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Mr Russell Phillips
Acting General Manager Regulatory Affairs - Gas
The Australian Competition and Consumer Commission
PO Box 1199
Dickson ACT 2602

Dear Mr Phillips

Moomba - Sydney Pipeline Access Arrangement

We refer to the Commission's Final Decision on the Access Arrangement proposed by N.T. Gas Pty Limited (NT Gas) for the Amadeus Basin to Darwin Pipeline (ABDP) and, in particular, the approach taken to the calculation of DORC in that Decision. The approach adopted highlights a number of shortcomings and matters of principle which must be addressed before the Commission proceeds to a final decision on the value of DORC for the Moomba Sydney Pipeline (MSP). We support the submission made recently by NT Gas concerning the calculation of DORC in the ABDP Final Decision (copy attached).

In the ABDP Final Decision, the Commission reaches the significant conclusion of principle that DORC is to be calculated "based solely on the economic principles that underpin it" and independently of the other factors to be considered in setting the ICB. We also concur with the Commission's view "that approaches to the determination of DORC that depart from the economically sound derivation of DORC are ... contrary to good regulatory practice." (ABDP Final Decision, pages 33 and 34).

The phrase "the economic principles that underpin it" must refer to the Commission's Draft Statement of Principles for Regulation of Transmission Assets (1999) which is the only comprehensive and broadly accepted statement of relevant principles by the Commission. As we and our advisers have argued in a number of submissions since as early as August 2000, to be consistent with those principles, the Commission must adopt the NPV DORC approach articulated by Agility, which is arguably the only approach that gives effect to those principles. It is also important to note that the Draft Regulatory Principles and the NPV DORC approach accord well with the interpretation of DORC by the WA Supreme Court in its Decision on the Epic Access Arrangement, viz that DORC is a forward looking methodology.

The DORC approach adopted in the ABDP Final Decision is essentially a refinement of the "traditional" straight line methodology which is clearly inconsistent with the Draft Regulatory Principles and, in the Commission's own words, is "therefore contrary to good regulatory practice". If the Commission intends to persevere with the straight line approach or any variant of it, it must establish the economic principles that are consistent with that approach, and we would expect to be consulted in any decision-making process. Clearly any such

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principles cannot be the same as the Draft Regulatory Principles and so, to take that course would require the Commission to compromise its commitment to the Draft Regulatory Principles. That would be unfortunate.

We submit that, for the sake of transparency and certainty, the Commission must decide on the method it will apply in the construction of DORC from ORC as soon as practicable, and that the decision must be made independently of the Commission's current review of the proposed access arrangement for the MSP. In any event, given its potential significance for the establishment of the initial Capital Base for the MSP, the matter must be resolved before the Commission makes its final decision on DORC for the MSP.

The Draft Regulatory Principles present a logical, consistent and economically sensible meaning of DORC which in turn requires that DORC be determined by reference to the NPV of a hypothetical new entrant's cash flows. When taken together with submissions by EAFL, Agility (including Professor King's advice) and NT Gas, and the Epic Decision, the Draft Regulatory Principles leave no doubt as to the DORC methodology that must adopted.

Yours sincerely

Michael McCormack
General Manager - Commercial

Attachment

N.T. Gas Pty. Limited

Submission concerning the ABDP Final Decision

NT Gas accepts the Initial Capital Base for the pipeline of $228.5 million as at 1 July, 2001, and the tariff schedule set out in the Final Decision. Having said that, there are a number of aspects of the Final Decision considerations regarding the ICB that we believe warrant comment.

DORC and ICB

NT Gas is concerned that, in arriving at its decision on the ICB, the Commission has, in relation to DORC:

- failed to address the substance of submissions made by NT Gas, and by Agility on behalf of NT Gas in respect of the NPV DORC approach,
- failed to properly take account of the Epic Decision in the Supreme Court of Western Australia[1] insofar as it provides guidance as to the proper calculation of DORC,
- failed to take account of advice available to it from NERA on the subject of depreciation within DORC valuations and of Agility's responses on behalf of EAPL to the NERA report and to a report by SKM on the same subject matter in respect of the Moomba - Sydney Pipeline[2], and
- failed to determine a value of DORC for the ABDP.

