs are maintained at efficient levels. It also finds that the demand estimates are reasonable and based on sound methodology.

The Tribunal accepts MMA's calculations that the project would require a project life of over 20 years to recover the proposed costs, using Europacific's required rate of return. This is within the asset lives of the pipelines and therefore should enable the Service Provider to earn a stream of revenue that recovers the efficient costs.

The Tribunal notes that the pipeline owners' required rate of return – a pre tax real weighted average cost of capital (WACC) of 11.995 per cent - is significantly higher than that it has accepted for other covered pipelines in NSW. While being an element of the proposed reference tariffs, the Code does not provide for the Tribunal to review the underlying rate of return in its assessment of the FAR.

Since Europacific does not expect to recover its proposed costs within the initial AA period of 15 years, it has proposed to capitalise any under-recoveries in the residual value to provide it with the opportunity to recover all efficient costs over the asset life. It has forecast a residual value of \$38m (July 2003 dollars) at the end of the AA period, although this may change as the residual value will be based on actual costs and revenues.

The Tribunal notes that the concept of capitalising under-recoveries in residual asset value and using actual values to calculate residual value has been adopted for other regional greenfields pipelines.<sup>29</sup>

The Tribunal is satisfied that, based upon the reasonableness of the cost and demand estimates combined with the capitalisation of under-recoveries, the proposed reference tariffs should enable the Service Provider to recover its efficient costs over the asset's lifetime.

*The Tribunal is satisfied that the proposed reference tariffs meet the section 8.1(a) objective in relation to the proposed distribution pipeline.*

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<sup>29</sup> See Final Decisions of the then Office of the Regulator-General, Victoria on the AA for Envestra Limited (Mildura) dated 3 June 1999, and EastCoast Gas Pty Ltd (East Gippsland) dated May 1999.

- **Section 8.1(b)** – replicate the outcome of a competitive market

The Tribunal notes that the reference tariffs proposed by Europacific were set with regard to the delivered prices of competing fuels (including LPG, electricity and coal) and Europacific's assessment of what each of the potential consumer groups would be willing to pay for natural gas.

The Tribunal accepts MMA's advice that the elements used for setting the proposed tariffs reflect what would be expected in a competitive market, including that they: are market based; minimise the risk of bypass; take account of competing fuel costs; are based on relevant cost allocation methodology and allocate direct costs to identifiable users.

The Tribunal considers that the resulting proposed tariffs should therefore replicate the outcome of a competitive market.

*The Tribunal is satisfied that the proposed reference tariffs meet the section 8.1(b) objective in relation to the proposed distribution pipeline.*

- **Section 8.1(c)** – ensure safe and reliable operation of the pipeline

The FAR indicates that Country Energy Gas (CEG) is intended to be the operator of the proposed pipelines. The Tribunal notes that CEG is an established operator in the gas industry and holds a reticulator's authorisation in NSW. The Tribunal considers that it is reasonable to expect the forecasts of costs presented in the FAR to be based on operating a pipeline according to existing standards of safety and reliability. It notes that the policy to capitalise actual under-recoveries will enable the Service Provider to recover any unforeseen costs that may result from changes to these standards.

*The Tribunal is satisfied that the proposed reference tariffs meet the section 8.1(c) objective in relation to the proposed distribution pipeline.*

- **Section 8.1(d)** – not distort investment decisions in pipeline transportation systems or in upstream and downstream industries

In considering this objective, the Tribunal considered that potential sources of distortion to investment may be that which arise from overcompensating Europacific through reference tariffs (which may distort decision-making in related markets) and under compensating Europacific (which may deter investment in related markets upstream and downstream).

As it notes in its assessment of the 8.1(a) objective, the Tribunal considers that the cost and demand estimates are reasonable, and therefore it does not consider that there is any material over or under compensation.

Furthermore, the Tribunal finds that since the tender process was conducted in such a way as to ensure a competitive outcome (which it concludes in section 3.2.2 above), this supports the proposition that the proposed reference tariffs will not distort investment decisions upstream or downstream or in related markets.

Consequently, the Tribunal does not consider that the proposed reference tariffs would distort investment in gas transportation systems, or upstream and downstream markets.

