

Submission to the Australian Competition and Consumer Commission
regarding the MSP Access Arrangement and the Epic Decision

Public Version

Australian Pipeline Trust
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Submission to ACCC
Impact of the Epic Decision on the MSP Draft Decision

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Attachments:

Attachment 1: Advice from KPMG regarding errors of law in the Draft Decision

Dictionary

In this submission, these words have the following meanings:

“Access Arrangement” means the proposed Access Arrangement for the MSP

“AGL” means The Australian Gas Light Company

“Agility” means Agility Pty Limited

“Code” means the National Third Party Access Code for Natural Gas Pipeline Systems

“Commission” means the Australian Competition and Consumer Commission

“Court” means the Western Australian Supreme Court in the Epic Decision

“DBNGP” means the Dampier Bunbury Natural Gas Pipeline referred to in the Epic Decision

“DORC” means depreciated optimised replacement cost

“Draft Decision” means the draft decision of the Commission on the Access Arrangement for the Moomba to Sydney Pipeline System dated 19 December 2000

“Draft Decision DORC” means the DORC of \$539.1m determined by the Commission in the Draft Decision

“EAPL” means East Australian Pipeline Limited ABN 33064629009

“Epic Decision” means the decision of the Court in the matter of *Re Dr Ken Michael AM; Ex Parte Epic Energy (WA) Nominees* [2002] WASCA 231 delivered on 23 August 2002

“ICB” means initial Capital Base under the Code

“MSP” means the Moomba to Sydney Pipeline System

“Response to Draft Decision” means the response from Agility on behalf of EAPL to the Draft Decision dated 14 March 2001

NOTE: Confidential and commercially sensitive information removed.

1. Executive Summary

This submission addresses the impact of the Epic Decision on the Draft Decision of the Commission on the Access Arrangement for the Moomba to Sydney Pipeline System.

The Epic Decision is the most significant interpretation of the proper meaning and operation of the Code to date, and has changed the way in which regulators and industry must view the Code.

As a result of the Epic Decision, the Draft Decision contains fundamental errors of law, which go to the determination of the ICB and hence to the basis of the Access Arrangement. Those errors are:

- ? DORC has been treated as a maximum in determining the ICB. The Epic Decision requires that DORC be taken into account as one element of section 8.10, that each of the elements of section 8.10 are considered on their merits and are not read down by the concept of economic efficiency and that the circumstances of the pipeline should be taken into account in determining whether the ICB should fall within the “normal” limits of DAC and DORC.
- ? In the Draft Decision, the avoidance of monopoly returns has been taken as a material consideration in the determination of the ICB, where the Epic Decision states that monopoly returns should be considered and may be a legitimate business interest of the service provider.
- ? The reasonable expectations of EAPL under the prior regulatory regime have not been taken into account to the extent that they exceeded DORC, where the Epic Decision states that these should be taken into account.
- ? The Commission has incorrectly applied a “fairness” test to the application of the Code, a test not specified in the Code. The Commission has applied that test so as to predetermine that the ICB needs to reflect a residual value based on historic depreciation. The Commission has also applied the fairness test to the determination of DORC to require a depreciation methodology which seeks to match that used as the basis for developing the tariffs prior to the setting of the asset valuation. The Epic Decision has explained at length how the provisions of sections 2.24, 2.25, 3 and 8 should be interpreted and applied and conflicts between them resolved, and this interpretation is not consistent with a “fairness” test.
- ? The Commission has failed to give weight or adequate weight to the legitimate business interests of EAPL under section 2.24.

Accordingly, the determination of the Commission expressed in the Draft Decision must be reconsidered.

In reconsidering the Draft Decision, the Commission must take into account:

- ? Reasonable expectations under the prior regulatory regime [s.8.10(g)] – the actual expectations of EAPL under the prior regulatory regime have been established by reference to its corporate documents. The reasonableness of the volume expectations is confirmed by a review of demand assumptions against actual demand, and conclusions in the 1997 AGA Supply and Demand Study. The reasonableness of the price assumptions has been confirmed by reference to actual contractual prices both for the GTA quantities and the additional quantities which were carried at the published prices. Both the GTA prices and the published prices were prices which were allowed both in theory and in practice under the regulatory regime in the MSP Act. The NPV of the reasonable expectations leads to a value of at least \$768m.
- ? Residual Economic Value [s.8.10(f)] – once the misconception of the Commission regarding the existence of a subsidy by the Commonwealth Government in the difference between the residual economic value and the purchase price of the MSP is corrected, the residual economic value of \$1700m is a relevant valuation methodology which allows the Service Provider to recover the capital value of the pipeline.
- ? NPV DORC [s.8.10(a)] – when the incorrect imposition of a “fairness” test in the Draft Decision is removed from the issue of the calculation of the DORC, the most appropriate economic concept of DORC, based on the Commission’s own definition and the expert evidence in the Epic Decision regarding a forward looking concept, is the NPV DORC of \$970m.
- ? Purchase price of EAPL [s.8.10(c)] – the purchase price of EAPL by APT is an indication of market value and hence a well recognised valuation methodology. Although the purchase price of EAPL reflected in the APT float is not the outcome of a competitive tender or market negotiation, it was subject to due diligence considerations and expert opinion, and the fact that the share price of APT increased after float indicates that the market considered the price paid for the assets, with the MSP being more than 50% of those assets, to have been at least no greater than market value. The value of the MSP on this methodology is ██████ .
- ? The circumstances of the privatisation of the MSP, as with the circumstances of the privatisation of the DBNGP, are such that the “normal” application of DORC as a maximum is not appropriate. The privatisation occurred amidst significant pressure on AGL from the Commonwealth Government, which included the introduction of legislation (defeated in the Senate) to double the transportation price on the MSP prior to privatisation, and the threat by the Commonwealth Government to ignore contractual rights of AGL, which threat was removed by a Court decision prohibiting such action. In that context, the sale of the MSP to EAPL proceeded with AGL purchasing 51% of MSP by negotiation and a competitive tender being held for the purchase of the balance of the MSP by unrelated entities. These circumstances of the purchase and the introduction of a regulatory regime specific to the MSP, and the reasonable expectations under that regime, are sufficient to warrant an ICB in excess of the Draft Decision DORC. (It should be noted that the NPV DORC would exceed all valuations except Residual Economic Value.)
- ? Application of 2.24 and legitimate business interests – if the Commission continues with the Draft Decision DORC (rather than accept NPV DORC as we believe is correct), the conflict between the foregoing valuations and the Draft Decision DORC must, under the

Epic Decision, be resolved by consideration of the objectives in section 8.1, giving fundamental weight to the matters set out in section 2.24. The legitimate business interests of the service provider are to recover at least its reasonable expectations under the prior regulatory regime, since these represent the benefits to EAPL of the purchase of the MSP under the privatisation process, and arguably the residual economic value of \$1700m. The interests of the public in encouraging long term investment in gas infrastructure and the interests of gas users in avoiding price shocks are served by setting the ICB at a level which reflects the reasonable expectations, being at least \$768m.

