Central Petroleum Limited

Submission in response to the

Draft Financial Reporting Guidelines for Non-Financial Scheme Pipelines

3 November 2017

Submission Background

Following the recent ACCC and Vertigan reviews, two of the most comprehensive independent examinations ever undertaken for the Australian domestic gas market, monopolistic pricing within the pipeline sector is now recognised as a major source of inefficiency within that market. This recognition validates what users of gas pipelines have long highlighted as a major distortion in gas price signals which are critical to efficient gas markets by stimulating new gas production and mitigating the magnitude of demand destruction associated with increasing gas production costs.

Whilst the GMRG is working to implement a number of reforms related to the Vertigan Review recommendations, the most critical element of this by far is providing clear and effective instruction on how a pipeline "asset value" should be determined under binding arbitration. This drives the "capital charge" which, noting the relatively low cost of pipeline operations, makes up the significant majority of current pipeline tariff costs.

The critical issue of "asset values" has been identified and addressed for non-scheme pipelines through section 569(4) of the National Gas Rules (NGR), which provides for the following methodology to determine pipeline values:

(i) the cost of construction of the pipeline and pipeline assets incurred before commissioning of the pipeline (including the cost of acquiring easements and other interests in land necessary for the establishment and operation of the pipeline);

plus:

(ii) the amount of capital expenditure since the commissioning of the pipeline;

less:

(iii) the return of capital recovered since the commissioning of the pipeline; and

(iv) the value of pipeline assets disposed of since the commissioning of the pipeline.

This methodology is referred to as the "Recovered Capital Method" (RCM) within Section 5 of the Draft Financial Reporting Guidelines for Non-Scheme Pipelines (DFRGs) and is clearly intended to avoid the flaws inherent in an accounting based approached to asset valuations. Central is highly supportive of the RCM asset valuation principles which, if implemented correctly, will significantly limit the monopolistic pricing behaviour clearly evident in the pipeline sector today.

The DFRGs should serve to support the transparency and evaluation of pipeline tariffs such that monopolistic pricing behaviour is constrained and the need for arbitration is ultimately minimised. As drafted, however, the DRFGs do not fully accomplish this information disclosure objective and create significant uncertainty and accounting loopholes that would be materially inconsistent with the pricing principles articulated under Rule 569(4) of the NGR.

Central welcomes the opportunity to make this submission on the DFRGs and to highlight the critical areas it believes need to be revisited in order to preserve the significant gas market efficiencies that that are possible through the binding arbitration framework for non-scheme pipelines.

1. Pipeline Asset Value – Acquisition Costs

Whilst there is clearly a practical need to rely on financial reports for the provision of financial information and accounting definitions for the articulation of the RCM, significant care needs to be taken to ensure that AASB accounting standards and definitions do not result in pipeline asset valuation outcomes that are clearly not the intent of Rule 569(4). As drafted, the DFRGs fail to appropriately manage these unintended accounting driven outcomes. Specific examples include:

1) The “cost of construction” for a pipeline is the essential basis for determining asset value under section 569(4) of the NGR through the RCM. Section 5(b)(i) of the DFRGs is consistent with section 569(4) in that it utilises “cost of construction” as the starting point for the RCM. Section 4.2.2 (Construction Cost) of the DFRGs, however, defines Construction Cost to be any costs that can be capitalised under AASB and then goes on to specifically allow acquisition costs to be the Construction Cost where it was purchased by the pipeline owner.

2) Under the RCM, “cost of construction” is increased through additional “capital expenditure”. Section 5(b)(ii) of the DFRGs makes “capital expenditure” a defined term on page 8. Under this definition, Capital Expenditure means pipeline expenditure of a capital nature that complies with the criteria specified in section 4.2.2 of the DFRGs. Under section 4.2.2 of the DFRGs, the Capitalisation Principles and Construction Cost sections, again specifically allow acquisition costs to be Capital Expenditure and therefore added to the “cost of construction” under the RCM.

3) Under the RCM, “cost of construction” relates to “pipeline assets”. Section 5(b)(i) and 5(b(ii) of the DFRGs makes “pipeline assets” a defined term on page 8, which then specifically allows acquisition cost to be included as a “pipeline asset”. This could be interpreted to mean that acquisition costs are to be included in the “cost of construction” under the RCM.