*The Tribunal is satisfied that the proposed reference tariffs meet the section 8.1(d) objective in relation to the proposed distribution pipeline.*

• *Section 8.1(e) – efficiency in reference tariff level and structure*

Europacific has proposed a tariff structure incorporating a common tariff for each of the four customer classes based on throughput. The reference tariffs for both distribution and transmission services are shown in **Table 1** below (in July 2003 prices).

**Table 1 Proposed reference tariffs**

Reference Service	Proposed distribution tariff \$ per GJ	Proposed transmission tariff \$ per GJ
Domestic	3.50	6.50
Industrial & Commercial	1.50	5.00
Contracts (>10 TJ pa)	1.20	2.50
Special Contracts (>1 PJ pa)	0.05	1.75

Source: FAR Attachment, p 23.

These tariffs are to remain constant throughout the initial AA period in real terms.

Europacific has clarified that this structure is to facilitate maximum gas sales in all the reference services and spread the recovery of costs over the maximum number of users from all references services and all towns.<sup>30</sup>

The Tribunal notes that the ‘postage stamp’ approach to pricing is not uncommon in greenfields projects where developers wish to encourage usage of the network. The throughput based tariffs are more likely to encourage uptake of gas (especially for less experienced gas consumers) since it avoids concerns about fixed fees and load management issues (associated with capacity based structures). It also notes that there was an expectation of and clear support for a common zonal tariff both in the tender documentation and also in the affected communities.<sup>31</sup>

The Tribunal accepts that the proposed split into four customer classes is generally consistent with tariff structures existing throughout the gas industry. It notes that MMA found that the proposed tariff levels and structure are reasonable, noting that these tariffs would be conducive to ‘market building’.

As discussed under objectives 8.1(a) and 8.1(c) above, the Tribunal considers that the reference tariffs have been based on efficient costs and with reference to customers’ willingness to pay. The Tribunal concludes that reference tariffs will serve the objective of reflecting efficient levels and structures.

*The Tribunal is satisfied that the proposed reference tariffs meet the section 8.1(e) objective in relation to the proposed distribution pipeline.*

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<sup>30</sup> FAR Attachment, p 18.

<sup>31</sup> The Tribunal received numerous letters from stakeholders (including prospective customers and local councils) supporting a “uniform pricing structure” for the region.

• **Section 8.1(f)** – *incentives to reduce costs and develop the market for services*

As discussed above a throughput-based charge is more likely to encourage faster uptake of gas which would in turn assist Europacific to expand distribution to new areas. This is particularly so given the proposed ARP contains a mechanism to facilitate wider reticulation (see section 3.2.5 below).

The Tribunal also considers that as tariffs are fixed the Service Provider should have an incentive to minimise costs. MMA's report supports this finding although it found that the incentives to reduce costs only exist to the extent that the fees to be received by Europacific members are reasonable, pre-set and transparent.

The Tribunal is satisfied that the proposed reference tariffs create incentives to reduce costs and develop the market for services.

*The Tribunal is satisfied that the proposed reference tariffs meet the section 8.1(f) objective in relation to the proposed distribution pipeline.*

**(ii) Fair and reasonable cost allocation**

In its FAR, the CRNG&TAI refers to sections 8.38 to 8.43 of the Code as prescribing the principles upon which cost allocation should be based. It interprets the Code as requiring that both the level of costs attributed to reference services, and the allocation of those costs to individual reference services and users, is to be fair and reasonable.<sup>32</sup>

Europacific's tender and its subsequent clarifications indicate that cost allocation is based on the following:

- capital costs have been attributed to each pipeline based on direct project costs
- operating costs for transmission and distribution have been allocated wholly to the transmission pipeline
- capital and operating costs for transmission have been allocated to customers on a Maximum Hourly Quantity (MHQ) basis
- capital costs for distribution have been allocated to identified contract and special contract users, with remaining capital costs allocated to smaller customers based on MHQ
- transmission and distribution pipelines are to earn the same rate of return.

