

**Attachment 18**

**KPMG report on justifying competitive tender process as an appropriate valuation methodology**

See attached.



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Our ref EpicLtr 21Nov02 DBNGP competitive  
bidding

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21 November 2002

Dear Anthony

**Can the price paid under a competitive tender process be relied upon as a market valuation?**

You asked KPMG to advise whether the price arising from the competitive tender process for the Dampier to Bunbury Natural Gas Pipeline can be regarded as a "market valuation", and, in consequence, whether valuing assets at such a price can be considered to be a conventional asset valuation methodology.

KPMG's response and conclusions to Epic Energy's questions, follow.

**Disclaimer**

Please note that, in accordance with KPMG's policy, we are obliged to advise that neither the firm nor any member nor employee undertakes responsibility in any way whatsoever to any person or organisation, other than Epic Energy, in respect of information set out in this report, including any errors or omissions therein, arising through negligence or otherwise however caused.

**Introduction**

In March 1998, the Government of Western Australia sold the Dampier to Bunbury Natural Gas Pipeline (DBNGP) to Epic Energy at the conclusion of a two-stage competitive tender process.

The Government's objectives in selling the DBNGP through this process were set out in its Gas Pipeline Sale Steering Committee's letter, dated 8 September 1997, covering transmittal of



copies of the sale *Information Memorandum* to Epic Energy.<sup>1</sup> In the letter, the Government advised that it was seeking to maximise the proceeds from Pipeline sale within the context of pursuing a number of other policy objectives.

In developing the reference tariffs of its proposed Access Arrangement, Epic Energy set the initial capital base for the DBNGP at \$2,570.34 million. This initial capital base was derived from the amount Epic Energy paid for the Pipeline in the Government's competitive tender process (\$2,407 million), adjusted for:

- certain other costs of acquisition not included in the purchase price;
- new capital expenditure between the date of purchase and the date proposed for commencement of the Access Arrangement (1 January 2000); and
- depreciation between the date of purchase and the date proposed for commencement of the Access Arrangement.<sup>2</sup>

Epic Energy's reasons for establishing the initial capital base of the DBNGP as an adjusted purchase price were set out in its amended Access Arrangement Information lodged with the Western Australian Independent Gas Pipelines Access Regulator (**Regulator**) on 28 July 2000.<sup>3</sup> In establishing the initial capital base in accordance with section 8.10 of the *National Third Party Access Code for Natural Gas Pipeline Systems (Code)*, Epic Energy considered, among other things:

- in accordance with section 8.10(b):

the value that would result from applying other well recognised asset valuation methodologies in valuing the Covered Pipeline; . . . ;

and

- in accordance with section 8.10(j):

the price paid for any asset recently purchased by the Service Provider and the circumstances of that purchase; . . .

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<sup>1</sup> See Epic Energy, *Proposed Access Arrangement Submission*, Submission Version, 15 December 1999, pages 4 – 6.

<sup>2</sup> Epic Energy, *Proposed Access Arrangement Information*, Submission Version, 15 December 1999, pages 14 – 15.

<sup>3</sup> Epic Energy, *Proposed Access Arrangement Information*, Amended Submission Version, 28 July 2000.

In his *Draft Decision: Proposed Access Arrangement Dampier to Bunbury Natural Gas Pipeline (Draft Decision)*, the Regulator made an assessment of the advantages and disadvantages of a purchase price valuation of the initial capital base. In this assessment he noted that previous Australian experience with the sale of gas pipeline assets indicated that sale prices for such assets may be established well in excess of regulatory asset values that were established prior to sale.<sup>4</sup> This, he observed, was the case with the sales of gas transmission and distribution assets by the Government of Victoria. In the view of the Australian Competition and Consumer Commission (ACCC), noted in the Regulator's Draft Decision, sale prices in excess of predetermined regulatory asset values may reflect:

- the so called "winner's curse";
- the winner's cost of capital being substantially below that proposed by the Regulator; and
- expectations of efficiency saving and benefits of getting a foothold in the Australian energy market.

