**RESPONSE BY AGILITY ON BEHALF OF EAPL TO SKM REPORT ENTITLED "DEPRECIATION WITHIN ODRC VALUATIONS"[1]**

In our view SKM's analysis is not fully developed. SKM's recommendation favouring the continued use of straight line depreciation of the ORC is inconsistent with many of the statements made or implied in the paper, and should be dismissed particularly in light of the reports by Professor King and NERA and the recent Epic decision.

The SKM document has scattered throughout it all of the elements that, when drawn together, support the conclusion argued for by Agility and confirmed by Professor King and now NERA, that DORC can and should be a forward looking valuation determined objectively and independently of other factors to be considered in setting the value of the ICB. However, SKM has not reached this conclusion. SKM has instead proposed an overriding principle of "wealth neutrality" in relation to the ICB, which has no foundation in the Code, and proceeded to rely on that principle and its implied consequences, to inform its conclusions. In addition SKM confuses the relationship between the ICB and DORC by arguing that considerations that are relevant in setting the ICB must also be reflected in the way that DORC is calculated. The Code requires no such relationship. SKM also justifies its conclusion by reference to the precedent of past regulatory practice in setting DORC (i.e. straight line depreciation of the ORC) without examining whether that practice is consistent with the economic principles underlying the Commission's new entrant hypothesis.

SKM correctly observes that, under the Code, DORC is the normal cap on the value of ICB and that the DORC methodology is not codified. However, SKM does not state a view as to whether this vacuum is appropriately filled by the Commission's proposition that DORC be defined in economic terms by reference to the hypothetical new entrant, although acceptance of the proposition is implied in the statement that:

> "The ODRC method is a method of estimating the top price in [the band between short run marginal cost of the existing asset and the long run marginal cost of a new entrant] – the cost of a new entrant competitor bypassing the asset in question."

Neither does SKM consider specifically how DORC should be calculated to give effect to the new entrant proposition, although it does acknowledge that "… there is nothing evidently wrong in itself with the method discussed by Professor King in finding a value for an asset that represents the value at any point in time that a potential new entrant might offer for the existing asset versus building his alternative new asset, and the method correctly adjusts for the difference in life of the existing asset and the replacement using an accepted methodology for comparing projects of unequal lives."

SKM also acknowledges the Agility/King approach as a valid forward-looking valuation methodology

> "If only forward looking ICB valuations were to be considered, then there is significant merit in the Agility/Professor King formulation."

observing that "… the past is usually irrelevant in an economic valuation context" and:

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[1] SKM (2002), *Depreciation within ODRC valuations, Report to the Australian Competition and Consumer Condition,* amended February 2002.

> "ODRC calculations with economic depreciation such as proposed [by Agility/King] are an elegant form of forward looking valuation. Even if this were accepted however as the ODRC value for the purposes of the Code Clause 8.10(b), there should be some form of backward looking element considered, whether by giving more weight to the depreciated historic cost or by considering an additional calculation modelling historic depreciation. This is considered necessary to account for the interests of the users of the system in the ICB and could be required under Clause 8.10 (c), (f), (g) or (k)."

By this statement SKM clearly identifies that the Code is workable when the Agility NPV approach is used to calculate DORC. The logical conclusion for SKM to have drawn from these observations is that it is desirable and consistent with the Code for DORC to be calculated objectively and independently of the other factors in Clause 8.10, and that the value of DORC produced by the Agility/King NPV approach is consistent with the hypothetical new entrant view of DORC and therefore with the position of DORC in the Code as the normal maximum value of the ICB.

Instead, SKM has complicated and confused its analysis by inferring, as a principle of the Gas Code, "that the ICB should be as wealth neutral as possible as between the asset owner and the users of the asset". SKM acknowledges (and we agree) that this principle has no precedent and is not mentioned in the Gas Code, and SKM advances no economic arguments to support it. SKM simply asserts that "Whilst it is a pity that this wealth-neutral constraint, if it exists, is not explicitly included in Clause 8.10, it does not seem too presumptuous to expect that it might be implied." Despite these qualifications, SKM proceeds as if the "principle" existed. As a consequence, SKM bases much of its argument on the incorrect view that backward looking factors should be given greater weight than forward looking ones in setting the ICB, concluding that straight line depreciation is most likely to give effect to its "principle".