The Code requires consideration of a number of valuation methodologies, which in the case of the MSP range up to \$1700m. Having taken the matters in sections 8.1 and 2.24 into account, the minimum value which would properly recognise the interests of EAPL as required under the Code while still recognising the interests of User is the amount which represents the reasonable expectations of EAPL under the prior regulatory regime, being at least \$768m.

2. Errors of Law in the Draft Decision

2.1. Initial Capital Base

The basic argument at the foundation of the Epic Decision was the determination of the ICB. Accordingly, the decision of the Court is directly primarily at the proper interpretation of the Code in relation to the determination of the ICB, and the impact of the Epic Decision on the Draft Decision is accordingly on the fundamental issue of ICB.

The discussion of the errors of law in this section 2 are supported by the detailed advice from Mr Geoff Taperell of KPMG Legal, in Attachment 1 to this Submission.

The elements of the Epic Decision which impact directly on the Draft Decision in relation to determination of the ICB are:

- ? The interpretation of DORC as the maximum for the ICB;
- ? The effect of monopoly returns on the valuation of the ICB;
- ? The reasonable expectations of the service provider under the prior regulatory regime;
- ? The interpretation of the Code to include a “fairness” test, particularly in determining the value assigned to the ICB and the DORC methodology, and the definition of DORC as a backward looking methodology in relation to depreciation; and
- ? The impact of section 2.24 and the legitimate business interests of the service provider.

2.1.1 *DORC as a maximum*

It is clear from the wording of the Draft Decision that the DORC valuation method has been taken as a maximum for the ICB of the pipeline system, and that valuations that exceed the Draft Decision value of DORC have been excluded from consideration or considered only to a cap of DORC.

The Court in the Epic Decision, on the other hand, makes it clear that DORC does not set a maximum for the ICB and that other valuation methods, as well as the reasonable expectations of the service provider under the prior regime, should also be taken into account whether or not they exceed an economically efficient valuation.

The Court found that:

- ? "Economic efficiency is but one of the factors identified in s 8.10 and there is no sufficient justification in that provision for regarding it as in any way a dominant consideration."¹
- ? "While the DAC and the DORC methodologies have an acceptability for the purposes of the concept of economic efficiency, it is clear from s 8.10(c) that other well-recognised

¹ Epic Decision para 176

asset valuation methodologies are to be considered, and by (d) the advantages and disadvantages of each are to be weighed. It is not provided that they are to be weighed only according to the economic theory of economic efficiency; they are to be considered and evaluated on their merits."²

Accordingly, the Commission in the Draft Decision has improperly excluded consideration of valuation methodologies to the extent that they exceed DORC, and EAPL has incorrectly argued (given the proper interpretation of the Code provided in the Epic Decision) the relevance of valuation methodologies to the extent that they exceed DORC.

2.1.2 *Monopoly returns*

In the Draft Decision, the Commission considered the impact of a privatisation value based on a value which exceeded the Draft Decision DORC, which thus in its view incorporated some elements of a monopoly return. The Commission concluded that the imposition of a maximum of DORC in the Code was appropriate to exclude that part of the valuation based on price which represented monopoly returns, or in the words of the Commission, "inadequately recognise(d) the contribution to the capital return already made by users."³

The Epic Decision clearly stated that a valuation methodology, such as a purchase price, which valued the pipeline at a figure greater than DORC and therefore took into account the NPV of monopoly returns, could be taken into account, and was not to be read down by a concept of economic efficiency to the maximum of DORC.

"there is no reason, implicit or explicit, why a valuation methodology which had regard to the present value of anticipated net returns, including monopoly returns, should necessarily be excluded for these purposes."⁴

The Commission has excluded from its consideration valuation methodologies to the extent that they exceed DORC on the basis that they include monopoly returns. The Epic Decision determines that such methodologies cannot be necessarily excluded for these purposes.

2.1.3 *Reasonable expectations*

In the Draft Decision, the Commission dismissed the reasonable expectations of EAPL under the prior regulatory regime, expressed as the NPV of the cash flows inherent in its long term contractual arrangements, on the basis that these would yield an asset value in excess of DORC. The Draft Decision concluded that these reasonable expectations would lead to a decision equivalent to DORC rather than to some lower valuation.

The Draft Decision states:

"Underpinning EAPL's purchase price of the MSP were the cash flows generated by the GTA, (recently replaced by the GTD). Contained in the GTA was an escalating tariff path for the duration of the agreement. EAPL has stated that the NPV of the

² Epic Decision para 176

³ Draft Decision page 41

⁴ Epic Decision para 176

cash flows inherent in its current long term contractual arrangements would yield an asset valuation in excess of the upper limit of DORC imposed by the Code. Accordingly, it may seem reasonable for EAPL to expect that the value of the initial capital base would be equivalent to DORC rather than to some lower valuation....”⁵

The Epic Decision clearly states that the reasonable expectations of service providers cannot be excluded simply because the valuation which they yield exceeds DORC.

The Epic Decision states:

"Nor should there be excluded the expectations of service providers of monopoly returns where those expectations were reasonable under the regulatory regime that applied to the pipeline before the commencement of the Code, s 8.10(g)."⁶

The Commission in the Draft Decision erred in law in failing to take into account the reasonable expectations of the service provider under the prior regulatory regime, because that valuation method yielded a value which exceeded DORC.