The Regulator concluded his assessment of the advantages and disadvantages of a purchase price valuation of the initial capital base as follows:

*The Regulator is not in a position to know the extent to which these factors may apply to the DBNGP, but notes that there is substantial uncertainty as to the extent to which a sale price for assets such as the DBNGP may represent a reasonable valuation of the assets as a stand alone operation. The Regulator is of the view that Epic Energy has not demonstrated that the sale price is consistent with a reasonable market valuation based on potential regulated revenue streams, and hence factors such as those mentioned by the ACCC may apply and limit the appropriateness of the purchase price as a valuation methodology.<sup>5</sup>*

In concluding his consideration of alternative methodologies for establishing the initial capital base of the DBNGP, the Regulator advised:

*it is difficult to determine the merit of valuation of the DBNGP at a purchase price as this price may have been affected by many factors other than a reasonable market value of the assets that is consistent with future regulated revenues and efficient capital investment. Epic Energy has not demonstrated to the satisfaction of the Regulator that the purchase*

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<sup>4</sup> Independent Gas Pipelines Access Regulator Western Australia, *Draft Decision: Proposed Access Arrangement Dampier to Bunbury Natural Gas Pipeline*, 21 June 2001, Part B, page 144.

<sup>5</sup> Draft Decision, Part B, page 144.

*price of the assets represented a reasonable valuation by any conventional valuation methodology.*<sup>6</sup>

The Regulator's conclusions raise two issues:

- Can the price at which an asset was purchased in a competitive tender process be taken to be a market valuation of that asset and, in consequence, can valuing an asset at such a purchase price be regarded as a conventional asset valuation methodology?
- Did the competitive tender process through which the DBNGP was sold in some way bias or distort the price it delivered to the Government of Western Australia so that although, in principle, valuing the Pipeline at the purchase price delivered by such a process can be regarded as a conventional asset valuation methodology, the price that was actually delivered should not be regarded as a reasonable market valuation of the DBNGP?

This paper is primarily concerned with principles. It argues that the price delivered by a competitive tender process can, in principle, be taken to be a market valuation and, in consequence, valuing assets at such a price can be regarded as a conventional asset valuation methodology. Moreover, in addressing principles, it provides some reasons for believing that the competitive tender process initiated by the Government of Western Australia did not produce a biased or distorted price.

These are important issues. In its reasons for decision in *Re Dr Ken Michael AM; ex parte Epic Energy (WA) Nominees Pty Ltd & anor* [2002] WASCA 231, the Full Court of the Supreme Court of Western Australia found that:

*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.*<sup>7</sup>

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<sup>6</sup> Draft Decision, Part B, page 152.

<sup>7</sup> Paragraph 179.

## Auctions

The competitive bidding process initiated by the Government of Western Australia for sale of the DBNGP is an example of an auction. In their survey of the economics of auctions and bidding, McAfee and McMillan define an auction as:

*a market institution with an explicit set of rules determining resource allocation and prices on the basis of bids from the market participants.*<sup>8</sup>

Auctions may be used for both purchasing and selling. Governments, in particular, have a long history of using auctions to purchase at least cost. More recently, they have used auctions to sell public sector assets. Government auctions of segments of the electromagnetic spectrum for the private sector provision of communications services have been some of the largest auctions in history.<sup>9</sup>

There are strong similarities between the auctions used in buying and selling, and economists have studied both types using the same methods of analysis. However, the remainder of this paper considers only the case of auctions used to sell goods and services (which will be referred to, generically, as “assets”). The paper discusses auctions in terms of a single seller seeking to sell an asset to multiple potential buyers or “bidders”.

In many markets the seller decides on the price of an asset to be sold, and the buyers either transact at that price, or do not purchase. In contrast, in a market in which selling is effected through an auction, the seller assigns the setting of the price at which the asset will be sold to the bidders, and relies on competition among them to deliver the best outcome.

In a market in which selling is effected through an auction, the seller assigns the setting of price to the bidders, but retains the right to set the rules which govern the bidding process. One important instance of this setting of the rules by the seller is a seller’s undertaking, given in advance, not to sell if the auction does not produce a bid which is sufficiently high. Often, the seller will impose a minimum or reserve price, and will advise prospective bidders that it will not sell if it does not receive a bid higher than the reserve price. The seller accepts the risk that all bids may come in below the reserve price, and the asset will not be sold, but does so expecting

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<sup>8</sup> R Preston McAfee and J McMillan, ‘Auctions and Bidding’, *Journal of Economic Literature*, vol. XXV (June 1987), page 701.

