IN THE WESTERN AUSTRALIAN ELECTRICITY REVIEW BOARD

File No. 2 of 2010

RE: Application under section 39(1) of Schedule 1 of the Gas Pipelines (Western Australia) Act 1998 (which provisions continue to apply by reason of section 28(4) of Schedule 3 of the *National Gas Access (WA) Act 2009*) for a review of the decision of the Economic Regulation Authority to draft and approve revisions of the access arrangement to apply to the Goldfields Gas Pipeline in place of the access arrangement revisions submitted for approval of Goldfields Gas Transmission Pty Ltd on behalf of the Goldfields Gas Transmission Joint Venture

BY: Southern Cross Pipelines Australia Pty Ltd, Southern Cross Pipelines (NPL) Australia Pty Ltd, Alinta DEWAP Pty Ltd and Goldfields Gas Transmission Pty Ltd

Applicant

APPLICANT'S OUTLINE OF WRITTEN SUBMISSIONS

(AS AMENDED 16 MARCH 2011)

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Part A Introduction

1 Overview of application for review

1.1 On 5 August 2010, the Economic Regulation Authority (**ERA**) published its further final decision in respect of revisions to the proposed access arrangement for the Goldfields Gas Pipeline (**ERA Further Final Decision**). The proposed revisions were submitted by or on behalf of the applicants (together **GGT**).[1]

1.2 The ERA Further Final Decision required GGT to incorporate into the final access arrangement an amendment which the ERA prescribed for the Extensions and Expansions Policy (**EEP**) applicable to the Goldfields Gas Pipeline (**Pipeline**).

1.3 In substance, the ERA required the final access arrangement to include a term in the EEP (cl. 10.3) which provides that if GGT expands the capacity of the Pipeline, the expanded capacity will be treated as part of the Covered Pipeline for all purposes under the National Third Party Access Code for Natural Gas Pipeline Systems (**Code**).

1.4 The Code had effect under the *Gas Pipelines Access (Western Australia) Act* 1998 (WA), which has now been materially repealed subject to the operation of various transitional provisions described below.

1.5 In making this decision, the ERA did not take into account further submissions and certain supporting documents (in particular, an expert report from NERA) submitted by GGT after the ERA's final decision, but prior to its further final decision.

1.6 GGT seeks to review the ERA Further Final Decision to require cl.10.3 to be included in the final access arrangement.

1.7 As well GGT raises other grounds of review concerning the determination of the pre-tax rate of return which affects the weighted average cost of capital (WACC) and is a component used to determine the Reference Tariff for the Pipeline.

1.8 In respect of each of the issues relating to the EEP and pre-tax rate of return, the basic approach of the Regulator to GGT's proposed revisions to the previous access arrangement was flawed, as it was contrary to a fundamental principle of regulation, viz, subject to compliance with the Code, it is for the Service Provider to choose the manner in which it complies with the Code, not for the Regulator to make this choice. That

[1] The Goldfields Gas Pipeline is owned by Southern Cross Pipelines Australia Pty Ltd, Southern Cross Pipelines (NPL) Australia Pty Ltd and Alinta DEWAP Pty Ltd, each of which is a member of the GGTJV. By agreement, Goldfields Gas Transmission Pty Ltd (**GGT**) acts in all respects for and on behalf of the GGTJV participants in relation to the operation of the Goldfields Gas Pipeline. GGT lodged the proposed revisions to the access arrangement applying to the Goldfields Gas Pipeline, and made submissions in relation to these revisions, on behalf of the GGTJV participants.

principle is embodied in the Code in recognition of the fact that it is the Service Provider that actually operates the pipeline and bears the financial risk of conducting that business. It is only if the Service Provider proposes an access arrangement that does not comply with the Code that the ERA may intervene and propose its own amendments.

1.9 Further, even if the ERA proposes its own amendments, the Service Provider remains entitled to propose different amendments which address the reasons for the ERA's amendments.

1.10 In the present case, the ERA was obliged to consider the substance of different amendments which GGT proposed, and the reasons for these amendments, before rejecting them. This obligation reflects the basic principle of regulation, that a Service Provider should determine how and on what terms the relevant services are provided, so long as this complies with the Code.

1.11 Contrary to this principle, the ERA failed to consider amendments which GGT proposed after the Final Decision and which addressed the reasons for amendments required by the ERA in relation to each of the EEP and pre-tax rate of return.

1.12 As well, in relation to the EEP which the ERA adopted, this is itself contrary to the Code and, for that reason, cannot be allowed to remain in the revised access arrangement.

1.13 A decision of the ERA may be set aside where the ERA incorrectly or unreasonably exercised its discretion to require amendments to revisions proposed by a Service Provider, or when the occasion for the exercise of the ERA's discretion did not arise. There may be an incorrect exercise of discretion where the ERA misconstrued or misapplied the Code.

1.14 If any such error is made out, the relevant part of the access arrangement, which was approved by the ERA after its further final decision, should be revised by the Board. GGT's proposed revisions to the previous access arrangement should be adopted in lieu of the ERA's proposed revisions.

2 ERA access arrangement approval process

2.1 Section 2.28 of the Code relevantly provides that by the date provided for in the Access Arrangement as the Revisions Submission Date, the Service Provider must submit to the Relevant Regulator proposed revisions to the Access Arrangement together with the applicable Access Arrangement Information.

2.2 The Access Arrangement applying to the Pipeline, which was approved by the ERA in July 2005 and revised in December 2008, provided for a Revisions Submission Date of 1 April 2009.

2.3 On 23 March 2009, GGT submitted it proposed revisions to the Access Arrangement and the applicable Access Arrangement Information (**GGT's Proposed Revisions**).

2.4 Section 2.29 of the Code provides that an Access Arrangement as revised by the proposed revisions may include any relevant matter but must include at least the elements described in ss. 3.1 to 3.20 of the Code. These elements include:

(a) a Reference Tariff for: (a) at least one Service that is likely to be sought by a significant part of the market; and (b) each Service that is likely to be sought by a significant part of the market and for which the Relevant Regulator considers a Reference Tariff should be included;[2]

(b) a policy (an **Extensions / Expansions Policy**) which sets out, amongst other things: the method to be applied to determine whether any extension to, or expansion of the Capacity of, the Covered Pipeline: (a) should be treated as part of the Covered Pipeline for all purposes under the Code; or (b) should not be treated as part of the Covered Pipeline for any purpose under the Code.[3]

2.5 After receiving a proposed revision to an Access Arrangement the Relevant Regulator must inform interested parties that it has received the proposed revisions to the Access Arrangement and Access Arrangement Information: s.2.31.

2.6 After considering submissions, the Relevant Regulator must issue a draft decision which either: (a) proposes to approve the revisions to the Access Arrangement; or (b) proposes not to approve the revisions and provides reasons and states the amendments which would have to be made to the revisions in order for the Relevant Regulator to approve them: s.2.35.

[2] Section 3.3.
[3] Section 3.16.

2.7 On 9 October 2009, the ERA published its draft decision in relation to GGT's Proposed Revisions (**ERA Draft Decision**). The ERA's Draft Decision was not to approve GGT's Proposed Revisions. The ERA's Draft Decision set out the amendments that would be required to GGT's Proposed Revisions in order for the ERA to approve them.

2.8 Section 2.37A provides that the Service Provider may, after the date of the draft decision, resubmit the revisions to the Access Arrangement, amended so as to incorporate or substantially incorporate the amendments specified by the Relevant Regulator in its draft decision or otherwise address the matters the Relevant Regulator identified in its draft decision as being the reasons for requiring the amendments specified in its draft decision.

2.9 On 22 April 2010, GGT submitted amended revisions to the Access Arrangement in response to the ERA Draft Decision (**GGT's Amended Proposed Revisions**).

2.10 After considering any further submissions received by the relevant date, the Relevant Regulator must issue a final decision that, if the Service Provider has submitted amended revisions to the Access Arrangement under s. 2.37A: (a) subject to s. 2.38A, approves the amended revisions to the Access Arrangement; or (b) does not approve the amended revisions to the Access Arrangement and states the amendments which would have to be made to the revisions in order for the Relevant Regulator to approve them: s.2.38.

2.11 The Relevant Regulator may approve amended revisions to an Access Arrangement only if the Relevant Regulator is satisfied that the amended revisions: (a) incorporate or substantially incorporate the amendments specified by the Relevant Regulator in its draft decision; or (b) otherwise address to the Relevant Regulator's satisfaction the matters the Relevant Regulator identified in its draft decision as being the reasons for requiring the amendments specified in its draft decision: s.2.38A.

2.12 On 13 May 2010, the ERA published its final decision in relation to GGT's Amended Proposed Revisions (**ERA Final Decision**). The ERA's Final Decision was not to approve GGT's Amended Proposed Revisions. The ERA's Final Decision set out the amendments that would be required to GGT's Amended Proposed Revisions in order for the ERA to approve GGT's Amended Proposed Revisions.

2.13 On 4 June 2010, GGT submitted amended revisions to the ERA in response to the ERA Final Decision (**GGT's Further Amended Proposed Revisions**).

2.14 Section 2.40 of the Code provides that if the Service Provider submits amended revisions to the Access Arrangement by the date specified by the Relevant Regulator in its final decision then the Relevant Regulator must issue a further final decision that:

(a) if the Relevant Regulator is satisfied that the amended revisions to the Access Arrangement incorporate the amendments specified by the Relevant Regulator in its final decision, approves the amended revisions to the Access Arrangement; or

(b) if the Relevant Regulator is satisfied that the amended revisions to the Access Arrangement either substantially incorporate the amendments specified by the Relevant Regulator or otherwise address to the Relevant Regulator's satisfaction the matters the Relevant Regulator identified in its final decision as being the reasons for requiring the amendments specified in its final decision, either approves or does not approve the amended revisions to the Access Arrangement; or

(c) in any other case, does not approve the amended revisions to the Access Arrangement.

2.15 On 5 August 2010, the ERA published the ERA Further Final Decision not to approve GGT's Further Amended Proposed Revisions.

2.16 If the Relevant Regulator does not approve amended revisions submitted in response to the Relevant Regulator's final decision, the Relevant Regulator must draft and approve its own amended revisions to the Access Arrangement, instead of the revisions proposed by the Service Provider: s.2.42.

2.17 The ERA's own amended revisions to the Access Arrangement were set out in Appendix 2 of the ERA Further Final Decision.

2.18 A decision by the Relevant Regulator under s.2.42 is subject to review by the Relevant Appeals Body under the Gas Pipelines Access Law: s.2.48.

3 Relevant legislative background governing review

3.1 The *National Gas Access (WA) Act* 2009 (WA) substantially came into effect on 1 January 2010.

3.2 Section 7(1) provides that the text of the Western Australian National Gas Access Law (**National Gas Access Law**) applies as a law of Western Australia. Schedule 1 to the *National Gas Access (WA) Act* 2009 contains the Western Australian National Gas Access Law.

3.3 By s.336 of the National Gas Access Law, certain savings and transitional provisions set out in Schedule 3 have effect. Section 28 of Schedule 3 applies to the situation where a proposed access arrangement has been submitted under s.2.2 of the Code, to a relevant Regulator before the commencement day for the National Gas Access Law, and at the time of the commencement of the National Gas Access Law the relevant Regulator has not approved the access arrangement in a further final decision under s.2.19 of the Gas Code, or drafted and approved its own access arrangement under s.2.20 of the Gas Code.

3.4 In such circumstances, s.28(2) provides that on and after the commencement day of the National Gas Access Law, the relevant Regulator must, despite the repeal of the Code, deal with the proposed access arrangement as if the Code continues to apply.

3.5 Further, s.28(3) provides that an access arrangement approved, or drafted and approved, in accordance with s.28(2) is deemed to be, on the day the relevant decision takes effect, in the case of an access arrangement drafted and approved by the Relevant Regulator under s.2.20 of the Gas Code, a full access arrangement made by the Australian Energy Regulator (**AER**) under a "full access arrangement decision".