It is CRNG&TAI's view that it is reasonable to assume that any revenue from non-reference services will not be material. It also accepted Europacific's arguments that its proposed cost allocation approach is consistent with the Code on the basis that it is simple to understand, and achieves the projected overall returns on pipelines and an acceptable bundled tariff for all customers.<sup>33</sup>

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<sup>32</sup> FAR Attachment, p 17.

<sup>33</sup> FAR Attachment, p 19.

*Tribunal's assessment of s3.33(c)(ii)*

The Tribunal referred to sections 8.38 to 8.43 of the Code for guidance in relation to cost allocation objectives. In summary these provisions provide that to the extent that it is commercially or technically reasonable, reference tariffs should recover costs directly attributable to the reference services (and users) and a fair and reasonable share of costs incurred jointly with other services (and users).

As previously noted, MMA were requested to review and comment on Europacific's cost allocation methodology.

MMA advised that Europacific's cost allocation methodology and mechanisms are reasonable. While noting that the allocation of all proposed operating costs to the transmission pipeline is not typical, MMA concluded that the impact of this is likely to be limited. Indeed, MMA found that the expected allocation of revenues between the transmission and distribution pipelines over the initial AA period matched well the allocation of costs.

However, MMA raised concerns with the cost reflectivity of the proposed reference tariffs, and in particular that they do not reflect the cost allocation methodology expressed in the tender. MMA found that, using the proposed tariffs, some customer groups would not earn sufficient revenue to recover the costs attributed to them in the expressed methodology, while others would earn more.

MMA noted that Europacific have set the proposed reference tariffs with regard to the prices of competing fuel options and overall objectives to ensure rapid uptake of and conversion to gas.

The Tribunal concludes that while the proposed reference tariffs are not fully cost-reflective, in light of the greenfield nature of the pipeline and Europacific's commercial imperatives, they reflect a fair and reasonable allocation of costs to users and services.

*The Tribunal is satisfied that the FAR meets the requirements of section 3.33(c) of the Code.*

### **3.2.4 Section 3.33(d) – Regulatory period**

Section 3.33(d) of the Code provides that the Relevant Regulator must be satisfied that the Revisions Commencement Date in the Access Arrangement for the proposed Pipeline is not later than 15 years after the Access Arrangement for the proposed Pipeline is approved or such later date as the Relevant Regulator considers appropriate for the proposed Pipeline on the basis of the proposed tariffs (including but not limited to Reference Tariffs).

In its tender, Europacific proposed a revisions commencement date of 1 July 2019 and an income start date of 1 July 2004 (a regulatory period of 15 years). This is consistent with the date and timeframe that was indicated in the tender documentation.

The FAR indicates that 1 July 2019 is now 14 years from the time that gas is expected to be first available and the time that the AA is expected to be approved – that is, 1 July 2005.<sup>34</sup>

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<sup>34</sup> FAR Attachment, p 20.

*Tribunal's assessment*

Despite Europacific and the CRNG&TAI's differing assumptions regarding the timing of the commencement of the initial regulatory period, the Tribunal is satisfied that the proposed revisions commencement date of 1 July 2019 will result in an initial AA period of not greater than 15 years.

*The Tribunal is satisfied that the FAR meets the requirements of section 3.33(d) of the Code.*

**3.2.5 Section 3.33(e) – Additional revenue policy**

Section 3.33(e) of the Code provides that the Relevant Regulator must be satisfied that the successful tenderer's Access Arrangement for the proposed Pipeline will contain an Additional Revenue Policy that is appropriate for the proposed Pipeline on the basis of the proposed tariffs (including but not limited to Reference Tariffs).

Following the selection of Europacific as the successful tenderer, the CRNG&TAI asked Europacific to clarify the operation of its proposed ARP and its relationship to the reference tariff policy and calculation of residual value. This clarification has also been submitted as part of the tender outcome in the FAR.<sup>35</sup>

Briefly, the ARP would operate such that any after tax profits in excess of the approved return and residual values in the tender would be retained in a separate account and, subject to the discretion of the Service Provider, be used to fund under-recovery in subsequent years or fund expansion of the distribution pipeline.