The result is that the Commission has failed to adopt a calculation methodology for DORC that is "based solely upon the economic principles that underpin it" adopting, instead, an "approach … that depart[s] from the economically sound derivation of DORC [and is therefore] contrary to good regulatory practice." (FD p33)

Agility's submissions

The Commission has recited some of the history of the debate on DORC. Section 2.4 of the Final Decision summarises the position up to and including the Draft Decision, and Section 2.5 summarises NT Gas' response to the Draft Decision. However, nowhere does the Commission address the substance of NT Gas' response to the Draft Decision, or the related issues raised by Agility in subsequent correspondence with Commissioner Shogren (letters from Mr Connery dated 23 November, 2001 and 14 January, 2002).

[1] re Dr Ken Michael AM; ex parte Epic Energy (WA) Nominees Pty Ltd & Anor [2002] WASCA 231

[2] The NERA (September 2002) and SKM (February 2002) reports referred to here were obtained by the Commission in the context of its assessment of EAPL's Access Arrangement for the MSP. Agility responded to both reports in November 2002. NERA's report is, arguably, supportive of the Agility NPV approach and provides little if any support for the approach recommended by SKM. The SKM report on the MSP is essentially the same in terms of the substance of its arguments and conclusions, as the SKM report on the ABDP (March 2002).

The Commission's approach: SKM, the Epic Decision and NERA

The Commission states that its has been guided in the Final Decision by advice it received from Sinclair Knight Mertz (SKM):

> "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 <u>based solely upon the economic principles that underpin it</u>, resulting in a stand-alone and independently reproducible valuation that excludes other factors that the regulator may take into account when establishing an ICB." (FD p33) (emphasis added)

We concur with this position which is also supported by Professor King, NERA, and the Epic Decision. However, we note that the underlined passage (or similar statement) cannot be found in the SKM report. The importance of DORC being based on sound economic principles is restated:

> "The Commission acknowledges that reflecting too many issues within a single instrument such as DORC, reduces the transparency of the ICB setting process and it is therefore desirable to determine DORC as a stand-alone value with other factors considered separately when determining the ICB. It is the Commission's view that approaches to the determination of DORC that depart from the economically sound derivation of DORC are therefore contrary to good regulatory practice." (FD p33)

Once again, we concur.

Despite these clear statements of principle, and without giving reasons, the Commission has decided to determine DORC by what amounts to straight line depreciation of ORC for the ABDP:

> "In this Final Decision, the Commission determined a DORC valuation based upon ORC multiplied by the remaining useful life of an asset divided by the useful life of a new replacement asset." (FD p3 1)

As we have argued, with support from Professor King, straight line depreciation of the ORC is economically meaningless and is "clearly inconsistent with the Commission's economic underpinnings and justification of DORC" as set out in the Commission's Draft Regulatory Principles and which in turn requires a NPV based approach to the calculation. The Epic Decision and NERA also confirm that DORC is a forward looking, NPV based valuation:

> "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." (Epic Decision, para 164)

and

> "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 p2)

We understand that the phrase "the economic principles that underpin [DORC]" (FD p33), is a reference to the Commission's Draft Regulatory Principles. To be consistent with those principles, the Commission must adopt the Agility NPV based approach which is arguably the only approach that gives effect to those principles. If the Commission intends to persevere with the approach adopted in the Final Decision it must establish the economic principles that are consistent with that approach. Clearly those principles cannot be the same as those in the Draft Regulatory Principles, and we would expect to be consulted in any decision making process.

The justification for the lower limit of the Commission's range of DORC value for the ABDP is flawed

Assuming for the moment that straight line depreciation was an acceptable methodology for constructing DORC from ORC, then the use of "remaining useful life of an asset divided by the useful life of a new replacement asset" is rational, amounting to a refinement of the pre-existing "rule" i.e. remaining life of existing asset divided by life of the replacement asset, where "life" was taken to be "technical life". For the rule to be valid in this form, it must be reasonable to assume that there will be a market for services, and gas to be transported, for at least the technical life of the replacement asset. The special circumstances of the ABDP, where its useful life is expected to be shorter than its technical life because of uncertainty beyond 2011, require the pre-existing rule to be refined.

If the useful life of an existing asset is shorter than its technical life, then the useful life of the replacement asset must be the same as that of the existing asset, and DORC (on any basis) must equal ORC. Only if the useful life of the replacement asset is longer than the technical life of the existing asset can the DORC be less than ORC.[3]

In the case of the ABDP, Agility has argued that "there is no reasonable expectation that the useful life of a new/ORC pipeline would extend beyond the economic life of the existing pipeline which ends in 2064 i.e. the 'commercial' lives of the ORC and existing pipelines can be assumed to be the same."[4] It follows that DORC is equal to ORC. The same conclusion is reached by the Commission in its "2011 uncertainty" case. However, the lower limit of the Commission's DORC range ($304.5m) appears to have been calculated on the basis of the ratio of technical lives i.e. 65/80, which is the same as saying that the replacement asset will have a longer useful life than the existing asset.