<sup>9</sup> P Klemperer, ‘What Really Matters in Auction Design’, *Journal of Economic Perspectives*, vol. 16 (Winter 2002), page 169.

the setting of a reserve price to force bidders to bid higher than would otherwise have been the case.<sup>10</sup>

### **First-price sealed bid auctions**

Four basic types of auctions have been widely used and extensively analysed by economists.<sup>11</sup> These are:

- ascending bid (English) auctions;
- descending bid (Dutch) auctions;
- first-price sealed bid auctions; and
- second-price sealed bid auctions.

This paper focuses on first-price sealed bid auctions. The competitive tender process through which the Government of Western Australia sold the Dampier to Bunbury Natural Gas Pipeline was a two-stage first-price sealed bid auction.

In a first-price sealed bid auction, each bidder submits a single bid – a price at which it will purchase the asset to be sold. Each buyer's bid is based on its particular valuation of the asset, a valuation made without the bidder having access to the bids of others. The asset is sold to the bidder offering the highest price, and the "winner" pays its bid price.

When bidders are risk averse, use of a first-price sealed bid auction is conducive to the seller achieving the maximum proceeds from the sale of an asset. A small increase in bid, increases a bidder's probability of winning at the cost of a small reduction in the value of winning. More aggressive bids are therefore likely to be received when bidders are risk averse and an auction is organised as a first-price sealed bid auction.<sup>12</sup>

### **Uncertainty**

Auctions play an important role in resource allocation in conditions of uncertainty arising when market participants value the asset to be sold differently, and neither the seller nor each of the bidders knows the exact valuations of the others.

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<sup>10</sup> J McMillan, *Games, Strategies and Managers*, New York: Oxford University Press, 1992, page 142.

<sup>11</sup> P Klemperer, 'Auction Theory: A Guide to the Literature', *Journal of Economic Surveys*, vol. 13 (July 1999), page 4.

<sup>12</sup> See Klemperer (1999), page 14.

In the absence of this uncertainty, organising the transaction – the sale of the asset – is a relatively simple exercise. When the seller knows the value each bidder places on the asset, it can negotiate directly with the bidder who has the highest valuation, and can extract from that bidder the highest price for the asset.

Uncertainty affecting bidders' valuations has two sources:

- differences in the information available to each of the bidders at the time of bidding, the asset having a "true" or common value at that time, but that common value is not known because none of the bidders has complete information; and
- differences in the inherent perceptions and preferences of the bidders themselves

Both of these sources of uncertainty were likely to have affected bidder valuations of the DBNGP at the time of its sale by the Government of Western Australia.

If the bidders could have been given true and complete information about the DBNGP at the time of sale they would, in all likelihood, have determined very similar valuations. That is, there would have been an underlying common value.

However, at the time of sale, it was not possible to provide each bidder with complete information. At the time of sale, each bidder had to estimate the common value of the Pipeline, initially from limited published information which included the sale *Information Memorandum*, and later from the more detailed information that was provided in the sale data room. Each bidder had to estimate the remaining life of the asset, the future demand for its services, the costs of operating and maintaining it, new capital investment which would be required, the transportation tariff which would be allowed by the Regulator, and the cost of financing a successful bid. None of these was known with certainty. Each bidder had different, and incomplete, information from which to estimate the value it would place on the DBNGP and, in the absence of collusion, no bidder knew the valuations of the others. In these circumstances, each bidder was likely to have an estimate of common value which was different from the estimates of its competitors.

Differences between the values that bidders placed on the DBNGP at the time of sale would not only have reflected differences in the information they held about the determinants of common value. They would also have reflected differences in perceptions and preferences among them concerning the way in which the Pipeline might be merged into their existing business activities, the way in which it would be used in the future, and the way in which its operation would be managed. These differences of perception and preference can be expected to have given rise to differences in value unrelated to the differences in common value. They can be expected to have given rise to "private value" differences.



Whether an auction can be characterised as following a common value model, or as following a private value model, has implications for the way in which it should be structured, and for the way in which bidders subsequently behave. In a common value situation, one bidder's learning another's valuation provides additional information to the first bidder, and may lead to a change in valuation. In a private value situation, learning another bidder's valuation is unlikely to impact on the valuation of the first bidder.