2.1.4 *“Fairness” test*

The Commission in the Draft Decision employs a notion of “fairness”, treating it as an overriding consideration. It concludes that the ICB to be fair needs to reflect a residual value based on historic depreciation.

“A significant conclusion drawn from the Commission’s interpretation of the Code is that the value assigned to the initial capital base should be a fair value to both the service provider and users of the pipeline system. For the initial capital base value of the existing assets to be fair to both the service provider and users it needs to reflect a residual value based on the historic depreciation which has been recovered by the owners”⁷

This “fairness” test which permeates the Draft Decision is not specified in the Code, and is inconsistent with the Epic Decision which sets out in detail the manner in which sections 2.24, 2.25, 3 and 8 should be interpreted and applied.

The conclusion that an ICB needs to reflect a residual value based on the historic depreciation which has been recovered by the owners, on the basis of the application of the fairness test, is a predetermination of the ICB which is inconsistent with the Code and the Epic Decision.

The Commission then applied the fairness test to the DORC methodology to require it to incorporate a depreciation methodology which seeks to match that used as the basis for developing the tariffs prior to the setting of the asset valuation. This application of the fairness test to the determination of DORC is inconsistent with the Code and the Epic Decision.

⁵ Draft Decision Page 46

⁶ Epic Decision para 176

⁷ Draft Decision page 25

The requirement in the Draft Decision that the depreciation of the ORC be strongly linked with historic depreciation is inconsistent with the Epic Decision requirement that DORC be given the meaning determined by generally established and accepted economic concepts, and with the expert evidence recited in the Epic Decision that DORC is a forward looking methodology.

2.1.5 *Impact of section 2.24 – Legitimate Business Interests*

The Commission in the Draft Decision reconciled the conflict caused by the valuation of reasonable expectations, which exceeded DORC, with the “maximum” of DORC referred to in section 8.10(a) and section 8.11, by minimising the revenue shock and applying DORC as a maximum.

The Epic Decision requires that if competing section 8 requirements are unable to be reconciled, or in deciding which should prevail, the Regulator should have regard to the broader considerations of section 2.24.

The Commission has failed to give weight or sufficient weight to the legitimate business interests of the service provider under section 2.24.

2.2. **Affected Recommendations in the Draft Decision**

The amendments required by the Draft Decision which are affected by the errors of law identified in this submission are:

Proposed amendment A2.1

In order for EAPL’s access arrangement for the MSP to be approved, the value of the initial capital base is to be set at \$502.081 million.

Proposed amendment A2.7

In order for EAPL’s access arrangement for the MSP to be approved, the basis of the depreciation schedule for the initial capital base should be the value of the initial capital base as proposed by the Commission in this *Draft Decision*.

Proposed amendment A2.12

In order for EAPL’s access arrangement for the MSP to be approved, the initial reference tariffs must be set in relation to the efficient forecast costs of providing reference services in accordance with the amendments proposed in this *Draft Decision*, rather than current published tariffs.

3. Application of EPIC to the MSP Access Arrangement

3.1. Reasonable Expectations under the Prior Regulatory Regime

Section 8.10(g) of the Code requires the Commission to take into account the reasonable expectations of persons under the regulatory regime that applied to the Pipeline prior to the commencement of the Code.

In order to determine the reasonable expectations of EAPL under the prior regulatory regime, we have taken the actual expectations of EAPL, and tested them for reasonableness.

The actual expectations of EAPL under the prior regulatory regime have been determined from corporate documents prepared by EAPL prior to the adoption of the Code, taking a conservative approach based on the estimates contained in those documents. Those expectations relate both to the volume which the MSP would transport, and the price which would be paid for that volume, which are then used to determine a net present value of the MSP.

Although the documents establish the expectations of EAPL under the prior regulatory regime, the reasonableness of these expectations depends upon the validity of the assumptions as to quantity and the assumption as to price.

Regarding the assumption on quantity, the volume assumptions of EAPL in the period prior to the Code were supported by the 1997 AGA Supply and Demand Reports which forecast much greater supply and demand figures than those assumed by EAPL. However, the most persuasive evidence in support of the reasonableness of those assumptions is the fact that the anticipated loads did not vary significantly from those that have actually occurred (after taking into account the loss of load to the EGP which could not have been reasonably anticipated by EAPL). Since the volume assumptions have been supported by actual demand, they are the appropriate basis for determining reasonable expectations.

The reasonableness of the assumption on price depends upon market expectations of price, and any regulatory constraint on that price. Contract prices were used for GTA volumes. The prices which have been used in calculating the reasonable expectations in respect of non-GTA volumes were “published prices” – that is, prices published by EAPL at the time at which they commenced to publicly offer the transport of gas for third parties. Those published prices were not significantly different from the GTA prices in the short and medium terms, and were anticipated to decline in the longer term, and as such were a reasonable assessment by EAPL of the price which was achievable in the market. In addition, the regulatory regime in the MSP Act which existed prior to the commencement of the Code did not affect the terms of the GTA, and allowed EAPL to negotiate transportation prices for third parties. EAPL was under an obligation to provide transportation services to third parties, and in the event of an access dispute as to those terms and conditions, the matter could be referred to the Trade Practices Commission as arbitrator, which had power to determine the terms and conditions including the haulage charge subject to taking into account certain specified matters. EAPL did in fact negotiate contracts at the published prices, and no access dispute was referred or determination made which affected the published prices. It is clear therefore that the published prices for volumes in excess of the

GTA volumes represented a reasonable expectation of EAPL under the prior regulatory regime.

In the Response to the Draft Decision, Agility on behalf of EAPL stated:

“The value of EAPL's expectation under the prior regulatory regime is at least \$666m, which happened to be EAPL's assessment of DORC at the time it submitted the Access Arrangement Information under the current regime.

It follows that the value which comes out of section 8.10(g) for consideration in setting the ICB is \$666m at least.”

The calculations to determine the appropriate figure in excess of \$666m have now been carried out using the assumptions outlined, and the reasonable expectations calculated as the NPV of EAPL's reasonably expected cash flows from 2001 to 2036, as at July 2000, are a range of \$768 - 972m.