3.6 For the purposes of the text of the WA version of the National Gas Access Law, the AER includes the ERA in respect of a pipeline for which the Minister under the *National Gas Access (WA) Act* is responsible: see s.2A(1) of the text of the WA version of the National Gas Access Law, definitions of "regulator" and "ERA pipeline" in s.9(1) of the *National Gas Access (WA) Act*.

3.7 Hence, for the purposes of WA, s.28(3) provides that an access arrangement approved, or drafted and approved, in accordance with s.28(2) is deemed to be, on the day the relevant decision takes effect a full access arrangement made by the ERA under a "full access arrangement decision".

3.8 Section 28(4) provides that despite anything to the contrary in the National Gas Access Law, and the repeal of the old access law (which gave effect to the Code), s.39 of the old access law continues to apply to a full access arrangement decision referred to in s.28 as

if a reference in s.39 of the old access law to a decision of the relevant Regulator under the Code were a reference to a full access arrangement decision of the AER. The reference to AER here must also be read as a reference to the ERA. Hence, the effect of s.28(4) is that s.39 of the old access law continues to apply to a decision by the ERA under the Code, as if that decision was a full access arrangement decision.

3.9 The old access law is the Gas Pipelines Access Law which was contained in Schedule 1 to the *Gas Pipelines Access (Western Australia) Act* 1998.

3.10 By s.39(1) of the old access law, if the ERA made a decision under the Code to approve its own access arrangement, or to approve its own revisions to an access arrangement, in place of an access arrangement or revision submitted for approval by a Service Provider, the Service Provider was entitled to apply to "the relevant appeals body" for a review of the decision.

3.11 By s.39(2)(a), an application for review might only be made on one of the following grounds, to be established by the applicant:

(a) an error in the Relevant Regulator's finding of facts; or

(b) the exercise of the Relevant Regulator's discretion was incorrect or was unreasonable having regard to all the circumstances; or

(c) the occasion for exercising the discretion did not arise.

3.12 The nature of the review process on these grounds is discussed in *Australian Competition and Consumer Commission v Australian Competition Tribunal* (2006) 152 FCR 33 at [169]-[179] (*ACCC v ACT*). As was explained there:

(a) the Relevant Regulator's discretion may be exercised incorrectly as a result of a misconstruction or misapplication of any aspect of the Code or by a failure to have regard to applicable principles, methodologies or factors; and

(b) the Relevant Regulator's exercise of discretion may have been incorrect or unreasonable in the manner in which it dealt with choices which were to be made under the Code.

3.13 That approach to the scope of the grounds of review was confirmed in *East Australian Pipeline Pty Ltd v ACCC* (2007) 233 CLR 229 at [79]-[80].

3.14 Further, by reason of s.39(2)(b), an application under s.39(1) may not raise any matter that was not raised in submissions to the relevant Regulator before the decision was made.

3.15 The materials available to be considered in reviewing a decision under s.39(1) are confined to the application for review and submissions in support of it, the relevant access arrangement, revisions or proposed revisions and related information, submissions made to the relevant Regulator before the decision was made, reports relied on by the relevant Regulator before the decision was made, and any decision: s.39(5).

4 Relevant appeals body

4.1 The relevant appeals body under the old access law was the Western Australian Gas Review Board, established under s.50 of the *Gas Pipelines Access (Western Australia) Act* 1998.

4.2 However, by s.36 of the *National Gas Access (WA) Act* 2009, the reference to the Gas Review Board in the *Gas Pipelines Access (Western Australia) Act* 1998 was altered to refer to the Western Australian Electricity Review Board.

4.3 Section 36 of the *National Gas Access (WA) Act* 2009 also amended s.50 of the *Gas Pipelines Access (Western Australia) Act* 1998 to add s.50(2A), which provides that the Western Australian Electricity Review Board has functions under the *Electricity Industry Act* 2004 (WA). As well, ss.37 and 38 of the *National Gas Access (WA) Act* 2009 amended ss.57 and 59 of the *Gas Pipelines Access (Western Australia) Act* 1998 to delete references to the old access law.

4.4 However, regulation 15(2) of the *National Gas Access (WA)(Part 3) Regulations 2009* provides that the Electricity Review Board has the functions of the "local appeals board" under the transitional provisions of the National Gas Access Law.

4.5 The "relevant appeals body" under s.39 of the old access law, in relation to a decision of the ERA, was the "local appeals body": see definitions in s.2 of the old access law. Section 11 of the *Gas Pipelines Access (Western Australia) Act* 1998 defined the "local appeals body" to mean the WA Gas Review Board.

4.6 While regulation 15(2) of the *National Gas Access (WA)(Part 3) Regulations 2009* refers to a "local appeals board" and not a "local appeals body", and the title of the regulations refers to "Part 3" rather than "Schedule 3" of the *National Gas Access (WA) Act* 2009, it is clear that the intention of regulation 15(2) was to confer power upon the Electricity Review Board to continue to hear appeals under the provisions of the Code which continue to apply by reason of the transitional arrangements under Schedule 3 of the *National Gas Access (WA) Act* 2009.

5 Code provisions governing the Relevant Regulator's decisions generally

5.1 The Relevant Regulator may approve proposed revisions to an Access Arrangement only if it is satisfied the Access Arrangement as revised would contain the elements and satisfy the principles set out in ss.3.1 to 3.20: Code s.2.46. The Relevant Regulator must not refuse to approve proposed revisions to the Access Arrangement solely for the reason that the Access Arrangement as revised would not address a matter that ss.3.1 to 3.20 do not require an Access Arrangement to address: s.2.46.

5.2 Section 2.46 of the Code also provides that in assessing proposed revisions to the Access Arrangement, the Relevant Regulator:

(a) must take into account the factors described in s. 2.24; and

(b) must take into account the provisions of the Access Arrangement.

5.3 The factors in s. 2.24 are as follows:

(a) the Service Provider's legitimate business interests and investment in the Covered Pipeline;

(b) firm and binding contractual obligations of the Service Provider or other persons (or both) already using the Covered Pipeline;

(c) the operational and technical requirements necessary for the safe and reliable operation of the Covered Pipeline;

(d) the economically efficient operation of the Covered Pipeline;

(e) the public interest, including the public interest in having competition in markets;

(f) the interests of Users and Prospective Users;

(g) any other matters that the Relevant Regulator considers are relevant.

5.4 As well, the Code sets out the objectives which a Reference Tariff should be designed to achieve and the factors about which the Regulator must be satisfied in approving a Reference Tariff: ss.8.1, 8.2. These are considered in the submissions below which deal with the Rate of Return.

6 The fundamental principle of regulation

6.1 The objectives of the Code are stated in the introduction to the Code (see also s.23 of the National Gas Law). Coverage of a pipeline emerge from the criteria which qualify coverage: s.1.9. Essentially the Code is aimed at encouraging efficient use of pipelines.

6.2 Once a pipeline is covered, regulation under the Code is achieved through approval of an access arrangement. As s.2.24 reveals, an access arrangement must take account of many factors, including the public interest in competition and the legitimate business interests of the Service Provider.

6.3 The Code also embodies many provisions which govern the terms of an access arrangement. An access arrangement must be prepared by a Service Provider and approved by the Relevant Regulator. In considering whether the requirements of the Code governing the contents of an access arrangement have been satisfied, the objectives of the Code and of coverage itself must be borne in mind. As well, it is necessary to appreciate that the subject matter of regulation (ie, operation of a pipeline) is a substantial business activity which involves capital investment and risk-taking.

6.4 On the proper construction of the Code, it is a fundamental principle of the system of regulation which it enacts that it is for a Service Provider to determine the manner in which it will comply with the Code. The Relevant Regulator is not permitted to substitute its own view about the way in which a Service Provider should comply with the Code. Rather, the Relevant Regulator's role is simply to ensure that the Service Provider does comply with the Code.

6.5 That fundamental principle arises upon the proper construction of the terms of the Code having due regard to the purpose of the Code and the nature of the subject matter with which it deals. The principle is supported by a combination of the following considerations:

(a) the requirements embodied in the Code are, of necessity, broad criteria, factors and objectives, in the application of which there is considerable scope for judgment and no uniquely correct outcome in a given case;

(b) the object of the Code is only to ensure that the requirements are observed and fulfilled; it is not to substitute regulatory decision-making for commercial decision-making which is within the parameters of the Code; thus, the role of the Relevant Regulator is to supervise regulated business to ensure that it operates within a permissible scope;

(c) it is the Service Provider, not the Relevant Regulator, which takes the financial risk of conducting the regulated business; consequently, within the scope of

permissible regulated conduct, the Service Provider should not be required to take risks which it does not choose to take;

(d) it is the Service Provider, not the Relevant Regulator, which has superior knowledge about what can be practically achieved;

(e) it is the Service Provider which must prepare and submit an access arrangement and revisions which are required to comply with the Code;

(f) the Relevant Regulator's role of approving an access arrangement and revisions involves determining whether what has been submitted complies with the Code; and

(g) when the Relevant Regulator proposes amendments to an access arrangement, it is open to the Service Provider to propose another means of addressing the underlying reasons for the Relevant Regulator's proposed amendments.

6.6 This analysis of the effect of the Code was adopted by the Full Federal Court in *ACCC v ACT* at [168]. That Court relevantly summarised the Relevant Regulator's role under the Code as follows:

(a) the Relevant Regulator administers the lodgement by a Service Provider of access arrangements and access arrangement information;

(b) the Relevant Regulator invites and receives public and interested party responses to proposed access arrangements;

(c) the Relevant Regulator supervises proposed access arrangements and access arrangement information for compliance with the Code;

(d) the Relevant Regulator may not substitute its own access arrangement for a proposed access arrangement or a revised version thereof unless of the opinion that the proposed access arrangement does not comply with the Code; and

(e) if of the opinion that a proposed access arrangement or revised access arrangement does not comply with the Code, the Relevant Regulator is empowered to formulate and approve its own access arrangement and is, subject to the Code, at large with respect to the terms of that access arrangement.

6.7 In stating these propositions, the Full Federal Court considered and expressly approved a similar conclusion by the Australian Competition Tribunal in *Re Gasnet Australia (Operations) Pty Ltd* [2004] ATPR 41-978 at [30] and the Full Court of Western Australia in *Re Michael; ex parte Epic Energy (WA) Nominees Pty Ltd* (2002) 25 WAR 511.

6.8 The Full Federal Court's decision in *ACCC v ACT* on the ultimate question raised in that case, namely the proper construction of s.8.10 of the Code, was reversed by the High Court: *East Australian Pipeline Pty Ltd v ACCC* (2007) 233 CLR 229. However, there was no criticism of the Full Federal Court's elucidation of the general effect of the regulatory scheme or of the role of the Relevant Regulator's within it.

6.9 The fundamental principle of regulation also informs the process of consultation and determination of required amendments to access arrangements,contained in the Code.

6.10 Both at the stage of the final decision and the further final decision, the Code provides for the Relevant Regulator to make a decision which incorporates amended revisions to the access arrangement proposed by a Service Provider, where those amendments "otherwise address to the Relevant Regulator's satisfaction the matters the Relevant Regulator identified as being the reasons for requiring the amendments specified in its" draft or final decision: ss.2.38A(b), 2.41(b).

6.11 Hence, the Code expressly obliges the Relevant Regulator to consider and determine whether proposed amendments, submitted after each of the Draft and Final Decisions, address, in a different manner from the one the Relevant Regulator proposed, the reasons for amendments which the Relevant Regulator required.

6.12 Whether reasons for amendments are addressed obviously depends upon an assessment of those reasons, and whether the proposed amendments deal with those reasons.