### **The winner's curse**

In an auction with a common value, and with each bidder having incomplete information, the winning bidder (the bidder who bids the highest price for the asset) has not taken into account the "bad news" implied in other (lower) bids, and may pay more, on average, than the asset is worth. This paying more than the asset is, on average, worth is referred to as "the winner's curse".

The winning bidder cannot, of course know that it has overestimated the value of the asset until after the auction. In the case of the DBNGP, with a remaining asset life of at least 60 years, whether the winning bid overestimated the value of the Pipeline will not be known for decades.

The significance of the winner's curse lies in its implications for bidding. Experienced bidders who know about the winner's curse will bid cautiously. Moreover, bidders who recognise that their lack of information makes them particularly vulnerable will be especially cautious because they are likely to win only when they have significantly overestimated the value of the asset. In auctions with common value components, rational bidders will adjust their bids downwards.

The magnitude of the downward adjustment of a bid price in circumstances where the winner's curse is anticipated, depends on the number of competing bidders and the amount of uncertainty over the common ("true") value of the asset. Each bidder must bid more cautiously when the number of competing bidders is large than when it is small. Winning, in these circumstances, implies a greater winner's curse. This lowering of bids in response to the winner's curse can more than compensate for the increase in bids that is usually associated with larger number of, and greater competition among, bidders: increasing the number of bidders may lower the expected proceeds for sale of an asset.<sup>13</sup>

### **Two-stage competitive bidding**

If winner's curse effects are present because an auction has common value components, a single-stage first-price sealed bid auction will not maximise the proceeds from the sale of an asset.

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<sup>13</sup> J Bulow and P Klemperer, 'Prices and the Winner's Curse', *Rand Journal of Economics*, forthcoming.

Each bidder is unable to learn anything about other bidders' valuations and, in these circumstances, bidders are likely to be very cautious and submit low bids.

This is, at least partially, overcome, by using a two-stage bidding process. In the first stage of the process, bidders are invited to submit non-binding bid prices together with information about their prior experience in owning and operating the asset that is to be sold, about their financial strength, and about how they expect to finance a successful bid.

At the conclusion of the first stage, bidders who do not have the necessary experience or the financial resources needed to complete the transaction are screened out. This screening may also exclude those bidders with the necessary experience and financial resources whose initial bids are seen by the seller as being too low.<sup>14</sup>

The screening of deficient bids leaves, at the second stage of the process, only those bidders with high bids who have the experience and financial backing needed to own and operate the asset. The result is a more credible auction among a smaller number of "strong bidders" with a lower dispersion of valuations. This should have the effect of limiting winner's curse effects, and should result in the seller obtaining a higher price for the asset.

### **Seller's objective**

The discussion above has assumed that, in selling an asset, the seller has the objective of maximising the proceeds from the sale.

This, however, need not be the case. In an important contribution to regulatory economics Demsetz proposed a form of auction for natural monopolies which would result in the services they supply being provided at the lowest price to the users of those services.<sup>15</sup> In the Demsetz proposal, bidders bid not only the price they are prepared to pay for the asset, but also the price they propose charging users of the service provided. The winning bidder is the bidder who offers to supply at the lowest price to users.

The competitive tender process for a new pipeline, set out in sections 3.21 to 3.35 of the Code, is an auction of this type. The winning bidder is to be the bidder who will deliver the lowest sustainable tariffs to users generally over the economic life of the proposed pipeline.<sup>16</sup>

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<sup>14</sup> L J Cameron, P Cramton and R Wilson, 'Using Auctions to Divest Generation Assets', *Electricity Journal*, vol. 10 (December 1997), pages 22 - 31.

<sup>15</sup> H Demsetz, 'Why Regulate Utilities?', *Journal of Law and Economics*, vol. 11 (1968), pages 55 - 65.

<sup>16</sup> Code, section 3.28(f).