The reasonable expectations of EAPL under the prior regulatory regime formed part of the agreement negotiated between EAPL and the Commonwealth Government in privatizing the MSP. The circumstances of the purchase of the MSP (set out in section 3.5) included the establishment of a regulatory regime specific to the MSP, which underpinned the reasonable expectations of EAPL at no less than \$768m.

Under the Epic Decision, the fact that an amount includes the NPV of monopoly returns does not exclude it from consideration. The Epic Decision states:

"Nor should there be excluded the expectations of service providers of monopoly returns where those expectations were reasonable under the regulatory regime that applied to the pipeline before the commencement of the Code, s 8.10(g)."⁸

Accordingly, EAPL submits that the reasonable expectations of EAPL under the prior regulatory regime of \$768 - 972m should be taken into account in determining the ICB.

3.2. Residual Economic Value

Section 8.10(f) of the Code requires the Commission to take into account the basis on which tariffs have been (or appear to have been) set in the past, the economic depreciation of the pipeline, and the historical returns to the Service Provider from the pipeline.

The Commission in the Draft Decision observes that:

“it would appear that the book depreciation values were not fully reflected in tariffs in addition to a commercial rate of return. ... The residual value at 30 June 1994 from this analysis is \$1 291 million, well above the 1994 sale price and the various DORC estimates. This would suggest that, if one of the DORC values were applied to the regulatory asset value moving forward from that point in time, there would be a windfall benefit to users and a possible windfall loss to the service provider.”⁹

⁸ Epic Decision para 176

⁹ Draft Decision, pages 37-38.

The Draft Decision concludes that:

"This difference [between the purchase price and the residual economic value] can be interpreted correctly as the value of the subsidy provided by the Government in establishing the pipeline up to that point including losses associated with changing market expectations."¹⁰

with the result that the residual economic value is effectively dismissed from further consideration, and the possibility of a windfall loss to the service provider is not further considered.

In the Response to the Draft Decision, Agility set out in detail the circumstances of the 1994 sale and purchase, to establish that no subsidy had been intended or provided by the Government to the gas users of NSW. Agility cited both the express intention of the Commonwealth Government as evidenced in the 1983 letter from Senator Peter Walsh, the then-responsible Minister, to the Chairman of AGL and the actions of the Commonwealth Government in attempting to double the gas transportation tariff prior to sale to support the conclusion that no subsidy existed.

Agility stated:

“Given the actual circumstances of the 1994 sale and purchase i.e. that it was not the intention of the Government to extend a subsidy to gas users and that the terms of the sale were the result of a commercial negotiation in which both parties sought to maximise their positions, the only reasonable conclusion to be drawn about the residual economic value is that customers would not be disadvantaged if the ICB were set as high as \$1,700m¹¹ as, over its lifetime, they would be paying no more than the full value of the pipeline.”

Given that there is no additional factor such as a subsidy which would apply to diminish the relevance of the residual economic value, the Epic Decision requires that this value be considered on its own merits, and not read down by any concept of economic efficiency such as a maximum of DORC. The Commission in the Draft Decision has recognised that EAPL may suffer a windfall loss and the users receive a windfall gain, should the ICB be set at less than residual economic value.

Accordingly, EAPL submits that the residual economic value of \$1700m should be taken into account in determining the ICB.

¹⁰ Draft Decision, page 40.

¹¹ If the estimated residual economic value as at June 1994 (\$1,291m) were brought up to its June 2000 equivalent, the unrecovered residual amount would exceed \$1,700m.

3.3. NPV DORC

Agility has presented and argued for a NPV based approach to the calculation of DORC in a number of submissions to the Commission before and after the Draft Decision was made¹². The essence of Agility's argument is that:

- the NPV based approach provides a forward-looking valuation that is consistent with the meaning and interpretation of DORC that the Commission itself has developed and restated consistently over a significant period of time in its public writings, including in decisions and related writings under the Code;
- the Commission's past practice, perpetuated in the Draft Decision, of constructing DORC by straight line depreciation of ORC is inconsistent with the Commission's stated economic underpinnings and justification of DORC and lacks economic justification; and
- there is no basis in the Code for the proposition, relied on by the Commission, that DORC must be calculated in such a way as to satisfy, simultaneously, other requirements of the Code. The fact that the value of DORC is one among a number of factors that should be considered in setting the ICB suggests strongly that the value of DORC can and should be determined objectively as a stand alone valuation by reference to the economic principles underlying the concept i.e. independently of the asset's service and financial history, and independently of other considerations in the Code.

These views are supported by Professor Stephen King and the proper application of the Code as clarified by the Epic Decision.

The Draft Decision expresses the Commission's view that the ICB must represent a fair value to both the service provider and users of the pipeline system, such that where the service provider has sought in the past to recover an allowance for depreciation of the assets in past tariff charges the ICB should be based on a residual value reflecting that extent of accumulated depreciation¹³. We have shown in section 2.1.4 that this "fairness" test is an error of law, and its application to the calculation of ICB and DORC are also errors of law.

The Draft Decision also shows that there is confusion on the part of the Commission as to the role of DORC and ICB and the relationship between them. The Code does not require that ICB be set equal to DORC – DORC is but one of a number of factors that should be considered in setting the ICB, and the Epic Decision has made this interpretation clear. The Draft Decision reflects an interpretation of the Code by the Commission which equates setting the ICB at a value that is to be called "DORC" and then "moulds" the calculation of

¹² The history of Agility's submissions to the Commission in relation to the proper construction of DORC is as follows:

Agility submission on proper (NPV-based) Construction of DORC from ORC	Aug 2000
Meeting and follow-up letter, including effect of applying NPV approach to MSP	Sept 2000
Submission re application of approach to ABDP	Sept 2000
Response to MSP draft decision (including Professor King's report) and follow-up letter	Mar 2001
Response to ABDP draft decision and follow-up letter	Nov 2001

¹³ Draft Decision page 25

the DORC value to reflect other factors that are considered relevant to the quantum of the ICB. To "mould" the DORC in this way would imply that DORC has no meaning outside the circumstances of a particular decision, which is untenable. Indeed, the Epic Decision requires at the very least an economic meaning to be given to DORC, which must be capable of being consistently applied to all decisions.