4) Section 5 of the DFRGs seeks to clarify the valuation for Shared assets. Specifically, “For shared assets” item (ii) allows the acquisition cost to be used where it is not of a type constructed by the service provider. Whilst the intent is to cover non-pipeline related assets that naturally must be purchased, this definition is vague and susceptible to the inclusion of acquisition costs for pipelines and related pipeline equipment where a pipeline service provider can claim they do not normally construct pipelines (e.g. an investment fund). The definition of “shared assets” should be tightened this wording to make clear that shared asset values may not be based on acquisition costs where those assets are pipelines or related pipeline facilities that <u>could</u> have been built by pipeline service providers.

The inclusion of acquisition costs in determining “cost of construction” under the RCM is a fundamental departure from the clear intent of section 569(4) of the NGR. The effect of this error is that pipeline assets (which have largely been acquired from the original developer) would have little or no connection with actual construction costs and ultimately renders the RCM meaningless.

Central recommends that section 5 of the DFRGs be revised to ensure that any reference to accounting principles or accounting based valuation methodologies (notably any reference to, or interpretation from, section 4.2.2 which deals with Financial Reporting) is consistent with the intent of section 569(4) of the NGR. In addition, we believe that given the magnitude of this issue for any binding arbitration, it would be beneficial to clarify this issue further by specifically highlighting that acquisition costs are not to be relevant to, or included within, asset values under the RCM.

2. Return of Capital – Non-Cash Adjustments

Section 5 of the DFRG offers a definition for “return of capital” that ultimately relies on an accounting based Profit/Loss Statement (P&L). As drafted, however, the proposed definition fails to adequately adjust for (exclude) non-cash items that are permitted under AASB but distort the actual profitability of a pipeline and, as a result, the “return of capital” calculation. The following are examples of non-cash items that require adjustment:

a) Direct Depreciation and Amortisation (D&A) is based on accounting values and is effectively a proxy for the return of capital that is included in operating expenses within the P&L. Given the RCM seeks to determine the actual “return of capital” which is specifically not intended to relate to accounting values, failing to exclude this item would result in significantly understating the actual “return of capital” to a pipeline owner each year.

b) Impairment and fair market value (FMV) adjustments are forward looking non-cash accounting items that flow through the P&L. As these items are non-cash adjustments, they do not reflect the actual profit/loss of a pipeline asset for that period. As a result, it is necessary to remove these items from the calculation of “return of capital” under the RCM.

c) Any amounts capitalised under AASB’s for Abandonment and Rehabilitation Costs that are included in the “cost of construction” should be adjusted to reflect a discounted rate that is equivalent to the post-tax WACC used to determine “return of capital” under the RCM (note the accounting based discount rate may significantly overstate the present value of Abandonment and Rehabilitation Costs thereby inflating “cost of construction” under the RCM.

A full review should be undertaken for required adjustments to any accounting based P&L statement used to determine “return of capital” under the RCM.

3. Return of Capital – Financing Costs

The treatment of financing costs has not been adequately considered within section 5 of the DFRGs as these are included in P&L statements. How specific assets are financed should not be relevant under the RCM because the RCM already allows for a market based “return on capital” to be available to the pipeline owner. Such a market based return will presumably be a post-tax weighted average cost of capital (WACC) which inherently includes assumptions for financial risk, gearing, cost of equity and cost of debt. Given all financing costs are already fully accommodated in a market based WACC, actual financing costs need to be excluded from the following:

(i) The P&L statement when used for the calculation of “return of capital” under the RCM, and

(ii) The “cost of construction” should exclude capitalised interest to determine pipeline asset value under the RCM

Excluding financing costs avoids an obvious and significant understatement of pipeline profitability and overstatement of pipeline asset value under the RCM.

4. Shared Costs

The DFRGs categorise costs as Direct and Shared costs. Given the obvious opportunity for manipulating Shared costs between corporate and pipeline assets, the DFRGs should provide an over-arching principle that any allocation of Shared costs, including employee costs, should be on a cost only basis and not reflect any “profit” to the Operator.