6.13 The purpose of allowing the Service Provider to otherwise address the reasons of the Relevant Regulator is because it is the Service Provider, not the Relevant Regulator, which must operate the pipeline and which has the discretion to ultimately determine just how it will comply with the Code. The Relevant Regulator simply "supervises proposed Access Arrangements ... for compliance with the Code": *ACCC v ACT*, at [168], point 3. Hence, if the concerns of the Relevant Regulator in its role as a supervisor can be addressed in a different way by the actual operator, with its superior knowledge of the practical operation and administration of the pipeline, then the Service Provider should be entitled to satisfy the Relevant Regulator's concerns in the manner most appropriate to it.

6.14 This is a clear manifestation of the basic principle of regulation, that the Relevant Regulator may not substitute its own access arrangement for the proposed access arrangement of the Service Provider if the Service Provider's access arrangement complies with the Code.

7 The EEP, its revisions and proposed revisions

The EEP, its revisions and proposed revisions

7.1 The EEP in the previous access arrangement (cl.10.3) provided that GGT should elect whether expanded capacity, obtained either by an expansion or extension of the Pipeline, should be:

(a) treated as part of the Pipeline for the purposes of the access arrangement; or

(b) the subject of a separate access arrangement; or

(c) uncovered.

7.2 The ERA has approved revisions to the previous access arrangement which distinguish between additional capacity obtained by pipeline extensions and pipeline expansions.

7.3 In respect of pipeline extensions, the ERA has effectively maintained the position which applied under the previous access arrangement: see cl.10.2 of the new access arrangement.

7.4 However, in respect of pipeline expansions, the ERA has approved its own revision to the previous access arrangement which provides that all expanded capacity will be treated as part of the Covered Pipeline for all purposes under the Code: see cl.10.3 of the new access arrangement.

7.5 GGT did not propose automatic coverage of additional capacity obtained through expansions. Instead, during the revision process, GGT advanced two proposals:

(a) first, that expanded capacity should be treated the same way as additional capacity obtained by extension of the pipeline, and coverage should be at GGT's election: see cl 10.2 of the proposed revisions to access arrangement, dated 23 March 2009; and

(b) second, that additional capacity obtained by way of extension or expansion should be covered by the revised access arrangement, unless the ERA did not consent to such coverage or unless GGT had agreed with the proposed user or users of a majority of additional capacity that it would not be treated as part of the Covered Pipeline: see cl.10.1(b) of the proposed revisions to access arrangement, dated 4 June 2010.

7.6 GGT has sought review of the ERA's decision to revise the old access arrangement so that additional capacity obtained through expansions is automatically covered, instead of approving the revisions proposed by GGT in its second EEP (see grounds 12-15).

Significant matters concerning expansion

7.7 There are a number of significant matters relating to expansion of pipeline capacity which must be elucidated prior to explaining the errors in the ERA's decision regarding expansions.

7.8 The Pipeline presently has only approximately 4 TJ/day of Spare Capacity. The Pipeline's capacity is otherwise fully contracted: see GGT's Supporting Submission to Proposed Revisions to Access Arrangement, dated 23 March 2009, p 29. Consequently, subject to the utilisation of this small amount of Spare Capacity, GGT will need to expand the Pipeline to service new users or existing users who require more capacity.

7.9 Additional capacity for the Pipeline may be obtained by means of additional compression or by means of looping. The difference is explained in NERA's report dated 4 June 2010, entitled "Economic Impact of Proposed Expansion Policy" at p 3. This states:

(a) looping involves adding a pipeline to run in parallel to one or more sections of the existing pipeline, but connected with it;

(b) compression enables more gas to flow through the same diameter pipe.

7.10 Extra compression can only expand capacity to a certain extent, after which looping is required.

7.11 The addition of capacity by means of either compression or looping requires capital investment by GGT, either to purchase compressors or to build additional pipeline loops.

7.12 The costs of adding capacity by way of additional compression and looping are different. The NERA report explains this at p 4:

(a) investments in looping effectively involve building additional pipelines and are likely to increase average unit costs, unless the new pipeline is larger in diameter than the existing facility;

(b) investments in compressors may enable additional capacity to be added at relatively modest cost, thereby reducing average unit costs.

7.13 The Pipeline comprises a transmission pipeline, not a network of distribution pipelines. Consequently, the Pipeline's capacity is contracted by a small number of large shippers rather than a very large number of small customers.

7.14 If any shipper defaults, that has a significant effect upon the utilised capacity of the pipeline. It is entirely different to the situation of a distribution network, where if one small customer defaults, it may reasonably be anticipated that the capacity utilised by that customer will be taken up by other customers.

7.15 Given the nature of the existing shippers who utilise the Pipeline, who are typically the owners of large scale mining projects, it cannot reasonably be anticipated that if a shipper using the Pipeline defaults, the capacity abandoned by the defaulting shipper will be utilised by another shipper. Whether a new shipper emerges effectively depends upon a new mining project or like project being constructed and becoming operational.

7.16 Given the size of individual shippers, and the fact that adding capacity to the Pipeline requires capital expenditure, it is not economically rational for GGT to incur the capital costs necessary for future expansions of the pipeline (either through looping or compression) without one or more shippers agreeing in advance to utilise the additional capacity at an agreed rate. GGT is not in the business of incurring additional capital costs in the hope that it may attract a large pipeline user who will utilise that capacity. Again, this is different from a distribution network, where small end users may be expected to utilise the network as a matter of course if it is built.

7.17 If a new shipper seeks access which GGT can only supply by expansion, GGT will seek to negotiate a tariff which enables GGT to recoup the capital costs of the expansion and to earn an appropriate return on those capital costs. It is unlikely that GGT would expand the Pipeline on the basis that the new shipper paid the Reference Tariff. A Reference Tariff is framed according to the life of the asset, whereas a Service Provider faced with capital costs of an expansion will seek to recover that capital over the life of the new foundation shipping contract or that shipper's project. These periods will usually be much less than the life of the asset itself.

7.18 The Reference Tariff does not necessarily or even usually govern the tariff charged by GGT to existing users of the Pipeline. It only applies to the extent that GGT and existing users have agreed to adopt the Reference Tariff rather than a different tariff.

7.19 If an expansion of the Pipeline is carried out, the effect of additional capacity becoming automatically covered as part of the Covered Pipeline is that the Reference Tariff will be affected at the next review of the access arrangement (whether this occurs after the expiry of an access arrangement or due to the happening of a trigger event). The Initial

Capital Base for the Pipeline would necessarily be increased by reason of the additional capital costs, and the Total Revenue for the Pipeline would also increase according to the extra capacity. The result may be that the Reference Tariff increases or decreases, depending upon whether the average unit cost of the additional capacity increases or decreases.

7.20 Any change in the Reference Tariff which occurs as a result of the additional capacity being automatically part of the Covered Pipeline will only directly affect those users who are charged the Reference Tariff or a tariff linked to the Reference Tariff.

7.21 On the basis that GGT (acting in an economically rational way) would likely only incur the capital costs of providing additional capacity if it had obtained contractual commitments to utilise that capacity in advance of incurring those costs, the persons utilising the additional capacity would likely not be directly affected by a change in the Reference Tariff.

7.22 Consequently, any change in the Reference Tariff which occurs by reason of additional capacity becoming part of the Covered Pipeline will likely provide no incentive or disincentive to a user of the additional capacity to enter a contract for the additional capacity.

7.23 Further, the possibility of a change occurring in the unit cost of delivering the Reference Services by reason of the additional capacity becoming part of the Covered Pipeline will have perverse effects, in that:

(a) if the effect of providing additional capacity was to lower the Reference Tariff and lower the overall revenue from existing customers who pay the Reference Tariff or a tariff linked to the Reference Tariff, then there would be a disincentive for GGT to provide additional capacity unless that reduction in overall revenue was recovered from a new shipper;

(b) conversely, if the effect of providing additional capacity was to increase the Reference Tariff and to increase the overall revenue from existing customers who pay the Reference Tariff, those customers would be subsidising the cost of additional capacity, while deriving no benefit from it.

Applicable Code provisions

7.24 As has already been noted, an Access Arrangement must include a policy which sets out "the method" to be applied to determine whether any extension to, or expansion of, the Pipeline should be treated as part of the Covered Pipeline under the Code: s.3.16. The

Relevant Regulator may not require such a policy to state that the Service Provider will fund an extension or expansion, unless the Service Provider agrees to do so: s.3.16.

7.25 The application of s.3.16 necessarily requires consideration of the limited objectives of coverage itself: s.1.9. Section 3.16 is simply a way of achieving coverage of extensions and expansions without going through the process that attends an examination of whether a pipeline should be covered in the first place. It does not supplant the principles which govern that process.

7.26 The fundamental principle of regulation that has been explained above, applies to the determination of an EEP, just as it does to the determination of the other elements of an Access Arrangement, including revisions to it.

7.27 The fact that the Code requires an EEP to describe the method to be applied to determine whether an extension or expansion is covered by the Code, is a recognition that it is appropriate for the ultimate determination to be made, not long in advance of an extension of an expansion being carried out, but at the time when one is proposed and the relevant circumstances are known. So much is confirmed by the example of such a policy that is given in s.3.16(a).

7.28 A "method" is a mode of procedure, especially an orderly or systematic mode, for doing something, such as attaining an objective: see the *Macquarie Dictionary*. In other words, the concept invoked by the Code is that of a process by which a decision on coverage will ultimately be made, if and when an occasion for it to be made arises.

7.29 The elements of a complying method are not prescribed by the Code. What constitutes a complying method must be determined having regard to the generally applicable criteria which govern coverage and an Access Arrangement.

ERA's Reasoning

7.30 The ERA considered that the EEP initially proposed by GGT was not consistent with s.3.16(a) of the Code, as it did not state a "method" to determine whether any extension to or expansion of capacity to the Pipeline should be treated as part of the Covered Pipeline for all or any purposes of the Code: see ERA Draft Decision at [1199].

7.31 The ERA did not consider the merits of the second EEP submitted by GGT, effectively because it declined to consider it by reason that it was submitted after the ERA Final Decision: see ERA Further Final Decision at [66]-[68].

7.32 The ERA considered that a policy of automatic coverage for expanded capacity should be adopted because "the Authority considers that this is a case in which the pipeline is

operating at or near capacity and the Service Provider may, in the absence of regulation and competition, be able to extract monopoly rents by pricing expansion just below the point where it would no longer be commercially viable for a user or prospective user to continue with its proposal": see ERA Draft Decision at [1209] and ERA Final Decision at [632].

7.33 It is important to note that this last aspect of the ERA's reasoning assumes that GGT would have the ability to extract monopoly rents in the future. It is not suggested that there is any basis for this assumption other than a supposition that a self-interested pipeline owner or operator would seek to act in that way. Thus, it is appropriate to consider the factors (outlined above) which are likely to affect the actions of a pipeline owner or operator in GGT's position.

7.34 The ERA's decision to impose its own EEP will be considered first, followed by a consideration of the errors made in rejecting the proposed method submitted by GGT.

Review of ERA's EEP

7.35 As set out in review ground 13(b), GGT contends that the EEP which the ERA has adopted does not comply with the Code, properly construed, in that it does not:

(a) set out a method to be applied to determine whether any expansion of the capacity of the Pipeline should be treated as part of the Covered Pipeline or should not be treated as part of the Covered Pipeline under s.3.16(a) of the Code;

(b) satisfy the requirement of s.2.24(a) of the Code relating to the Service Provider's legitimate business interests and investment in the Covered Pipeline and extensions and expansions of it, in that it discourages investment in extensions and expansions in certain circumstances including by reason of the likely adverse impact of the ERA's EEP on Total Revenue following an expansion or extension;

(c) satisfy the requirement of the s.2.24(f) of the Code relating to the interests of Users and Prospective Users, in that it discourages the provision of extra capacity in certain circumstances; and/or

(d) satisfy the requirements of s.2.24(e) in that it fails to encourage competition in downstream markets.