Apart from that, it is unnecessary to "mould" DORC to give effect to the scheme of the Code for setting ICB and, most significantly, such "moulding" is inconsistent with the proper interpretation of the Code. The Epic Decision states that DORC should be given the generally established and accepted economic meaning.

"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."¹⁴

As argued by Agility and Professor King, DORC should be determined in accordance with the economic principles that underpin the concept and is therefore a forward looking valuation. This meaning has been confirmed by the expert evidence in the Epic Decision which reached conclusions on the meaning of DORC.

"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."¹⁵

This description of the DORC methodology as forward looking precludes the Commission requirement that past depreciation be adopted as the primary method of determining the DORC. Rather, the definition of DORC as indicated by the expert evidence is both for a forward looking DORC, and one which provides a proxy for a competitive market price, two of the characteristics of the meaning and interpretation of DORC adopted by the Commission, and reflected in the NPV DORC as proposed by Agility.

Based on the economic principles expounded by the Commission for the calculation of DORC,¹⁶ now strongly supported in the Epic Decision, it is the submission of Agility and the conclusion of King that the NPV DORC is the only correct definition of DORC.

In addition to the expert evidence in the Epic Decision, NERA also supports economic principles consistent with the NPV DORC. Recently, NERA was retained by the Commission to review the subject of depreciation within DORC valuations¹⁷, including the Agility and King submissions, in the context of the Commission's economic justification of

¹⁴ Epic Decision para 119

¹⁵ Epic Decision para 164

¹⁶ Draft Statement of Principles for the Regulation of Transmission Revenues (ACCC) 27 May 1999

¹⁷ NERA, *Depreciation within ODRC Valuations, A Report for the ACCC*, September 2002.

DORC, and concluded that a methodology revolving around the NPV of costs is consistent with that economic justification and that DORC should be determined exclusively by reference to the economic principles underpinning the concept and not by reference to factors that are addressed separately and specifically elsewhere in section 8.10 of the Code. EAPL will provide a detailed submission commenting on the NERA Report. That submission will show that while NERA has focussed on the NPV of costs and while there are differences in application, there is a common view that DORC is forward looking and NPV based. In these circumstances, there is significant economic support for the principle of NPV DORC from the Commission's expert.

It is of course open to the Commission under the Epic Decision to consider past depreciation under section 8.10(a) in DAC and the values obtained under section 8.10(f) as a separate valuation methodologies to DORC, and it may, should it exercise its discretion under the Code, determine that such a valuation is appropriate for the ICB. However those considerations are not relevant to the determination of DORC itself.

It is submitted that the expert evidence supports the contention that the NPV DORC is the proper definition of DORC within the established economic meaning of the term. The NPV DORC value is \$970m.

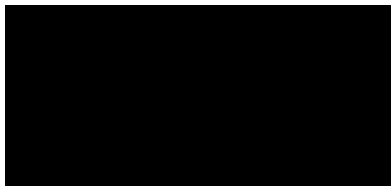
3.4. Other Methodologies – Purchase Price of APT

Confidential material in has been deleted from this and other sections of the report section.

Section 8.10(c) requires that the Regulator take into account other well recognised valuation methodologies. One such methodology is the value established by a market price for the asset.

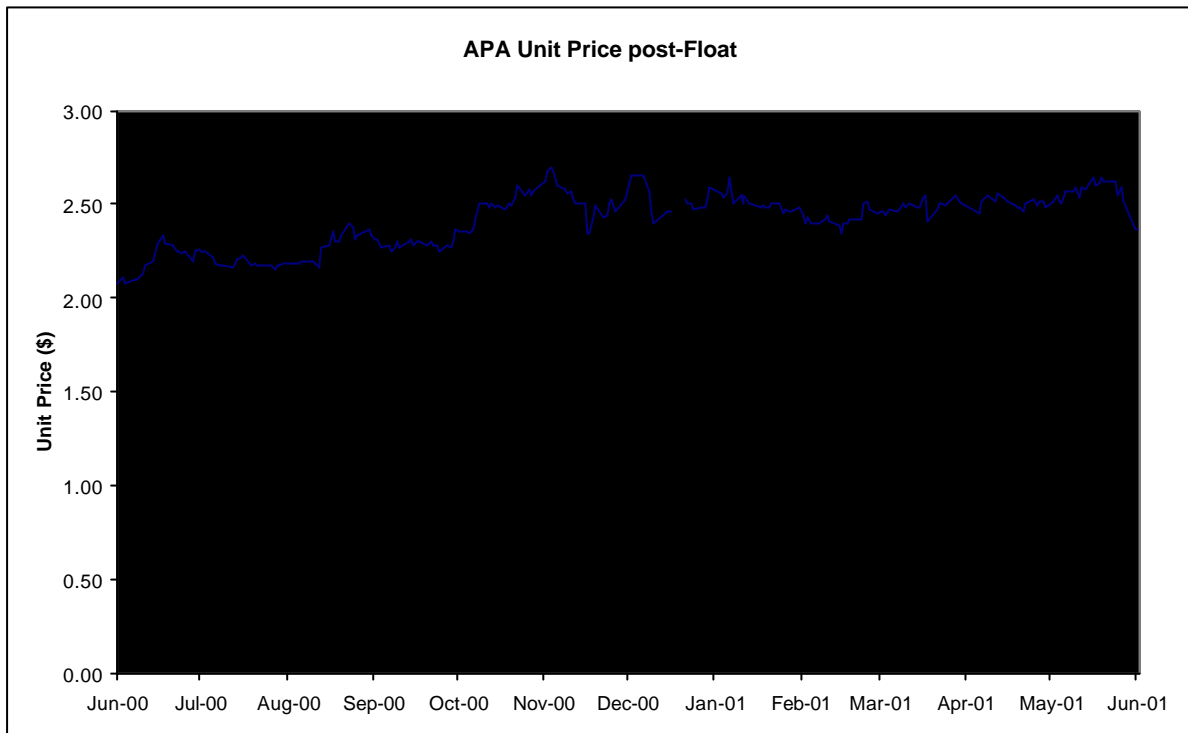
During its 2000 float, APT purchased all of the shares in EAPL, the only asset of which was the MSP. The quantum attributed to those shares can therefore be considered a valuation of the MSP. That amount was

\$m



It may be argued that the amount attributed to EAPL in that process should be given less weight because it is not an arms length transaction, since it was not determined in a market transaction or by competitive tender. Certainly, the float of APT required due diligence investigations and expert advice as to the proper value of the assets included. However, the validity of the price attributed to the EAPL shares might best be tested by the share price of APT, since the EAPL shareholding represents over 50% of the assets of APT. The following graphs show that the market place has increased the value of the shares in APT, evidence that

the underlying value of the company assets is considered by the market to reflect at least the proper value of the assets.