However, in drawing conclusions about an appropriate ICB the Commission argues that the ICB must be set at ODV because of the high risk of stranding beyond 2011 (FD p36). The risk that there will be no market for services beyond 2064 must be even greater. Thus, on an any assessment, the probability weighted useful life of a replacement asset (to use SKM's

[3] When the useful lives of an existing asset and new assets are the same, the results of Commission's approach and the Agility method are coincidentally the same, setting aside the second order effect of different O&M costs as between new and old assets.

[4] Submission on application of Agility DORC to ABDP, September 2000

approach) must be significantly less than the technical life of the existing assets. That being the case, it is not sustainable to argue that DORC could be as low as $304.5m given that it is based on an assumed useful life of 80 years for the replacement asset.

Another consideration, not addressed by the Commission, is the effect on DORC of the differential between the operating costs of new and old assets. This effect has been discussed in submissions by NT Gas and Agility on behalf of NT Gas. It is also recognised by NERA in its report to the Commission in relation to the MSP.

NT Gas believes that, when all these factors are taken into account, it would have been reasonable for the Commission to determine a DORC value for the ABDP of $336.3 million as at 1 July 2001. In calculating this value NT Gas has adopted the NPV methodology which is discussed at length in its response to the Commission's Draft Decision. That methodology is in turn consistent with:

- the principles established by the Commission as early as 1998 and expressed most comprehensively in the Commission's Draft Statement of Principles for Regulation of Transmission Assets (1999);
- the principles accepted by the Court in the Epic Decision – that DORC is a forward looking valuation methodology;
- the requirement of the Code, clarified by the Epic Decision and accepted by the Commission, 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"

On current information there is a reasonable likelihood that gas will no longer be available and/or the market for transportation services via the pipeline will terminate before the ABDP reaches the end of its technical life i.e. the pipeline's useful life will be shorter than its technical life. From this it follows that the useful life of a hypothetical replacement asset would be the same as that of the existing asset. In that case, the value of DORC will be less than ORC only to the extent that the operating costs of existing assets are greater than those of the hypothetical replacement asset. When these cost relativities are taken into account, DORC will be no less than 90% of the ORC value i.e. DORC will be no less than $336.3 million.

If the view is taken that there will be a market for services for at least the technical life of the hypothetical replacement pipeline (80 years), then the difference in the lives of the existing and replacement assets results in the lower limit of DORC being reduced to 85% of ORC i.e. DORC is no less than $317.6 million.

Given the conservatism of the cost assumptions underlying these lower limits and the uncertainties associated with continued use of the pipeline between 2011 and 2064 and beyond, we conclude that the appropriate value of DORC for the ABDP is $336.3 million as at 1 July 2001.

Other matters relating to the ICB determination

Residual Value, 8.10(f) and 8.10(g)

We note that residual value is considered by the Commission in the context of 8.10(c) (section 2.8.2) rather than under 8.10(f) which would appear more logical given the specific mention of "economic depreciation" in that clause. In discussing 8.10(f) (section 2.8.4) the statement is made that:

> *"Wealth transfers **or** windfall gains*
>
> The Commission does not agree with NT Gas' assertion that the Code imposes no obligation on the regulator to consider wealth transfers or 'windfall gains', to either the service provider or users, when setting the ICB. While section 8.10 of the Code does not explicitly refer to windfall gains (or their avoidance), the Commission considers that possible wealth transfers are relevant to the determination of the ICB.
>
> For example, section 8.10(a) of the Code requires the regulator to consider the actual capital cost of assets and the accumulated depreciation already charged to users. Section 8.10(f) also requires the regulator to consider the basis upon which tariffs have been (or appear to have been) set in the past and historical returns to the service provider. Thus, it is implicit that the Commission ought to have regard to past recovery levels when determining an appropriate ICB. Hence, there is a need to ensure that, where possible, wealth transfers are kept to a minimum." (FD p39)

NT Gas accepts that the possibility of wealth transfers is one among a number of relevant considerations in determining the ICB. However, and what we said in our response to the Draft Decision is that, "... the Code makes no reference to "windfall gains" (or their avoidance) and <u>it imposes no requirement that the initial capital base be established so that the cost of me-existing assets is depreciated only once.</u>" (NT Gas p12) (emphasis added)

While wealth transfers may be a relevant consideration, it is also the case that monopoly profits may be appropriate as confirmed by the Epic Decision:

