# ACCC DRAFT DECISION
# REVIEW OF EPIC ENERGY MAPS ACCESS ARRANGEMENTS
# AUSTRALIAN GAS USERS GROUP SUBMISSION

21/09/2000

At this stage of the review we would like to limit our comments to the following central issues: Initial Asset Base, Weighted Average Cost of Capital and the term of the decision.

## 1. INITIAL ASSET BASE

The initial asset base is the single most important item in any access review not only because of its effect on authorised revenue but also as it forms the base for all subsequent reviews of a particular pipeline system.

Initial asset base methodology and its determination has been a difficult issue for the Office of the Regulator General in Victoria and IPART in New South Wales. Each of these regulators has painstakingly analysed the options for asset base determination and been rigorous in their explanation of the rationale for choosing their particular "line in the sand". At this time considerable doubt exists as to the best methodology or combination of methodologies for fair and accurate estimation.

When the National Gas Access Code was developed it was recognised that initial asset base determination was a difficult issue and that a fair and accurate estimate would lie between Depreciated Actual Cost and DORC. An incredible amount of debate and discussion has been heard since that time on this issue and the position of the various players in the argument has not moved very far at all.

It is not surprising that Epic Energy has opted for an asset valuation methodology based upon DORC. This methodology maximises the value of the asset base compared with other methodologies and thereby maximises the level of tariffs applied for in the access arrangement application.

The experience of prior reviews has now demonstrated that economic arguments are not the core of this matter at all. It was considered that the DORC methodology was in fact a science and that its application would lead to a single "hard" number. There have now been a number of well documented instances where experts in this field have been commissioned to provide DORC valuations and these have been found to result in widely differing estimates for particular pipeline systems. In Victorian gas access reviews conducted in 1998, Gutteridge Haskins and Davies provided an analysis for the Energy Projects Division of State Treasury while Sinclair Knight also performed an analysis on the same pipeline system. The two estimates varied by some thirty percent! In discussion with the estimating organisations it was evident that that a variation of this order was not unusual in an estimate of complex structures such as gas pipeline systems. Estimates of electricity assets in IPART reviews in New South Wales have come up with similar discrepancies.

Not only is there a difficulty in arriving at a reliable and accurate valuation but experience to date indicates that DORC valuations in some instances have been wildly overvalued.

It is recognised that the Depreciated Actual Cost methodology is not a perfect methodology in all instances but it does have a fundamental advantage over DORC - it does provide a single, verifiable and accurate figure. Certainly, this aspect alone should mean that it is to be the preferred methodology where the necessary historical information is available for analysis. It was notable in the Victorian gas access reviews that the lack of historical information was a problem and that this contributed to the acceptance of DORC as the preferred methodology of the Commission and the ORG in that instance.

In cases where historical cost information is not readily available it behoves the regulator to use means of arriving at an acceptable valuation other than DORC now that it has been shown to be seriously flawed and thereby discredited as an asset valuation methodology.

In the case of the Epic Energy review we would suggest that as the historical cost information is available that it be used as the basis of the initial asset valuation and any allowances considered necessary in this particular instance be applied to that "hard" figure.

Considering the importance of this issue to the outcome of the Review we are concerned and surprised at the cursory treatment of it in the two hundred page Draft Report where it is referred to on p. xi:

"However, in the Commission's view the aggregation of depreciated capital expenditures made over a long period while the pipeline was in government ownership does not provide a useful indicator of the return on capital that a private sector operator could reasonably expect".

In our view this does not justify the use of a flawed methodology. The Commission is well equipped to calculate the allowances necessary to overcome the above problem.

Ample justification provides the basis for reasoned explanation of the discretion used by a regulator in arriving at a particular position. This approach is noticeably absent in the draft decision and we would encourage the Commission to undertake this task.

## 2. WEIGHTED AVERAGE COST OF CAPITAL

Determination of the Weighted Average Cost of Capital (WACC) to be used is another key determinant of any access decision. It is of less importance than the initial capital base but only because it is re-calculated at each access review.

In our view the analysis and treatment given to determination of an appropriate rate of return in the Draft Report has been thorough and rigorous.

We remain strongly of the view that the assessment of risk associated with the class of business under review is crucially important. Regulated businesses are by definition low risk and this should be central to the determination of appropriate WACC. The risk premium sought by the applicant has been adequately refuted by a number of submissions to the Commission and we are supportive of those submissions.

## 3. TERM OF THE DECISION

Our experience to date indicates that the interval between access application and access commencement is well in excess of six months and this is probably to be expected for initial reviews. In subsequent reviews we would expect that this interval would be shorter due to familiarity with the process, the issues to be addressed and improved information disclosure by the applicant. Our recommendation would be to maintain a six month interval.

In respect of the duration of the determination we disagree with the Commission's proposal for five years and would recommend that a two year period be considered. Not only is there some doubt about the accuracy of a range of forecasts made by the applicant but there is also considerable market uncertainty as the reform program unfolds that needs to be factored into the Commission's decision.

Other aspects that would impinge on the decision include the potential for generation and cogeneration in South Australia, privatisation of the electricity industry in the state, convergence between gas and electricity utilities and additional gas supply from Victoria in the next few years.