Accordingly, EAPL submits that the value determined by the price paid by APT for the shares in EAPL of [REDACTED] should be taken into account in determining the ICB.

3.5. Historical Context – MSP outside the “normal” DORC

If, as EAPL contends is correct, NPV DORC is accepted as the correct method of calculation of DORC, then it is only if the Residual Economic Value is adopted that the Commission must consider an ICB exceeding DORC.

If, however, the Commission adopts the Draft Decision DORC as the correct method, then all other valuations which the Commission is required to take into account (other than DAC) under section 8.10 exceed that DORC.

The Commission must then consider whether the situation of the MSP meets the criteria of “normally” falling between DORC and DAC under section 8.11, or whether the ICB should be established outside these bounds.

Under the Epic Decision, the Court found that section 8.11 must be accepted for what it says, and that an acquisition of a pipeline on the open market before the commencement of the Code may take the application of section 8.10 outside what is normal within the meaning of section 8.11. It then found that the circumstances of the privatisation of the DBNGP could be taken into account by the Regulator in determining whether the initial Capital Base for the DBNGP should fall outside the range of values determined under section 8.10(a) and (b).

“In my view, s8.11 is to be accepted for what it says, rather than seeking by implication to read much more into it. The expert evidence indicates that when the nature of the DAC and DORC valuation methodologies is understood, it can be accepted that, normally, the value of an existing pipeline would fall within that range of values. In a case, however, where there has been an acquisition of a pipeline on the open market before the commencement of the Code, that circumstance may take the application of s 8.10 outside of what is normal within the meaning of s 8.11, because a sale at market value may well involve the capitalisation of some monopoly returns. These will have been paid to the original owner by the new purchaser. While economic theory would turn its face against such a market value, a sale in these circumstances introduces, as an additional factor, the legitimate investment and business interests of the new purchaser which, at the time of the commencement of the Code, is the service provider. Economic theory aside, this investment has social, political and public interest dimensions and it is not a surprising circumstance that the Act and the Code should seek to accommodate them.

At least in cases where an investment in a pipeline before the Code applied is made in the course of an arm's-length commercial transaction, and is based on a sound commercial assessment of the value of the pipeline in the circumstances then prevailing and anticipated, it is not apparent from the terms of the Act and the Code that the intention is, automatically and necessarily, to preclude consideration of the investment, or the interests of the service provider in recovering it together with a reasonable return, or the reasonable expectations under the preceding regulatory regime of such a service provider. The interests of such a service provider may well be in tension with other considerations, but it is not apparent that their exclusion is intended by the Act and the Code. Were that the intention, some much clearer expression of it would be expected. In some cases, at least, to exclude such interests would infringe seriously on established and legitimate rights, interests and expectations. In my view, that result should not be arrived at by strained implication and in the face of many clear indications of a contrary intention.”¹⁸

And on the issue of the specific circumstances of the DBNGP:

“The purchase of the DBNGP by Epic on 25 March 1998, the circumstances of that purchase including the price paid, and any value according to a recognised asset valuation methodology which may be revealed by the price paid in those circumstances, are matters which the Regulator may properly take into account in determining, for the purposes of s8.11, whether the initial Capital Base for the DBNGP should fall outside the range of values determined under s 10(a) and (b).¹⁹

It is submitted that the circumstances of the sale of the MSP to EAPL are equally sufficient to justify a determination of ICB outside the “normal” range of DORC and DAC.

In the 1970s, the project commenced by AGL to construct the MSP was taken over by the Federal Government, which entered into a long term haulage contract with AGL for use of the pipeline. In early 1990, the Federal Government called for expressions of interest from third parties in purchasing the MSP. To achieve a substantial increase in the value of the

¹⁸ Epic Decision paras 178-179

¹⁹ Epic Decision para 223

pipeline, the Government proposed to legislate to increase the cost of gas haulage, by an initial 25% and then by a further 25% a year later, notwithstanding that this breached existing contractual arrangements between AGL and the Government.

In its Sales Memorandum, the Government denied AGL’s contractual right of first refusal in the event of any sale of the pipeline. AGL took legal action to assert that right, which was upheld by the NSW Supreme Court in 1990, and on appeal to the High Court. The legislation to increase the cost of haulage was defeated in the Senate, and the pipeline was withdrawn from sale.

In these circumstances, AGL and the Government in 1993 reached agreement for AGL to acquire a 51% interest in the MSP (the maximum ownership which the Government would allow) with the balance being sold by a tender process to Gasinvest Australia Pty Limited, a joint venture company for Novacorp International Inc of Canada and Petroliam Nasional Berhad of Malaysia. Part of the sale process was the extinguishment of AGL’s long standing contractual rights to be replaced by the Gas Transportation Agreement, and the introduction of the Moomba-Sydney Pipeline System Sale Act 1994 establishing a regulatory framework specific to the MSP.

In these circumstances, the reasonable expectations of EAPL under the regulatory regime created by the Government in the context of a controversial privatisation process, and the residual economic value of the pipeline purchased in those conditions, are ample justification for the determination of an ICB which departs from the “normal” maximum of DORC in section 8.11.