Whether the Government of Western Australia considered alternatives to a sale process which was intended to maximise the proceeds from sale of the DBNGP is difficult to ascertain. The report on the sale, prepared by the Gas Pipeline Sale Steering Committee at the conclusion of its work, suggests that the Government did not.<sup>17</sup> Four alternatives were examined by the Steering Committee and its strategic advisor:

- a trade sale, targeting bidders with the appropriate expertise to operate the business, and making use of an indicative bid process from which a selected short list would be invited to make final bids;
- an accelerated trade sale omitting the indicative bid process;
- an initial public offering of all or part of the equity in the business to retail, institutional, strategic and trade investors; and
- a combination of initial public offering and trade sale.

The Gas Pipeline Sale Steering Committee gave the following reasons for selecting the first of these four alternatives:

- *a trade sale would be likely to generate greater sale proceeds for the State than an initial public offering or combined trade sale/initial public offering given that strategic infrastructure investors would attribute greater strategic, financial and business value to the asset than institutional and retail investors;*
- *a four phase trade sale process would maximise competition, and therefore sale proceeds, from the process by involving a broad range of bidders who would utilise a diverse range of approaches in seeking to acquire the DBNGP;*
- *while an accelerated process would save between six and eight weeks on the scheduled sale process, such a process might reduce the opportunity to optimise the group of potential acquirers included in the process in terms of qualitative and quantitative criteria set down for them; and*
- *the need for public ownership through a public offering of stock to entrench a focus on service to Western Australia is less critical given the slim likelihood of a shift in service focus of the DBNGP operators away from Western Australian consumers.*<sup>18</sup>

Clearly, the Government was seeking to maximise the proceeds from the sale of the DBNGP, and adopted a competitive tendering process – a two-stage first-price sealed bid auction – which

<sup>17</sup> Gas Pipeline Sale Steering Committee, *Report on the Sale of the Dampier to Bunbury Natural Gas Pipeline*, May 1998.

<sup>18</sup> Gas Pipeline Sale Steering Committee, May 1998, page 8.

was consistent with that objective. There is no indication from the Steering Committee's report that other sale objectives – for example, delivering the lowest possible gas transmission tariffs – were considered.

### **Does price measure market value?**

A market is the context within which the sellers of assets and potential buyers come together to transact. That context includes the rules which will govern their transactions.

An auction is, as was noted above, an explicit set of rules for determining resource allocation and prices on the basis of bids from market participants. An auction is a particular context within which a transaction can take place between the seller of an asset and a buyer, in accordance with rules which are largely set by the seller. It is a particular type of market.

In other – perhaps more familiar – markets, resource allocation is effected through buyers transacting with sellers at prices set by those sellers, the rules governing their transactions being a mix of social norms (for example, if the price is too high, the buyer can walk away), the common law, law pertaining to the sale of goods, and law governing trade practices.

The value assigned to an asset by the price at which it is sold in an auction is, in consequence, a market value. It is the value established in a market.

The price, and hence the valuation of the asset, may be different in a different context. A different price may be obtained if an asset (say, a house and land) is sold through a process of negotiation between the seller and potential buyers, than if it is sold through an auction.

Differences in value resulting from differences in context – from transactions taking place in different markets – may have important consequences for at least some individuals in the society which includes the seller of an asset and the potential buyers. However, these consequences are conceptually distinct from the circumstances in which they arise. The value assigned to an asset through a transaction in a market may have desirable or adverse social consequences. Irrespective of these consequences, the value assigned to the asset is a market value.

In these circumstances, the price paid by Epic Energy as winning bidder in the competitive tender process through which the Government of Western Australia sold the DBNGP can be relied upon as a market valuation.

### **Can valuation at purchase price be regarded as a conventional asset valuation methodology?**

In Australia and elsewhere, significant assets have been sold through auctions. As Klemperer notes:

*Auctions have become enormously popular in recent years. Governments are now especially keen, using auctions to sell mobile-phone licenses, operate decentralized electricity markets, privatise companies and for many other purposes. The growth of e-commerce has led to many business-to-business auctions for goods whose trade was previously negotiated bilaterally.<sup>19</sup>*

Where assets have been sold through auctions, both in Australia and overseas, the prices at which those assets have been acquired have been used as asset values. Under Australian accounting standards, for example, the price of an asset acquired through an auction must usually be taken as the valuation of that asset for financial reporting purposes.

