



6 January 2004

Mr Sebastian Roberts
General Manager
Regulatory Affairs – Electricity
Australian Competition and Consumer Commission

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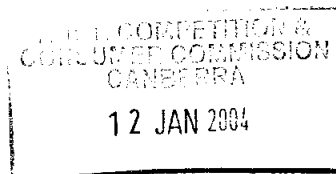
Dear Mr Roberts,

**Review of Draft Statement of Principles
for the Regulation of Transmission Revenues**

On 25 September last year APT wrote to Commissioner Willett in the context of the Commission's review of the Moomba Sydney Pipeline Access Arrangement. The letter dealt principally with the definition and calculation of DORC and it was our intention to send a copy to you as a submission to the Commission's review of the Draft Statement of Principles for the Regulation of Transmission Revenues (DRP). It now appears that may not have been done. Accordingly, a copy of the letter is enclosed now. While the date for submissions to the review of the DRP has passed, we trust that there is still an opportunity for the Commission to take into account the important matters of principle raised in the letter.

Yours sincerely,

Robert McMaster
Commercial Manager



COPY

25 September 2003

Mr Ed Willett
Commissioner
Australian Competition and Consumer Commission
PO Box 1199
Dickson ACT 2602

Moomba Sydney Pipeline Access Arrangement

Dear Mr Willett

We have received a letter yesterday from Michael Buckley, General Manager Regulatory Affairs – Gas, confirming that the Commission intends to make its Final Decision on the Moomba Sydney Pipeline Access Arrangement sometime after 1 October 2003. I note the imminence of that time, but given the significance of the Access Arrangement, feel it is important to raise a matter of concern to EAPL that has recently arisen, on which I have only been able to be appraised since my return from overseas this week.

Since August 2000 APT, its associates, and its regulatory advisers, have made numerous submissions to the Commission on the subject of the correct calculation of DORC in the context of the Gas Code.

In my letter to the Commission of 15 April 2003, I expressed my concern about the need for the Commission to establish a definitive DORC methodology that is economically sound and consistent with the Gas Code. That concern has now been reinforced by the Commission's publication on 29 August of a Discussion Paper in connection with a Review of the Draft Statement of Regulatory Principles for the Regulation of [Electricity] Transmission Revenues (DRP). In the DRP published in 1999, the Commission established a coherent and logical meaning for DORC founded on the "hypothetical new entrant" model. The Commission has since referred to that model as the basis for DORC in a number of contexts, and the proposition now has significant acceptance including from the Commission's own consultants. The corollary to the hypothetical new entrant model is that the calculation of DORC requires a NPV based approach.

The inference I draw from the Discussion Paper is that the Commission intends to adopt straight line depreciation rather than an approach which is consistent with the hypothetical new entrant model. This would mean abandoning the hypothetical new entrant model because straight line depreciation is incompatible with that model.

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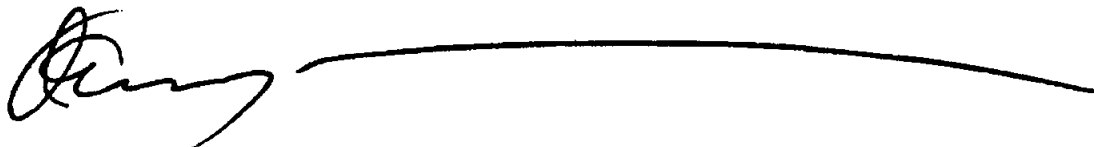
We are not aware of any economically sensible meaning for DORC that would support straight line depreciation. These observations are elaborated in the attachment to this letter.

I have grave concerns about the implications of the Discussion Paper for the manner in which the Commission might approach the calculation of DORC in its impending Final Decision on the Access Arrangement for the MSP under the Gas Code. A correctly determined DORC value “based solely upon the economic principles that underpin it” is a crucial element in the process of determining an initial capital base under the Code.

I reiterate APT’s and EAPL’s position that the Commission must establish a definitive DORC methodology that is economically sound and consistent with the Gas Code as soon as practicable and certainly prior to issuing a Final Decision on the MSP Access Arrangement.

In closing, I note that the Discussion Paper canvasses positions on a wide range of issues besides depreciation in the DORC calculation. It would be of concern to us if a number of those positions were to be adopted by the Commission in respect of the MSP Access Arrangement without appropriate consultation. On that basis, we and/or our advisers may choose to make a further submission in response to the Discussion Paper in due course. In the meantime, I am sending a copy of this letter to your Mr Roberts as an initial submission.

Yours sincerely

A handwritten signature in black ink, appearing to read 'JK McDonald', followed by a long, horizontal, slightly curved line that extends across the width of the page.