3.6. Application of Section 2.24 – Legitimate Business Interests

The valuation methodologies set out in this section 3 provide four different values of the MSP not previously considered as required by the Code:

	\$m
Reasonable Expectations under prior regulatory regime (s.8.10(g))	768 - 972
Residual Economic Value (s.8.10(f))	1700
NPV DORC (s.8.10(a))	970
APT Purchase Price (s.8.10(c))	■

These valuations clearly conflict. The Court in the Epic Decision considered that, in establishing the Initial Capital Base, the Regulator must consider the factors listed in section 8.10. In seeking to give effect to these, the Regulator will require guidance how to evaluate and weigh the diverse factors. The Court considered the section 8.1 objectives would guide the Regulator in doing so, particularly whether it is appropriate to move outside the bounds of DAC and DORC. Section 8.1 provides that, where any of the objectives conflict, the Regulator shall determine the manner in which they shall be reconciled. In reconciling the objectives, the Court determined that the Regulator must have regard to the fundamental principles set out in section 2.24.

The application of the section 8.1 objectives to the MSP pipeline in the light of these valuations leads to the same conflict identified in the Epic Decision – that is, the objectives of economic efficiency contained in section 8.1(a) and (c) conflict with the objective in section 8.1(d) of “not distorting investment decisions in Pipeline transportation systems”, which under the Epic Decision clearly include the basis on which past decisions have been made.

The Court in the Epic Decision gave a detailed discussion of the implications of section 8.1(d), which are of such significance in the consideration of the MSP generally that they are reproduced in full here.

“In respect of the distortion of investment decisions in pipeline transportation systems, the submissions of the Regulator and Alinta seem to regard this objective as being adequately reflected by the provision of a revenue stream in accordance with s 8.1(a). In their submission, at least in economic theory, that should enable the recovery of the replacement cost of the pipeline over the expected life of the pipeline. In support of this there was reliance on the expert evidence which suggests that the theory of economic efficiency, albeit described simplistically, is "forward looking", essentially treating past investment as sunken, ie forever bygone. On this view, an asset such as a pipeline would not be regarded as having a capital value greater than the cost of replacing the service capacity which it provides.

The language of s 8.1(d), however, provides no reason to confine this objective in this way. To do so, fails to recognise that a reference tariff which is based only on a cheaper present replacement value, and which has no regard to the actual unrecovered capital investment in the pipeline, may well undermine the viability of the earlier investment decision. If future investment in significant infrastructure, such as a natural gas pipeline, is to be maintained and encouraged, as the public interest requires, regard seems to be required to the need for both existing and potential investors to have confidence that the very substantial long term investment decisions which are required, and which were sound when judged by the commercial circumstances existing at the time of the investment, are not rendered loss-making, or do not result in liquidation, by virtue of future governmental intervention. As the Hilmer Report noted at p 251:

" ... the public interest would need to place special emphasis on the need to ensure access rights did not undermine the viability of long-term investment decisions, and hence risk deterring future investment in important infrastructure projects."

The expert evidence and writings in this respect appear to reveal an unresolved tension. There was general acceptance of the view that, as a matter of theory, economic efficiency required that actual past investment decisions be ignored. This appeared to be the case because, among other reasons, they may have been based on an expectation of recovering monopoly profits. The economists seemed to accept that, as a matter of economic theory, where a significant infrastructure asset, such as a pipeline, became the subject of regulation, the price of obtaining improved economic efficiency might be that the owner would be forced "to vacate the market". In such a case, the view in economic theory was that another party would no doubt enter the market to acquire the right to operate the asset, so that the "services" provided by the asset would continue. Failing that, economic forces would lead to a replacement of the services by some other means, at least if there was a sufficient demand for them.

As against that view some of the expert evidence and the writings tendered to the Court revealed a growing awareness that such an outcome, although offering the advantage of lower prices for consumers in the short term, could be contrary to public interest in the long term, because of the adverse effect on necessary future investment in such assets of any adverse outcomes of past investments.

The extent to which this growing concern has been or will come to be accommodated into economic theory and practice is one issue. In my view, however, s8.1(d) has dealt with the issue expressly, and has done so by not denying the potential relevance of past investment decisions to the design of a reference tariff or a reference tariff policy.

In this respect, in my view, s8.1(d) can be seen to reflect a public interest broader than the mere understanding and application of economic theory, by taking account of wider political and social considerations. Past investment in a Covered Pipeline has not been rendered necessarily irrelevant, as the application of economic theory might suggest. In particular, there may be seen in s 8.1(d) a reflection of the general scope and policy of the Act, in so far as this sought to provide for third party access to pipelines on terms and conditions that were fair and reasonable to owners and operators. In this respect there is some underlying consistency of objective between s 8.1(d) and provisions such as s 2.24(a), and s 8.10(c), (d), (f), (g) and (j).

So understood, it would be consistent with the objective reflected in s8.1(d) if the Regulator, in an appropriate case, were to accept or to take into account the actual investment of the owner in a Covered Pipeline which existed at the time the Act and Code came into force, when establishing the initial Capital Base.”²⁰

In the case of the MSP, the investment decision was made on the basis of the regulatory regime established under the MSP Act, and any ICB which did not reflect the deal which was reached between the Government and EAPL at that time, including the reasonable expectations under that regime, would distort the basis on which that investment had been made.

This objective in section 8.1(d) conflicts with the objective of economic efficiency in other subsections of section 8.1. The Epic Decision requires the Regulator to give fundamental weight to the principles in section 2.24 of the Code, in order to resolve this conflict. Each of those factors is considered below:

- (a) the Service Provider’s legitimate business interests and investment in the Covered Pipeline

The Court in the Epic Decision found that:

“The service provider's legitimate business interests and investment in the pipeline (s 2.24(a)) would appear directly relevant to the objective that access rights by third parties be on conditions that are fair and reasonable for the owners and operators of a pipeline. The investment in this case is relevantly the full purchase price of \$2.407

²⁰ Epic Decision paras 148-154

billion, (some other items are also relied on). Within the meaning of s 2.24(a) both that investment and the legitimate business interests of Epic might properly extend to the recovery of that \$2.407 billion, at least over the expected life or operation of the pipeline, together with an appropriate return on investment.”²¹

It is submitted that, in the context of the controversial privatisation of the MSP which included the establishment of a regulatory framework, the legitimate business interests of EAPL in the MSP are represented at the very least by its reasonable expectations under that regime – that is, no less than \$768m. That figure represents the value to EAPL of the deal, which included both the purchase price and the establishment of a regulatory regime specific to the MSP.