Similarly the term “Shared Costs” is not a defined term. The DFRGs should provide a definition of “Shared Costs” for purposes of the RCM, being those costs related to *“shared supporting assets”.* In terms of the Shared costs categories listed on Pages 14 and 15 of the DFRGs:

- Depreciation and amortisation of Shared assets should be allowed only to the extent that the depreciation is based on AASB accounting standards and the original construction cost or the original acquisition cost for the shared asset;
- Consideration needs to be given to borrowing, interest and any other financing costs for Shared assets in that they need to reasonably relate to the cost base for the Shared asset and the depreciation period used to allocate depreciation and amortisation of the Shared asset. This would avoid a fully depreciated shared asset from generating return on capital through their allocation to pipelines;
- Any Shared asset value adjustments or charges relating to FMV or Impairment losses should be excluded for the reasons highlighted in Section 2 above;

- To the extent any exists, revenue from Shared assets should be allocated appropriately to pipeline assets on a basis consistent with their cost allocations.

Shared costs includes a category named "Indirect Operating Expenses" for which no definition exists. Central recommends including a definition for this term being *"those Operating expenses necessary for the Operation of Shared assets but excludes any costs that have no such connection (for example Business Development costs and certain corporate costs not necessary for the operation of that Shared asset)".*

5. Additional Information Disclosure

The information disclosure requirement under the DFRGs are critical in that if correctly structured, it gives prospective pipeline users the opportunity to reasonably assess pipeline tariff offers in the context of Section 569(4) of the NGR and the RCM. This outcome allows binding arbitration to have the intended effect of constraining monopolistic pipeline pricing and avoid creating significant uncertainty for pipeline users considering arbitration process. Currently, the DFRGs cover the suite of relevant accounting statements. Whilst these provide pipeline users with a foundation, further information is necessary to assess pipeline asset values under the RCM and to evaluate forward looking assumptions necessary on utilisation and costs. Additional information disclosure requirements would include:

(i) Construction cost and capital expenditure detail used by the pipeline owner to quantify the pipelines initial "cost of construction" and ongoing capital expenditure for purposes of the RCM.

(ii) Adjustments made to the P&L schedule any for non-cash items and financing costs that impact the "return of capital" calculation under the RCM.

(iii) The market based post-tax WACC used by the pipeline owner to determine the "return on capital" and the "return of capital" under the RCM.

(iv) A forecast of pipeline utilisation, revenues (based on existing contract tariffs and those being offered for future pipeline users) and operating costs, and corresponding reconciliation with the current pipeline asset value and market based post-tax WACC under the RCM.

This information would have been developed by a pipeline owner in advance of determining a tariff and shouldn't represent significant new work.

6. Pipeline Asset Values – Prior Ownership Determination

In certain circumstances, it may not be possible for a current pipeline owner to access or otherwise reasonably determine their starting pipeline asset value under the RCM. Whilst this situation will likely be an exception, it is important to address the scenario to avoid delays and uncertainty in both information disclosure and the arbitration process itself. The following principles may provide a reasonable pathway for compliance under the RCM should such situations eventuate:

1) Pipeline owners must take all reasonable efforts to determine starting pipeline asset values under the RCM for acquired pipelines. In situations where this is not possible, the pipeline owner must demonstrate why such a pipeline asset valuation under the RCM is not possible and what specific required information is not able to be sourced to determine a pipeline asset value under the RCM.

2) Where item 1) above can be demonstrated for determining the "cost of construction" under the RCM for an acquired pipeline, the pipeline owner should make a reasonable estimate for the "cost of construction" at the time of commissioning based on the principles under the RCM. Given the accounting compliance and reporting standards in Australia over the last 30 years and the significant information available for historical pipeline construction costs, determining (or at the very least reasonably estimating) "cost of construction" under the RCM is possible for prior owned pipelines.

3) Where item 1) above can be demonstrated for determining the "return of capital" under the RCM for an acquired pipeline, the pipeline owner should, as a fall-back position, utilise standard depreciation

and amortisation schedules for those assets as a proxy for “return of capital” during that period of prior ownership. Whilst this clearly doesn’t fully capture the actual “return of capital” for the prior owner(s), it has some logic in that the depreciation and amortisation schedules should have been the basis on which previous pipeline owners set as a “return of capital” for purposes of determining tariffs (assuming they were not engaged in monopolistic pricing behaviour). The “cost of construction” under the RCM reduced for this “depreciation” would then provide a starting pipeline asset value for the current pipeline owner and the basis for determining current pipeline asset value under the RCM.

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