J K McDonald
Managing Director

cc Mr Sebastian Roberts General Manager
Regulatory Affairs – Electricity
Australian Competition and Consumer Commission

ATTACHMENT

Issues raised by proposals in relation to the calculation of DORC

ACCC Discussion Paper in connection with a Review of the Draft Statement of Regulatory Principles for the Regulation of [Electricity] Transmission Revenues, August 2003

In its 1999 Draft Statement of Regulatory Principles, the Commission developed a coherent and logical meaning for DORC founded on the “hypothetical new entrant” model. The Discussion Paper paraphrases the principles:

“... the underlying economic concept for DORC is that the DORC-based tariffs mimic the discipline of an *efficient* market. More specifically, DORC is held out as the upper limit of the regulated asset base (RAB), above which a new entrant would be attracted, and is therefore the asset base on which a profit maximising asset owner would fix tariffs in a contestable market.” (p16)

The Commission has since referred to the hypothetical new entrant model as the basis for DORC in a number of contexts, and the proposition now has significant acceptance including from the Commission’s own consultants. National Economic Research Associates (NERA) and The Allen Consulting Group (ACG), both define DORC unequivocally by reference to the hypothetical new entrant model and conclude that the definition requires that DORC be formulated as a forward-looking NPV based calculation. For example:

“The third key message is that the DORC should be determined by reference to the economic principles that underpin it. ... DORC is intended to reflect the economic cost of replacing a specified service capability by reference to an existing asset. ... Accordingly, the DORC valuation should balance the net present value (NPV) of the expected future costs associated with a decision to purchase a new asset and those associated with using the existing asset.” (NERA, September 2002, Depreciation Within ODRC Valuations, A Report for ACCC. pp1,2)

“... the asset valuation methodology consistent with the hypothetical new entrant test is ODRC” (NERA, August 2003, A Report for NGC Holdings as submitted to the New Zealand Commerce Commission. p8)

“The concepts of historical cost and ODRC and their economic or institutional underpinnings are invariant to the nature of the infrastructure assets” (Ibid. p27)

“A straightforward implication is that the ODRC value provides an estimate of the value that existing assets (that is, those that are inputs to production) would have in a market where the price was set at the level consistent with the price that would be charged by a hypothetical (efficient) new entrant (that is, assuming a perfectly contestable market).” (ACG, August 2003, Attachment A to the Discussion Paper. p21)

“Regarding the *depreciation step*, the common method for depreciating the ORC value has been to use standard financial accounting approaches, that is, to scale down the cost of the new asset to take account of the expired age of the asset in place. This contrasts with the required [NPV based] adjustment ...” (Ibid. p26. Emphasis added.)

In addition, the Western Australian Supreme Court in the Epic Decision accepted that DORC is a forward-looking valuation methodology which provides a proxy for a competitive market price.

Since August 2000, APT, its associates, and its advisers have made numerous submissions to the Commission on the subject of the correct calculation of DORC in the context of the Gas Code, arguing in particular that the corollary to the hypothetical new entrant model is that the calculation of DORC from ORC requires a NPV based approach. It is apparent from the citations above that this principle is supported by the Commission’s consultants.

The Discussion Paper now contains the following discussion under the heading “Depreciation [of ORC]”:

“The Commission has traditionally adopted DORC as the Optimised Replacement Cost (ORC) multiplied by the ratio of the existing TNSP’s assets remaining useful life over the useful life of a new asset. The way in which depreciation is handled is of great importance, particularly in regard to any incorporation of accelerated depreciation either due to technological obsolescence or due to stranding (ie economic obsolescence). The depreciation profile chosen will have an impact on the DORC valuation. For example, a front-loaded profile would result in a higher DORC valuation whereas an escalating profile would result in a lower DORC valuation.

The Commission always has the discretion to adopt an annuity depreciation scheme which can respond to the associated pricing changes in replacement cost taking account of general price increases and technological change in a manner which mimics competitive market behaviour. However, the Commission’s initial view is that factors such as technological change do not have major impacts in the electricity industry. Therefore, a straight-line approach for the electricity industry is easier to implement and gives rise to clearer incentives for efficient investment than alternatives such as annuity depreciation.” (p29)

The Commission goes on to invite comments on the use of straight line depreciation.

Straight line depreciation of the ORC is inconsistent with the economic underpinnings and meaning of DORC which, it is now well accepted, require a NPV approach. The fact that rates of technological change might be low cannot be used as a justification for the use of straight-line depreciation. We have demonstrated previously that the NPV approach reduces to straight line only when the investor is indifferent between spending money now and in the future. Setting aside the effect of differences between the operating costs of new and old assets, this will occur only in the extremely unlikely circumstances where the rate of technological change is negative (ie technology is regressing) and equal in magnitude to the real value of WACC.

In its Final Decision on the Access Arrangement for the Amadeus Basin to Darwin Pipeline under the Gas Code, the Commission states that:

“In assessing the various DORC and DORC-based valuations, the Commission has been guided by the advice of SKM that concluded that DORC should be determined based solely upon the economic principles that underpin it, resulting in a stand-alone and independently reproducible valuation that excludes other factors that the regulator may take into account when establishing an ICB.” (p33)

This also echoes NERA’s advice to the Commission (see above). We fully support that position.

To our knowledge, the only relevant economic principles that have any degree of acceptance are those premised on the hypothetical new entrant model which in turn requires a NPV-based approach to the DORC calculation. The hypothetical new entrant model and straight line depreciation of ORC are incompatible. It follows that the Commission cannot continue to adhere to the hypothetical new entrant model as the economic basis for DORC unless it adopts an NPV-based approach as recommended by its consultants. Having said that, we note that once an initial capital base is set under the Gas Code there is nothing that requires that the depreciation method used to determine DORC be adopted as the method of ongoing depreciation. (This proposition is discussed at some length by ACG in Attachment A to the Discussion Paper at p40 et seq.)

It is therefore essential in maintaining sound economic principles for regulation that the Commission maintain consistency with the new entrant model already propounded by it and acknowledged by NERA and ACG by adopting DORC based on the NPV approach.