Indeed, to establish an ICB at any lesser valuation is to retrospectively confiscate the benefit to EAPL of the deal attained in the privatisation process, a confiscation directly in contrast to the view held by the Court in the Epic Decision.

However, as the Commission has noted in the Draft Decision, if on privatisation the residual economic value exceeds the DORC, an approach limiting the ICB to DORC “may imply windfall losses for the owner.”²² Therefore, the legitimate business interests of the owner may also be properly viewed as the recovery of the residual economic value of \$1700m.

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

It is a legitimate business interest of existing contracted users that the ICB does not result in tariffs falling below the tariff payable under the existing contractual obligations, since the contracted users having taken risk and contracted to support the pipeline could be disadvantaged in competition with new users at lower prices

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

This factor is not relevant to the present consideration.

(d) the economically efficient operation of the Covered Pipeline

The Court in Epic found that “the DAC and DORC methodologies have an acceptability for the purposes of the concept of economic efficiency”²³, and so the economically efficient operation of the pipeline might well suggest an ICB between DORC, which EAPL suggests is properly defined as the NPV DORC, and DAC.

²¹ Epic Decision para 130

²² Draft Decision page 47

²³ Epic Decision para 176

(e) the public interest, including the public interest in having competition in markets (whether or not in Australia)

The public interest includes the interest in encouraging and securing long term investment in pipelines in Australia, so that competition in markets can eventuate. Such interest is reasonably served by setting an ICB and resultant tariff which recognises the basis on which the investment decision was made prior to the Code, rather than placing greater emphasis on the interest in lower prices.

The Court in the Epic Decision noted that the “expert evidence, including the supportive expert writings, suggested a growing awareness of the long term disadvantages of striking the balance with too great an emphasis on the interest of consumers in securing lower prices, and without due regard to the interest of the service provider in recovering both higher prices and its investment.”

It is submitted that the public interest is served by an ICB of \$768m.

(f) the interests of Users and Prospective Users

The interests of the Users can reasonably be directed at lower prices, but prices which sustain the economic viability of the pipeline.

On one argument, if the ICB is set at the residual economic value of \$1700m, the user is no worse off. As the Commission noted in the Draft Decision:

“If the initial capital base were set below the residual value then the service provider would suffer a windfall loss equal to the difference between the initial capital base and the residual value. If the value of the initial capital base were set above this residual value the users would be paying a second time for depreciation of a portion of the assets delivering what is a windfall gain to the service provider above a reasonable commercial rate of return.”²⁴

Users might legitimately argue that the price shock which would be inherent in such an ICB would not adequately take into account their interests. However, an ICB set at the value of the reasonable expectation under the prior regulatory regime, being \$768m, does not involve such price shocks, since the tariff at commencement of the Access Arrangement would not alter from existing tariffs. Accordingly, it is submitted that an ICB of \$768m properly takes into account the interests of users.

²⁴ Draft Decision Page 50-51

4. Proposed Access Arrangement

4.1. Proposed ICB

The valuation methodologies set out in this submission provide four different values of the MSP not previously considered as required by the Code:

	\$m
Reasonable Expectations under prior regulatory regime [s.8.10(g)]	768 - 972
Residual Economic Value [s.8.10(f)]	1700
NPV DORC [s.8.10(a)]	970
APT Purchase Price [s.8.10(c)]	████████

The Code also requires the Commission to take into account the DAC of \$459m for 30 June 2000²⁵.

To the extent that these valuation methodologies exceed DORC (and that is the case for the Residual Economic Value in the case of NPV DORC, and all other methodologies except DAC in the case of the Draft Decision DORC), the Commission must consider whether the circumstances of the MSP warrant an ICB outside the “normal” range of DORC and DAC. It is submitted on the argument set out in section 3.5 above that a determination exceeding the Draft Decision DORC is clearly justified, under the principles established in the Epic Decision.

In determining the ICB, the last paragraph of s 8.1 recognises that the objectives (a) to (f) in s. 8.1 may conflict in their application to a particular reference tariff determination, in which event the Regulator may determine the manner in which they can best be reconciled or which of them should prevail. The discretionary task of seeking to reconcile conflicting objectives within s. 8.1, and even more significantly of determining which of them should prevail, cannot be decided by reference to s. 8.1 itself.

Accordingly, in order to determine ICB, the Commission is required to consider the objectives set out in section 8.1. In respect to the MSP, those objectives lead to a conflict in their application between the requirements for economic efficiency and the requirement not to distort investment decisions in pipeline transportation systems. It is for the Commission to determine the manner in which this conflict should be resolved, or which of these objectives should prevail.

In making that decision, the Commission is required under the Epic Decision to take into account the matters set out in section 2.24. A consideration of those matters includes the service provider’s legitimate business interests and investment in the pipeline. Those legitimate interests and investment indicate an ICB in the range of the value of the reasonable

²⁵ Draft Decision page 21, being \$473m at 30 June 1999.

expectations under the prior regulatory regime at \$768m, to the residual economic value of the pipeline at \$1700m. The interests of users can be argued to be taken into account at residual economic value, but might be better served by avoiding price shocks, which would indicate an ICB set at the level of \$768m which would ensure that the price payable by users did not increase. The public interest in encouraging long term investment in gas infrastructure is also best served by recognising the legitimate interest of the service provider in retaining the benefit of the deal negotiated on privatisation of the pipeline.

The Code requires consideration of a number of valuation methodologies, which in the case of the MSP range up to \$1700m. The minimum value which would properly recognise the interests of EAPL as required under the Code while still recognising the interests of Users is the amount which represents the reasonable expectations of EAPL under the prior regulatory regime, being no less than \$768m.

4.2. **Proposed Price Path and P_0**

The price path proposed in the Draft Decision reflects the ICB determined by the Commission and includes a significant initial price adjustment (P_0 adjustment). On the basis of the Epic Decision EAPL has submitted that an ICB of at least \$768m is required. Taking this value into account EAPL proposes a price path which is consistent with the Revised Access Arrangement, but which reflects the higher asset base. That is, P_0 is set at the present levels (66c/GJ) and an X factor calculated reflecting the revised ICB and a similar depreciation approach.

ATTACHMENT 1
Advice from KMPG Legal regarding errors of law in the Draft Decision