7.36 By review grounds 20 and 21, GGT contends that the ERA exercised its discretion incorrectly or unreasonably, in that:

(a) it adopted an extreme and unreasonable position in relation to extensions and expansions, that made no allowance for any relevant circumstances that may arise

in the future in relation to proposed or contemplated extensions or expansions of the Pipeline;

(b) drafted and approved the ERA's EEP on this unreasonable approach;

(c) adopted an EEP which arose from attributing paramount significance to the possible degree of market power which might be exercisable by GGT in the future, when there was not sufficient evidence to support that conclusion;

(d) unreasonably failed to provide for proposed or contemplated extensions or expansions to be assessed on a case by case basis in the future according to prevailing circumstances; and

(e) unreasonably assumed that future circumstances, over the entire 5 years (unless revised earlier) would justify coverage or expansions of the Pipeline.

7.37 The purpose of an EEP is to determine whether additional capacity should be treated as part of a Covered Pipeline. That is why an EEP must state a method for making such a decision, and specify the effect that additional capacity will have upon Reference Tariffs: s.3.16(a) and (b).

7.38 Whether a pipeline should be covered depends upon various criteria, including whether access to services provided by means of the pipeline would promote competition in at least one market other than the market for such services provided by means of the pipeline and whether it would be uneconomic for anyone to develop another pipeline: ss.1.9(a) and (b) of the Code.

7.39 It follows that, in determining an EEP, regard must be had to the criteria which govern coverage in the first place.

7.40 In recognition of the link between an initial coverage decision and a decision whether to cover additional capacity, s.1.40 of the Code expressly refers to the EEP for a pipeline. Section 1.40 provides that an extension or expansion of the capacity of a Covered Pipeline shall be treated as part of the Covered Pipeline for all purposes under the Code if the policy contained in the access arrangement so provides.

7.41 The fact that a pipeline is covered does not suggest that, absent coverage, the pipeline owners would or even might misuse their market power. Nor should the determination of an EEP be affected by such an assumption.

7.42 The Code itself provides a constraint upon the exercise of market power by a pipeline operator with respect to a proposed expansion, by the provisions which enable a

Prospective User to invoke arbitration: ss.6.22, 6.23, definition of Covered Pipeline in s.10.8.

7.43 The supposition that GGT would exercise market power was unsupported by evidence and disregarded the nature of prospective new users of an expansion of this pipeline. Such parties will inevitably be large project owners or operators with the ability to defend and advance their own economic interests. The ERA's approach also disregarded the significant matters explained above.

7.44 The potentially perverse economic effects of the ERA's EEP compound the problem of the disincentive for GGT to construct additional capacity, where that capacity will automatically be covered. Coverage of additional capacity will likely have no effect in improving competition in downstream markets. The prospect of coverage will likely impede expansion.

7.45 Thus, the ERA's policy of automatic coverage for expanded capacity over the 5 year term of the revised access arrangement cannot be expected to achieve the purposes of the Code. The question whether there should be coverage of additional expanded capacity needs to be determined on a case by case basis, depending upon the particular effects of coverage in the circumstances which prevail when an expansion is proposed or occurs.

7.46 Further, the analysis above demonstrates that the ERA could not rationally have been satisfied that its EEP satisfied the objects of s.2.24(a), (e) and (f), to the extent that these govern an EEP.

7.47 The ERA's EEP does not protect any legitimate business interest or investment of GGT and does not accord with the interests of users and prospective users of the Pipeline, contrary to s.2.24(a) and (f). Instead, the ERA's EEP promotes a decision about whether to construct additional capacity by reference to the effect of that decision upon the price paid by existing users rather than users of the additional capacity.

7.48 Further, the ERA's EEP does not promote competition in other markets, contrary to s.2.24(e), as it impedes the prospect of expansion and encourages pricing for new users being based upon the effect upon total revenue from existing users who pay a tariff based upon the Reference Tariff.

7.49 Additionally, a policy of automatic coverage for expanded capacity does not set out a "method" for determining whether expanded capacity should be covered. Automatic coverage is not a procedure for attaining an objective. The ERA's EEP states an inflexible policy. For this reason also, the ERA's EEP does not conform with s.3.16(a) of the Code.

7.50 Even if it was thought that there was a possibility that market power might be misused in relation to an expansion, it was an unreasonable and erroneous exercise of discretion to impose a purported "method" which effectively assumed that power would be misused if there was no coverage and which dictated that an expansion would necessarily be covered. Such an approach leaves no scope for a proper consideration and evaluation of the circumstances which prevail when an expansion is contemplated.

7.51 There is nothing in the Code or in the facts which justified the disregard of those circumstances. Such an approach does not advance the objectives of the Code. An important reason for requiring adoption of a "method" is to preserve an appropriate degree of flexibility. The Regulator's dogmatic approach is inconsistent with the Code and its proper application. It does nothing to protect or advance the interests of a potential access seeker. It denies the opportunity for a commercially negotiated outcome which may benefit a new shipper.

7.52 In these circumstances, review grounds 13(b), 20 and 21 should be upheld and the ERA's EEP should not be included in the revised access arrangement.

Review based upon ERA failing to approve GGT's proposed EEP

7.53 GGT also seeks review of the decision of the ERA on the basis that the ERA impermissibly rejected GGT's proposed EEP and substituted its own EEP, when it should have adopted GGT EEP which complied with the Code. In other words, if GGT's proposed EEP complied with the Code, the ERA applied a wrong principle by rejecting GGT's EEP and substituting its own, even if the ERA's own EEP also complied with the Code. The various relevant grounds are referred to below.

7.54 By review ground 12, GGT contends that the ERA:

(a) failed to construe and apply the Code as permitting GGT to select the elements of an EEP that complied with the Code, and failed to construe and apply the Code as only requiring an assessment of whether the EEPs put forward by GGT included elements which complied with the Code;

(b) failed to determine whether the elements of GGT's EEPs were within the range of elements which complied with the Code;

(c) instead wrongly construed and applied the Code as if compliance with s.3.16 of the Code depended upon identification of a single uniquely correct policy;

and as a result of these errors, the ERA:

(d) failed to determine the applicable complying ranges for extensions and expansions policies and their elements;

(e) failed to approve GGT's EEPs as being within the admitted range of complying outcomes, as was the case with those EEPs;

(f) rejected GGT's EEPs when there was no evidence before the ERA and no basis from which it could reasonably be concluded that GGT's EEPs fell beyond the permitted complying ranges.

7.55 Likewise, by review grounds 24-26(a), GGT contends that the occasion for the ERA purporting to exercise its discretion to approve its own EEP did not arise, because GGT's EEPs complied with the Code and hence should have been approved. Review ground 26(a) claims that the ERA purported to exercise a discretion in relation to the failure to accept either of GGT's EEPs when the occasion for exercising the discretion did not arise, by reason that each of these policies complied with s.3.16 of the Code (and if necessary s.2.24 of the Code) and as a consequence, the ERA was required to accept them and had no discretion to substitute those policies with the ERA's EEP.

7.56 The first reason given by the ERA for rejecting GGT's initial EEP was that it did not prescribe a "method" for determining whether expanded capacity should be treated as part of the Covered Pipeline.

7.57 That reason is plainly wrong. GGT's initial EEP effectively replicated the EEP approved by the ERA in the previous access arrangement. Previously, the ERA considered that the process of election by GGT as to whether expanded capacity should be covered was a "method" which satisfied the requirements of s.3.16(a) of the Code.

7.58 The prior view of the ERA was correct. The process of an election by GGT as to whether additional capacity should be covered , made in the then prevailing circumstances, clearly constitutes a method for determining whether coverage should occur.

7.59 Hence, to the extent that the ERA rejected GGT's initial EEP on the basis that it did not state a "method", it not only acted inconsistently with its previous decision to approve the previous access arrangement, it also failed to properly construe and apply the requirements of s.3.16 of the Code.

7.60 At a more fundamental level, the ERA also failed to consider whether the elements of either of GGT's EEPs complied with the Code. As has already been explained, that was the task it was required to undertake. It had no power simply to substitute its own view as to a preferable EEP.

7.61 Approaching the proposed EEPs correctly, the ERA should have considered whether either of GGT's EEPs contained elements which satisfied s.3.16 of the Code. Each of GGT's EEPs plainly proposed a "method" for determining whether expanded capacity would be covered, on a case by case basis, complied with the Code.

7.62 GGT's second EEP provided for coverage except where there was consensual agreement with the majority of users for the expanded capacity not to be covered or where the Relevant Regulator did not consent to coverage.

7.63 In substance, the elements of this method were the following:

(a) there should be coverage of expanded capacity unless the circumstances of a particular case (referred to in the following subparagraphs) meant that expanded capacity should not be covered;

(b) expanded capacity would not be covered if market forces determined that coverage was inappropriate in the interests of new users of expanded capacity;

(c) coverage would also be subject to the Relevant Regulator having a right of veto, which the Relevant Regulator could use to prevent automatic coverage operating to the detriment of existing users.

7.64 There is no basis upon which the Regulator could conclude that this method did not comply with the Code. This method applied coverage, which would prevent extraction of any monopoly profits, unless the market determined otherwise in order to obtain the necessary investment to finance additional capacity; or unless the Relevant Regulator determined that coverage was not appropriate and would operate to the detriment of existing or prospective users. The method proposed by GGT is apt to address any possible issue of misuse of market power in an appropriate manner, which properly takes account of events which occur in the future.

Review based upon ERA failing to assess GGT's second EEP

7.65 The ERA erred in not considering the substance of the second EEP which GGT proposed in June 2010, after the Final Decision but before the Further Final Decision.

7.66 By review ground 13(a), GGT claims that the ERA exercised its discretion incorrectly or unreasonably in approving its own EEP, in that it misconstrued and misapplied the Code by failing to find that on a proper construction and application of the Code, GGT's second EEP otherwise addressed, under s.2.41(b) of the Code, the matters identified in the ERA Final Decision as being the reasons for amending the proposed EEP and therefore GGT's second EEP should have been accepted.

7.67 By review ground 14, GGT also claims that the ERA misconstrued and misapplied the Code in that it:

(a) failed to construe and apply the Code as requiring it to consider the documents provided by GGT in support of GGT's second EEP;

(b) instead resolved not to consider these documents for the purpose of making its Further Final Decision or for the purpose of the drafting and approval of a revised access arrangement for the Pipeline.

7.68 Section 2.41(b) of the Code provides for a further final decision which incorporates amended revisions to the access arrangement, which either substantially incorporate the amendments specified by the Relevant Regulator, or which "otherwise address to the Relevant Regulator's satisfaction the matters the Relevant Regulator identified as being the reasons for requiring the amendments specified in its final decision". This follows the making of a final decision and an opportunity to the Service Provider to submit revisions to the Relevant Regulator thereafter: ss.2.38-2.40.

7.69 Hence, s.2.41 of the Code expressly contemplates that a Service Provider may submit proposed amendments after the Final Decision, seeking to address, in a different manner from that proposed by the Regulator, the reasons for amendments which the Regulator required. The Code also necessarily requires the Regulator to consider the proposed amendments and determine whether they do address those requirements.

7.70 Whether reasons for amendments are addressed obviously depends upon an assessment of those reasons, the nature and terms of the proposed amendments and whether the proposed amendments deal with those reasons.

7.71 The purpose of allowing the Service Provider to otherwise address the reasons of the Regulator is because it is the Service Provider, not the Regulator, which must operate the pipeline and which has the ultimate discretion to determine just how it will comply with the Code. Hence, if the concerns of the Regulator in its role as a supervisor can be addressed in a different way by the actual operator, the Regulator has no power to reject the Service Provider's proposal.

7.72 The Code does not expressly describe the material which the Regulator may consider in relation to carrying out its obligation to consider whether new proposed amendments by the Service Provider "otherwise address" the Regulator's reasons for amendments.

7.73 However, it is quite clear that, in the context of economic regulation of an asset, the reasons for amendments required by the Relevant Regulator will probably deal with the economic effects of the proposed access arrangement. In order to address such reasons

which deal with the economic effects of an access arrangement, an explanation for amendments which differ from those required by the Relevant Regulator is called for.