> "the outcome under the Code of an investment decision in a pipeline made before the introduction of the Code, even though that decision anticipated some 'monopoly' profits, would not be irrelevant to the Regulator's deliberations, under s8, including the establishment of the initial Capital Base." (Epic Decision, para 154)
>
> "There is nothing [to suggest that the pipeline valuation process must] exclude the effects of monopoly pricing from the calculation of value" (Epic Decision, para 161)

The final sentence in the passage quoted above from FD p39 clearly does not follow from those before it, and is inconsistent with the proper interpretation of the Code to the extent that the Commission has taken it to be an ovemding principle. In terms of a proper analysis of wealth transfers, the fact that consumers would not be disadvantaged if the ICB were set at the economic WDV should be given serious consideration.

The SKM Report

The Final Decision correctly notes that NT Gas did not provide comments on SKM's report entitled "NT Gas: Depreciation within DORC". Given the flaws in the report and the Commission's reliance on it, it is appropriate to respond briefly here. Most of the comments that can be made simply reiterate those made to the Commission in Agility's November 2002 response on behalf of EAPL to SKM's similar report in relation to the MSP. However, we will make some observations here for the record.

SKM acknowledge the new entrant model for DORC but do not give a view as to its consequences for the construction of DORC from ORC. Instead they state that:

> "We do not see the DORC as a slavish implementation of a new entrant bypass costing analysis but suggest instead that this model provides an indication of the historical and economic roots of the ODRC model and can be used to provide guidance in the event of procedural uncertainties in the DORC method." (p6)

SKM have clearly been asked to address a "procedural uncertainty in the DORC method" i.e. what is the appropriate method of depreciation of ORC to arrive at DORC? Instead of looking to the new entrant model for guidance, as the above paragraph would suggest is appropriate, SKM adopt the limited position that it is more important to follow the precedent of past practice (i.e. straight line) on the basis that "using the algorithm consistently in this regard produces a degree of stability and confidence within the industry as to how future assessments are to be evaluated. To allow a range of alternatives, particularly where they might be selectable at the discretion of the owner ... would seem to make the calculation of the DORC a very arbitrary process." (p6). SKM then go on to recommend codification of the method "to maintain a consistent treatment between practitioners" (p6).

This line of argument reflects a misapprehension by SKM that there can be more than one meaning for DORC and that it is open to the Service Provider to choose among them. More importantly SKM has not recognised the importance of determining DORC consistently with the economic principles that underly the concept – principles which are documented in the Draft Regulatory Principles. In fact SKM conclude their paper with the surprising recommendation that:

> "Depreciation for DORC should be straight-line based, consistent with our recommendations on the MSP decision and with previous application of DORC for gas and electricity assets in Australia. We would prefer if the Commission amended the relevant areas of the Draft Regulatory Principles 1999 to reflect this recommendation." (p16)

SKM's argument for ignoring the important and broadly accepted economic principles documented in the Draft Regulatory Principles appears to be one of expediency.

SKM develop the "useful life" concept, suggesting that, where there is uncertainty, the remaining useful life of the existing asset can be calculated as a probability weighted average. However, setting aside the question of whether straight line adjustment is appropriate, the useful life is misapplied by SKM in the example given on p11 – the useful life of the new asset (in the denominator) should be (40-13), not 40. With this change, SKM's DORC would equal ORC in the particular case of the ABDP. The Commission appears to have recognised this error in the Final Decision.

As they did in their report on the MSP, SKM state:

> "Notwithstanding NT Gas' observation [in] their submission against consideration of 'windfall gains' (and presumably windfall losses also), we remain of the view that it might be implied that the entry of **an** asset to the regulatory regime under the Code is not intended, ex ante, to be a process redistribution wealth from asset owners to asset users of vice versa. It is a pity that this intention is not explicit in the Code but it seems a reasonable implied term nevertheless [eg under the Constitution s51(xxxi)]." (p13)

If there was ever any doubt on this point, it has now been resolved by the Epic Decision.

SKM close with the statement:

> "Should there be an ongoing need for the DORC methodology to be applied in the Australian regulatory context then we would recommend that a more encompassing set of principles be developed and subjected to a consultation process with the industry." (p 16)

Once again this is a surprising statement given the process already undertaken by the Commission (of which Draft Regulatory Principles are a part) and the standing of those Principles as an authoritative point of reference, notwithstanding their draft status.

SKM's recommendation favouring the continued use of straight line depreciation of the ORC should be dismissed.