The proper construction of the Code in relation to ICB has now been clarified by the recent Epic decision in the Supreme Court of Western Australia. While the factors in section 2.24 are to be given fundamental weight in considering an Access Arrangement, and those factors include the interests of service providers and users, the Code does not seek to impose a balance between those interests, but rather requires that each of them be taken into account along with the other factors – the outcome of that consideration is a matter for the Regulator. The Epic decision also makes it clear that in considering the interests of the service provider, the existence of monopoly profits is not a basis for discounting those interests. There is no foundation in the Code for SKM's principle of "wealth neutrality".

SKM's arguments also reflect a confusion as to the relationship between ICB and DORC, leading to the incorrect conclusion that DORC should be determined in a manner that is consistent with the backward-looking focus that SKM believes is appropriate for the ICB. This is despite SKM's apparent acknowledgment of the forward looking character of DORC when it is calculated in a manner that is consistent with the new entrant view of DORC. SKM also gives weight to the precedent of past regulatory practice, without examining whether that practice is consistent with the economic principles underlying the Commission's new entrant view, and the position of DORC in the Code as the normal upper bound on the value of the ICB.

The Epic decision (at paragraphs 99 and 119) clarifies how the concept of DORC should be interpreted:

> "To the extent, therefore, that words or phrases used in the Act and Code [including DORC] reflected, at the relevant time, generally established and accepted concepts in this specialised field of economics [dealing with infrastructure regulation], albeit not necessarily universally held or expressed with precise uniformity, there is strong reason to favour the view that the words were intended to refer to such generally established and accepted economic concepts." (¶119)

and, at paragraph 164, summarises expert evidence in relation to DORC as follows:

> "The expert evidence indicates that the DORC methodology is one of a number of methodologies which are described as "forward looking". … The expert evidence indicates that a DORC valuation will usually provide a good proxy for the price that a pipeline would realise had the owner faced workable competition at the time of its sale. Under the DORC methodology the actual or historic capital investment of the pipeline owner has no relevance."

In this context, the backward-looking straight line depreciation approach to construction of DORC from ORC is unsustainable, and SKM's recommendations must be dismissed.

In our view, the correct conclusion to be drawn is the one argued by Agility and confirmed by Professor King[2] and now NERA[3]: that DORC can and should be determined objectively as a stand alone valuation by reference to the economic principles underlying the concept, and independently of other considerations in the Code. The resultant value of DORC is then one among a number of factors that should be taken into account in setting the ICB.

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[2] "If the arguments used to justify DORC presented by the ACCC and the ORG are taken seriously, then there is a well-defined value of DORC. To claim that the arguments used to justify DORC are correct but that the resulting value of DORC is excessive seems inconsistent. Further, under the Code, the DORC value represents an upper bound on asset valuation. As such, there appears to be no constraint on the regulator to set the asset value at, or close to, DORC. If the regulator believes that the calculated DORC is too high then the regulator has the ability to set a lower initial capital base under the Code.

In summary, the straight-line adjustment to transform ORC to DORC adopted by the ACCC in the Draft Decision on EAPL is clearly inconsistent with the Commission's stated economic underpinnings and justification of DORC." (King, p12)

[3] "Our view is that, in this (or any other) context, DORC should be established exclusively on the basis of the economic principles underlying the concept and not by reference to factors that are addressed separately and specifically elsewhere in section 8.10 of the gas code.

In our view, this approach is consistent with the wording of section 8.10, which states the regulator should consider DORC *and* a range of other issues when setting the ICB. There does not appear to be any implication within section 8.10 that the DORC under the gas code should differ from DORC as it is generally understood, and we can see no reason DORC should be estimated on the basis of anything other than the economic principles underpinning this valuation concept.

Therefore, while the issues raised in the first three bullet points above may be useful in developing the ICB, they should not be incorporated into the DORC estimate. NERA's view is that there is a case for divorcing the strong link between the DORC and the ICB." (NERA, p21)

References:

King, S.P. (2001) *Report on the construction of DORC from ORC,* February 2001

NERA (2002) *Depreciation within ODRC Valuations: a Report for the ACCC,* September 2002

Decision of the Court in *Re Dr Ken Michael AM; ex parte Epic Energy (WA) Nominees Pty Ltd & Anor* [2002], WASCA 231, delivered on 23 August 2002