7.74 In other words, by providing a final opportunity to a Service Provider to persuade the Relevant Regulator to accept a method of compliance with the Code, the Code necessarily contemplates the submission of further material which the Relevant Regulator is bound to consider.

7.75 Additionally, if the Service Provider has proposed new amendments which do otherwise address the Relevant Regulator's reasons for required amendments, then the Relevant Regulator must approve those amendments rather than adopting its own preferred amendments, consistent with the basic principle that the Relevant Regulator supervises and regulates the Service Provider rather than dictates the Service Provider's actions.

7.76 In the present case, GGT proposed its second EEP after the ERA Final Decision in order to address the amendments to the EEP required by the Regulator in the ERA Final Decision.

7.77 As explained above, GGT's second EEP contained the elements necessary to satisfy s.3.16 of the Code (and in fact the ERA's EEP did not contain such elements).

7.78 GGT supported the second EEP by economic information about the comparative effects of the ERA's EEP and GGT's second EEP. In particular, GGT provided the NERA report. For the reasons explained earlier, the ERA was obliged to consider this supporting information and GGT's second EEP.

7.79 However, the ERA did not at all consider the substance of GGT's second EEP or the supporting documents. This was an error of misconstruction or misapplication of s.2.41 of the Code. It is an additional ground for reviewing the ERA's decision to adopt its own EEP.

Conclusion on EEP grounds

7.80 The Board should conclude that:

(a) the ERA's EEP does not comply with s.3.16 of the Code;

(b) GGT's second EEP complies with s.3.16 of the Code;

(c) the ERA should have considered the elements of GGT's second EEP and the supporting material for this EEP;

(d) the ERA was obliged to adopt GGT's second EEP, whether or not the ERA's EEP complied with s.3.16 of the Code; and

(e) the new access arrangement should be revised so that the ERA's EEP is replaced with GGT's second EEP.

Part C Rate of Return

8 Overview

8.1 As the Pipeline is a regulated asset, the ERA sets a rate of return which it permits GGT to earn from the use of the asset.

8.2 The return should be set to achieve certain objectives, referred to in s.8.1 of the Code. Importantly, these include the following:

(a) the return should not be less than the return which would provide GGT with the opportunity to earn a stream of revenue that recovers the efficient costs of delivering the Reference Service over the life of the Pipeline: s.8.1(a). This effectively represents the minimum level of return. If such a return cannot be earned, there would be no reason for any person to operate a regulated asset;

(b) replicating the outcome of a competitive market: s.8.1(b). This effectively represents the maximum permissible level of return which ought to be allowed. If more than this is permitted, the Service Provider will have gained an advantage from the operation of a monopoly asset.

8.3 As Gleeson CJ, Heydon and Crennan JJ said in *East Australian Pipeline Pty Ltd v ACCC* (2007) 233 CLR 229 at [18], and [49]-[50]:

> "No party disputed the fact that the regulatory process set out in the legislation was directed to eliminating monopoly pricing whilst nevertheless providing a rate of return to pipeline owners, commensurate with a competitive market."
>
> and
>
> "The framework for third party access to natural gas pipelines set out [in the Code] directs attention to the multiple objectives of an approved access regime. Stripped to essentials, such a regime is at least intended to allow efficient costs recovery to a service provider and at the same time ensure pricing arrangements for the consuming public which reflect the benefits of competition, despite the provision of such services by monopolies. The balancing of those objectives properly has a natural flow-on effect for future investment in infrastructure in Australia.
>
> The greater the degree of uncertainty and unpredictability in the regulatory process, the greater will be the perceived risk of investment. The greater the perceived risk of investment, the higher will be the returns sought. Various

methodologies referred to in the Code must at least not be inconsistent with the principles stated by the legislature, which are directed to economic efficiency."

8.4 For these reasons, the determination of an appropriate rate of return is probably the most critical outcome for the whole regulation process. It governs whether a Service Provider will be able to conduct a viable business and whether consumers are adversely affected by the operation of a monopoly asset.

8.5 These considerations mean that there is a difference between the upside and downside risks for a Service Provider in the selection of an appropriate rate of return.

8.6 The upside is that a Service Provider might obtain more profits than a fully competitive market would permit. However, this does not mean that a Service Provider will extract significant monopoly profits. Many unregulated industries are not fully competitive for many different reasons.

8.7 On the other hand, the downside risk for a Service Provider is that it will go out of business if too low a rate of return is selected or it fails to make efficient investments. This will have flow-on effects for the public using the regulated asset.

8.8 The very nature of the task of determining an appropriate rate of return is such that there may be a range of outcomes which conform with the governing principles.

8.9 Once an appropriate conforming range is determined, the process of selecting a particular value within that range will itself be a product of an exercise involving the application of relevant principles and criteria.

8.10 At both stages of this process of determining an ultimate rate of return, the fundamental principle of regulation applies. In other words, at the first stage, the task for the Relevant Regulator is to consider whether the Service Provider has identified a conforming range, and at the second stage the task of the Relevant Regulator is to consider whether the Service Provider's reasons for selecting a particular value, within a conforming range, are reasons which are consistent with the Code. At neither stage is the Relevant Regulator simply entitled to impose its own decision as if there was a uniquely correct outcome.

8.11 In determining a rate of return within the appropriate range, it is necessary to bear in mind the difference between the downside and upside risks of selecting a rate of return. The significantly adverse effects following from determining a rate of return which is too low, compared to the potentially weak adverse effects of selecting a rate of return which may be too high, mean that there should be a bias towards determining a rate of return towards the high end of the appropriate range. This approach gives effect to the asymmetric risks.

8.12 The very nature of the Code is such that, even at the upper end of the range, a Service Provider would not be able to earn impermissible profits beyond the level of a competitive market. However, a Service Provider is entitled, and should be encouraged, to earn the level of profits which it could derive in a fully competitive market. As in a competitive environment, the incentive of a full measure of profits will mean that a Service Provider will do its utmost to promote use of the asset. In turn, this will encourage further investment in, and further development of, regulated assets, in the public's interest.

8.13 In the present case, the ERA accepted that there was a range of possible outcomes for the rate of return. In its Final Decision, the ERA determined that this range was between 9.62% and 11.34%. Having stated that range, the ERA adopted the midpoint of the range, which was **10.48%**. The ERA did so for no better reason than 10.48% represented the midpoint.

8.14 GGT initially proposed a different range, between 12.2% to 14.8%, and nominated 14.3% as the appropriate range. However, after the ERA Final Decision, GGT proposed that the appropriate rate of return was **11.3%** on the basis of the ERA's range.

8.15 This figure was at the upper end of the ERA's range, and was proposed taking into account the following factors, which are entirely consistent with the Code:

(a) the asymmetric risks described above;

(b) the risk of estimation errors in the components which the ERA used to estimate the appropriate range for the rate of return, and the likelihood that individual parameters adopted by the ERA were on the low side of what was appropriate; and

(c) the need to encourage decisions to invest in pipeline systems, rather than distort such decisions, by allowing a Service Provider to select a rate of return within a legitimate range where that rate provides the equivalent of the full return which would be available to a person operating in a competitive market.

8.16 GGT now contends that the ERA erred in adopting a rate of 10.48% instead of 11.3%. In substance, this is on the basis that the ERA substituted its own view of the desirable rate of return within its chosen range for GGT's conforming proposal (review grounds 18, 23, 27), and also because the ERA failed to consider further material provided by GGT after the Final Decision (review ground 19) in support of 11.3%.

9 Background

Relevant Code provisions

9.1 Section 8.4 of the Code provides that the Total Revenue (being the revenue to be generated from the sales (or forecast sales) of all Services over the Access Arrangement Period[4]) should be calculated according to one of three specified methodology, including Cost of Service.

9.2 Where a Cost of Service methodology is adopted, s.8.4 of the Code provides that Total Revenue is equal to the cost of providing all Services and with this cost to be calculated on the basis of 3 elements, including a return (**Rate of Return**) on the value of the capital assets that form the Covered Pipeline or are otherwise used to provide Services.

9.3 Section 8.30 of the Code provides that the Rate of Return used in determining a Reference Tariff should provide a return which is commensurate with prevailing conditions in the market for funds and the risk involved in delivering the Reference Service (as reflected in the terms and conditions on which the Reference Service is offered and any other risk associated with delivering the Reference Service).

9.4 Section 8.31 of the Code provides that, by way of example, the Rate of Return may be set on the basis of a weighted average of the return applicable to each source of funds (equity, debt and any other relevant source of funds). Section 8.31 also provides that such returns may be determined on the basis of a well accepted financial model, such as the Capital Asset Pricing Model. In general, the weighted average of the return on funds should be calculated by reference to a financing structure that reflects standard industry structures for a going concern and best practice – however, other approaches may be adopted where the Relevant Regulator is satisfied that to do so would be consistent with the objectives in s.8.1.

9.5 Section 8.1 of the Code provides that a Reference Tariff and Reference Tariff Policy should be designed with a view to achieving the following objectives:

(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;

[4] See section 8.2(a).

(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.

9.6 Section 8.2 of the Code provides that the factors about which the Relevant Regulator must be satisfied in determining to approve a Reference Tariff and Reference Tariff Policy include:

(a) the revenue to be generated from the sales (or forecast sales) of all Service over the Access Arrangement Period (the Total Revenue) should be established consistently with the principles and according to one of the methodologies contained in s.8 of the Code;

(b) to the extent that the Covered Pipeline is used to provide a number of Services, that portion of Total Revenue that a Reference Tariff is designed to recover (which may be based on forecasts) is calculated consistently with the principles in s.8 of the Code;

(c) a Reference Tariff (which may be based on forecasts) is designed so that the portion of Total Revenue to be recovered from a Reference Service is recovered from the Users of that Reference Service consistently with the principles contained in s.8 of the Code;

(d) Incentive Mechanisms are incorporated into the Reference Tariff Policy wherever the Relevant Regulator considers appropriate and such Incentive Mechanisms are consistent with the principles contained in s.8 of the Code; and

(e) any forecasts required in setting the Reference Tariff represent best estimates arrived at on a reasonable basis.

GGT's Proposed Revisions

9.7 The methodology used by GGT to determine the Rate of Return in GGT's Proposed Revisions was a weighted average cost of capital (**WACC**) approach based on the capital asset pricing model (**CAPM**).[5]

9.8 In determining the WACC, GGT applied the "ranges approach". As set out in the supporting information lodged with GGT's Proposed Revisions, the approach had been previously used by the ERA, including in the ERA's previous assessment of the access arrangement to apply to the Goldfields Gas Pipeline in 2005:

> The Authority accepts that its task is to consider whether the Rate of Return used for the derivation of Reference Tariffs in the revised Access Arrangement falls within the range of rates commensurate with the prevailing market conditions and the relevant risk. The Rate of Return will comply with the Code if the value used is within the range of values that different minds acting reasonably might attribute to the Rate of Return, applying the methodology of the CAPM that was chosen by GGT. In undertaking this task, the Authority has given consideration to the range of values within which the Rate of Return might be supported by reasonable minds as being commensurate with prevailing conditions in capital markets.[6]

9.9 The supporting information lodged with GGT's Proposed Revisions noted that in applying the ranges approach to the cost of capital, GGT had undertaken the following steps:

(a) measured the cost of equity using the CAPM and determined the cost of debt as the sum of the risk free rate of return, an estimate of the corporate debt margin, and an estimate of the ongoing costs of raising debt;

(b) used recent observable market data for those WACC parameters where the data underpinning the parameters is readily observable with these parameters having no relevant range;

(c) used empirical evidence for WACC parameters where the empirical evidence is strong with these parameters having no relevant range;

(d) set ranges for parameters where these parameters are not readily observable and empirical evidence is uncertain; and

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[5] GGT, *Goldfields Gas Pipeline: Supporting Information to Proposed Revisions to Access Arrangement – Submitted to Economic Regulation Authority 23 March 2009*, 7 April 2009, p 11.

[6] GGT *Supporting Information*, p 11, quoting: ERA *Final Decision on the Proposed Access Arrangement for the Goldfields Gas Pipeline*, 17 May 2005, p 63.

