Response to ACCC Sept 2002 submission to NCC on MSP

28 October 2002

Background

In September 2002, the ACCC made a submission to the NCC entitled *"EAPL's application to the NCC for partial revocation of coverage of the Moomba to Sydney Pipeline System"*. That submission was partly a response to criticisms raised by NECG of the Commission's Draft Decision on the MSP Access Arrangements.

The Commission's responses to those criticisms indicate a misunderstanding of the concerns which we were placing on the public record. The purpose of this note is to clarify these misunderstandings, prior to the Commission's Final Decision.

The sections below follow the Commission's subsections of part 3 of their submission to the NCC.

Economic life of the MSP

The Commission has mis-characterised our objection to their calculation of DORC from ORC and their depreciation estimates. Our February 11, 2002 submission to the NCC noted two objections:

> "*The ACCC has derived the DORC valuation from their ORC valuation by applying a factor of (26/50) to ORC. This is inconsistent with the method previously applied by the ACCC under the Gas Code and the choice of 50 years is arbitrary.*" (p.3)

> "*The ACCC has estimated future economic depreciation for the pipeline component of the asset base on the assumption of a remaining life which far exceeds the actual remaining life of the Moomba-Wilton mainline.*" (p. 4)

In a nutshell, our actual concern was that the Commission's ORC and depreciation estimates are inconsistent with each other. Nothing said in the Commission's recent NCC submission addresses that problem. The choice of a 60 year pipeline life or an 80 year pipeline life makes very little difference as long as it is applied consistently. Our February 11, 2002 NCC submission explained this point:

> "*If we varied nothing in the ACCC calculation except: the method of deriving DORC from ORC; and the method of deriving depreciation from DORC, to make*

> *these internally consistent with equations (1) – (4) in the technical attachment, the revenue requirement would rise to $70.71m in the year 2001, if a 60 year mainline pipeline life is assumed. If instead an 80 year mainline pipeline life is assumed, the revenue requirement would actually be higher: $72.84m. These figures can be contrasted with the ACCC's proposed year 2001 access arrangement revenue figure of $59.31m."* (p.10)

Deferred tax liabilities

The Commission appears to concede, on page 5 of their NCC submission, that they did err in writing down the MSP initial capital base to reflect an approach to deferred tax liabilities which they have subsequently abandoned.

The effect of this error is not trivial. According to our own estimates, correcting it would increase the ACCC-estimated permitted revenue by nearly 10%. According to the ACCC's estimates, the effect of $0.03/GJ on tariffs is significant at 7% of the reference tariff levels proposed by the Commission.

Optimised replacement cost and contingency factors

The disagreement between ourselves and the Commission (who quote NERA on this point) on the appropriate use of construction contingency factors can perhaps be attributed to a difference of view as to what the contingency represents, and what is the basis of the construction cost estimates to which the contingency is added.

On one hand, if the construction cost estimates are based on average productivity rates for given plant and work teams spanning a range of stochastic variables, then the primary utility of a contingency factor is the avoidance of underestimation in the capital budgeting process. On the other hand, if the construction cost estimates assume that everything goes well, then a contingency must be added to arrive at a properly risk-adjusted capital cost.

Risk

The Commission's Draft Decision proposed a WACC for the MSP which corresponds to a business with low risk. However, as we pointed out in our February 11, 2002 submission to the NCC (p. 13), the MSP is not a low risk business because "*The MSP must contend with the simultaneous incidence of price regulation and competition with the unregulated Eastern Gas Pipeline.*"

In our view, the Commission has not given due consideration to the risks faced by MSP. It has been influenced by the extreme low-end beta estimates put forward by the Allen Consulting Group. More importantly, the Commission has not properly taken into account the MSP's non-systematic risks in its permitted rate of return.

The approach the ACCC adopts means that whenever entry occurs (for example the construction of the EGP), the covered pipeline (MSP) incurs an uncompensated loss. The loss is uncompensated in the sense that the down-side is not matched by any allowed up-side.

The CAPM WACC relies on a symmetric distribution of the underlying cash flows. This implies that the ACCC, if it chooses to use the CAPM, should either ensure that the underlying cash flows are indeed symmetric or make adjustments to secure consistency with that assumption.

However, the fact of the matter is that it the ACCC has made it clear that it has no intention of making any such adjustment. Indeed, in its submission, the ACCC goes further than it has ever gone before and says (seemingly in stark contradiction to the Epic decision) that the Gas Code requires it to implement the CAPM in a way that excludes making adjustments that might be needed to ensure *ex ante* capital maintenance.

Effective versus statutory tax rates

Our submission of February 11, 2002 to the NCC noted (p.14) that the use of an effective tax rate rather than an statutory tax rate posed a number of public policy concerns, in that it gave the ACCC a mechanism to capture for pipeline customers taxation benefits such as accelerated depreciation which were intended by Government to stimulate infrastructure investments.

The Commission's reply on this point (pp.9-10 of their NCC submission) did not respond to the issue raised. The convenience of calculation and avoidance of difficult conversion formulae are cited by the Commission in favour of their approach.

Statutory versus effective tax rates involve essentially the same policy issue created by the deferred tax liability adjustment. Given the Commission's position now on deferred tax liability, consistency with policy intent argues strongly for using statutory tax rates, rather than effective rates.

Working capital

Our submission of February 11, 2002 to the NCC noted (p.8) that "*The ACCC has essentially adopted EAPL's proposed non-capital costs, except that the line item for return on working capital was ruled out by the ACCC, resulting in an immaterial difference of $85,000 in a total $12,000,000 non-capital costs in 2001.*"

Given that our point was that, on non-capital costs at least, the differences between the ACCC and NECG's views were immaterial, it seems more accurate to characterise this item as a point of agreement.