The ARP also provides that if funds in the account are unused in ten years from the end of the year the profit was made, then this will be returned to gas users in the form of a reduction in delivery tariffs. Moreover, once all towns mentioned in the tender have been reticulated, any surplus profit after tax will be split 50/50 between the gas users and owners, in the form of reduced tariffs and additional profit distributions.

Relevant to the ARP, the residual value of the distribution pipeline (which, in July 2003 prices, is estimated to be \$38m at the revisions commencement date based on an initial capital base of \$22.1m) is to be adjusted for any under or over recovery to ensure that the pipeline owners receive their required rate of return (11.955 per cent pre-tax WACC) throughout the tariff period. For any year:

Under-recovery = operating costs + (capital base \* 11.955 per cent) - revenue, using actual costs and revenues

The CRNG&TAI accepted Europacific's proposed ARP as appropriate on the basis that it:

- incorporated an intention to share some of the additional revenue with users and extend the network to additional towns
- is consistent with the selection criteria for the tender of ensuring the lowest sustainable tariffs to users over the lifetime of the pipeline and maximising the area to be supplied with gas, and

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<sup>35</sup> FAR Attachment, pp 25-26

- is consistent with other regulatory arrangements which allow for capitalising of any under-recovery in the early stages of pipelines.<sup>36</sup>

#### *Tribunal's assessment*

Section 3.28(d)(ii) of the Code describes an ARP in general terms - as a policy on whether the additional revenue which would result if the volume of gas actually transported by the proposed pipeline exceeds a certain volume will be either retained by the Service Provider or returned in whole or in part to users in the form of lower charges or some other form.

The Tribunal notes that the policy that is proposed by Europacific is not confined to looking at volumes alone, but sets a target that is based upon actual returns exceeding the approved return. Volumes are one component of this equation as it determines the revenues when multiplied by the tariffs. Costs are the other component of calculating the actual return, from which any excess returns may be calculated.

Nevertheless, the Tribunal considers that the proposed ARP is consistent with the minimum requirement specified by the Code as to the content of an ARP. That the ARP in this case also deals with the distribution of actual net returns (that is, revenue less costs) that flow from increased volume, makes the policy more specific than is required by section 3.28, but not in conflict with Code requirements. The Tribunal also accepts that this is a reasonable extension of the minimum requirement as volume estimates for this type of project are, on their own, inherently uncertain, and the fixed tariffs create an incentive to reduce costs and increase volume.

In assessing the appropriateness of the proposed ARP, the Tribunal notes that the Code does not clarify what would be 'appropriate' apart from having regard to the proposed tariffs. In these circumstances, the Tribunal also considered the consistency or otherwise of the ARP with the overall objectives of the Code and the tender.

The Tribunal notes that the potential benefits of the ARP would be subject to the sole discretion of the pipeline owner. The Tribunal finds that, while this may allow for the possibility that no excess funds are applied to fund expansion of the pipeline or to reduce under-recoveries up to the revisions commencement date, the ARP results in potential benefits to the Service Provider and users and customers of the pipeline in a number of ways:

- if applied to fund distribution expansion, the users of expanded systems benefit from the availability of gas infrastructure
- if specified minimum expansions are completed, then users and the Service Provider stand to share equally
- if not applied to either purpose, then the users stand to benefit from reduced tariffs (after 10 years).

The Tribunal further finds that reduced under-recoveries would result in a lower residual value for the pipeline at the end of the AA period thereby lowering the regulatory asset base from which reference tariffs will be derived for the subsequent AA period

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<sup>36</sup> FAR Attachment, p 21.

The Tribunal concludes that the operation of the ARP is generally consistent with the primary and secondary criteria expressed in the tender documentation (to deliver the lowest sustainable tariffs and maximise the areas and customers served by the pipeline). It notes that the former principle is also reflected in the Code.<sup>37</sup>

Given the potential benefits to be obtained from its application during the initial proposed and future regulatory periods, the Tribunal finds that the proposed ARP is appropriate.

*The Tribunal is satisfied that the FAR meets the requirements of section 3.33(e) of the Code.*

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<sup>37</sup> Section 3.28(f)(i).

## APPENDIX 1 REGULATORY APPROVAL PROCESS