(e) calculated the cost of equity and cost of debt to give a range of outcomes.[7]

9.10 That supporting information lodged with GGT's Proposed Revisions also highlighted the impact of the Global Financial Crisis on pipeline infrastructure investment and that the ERA should have particular regard to the impact of the financial crisis in considering the appropriate cost of capital to apply.[8] GGT noted that as well as impacting on the ability of infrastructure providers to raise capital, the financial crisis was having a significant impact on users of the pipeline with price in the minerals sector (with the exception of gold) having generally halved with nickel prices reducing approximately 20–25% of previous highs following the crisis. As a consequence, the demand outlook for pipeline services was particularly uncertain.[9]

9.11 The WACC parameters and a description of the methodology used to determine those parameters are set out in Table 1 below.[10]

Table 1 WACC parameters from GGT's Proposed Revisions

Parameter	High	Low	Methodology / basis
Nominal risk free rate	4.27%		Based on the 20 working day average of Australian Government 10-year bonds from2 February 2009 to 27 February 2009 (a proxy averaging period)
Inflation rate	2.40%		Forecast cost of Reserve Bank of Australia 6 February 2009 Statement of Monetary Policy
Cost of debt margin over risk free rate	3.60%		Based on BBB- corporate bond rate
Cost of raising debt	0.30%	0.125%	Based on expert material from Synergies
Nominal pre-tax cost of debt	8.17%	8.00%	
Real pre-tax cost of	5.63%	5.46%	

[7] GGT *Supporting Information*, pp 11 – 12.
[8] GGT *Supporting Information*, pp 13 – 14.
[9] GGT *Supporting Information*, p 14.
[10] GGT *Supporting Information,* 7 April 2009, pp 15 – 23.

Parameter	High	Low	Methodology / basis
debt			
Market risk premium	7.00%		Based on Joint Industry Associations (JIA) submissions to Australian Energy Regulator WACC review
Corporate tax rate	30%		Based on the statutory corporate tax rate
Value of imputation credits	20%		Based on Joint Industry Associations (JIA) submissions to Australian Energy Regulator WACC review
LT proportion of equity funding	40%		Broadly accepted value from previous regulatory decisions
LT proportion of debt funding	60%		Broadly accepted value from previous regulatory decisions
Equity beta	1.8	1.0	Based on expert material from Synergies

9.12 Based on the above parameters, the Rate of Return Values in Table 2 below were derived.[11]

Table 2 Weighted Average Cost of Capital range

Cost of Capital measure	High	Low
Nominal cost of equity	16.87%	11.27%
Pre-tax nominal WACC	13.78%	10.73%
Pre-Tax real WACC	11.11%	8.13%

9.13 From Table 2, GGT adopted a Pre-Tax nominal WACC in the range of 13.78% to 10.73%.[12] In selecting a point within this range, GGT noted previous comments from the

[11] GGT *Supporting Information*, 7 April 2009, p 24.
[12] GGT *Supporting Information*, p 24.

ERA where the ERA had suggested it was appropriate to exclude the values within the lower and upper 10 per cent of the range.

> …the range of values that different minds acting reasonably could attribute to the cost of equity and WACC is narrower than the ranges that the extremes of ranges in CAPM parameters would suggest…the Authority is of the view that the range of values that would comply with the Code should not include the values that lie within the lower 10 percent or upper 10 percent of the range that may be derived by the application of the extremes of values for each of the parameters of the CAPM.[13]

9.14 In GGT's Proposed Revisions, GGT adopted the previous approach of the ERA in eliminating the lower and upper 10% of the range, which gave a revised range for the Pre-Tax nominal WACC of 13.5% to 11.0%. From this range, GGT proposed a Pre-Tax nominal WACC of 13.5%. In selecting this figure, GGT stated:

> The reason for going to the upper end of the truncated range relates to:
>
> - the fact that WACC estimation is imprecise, and the probability of estimating a WACC that is different from the 'true' WACC is high. It is then important to consider the consequences of any regulatory error. If prices are set too low, the resulting under-investment is worse from an economic and social perspective that if prices are set too high. Given this, the estimation of the regulated WACC should seek to minimise the probability that the true WACC is higher than the estimate. Consideration of the asymmetric consequences of regulatory error results in a selection of the cost of capital towards the upper bound of the cost of capital range; and
>
> - the fact that price cap regulation exposes the GGP to greater volume risk in the long-term compared to some comparators.

In conclusion, it is important to give regard to the imprecise nature of WACC estimation and the consequences which can arise if the regulated WACC underestimates the true value. This approach ensures that sufficient incentive is provided to invest, but it should not result in over-compensation provided the WACC is selected from within the bounds of a reasonable range.[14]

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[13] GGT *Supporting Information*, p 24, quoting: Economic Regulation Authority, *Final Decision on the Proposed Access Arrangement for the Goldfields Gas Pipeline* , 17 May 2005, pp 65 – 66.

[14] GGT *Supporting Information*, pp 24 – 25.

ERA Draft Decision

9.15 In the ERA Draft Decision, the ERA accepted that GGT's proposed method of ascertaining the Rate of Return satisfied the requirements of the Code.[15]

9.16 In relation to specific WACC parameters, the ERA:

(a) accepted GGT's proposed methodology for determining the nominal risk free rate (updated for a later proxy averaging period)[16];

(b) accepted the inflation value of 2.40%, but not the underlying methodology, considering it appropriate to use updated inflation forecasts and to adopt an averaged indexed rate rather than the arithmetic average proposed by GGT[17];

(c) adopted a range for the market risk premium of 5% to 7%, rejecting GGT's proposed value of 7%[18], despite the ERA's expert finding that the 7% proposed by GGT was not unreasonable[19];

(d) adopted a range of 0.8 to 1.2 for the equity beta, rejecting GGT's proposed value of 1.0 to 1.8[20];

(e) adopted a credit rating of BBB+ to determine the debt margin, rejecting GGT's proposed credit rating of BBB-[21];

(f) adopted a debt raising cost of 0.125 per cent, rejecting GGT's proposed range of 0.125% to 0.30%[22];

(g) accepted GGT's proposed corporate tax rate of 30%[23];

(h) adopted a range for gamma of 0.57 to 0.81, rejecting GGT's proposed value of 0.20[24], despite the ERA's expert finding that 40% is the upper bound of the reasonable range[25]; and

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[15] ERA *Draft Decision on GGT's Proposed Revisions to the Access Arrangement for the Goldfields Gas Pipeline Submitted by Goldfields Gas Transmission Pty Ltd*, 9 October 2009, [403].
[16] ERA *Draft Decision*, [420].
[17] ERA *Draft Decision*, [432] – [438].
[18] ERA *Draft Decision*, [450] – [453].
[19] ERA, *Draft Decision* [449].
[20] ERA, *Draft Decision* [468] – [475].
[21] ERA, *Draft Decision* [487] – [499].
[22] ERA, *Draft Decision* [508] – [512].
[23] ERA, *Draft Decision* [516].
[24] ERA, *Draft Decision* [525] – [529].

(i) accepted GGT's proposed proportions of the value of the regulated business assumed to be financed by debt and equity[26].

9.17 The significant areas of difference between GGT and the ERA in relation to individual WACC parameters related to: the market risk premium; the equity beta; the credit rating used to determine the debt margin; debt raising costs; and the value for gamma.

9.18 The ERA Draft Decision determined a range for the Pre-Tax nominal WACC of 9.11% to 11.46%. Consistent with previous practice, the ERA then eliminated the lower and upper 10% of values to generate a range of 9.34% to 11.22%. The ERA then adopted the mid-point in this range (10.28%) to be the Rate of Return.[27]

GGT Amended Proposed Revisions

9.19 In the supporting material submitted with the GGT Amended Proposed Revisions, GGT submitted that the following parameter values should be used:

(a) credit rating of BBB- to BBB to determine the debt margin, giving a debt margin of 4.58% to 4.38%;

(b) debt raising costs of 0.75%;

(c) market risk premium of 6% to 7%;

(d) a value for gamma of 0% to 40%; and

(e) an equity beta of 1.4 to 1.0[28].

9.20 The GGT Amended Proposed Revisions adopted a Pre-Tax nominal WACC range of 15.1% to 11.9%, giving a range of 14.8% to 12.2% with the lower and upper 10% of values removed.[29] Within this range GGT proposed a value for the Pre-Tax nominal WACC of 14.3%.[30]

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[25] ERA, *Draft Decision* [524].
[26] ERA, *Draft Decision* [535].
[27] ERA, *Draft Decision* [537] – [544].
[28] GGT *Goldfields Gas Pipeline: Response to Draft Decision to Proposed Revisions to Access Arrangement – Submitted to ERA 11 December 2009*, 10 February 2010 (errata), p 68.
[29] GGT *Response to Draft Decision*, p 98.
[30] GGT *Response to Draft Decision*, p 99.

ERA Final Decision

9.21 In the ERA Final Decision, the ERA:

(a) continued to consider that a reasonable range of values for the market risk premium was 5% to 7%[31];

(b) considered that a reasonable range of values for the equity beta was 0.8 to 1.0[32];

(c) the debt margin should be determined on the basis of a BBB+ credit rating and that CBASpectrum should be used to derive this estimate[33];

(d) continued to consider that a reasonable allowance for debt raising costs is 0.125%[34]; and

(e) determined that the reasonable range for gamma is 0.37 to 0.81[35].

9.22 Including on the basis of the above parameter values, the ERA determined a range for the Pre-Tax nominal WACC of 9.40% to 11.56%, giving a range of 9.62% to 11.34% with the lower and upper 10% of values removed.[36] The ERA adopted the mid-point of this range (10.48%).[37]

GGT Further Amended Proposed Revisions

9.23 In the GGT Further Amended Proposed Revisions, and without agreeing with the reasoning in the ERA's Final Decision, GGT adopted the WACC parameters set out in the ERA's Final Decision.[38]

9.24 The adoption of these parameters gave a range for the Pre-Tax nominal WACC of 9.40% to 11.56%, giving a range of 9.62% to 11.34% with the lower and upper 10% of values removed.[39]

9.25 In the GGT Further Amended Proposed Revisions, GGT proposed a value of 11.3% for the WACC within the range established by the ERA in the ERA Final Decision.[40] In so

[31] ERA *Final Decision on GGT's Proposed Revisions to the Access Arrangement for the Goldfields Gas Pipeline Submitted by Goldfields Gas Transmission Pty Ltd*, 13 May 2010, [198] – [211].
[32] ERA *Final Decision,* [226] – [250].
[33] ERA *Final Decision*, [261] – [270].
[34] ERA *Final Decision*, [277] – [281].
[35] ERA *Final Decision*, [298] – [311].
[36] ERA *Final Decision*, [318].
[37] ERA *Final Decision*, [392].
[38] GGT, *Goldfields Gas Pipeline Response to Final Decision on Proposed Revisions to Access Arrangement*, 4 June 2010, p 7.
[39] GGT *Response to Final Decision*, p 7.

doing, GGT noted the inherent uncertainty in estimating the WACC and the asymmetric consequences associated with the regulatory error of setting too low a value for the WACC.[41]

ERA Further Final Decision

9.26 In the ERA Further Final Decision, the ERA noted that GGT had not complied with required amendment 7 in the ERA Final Decision, which was that GGT's Amended Proposed Revisions should be amended to adopt a nominal pre-tax Rate of Return of 10.48%.[42]

9.27 The ERA Further Final Decision commented that in the GGT Further Amended Proposed Revisions GGT had proposed a value of 11.3% as the Pre-Tax nominal rate of return to use in determining Total Revenue, which is within the reasonable range adopted by the ERA in the Final Decision.[43] However, in the ERA Further Final Decision, the ERA continues to require that a Pre-Tax nominal rate of return of 10.48% be adopted in the Access Arrangement.[44]

10 GGT proposed Rate of Return consistent with Code requirements

10.1 As noted above, s.8.30 of the Code provides that the Rate of Return used in determining a Reference Tariff should provide a return which is commensurate with prevailing conditions in the market for funds and the risk involved in delivering the Reference Service. Also of particular relevance are the Reference Tariff and Reference Tariff Policy objectives in s.8.1 of the Code which include providing the Service Provider with the opportunity to earn a stream of revenue that recovers the efficient costs of delivering the Reference Service.[45]

10.2 The Pre-Tax nominal WACC value of 11.3% set out in the GGT Further Amended Proposed Revisions was consistent with the requirements of the Code and the ERA was in error in not approving that value, for the reasons set out below.

[40] GGT *Response to Final Decision*, p 8.
[41] GGT *Response to Final Decision*, p 8.
[42] ERA *Further Final Decision on GGT's Proposed Revisions to the Access Arrangement for the Goldfields Gas Pipeline Submitted by Goldfields Gas Transmission Pty Ltd*, 5 August 2010, [98].
[43] ERA *Further Final Decision*, [100].
[44] ERA *Further Final Decision*, [101] – [102].
[45] Section 8.1(a).

Asymmetric risk

10.3 The selection of the upper value within the range established by the ERA Final Decision was consistent with the requirements of the Code and was appropriate and justifiable, particularly in light of the asymmetric risks associated with setting the WACC too low.

10.4 The Synergies report on the value to be adopted for the equity beta noted the following in connection with the asymmetric consequences of regulatory error:

> It is generally recognised that regulatory error has asymmetric consequences. The Productivity Commission stated:
>
> " • Over-compensation may sometimes result in inefficiencies in the timing of new investment in essential infrastructure (with flow-ons to investment in related markets), and occasionally lead to inefficient investment to by-pass parts of a network. However, it will never preclude socially worthwhile investments from proceeding.
>
> • On the other hand, if the truncation of balancing upside profits is expected to be substantial, major investments of considerable benefit to the community could be forgone, again with flow-on effects for investment in related markets.
>
> In the Commission's view, the latter is likely to be a worse outcome."
>
> In other words, the consequences of setting WACC too low, and discouraging efficient investment in essential infrastructure, are considered worse than setting it too high.[46]

10.5 The Synergies report also noted that the estimation of the WACC is "inherently imprecise and hence the probability of specifying a WACC other than the 'true' value is high".[47] Noting the asymmetric consequences of regulatory error, the Synergies report states that it is important to lower the risk that the true value is higher than the estimated value and that one way this can be achieved is by selecting a value towards the upper end of the range of reasonable values.[48]

10.6 As set out below, the ERA's approach to a number of the individual WACC parameters, and the value for gamma, which determined values at the lower end of the ranges against the interests of GGT (or, in the case of gamma, at the upper end of the range) which were

[46] Synergies Economic Consulting, *Goldfields Gas Pipelines Access Arrangement 2009: Equity Beta Analysis*, March 2009, p 14, quoting: Productivity Commission, *Review of the National Access Regime*, 28 September 2001, p 83.

[47] Synergies Economic Consulting, March 2009, p 14.

[48] Synergies Economic Consulting, March 2009, p 15.

unsupported by evidence, further supports the argument that GGT's selection of the WACC at the upper end of the ERA's range in the ERA Final Decision was consistent with the requirements of the Code.

Risk of estimation error for individual parameters

10.7 The selection by the ERA of values for some of the parameters also indicates that the ERA's range was more likely to be too low, than too high, with the consequence that it was reasonable to err towards the higher end of the WACC range established in the ERA's Final Decision. This is particularly so in relation to: the equity beta; the market risk premium; and gamma.

Equity beta

10.8 In the ERA Final Decision and ERA Further Final Decision[49], the ERA adopted a value of 0.8 to 1.0 for the equity beta. GGT submits that the upper end of the equity beta range determined by the ERA is too low and supports GGT's selection of a WACC value at the upper end of the range determined by the ERA.

10.9 In their first report, Frontier Economics considers that the appropriate range for the equity beta is 0.8 to 1.2. Frontier Economics state as follows:

> **Taking all of the information available to us, our view is that an appropriate range for the equity beta estimate is 0.8 – 1.2.**
>
> This conclusion is based on:
>
> (a) The mid-point estimate for any equity beta is 1.0, the beta for the average firm. One would only adopt an estimate different from 1.0 to the extent supported by reliable empirical analysis;
>
> (b) The ACCC has consistently adopted an equity beta of 1.0 for gas pipeline businesses;
>
> (c) The ERA has previously used a range of 0.8 to 1.33 for the GGP and we are unaware of any reason why its systematic risk is any higher or lower than it was previously;

[49] ERA, *Final Decision on GGT's Proposed Revisions to the Access Arrangement for the Goldfields Gas Pipeline Submitted by Goldfields Gas Transmission Pty Ltd*, 13 May 2010, [318].

(d) After considering a range of equity beta estimates for the available "comparable" firms, the AER has adopted an equity beta estimate of 0.8 for electricity transmission and distribution firms (also with 60% assumed gearing);

(e) The GGT submission on this point notes that there are some aspects suggesting that the pipeline's systematic risk is higher than that faced by the average pipeline business and some evidence that systematic risk is below average. There is no compelling evidence to suggest which of these effects might dominate the other;…[50]

10.10 The second Frontier Economics report continues to maintain that upper bound for the equity beta is 1.2, noting the following:

a. The GGT proposal sets out a methodology for incorporating the systematic risk of the customer base into the estimate of the equity beta for GGP. If this approach is applied to the equity beta estimates in table 3 above, using the ERA's preferred re-levering formula, the result is an equity beta estimate of 1.2;

b. An upper bound of 1.2 completes a symmetric range with a lower bound of 0.8 and a mid-point of 1.0; and

c. The ERA has previously adopted an upper bound of 1.33 for the GGP. We agree that the upper bound estimate should be substantially above 1.0 given the uncertainty with which betas are estimated and the lack of listed companies that are even broadly comparable to GGP. However, our view is that the available evidence no longer supports an estimate of 1.33, even as the upper bound of the reasonable range – that the presently available evidence does not support an upper bound range above 1.2.[51]

10.11 The material in the Synergies report on the equity beta also supported a finding that the range for the equity beta to apply to the Pipeline should have an upper bound above 1.0. The reasons for this included the nature of the product and the nature of the customer. The demand for the pipeline's services is driven by the mining sector, in particular, nickel, iron ore and gold, and the commodity sector is inherently volatile. In this regard, the Pipeline is unlike gas distribution and electricity transmission and distribution networks which are underpinned by broad based residential, commercial and industrial demand. The demand for gas for residential purposes will be less sensitive to changes in economic conditions. Commercial and industrial demand will be more sensitive to economic

[50] Frontier Economics, *Review of Weighted Average Cost of Capital Estimate Proposed by Goldfields Gas Transmission*, 6 August 2009, pp 32 – 33.

[51] Frontier Economics, *Review of Weighted Average Cost of Capital Estimate Proposed by Goldfields Gas Transmission*, 6 August 2009, pp 34.

growth, with demand by users that only operate in the mining sector more sensitive again.[52]

10.12 Regulatory precedent also supports an equity beta of at least 1.0. Table 3 below was set out in the Synergies report on the equity beta.[53]

Table 3 Regulatory Decisions on equity beta: Gas transmission

Decision (Year)	Regulator	Equity beta
Central West Pipeline (2000) (note: greenfields)	ACCC	1.5
Parmelia Pipeline (2000) (note: now unregulated)	OffGAR	1.33
Moomba to Adelaide Pipeline (2001) (note: now unregulated)	ACCC	1.16
Tubridgi Pipeline (2000) (note: now unregulated)	OffGAR	1.33
Amadeus Basin to Darwin Pipeline (2002)	ACCC	1.0
Moomba to Sydney Pipeline (2003) (note: now subject to light-handed regulation)	ACCC	1.0
Dampier to Bunbury Pipeline (2005)	ERA	0.8 – 1.2
Goldfields Gas Pipeline (2005)	ERA	0.8 – 1.2
Roma to Brisbane Pipeline (2006)	ACCC	1.0
Dawson Valley Pipeline (2007)	ACCC	1.0
Victoria Gas Transmission System (2008)	ACCC	1.0

10.13 In the ERA Final Decision, the ERA noted three recent decisions of the AER that adopted an equity beta of 0.8.[54] The three networks were all gas distribution networks with a customer base that would differ significantly from the Pipeline's customer base. The ERA

[52] Synergies Economic Consulting, , March 2009, p 21.

[53] Synergies Economic Consulting, , March 2009, p 33.

[54] ERA, *Final Decision on GGT's Proposed Revisions to the Access Arrangement for the Goldfields Gas Pipeline Submitted by Goldfields Gas Transmission Pty Ltd*, 13 May 2010, [243].

appears to rely heavily on these AER decisions in determining the lower value of 0.8 for the equity beta.[55]

10.14 In the ERA Final Decision, the ERA notes that the Pipeline has a small number of users whose operations are primarily in the mining industry.[56] In determining the upper bound for the equity beta, the ERA states, without analysis, that:

> …with any expiration of customer contracts on the covered portion of the capacity on the GGP, it is reasonable to assume that existing customers (currently taking gas from the covered or uncovered capacity) and / or new customers, would provide continued demand for the covered capacity. Given the above, the Authority considers it reasonable to assume that there is limited volume or price risk for the covered portion of the GGP capacity. Given an assessment of the latest available information and on the basis of the above, the Authority has revised its view on the upper bound of the equity beta range. The Authority considers that a reasonable value for this upper bound is 1.0.[57]

10.15 The decision of the ERA to determine a range for the equity beta with an upper bound of 1.0 in circumstances where the material before the ERA supported an upper bound of 1.2 (and a lower bound no lower than 0.8) supports a finding that it was consistent with the Code for GGT to select a value for the WACC at the upper bound of the range determined by the ERA in the ERA Final Decision and that the ERA should not have rejected the selection of this value.

Market risk premium

10.16 In the ERA Draft Decision, the ERA Final Decision and the ERA Further Final Decision, the ERA selected a range of 5–7% for the market risk premium.[58] The ERA purported to support this range largely based on material contained in the Australian Energy Regulator's review of WACC parameters (**AER WACC Review**).[59]

10.17 The material in the AER WACC Review does not support the ERA's range of 5–7%. The material in the AER WACC Review, properly characterised, supports a finding that the long-term historical market risk premium is at least 6%, and that during the period that the outcome of the WACC Review is to apply (being at least 1 May 2009 to 2019) a market

[55] ERA, *Final Decision* , 13 May 2010, [245].
[56] ERA, *Final Decision*, [247].
[57] ERA, *Final Decision* , [249].
[58] ERA, 13 May 2010, [198] – [211].
[59] ERA *Final Decision*, [200] – [203].

risk premium of 6.5% is appropriate. In its final decision on the WACC review, the AER notes the following with respect to the market risk premium:

(a) long term historical estimates (1883 – 2008, 1937 – 2008, 1958 – 2008), 'grossed up' for a 0.65 value of imputation credits, produce a range of 5.7% to 6.2% – however, while not the preferred estimation period, the AER notes that this range would have been 6.6% to 7.2% had the estimation period ended in 2007;

(b) survey measures strongly indicate that a market risk premium of 6% is by far the most commonly adopted value by market practitioners – though these surveys were before the global financial crisis;

(c) cash flow based measure currently indicate a forward looking market risk premium well above 6%;

(d) the AER considers that prior to the onset of the Global Financial Crisis, an estimate of 6% was the best estimate of a forward looking long term market risk premium, and accordingly, under relatively stable market conditions – assuming no structural break has occurred in the market – this would remain the AER's review as to the best estimate of the forward looking long term market risk premium;

(e) current market conditions (as at the date of the statement being 1 May 2009) suggest a market risk premium of above 6% may be reasonable, however, having regard to the desirability of regulatory certainty and stability, the AER does not consider that the weight of evidence suggests a market risk premium significantly above 6% should be set;

(f) accordingly, the AER considers that a market risk premium of 6.5% is reasonable, at this time, and is an estimate of a forward looking long term market risk premium commensurate with the conditions in the market for funds that are likely to prevail at the time of the reset determinations to which this review applies;

(g) the AER considers the market risk premium of 6.5% for a benchmark efficient network service provider:

    (i) together with values, methods and a credit rating for the other parameters, provides a network service provider with a reasonable opportunity to recover at least efficient costs and provides a network service provider with effective incentives for efficient investment; and

(ii) is appropriate having regard to the economic costs and risks of potential under and over investment.[60]

10.18 The ERA's expert, Frontier Economics made the following comments in relation to the value to be adopted for the market risk premium:

(a) the long-term historical average of around 6% will always be within the reasonable range, in all market conditions;

(b) the 7% proposed by GGT is not unreasonable in the current market circumstances – given present levels of dividend yields, debt spreads, and option implied volatilities;

(c) given the above, Frontier Economics has adopted a range of 6% to 7% for the market risk premium;

(d) the range adopted by Frontier Economics is consistent with the recent point estimate of 6.5% adopted by the Australian Energy Regulator as part of its review of WACC parameters.[61]

10.19 In the final report for the ERA, Frontier Economics continued to maintain that a range of 6% to 7% for the market risk premium was reasonable in the current circumstances.[62]

10.20 The evidence before the ERA did not support a lower value of 5% for the market risk premium, particularly in light of the ongoing effects of the Global Financial Crisis. As the ERA's range was based on a range for the market risk premium the lower end of which was not supported by the evidence, it was consistent with the requirements of the Code for GGT to adopt a value at the higher end of the WACC range in the ERA Final Decision.

Gamma

10.21 In the ERA Final Decision and the ERA Further Final Decision, the ERA selected a range of 0.37 to 0.81 for gamma.[63] The ERA purported to support this range including on the basis of the distribution rate of 1.0 adopted by the AER in the AER WACC Review.[64]

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[60] Australian Energy Regulator, *Electricity Transmission and Distribution Network Service Providers Review of the Weighted Average Cost of Capital (WACC) Parameters*, May 2009, pp 237 – 238.

[61] Frontier Economics, *Review of Weighted Average Cost of Capital Estimate Proposed by Goldfields Gas Transmission*, 6 August 2009, pp 15 – 17.

[62] Frontier Economics, *Review of Weighted Average Cost of Capital Estimate Proposed by Goldfields Gas Transmission*, 15 March 2010, pp 5 – 6.

[63] ERA, *Final Decision*, 13 May 2010, [311].

[64] ERA, *Final Decision*, [302] – [303].

10.22 The advice from the ERA's expert, Frontier Economics, was that:

> …the AER analysis in relation to gamma is fundamentally flawed and should receive no weight…
>
> In our view, zero must be included within the reasonable range for any estimate of gamma. Consequently, we adopt zero as the lower bound for our reasonable range. Our view is that the upper bound of the reasonable range should be set to 0.4. This is based on:
>
> (a) An estimate of 0.57 for theta, and an estimate of 0.7 for *F*. That is, even if one fully accepts the single result from Beggs and Skeels (2006) on which the AER focuses and ignores the fact that it is conditional on dividends being valued at 80% of face value, this must be adjusted to reflect the extent to which firms actually distribute franking credits. Note that 0.57 x 0.7 = 0.4.
>
> (b) The ERA's last estimate for gamma of a range of 0.3 to 0.6 and the need for a degree of regulatory stability.[65]

10.23 The Australian Competition Tribunal has recently issued a determination that in the calculation of the value for gamma, a distribution rate of 0.7 is to be adopted. The AER conceded as part of those proceedings that it was in error in determining a value of 1.0 for the distribution rate, and that the distribution rate to be used in the calculation of gamma should be 0.7.[66]

10.24 The application of a distribution rate of 0.7 to the ERA's theta estimates would provide a range for gamma of 0.26 to 0.57.

10.25 As the ERA's range for gamma was based on a range for the gamma the upper end of which was not supported by the evidence, it was consistent with the requirements of the Code for GGT to adopt a value at the higher end of the WACC range in the ERA Final Decision to better ensure that GGT was provided with an opportunity to earn a stream of revenue that recovers the efficient costs of delivering the Reference Services.

Occasion for exercising the discretion did not arise

10.26 GGT submits that having selected a value for the WACC from within the range specified in the ERA Final Decision, it was not open to the ERA to reject this aspect of the GGT Further Amended Proposed Revisions.

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[65] Frontier Economics, 6 August 2009, pp 22 – 23.

[66] *Application by Energex Limited (Distribution Ratio (Gamma)) (No 3)* [2010] ACompT 9 (24 December 2010).

10.27 In its Further Amended Proposed Revisions, GGT referred to the decision in *Re GasNet Australia (Operations) Pty Ltd* [2003] ACompT6, in which the Australian Competition Tribunal stated:

> Where the Reference Tariff Principles produce tension, the Relevant Regulator has an overriding discretion to resolve the tensions in a way which best reflects the statutory objectives of the Law. However, where there are no conflicts or tensions in the application of the Reference Tariff Principles, and where the [Access Arrangement] proposed by the Service Provider falls within the range of choice reasonably open and consistent with the Reference Tariff Principles, it is beyond the power of the Relevant Regulator not to approve the proposed [Access Arrangement] simply because it prefers a different [Access Arrangement] which it believes would better achieve the Relevant Regulator's understanding of the statutory objectives of the Law.[67]

10.28 The ERA has previously noted that under the Code, as interpreted by the Australian Competition Tribunal, the ERA is required to accept the proposed rate of return if it falls within the range considered by the ERA to be appropriate.

> …under the Code, as interpreted by the Australian Competition Tribunal (ACT) there was a range of possible compliant outcomes for the rate of return on capital. Under the ACT's interpretation, the Authority was required to accept the proposed rate of return if it fell within the range considered by the Authority to be appropriate.[68]

10.29 In approving the amendments to the Access Arrangement to apply to the Pipeline in 2005, the ERA accepted the rate of return set out in GGT's revised proposed access arrangement which adopted the upper value of the ERA's reasonable range for the WACC set out in its final decision.

> In its Final Decision, the Authority determined that the range of values of the Rate of Return that would comply with the Code is 8.4 percent to 10.6 percent, pre-tax nominal…
>
> GGT's Revised Proposed Access Arrangement includes a Reference Tariff calculated on the basis of, *inter alia*, a Rate of Return on 10.6 percent nominal. GGT indicates that it has addressed the matters the Authority identified in its Final Decision as being the reasons for requiring an amendment to the proposed Rate of Return by proposing a Rate of Return on 10.6 percent in the revised Access

[67] *Re GasNet Australia (Operations) Pty Ltd* [2003] ACompT6 [29]; (2004) ATPR 41-978, at 48-467.

[68] ERA, *Mid-West and South-West Gas Distribution Systems: Issues Paper on the Proposed Revisions to the Access Arrangement*, 26 February 2010, [45].

> Arrangement, as this Rate of Return is within the range that the Authority consider would comply with the Code.
>
> The Authority notes that the Rate of Return now proposed by GGT is higher than that determined by the Authority in the Final Decision. The Authority accepts, however, that in revising the Reference Tariff to reflect a Rate of Return on 10.6 percent pre-tax nominal, GGT has adopted a Rate of Return that the Authority considers is within a range of values that would comply with the Code and the Authority is therefore satisfied that, in applying a Rate of Return of 10.6 per cent, GGT has addressed the reasons of the Authority for requiring the Reference Tariff to be revised to reflect a Rate of Return that complies with the requirements of the Code.[69]

10.30 As set out in GGT's response to the ERA Final Decision, the approval of a WACC value towards the upper end of the range will appropriately balance the risk of estimation error – which would be consistent with the Reference Tariff and Reference Tariff Policy objectives, including providing GGT with the opportunity to earn a stream of revenue that recovers the efficient costs of delivering the Reference Service, and not distorting investment decisions in pipeline transportation systems or in upstream and downstream industries.

11 ERA was required to consider updated information

11.1 The submissions made at paragraphs 7.67 to 7.75 above in relation to the ERA being required to review the material submitted by GGT after the Final Decision but before the Further Final Decision that related to the EEP are equally applicable to the material submitted by GGT after the Final Decision but before the Further Final Decision that related to the Rate of Return. As relevant information, the ERA was required to review this material and take it into account in making the ERA Further Final Decision.

11.2 In the ERA Further Final Decision, the ERA indicates that it may not have considered the material provided by GGT on 4 April 2010 responding to the ERA Final Decision. The ERA stated:

> On 4 June 2010, GGT submitted a further amended version of its Proposed Revisions (**Further Proposed Revisions**) and a further amended version of its proposed Access Arrangement Information (**Further Amended AAI**) to the Authority.

[69] ERA, *Further Final Decision and Final Approval on the Proposed Access Arrangement for the Goldfields Gas Pipeline Submitted by Goldfields Gas Transmission Pty Ltd*, 14 July 2005, [51] – [53].

> GGT also submitted to the Authority, on 4 June 2010, a document marked as confidential entitled "Response to Final Decision on Proposed Revisions to Access Arrangement" (**Confidential Response**).
>
> The Authority has considered the extent to which it may or ought to have regard to GGT's Confidential Response. It is noted that the Code explicitly obliges the Authority to invite and consider submissions prior to both the draft and final decisions but does not contain an equivalent obligation to invite and consider submissions prior to a further final decision. After appropriate consideration the Authority has resolved not to consider the Confidential Response before making this Further Final Decision or for the purpose of the drafting and approval by the Authority of a revised Access Arrangement for the GGP.[70]

11.3 It is plain from s.2.41 of the Code that the Service Provider is entitled to submit supporting information together with amended revisions to the Access Arrangement by the date specified by the Relevant Regulator in the final decision. Specifically, s.2.41(b) provides that the Relevant Regulator may approve or not approve the amended revisions if it is satisfied that the amended revisions "either substantially incorporate the amendments specified by the Relevant Regulator or otherwise address to the Relevant Regulator's satisfaction" the matters the Relevant Regulator identified in the final decision as being the reasons for requiring the amendments specified in the final decision.

11.4 In order for a Service Provider's amended revisions to "otherwise address" the matters the Relevant Regulator identified in the final decision, the Service Provider would require an opportunity to explain the basis for the amended revision incorporated by the Service Provider in the Access Arrangement and to make submissions as to how the amended revision "otherwise addresses" the matters identified by the Relevant Regulator in its final decision.

11.5 In this regard it is also relevant to note that s.2.43(c) provides for a period of at least 14 days between the publication of a final decision and the date specified by the Relevant Regulator as the last day for the Service Provider to submit amended revisions to the Access Arrangement. This is similar to the minimum period that the Relevant Regulator must provide between the publication of a draft decision and the last day for submissions on the draft decision (s.2.43(b)). The period of time provided for between the final decision and the date for the submission of amened revisions contemplates a sufficient amount of time for the Service Provider to develop supporting material to explain the amended revisions submitted to the Relevant Regulator in response to the final decision.

[70] ERA, *Further Final Decision*, [6] – [8].

12 Conclusion on WACC

12.1 The ERA should have considered and endorsed the rate of return of 11.3% which GGT proposed after the Final Decision.

12.2 That rate of return was within the range adopted by the ERA.

12.3 Further, it was appropriate that a figure at the upper of the range should be chosen for the following reasons:

(a) the asymmetric risks of choosing a rate which is too low, as opposed to too high, militate towards a rate at the upper end of the appropriate range;

(b) there was a risk of estimation error which mean that the ERA may have tended to use parameters which were too low in determining the appropriate range for the rate of return. Hence, it was appropriate to select a rate of return at the upper end of the ERA's range; and

(c) the fundamental principle of regulation means that it is acceptable for the Service Provider to select a rate at the upper end of a permissible range, and that this will encourage appropriate investment decisions.

Date: 16 March 2011

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