In the United States, auctions have been used by electricity utilities for divesting generating assets stranded by deregulation. In commenting on this practice, Cameron, Cramton and Wilson note:

*Auctions are currently the most popular market valuation method because they are easily monitored and understood by regulators, ratepayers and bidders. As a result, they can withstand public scrutiny better than alternative market valuation methods.<sup>20</sup>*

Clearly, valuation at purchase price in an auction is a conventional asset valuation methodology. However, to date, it has not been used in the Australian gas industry to establish the initial capital base for covered pipeline existing at commencement of the Code.

### **Did the competitive tender process through which the DBNGP was sold deliver a reasonable market valuation?**

The competitive tender process through which the DBNGP was sold was designed to secure the maximum proceeds from the sale of the Pipeline. It was not designed to yield low gas transportation tariffs, nor was it designed to achieve other major public policy objectives (for example, sectoral or regional economic development).

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<sup>19</sup> Klemperer (2002), page 169.

<sup>20</sup> Cameron, Cramton and Wilson (1997), page 23.

To secure the maximum proceeds from sale of the Pipeline, the Government of Western Australia chose to use a first-price sealed bid auction. When bidders are risk averse (which was likely to have been the case), use of a first-price sealed bid auction was conducive to the Government achieving the maximum proceeds from the sale.

Through a two-stage process, the Government sought to reduce the effect of winner's curse whereby the proceeds from sale would otherwise have been reduced by rational buyers bidding low to avoid overpaying for the asset that they might win.

Judged against the Government's objective of maximising the proceeds of the sale, the competitive tender process through which the DBNGP was sold was likely to have delivered a reasonable market valuation.

Whether the valuation it delivered was reasonable when assessed against other criteria is largely an irrelevant question. It was open to the Government of Western Australia to choose the objectives it would pursue through Pipeline sale, and to structure the sale process to achieve those objectives. The Government chose to maximise the proceeds from sale, and structured the sale process accordingly.

Was the outcome of the sale process economically efficient? That is, did it maximize the wealth to be allocated in through sale in the sense of delivering a price for the DBNGP which was equal to the winning bidder's valuation of the Pipeline? This is not an easy question to answer. What is clear, however, is that the DBNGP sale process delivered a higher price for the Pipeline than was generally expected prior to conclusion of the sale.

## Conclusions

Auction processes like the competitive tender process through which the Government of Western Australia sold the DBNGP have become increasingly common:

*Not long ago, auctions were confined to the fringe: farmers hawking pork bellies in Chicago, say, or down-at-heel aristocrats selling family pictures at Sotheby's. Over the past decade, however, auctions have moved into the mainstream. Two things have helped to spread their use: the fashion for the sale of state assets and the rise of the Internet. Today, power plants, radio spectrum and even whole companies are sold by governments at auction.<sup>21</sup>*

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<sup>21</sup> "Bidding adieu", *The Economist*, 27 June 2002.

The auctions through which these state assets, and through which other goods and services, provided by both the public and the private sectors, are sold are markets. The prices at which transactions take place in these auction markets are market valuations of the assets and other commodities traded. Accordingly, the price at which the DBNGP was purchased in the competitive tender process initiated by the Government of Western Australia was a market valuation of the Pipeline.

These auction market valuations are routinely used, in Australia and elsewhere, as valuations for financial reporting purposes. In the United States, they have been used to value regulated assets in the electricity industry. Valuing an asset at the price for which it was purchased in an auction must, in these circumstances, be regarded as a conventional valuation methodology.

Against the principal objective set by the Government of Western Australia – maximisation of the sale proceeds – the competitive tender process through which the DBNGP was sold was likely to have delivered a reasonable market valuation.

In its August 1997 report, the Government's expert advisor on tariff and regulatory matters, Price Waterhouse, did not reject, in principle, a market valuation for the DBNGP. Price Waterhouse advised that market valuations had been used for the assets of the privatised gas and water utilities in the United Kingdom, but argued that a similar approach was not appropriate in Western Australia because "there has been no stand alone market based price for the DBNGP assets".<sup>22</sup> Price Waterhouse concluded that use of an ODRC methodology, therefore, best met the regulatory balance in estimating the initial capital base of the DBNGP.<sup>23</sup> The Government's advisor also noted that a tariff of about \$1.00/GJ to Perth could be sustained under the Code.

The DBNGP sale process provided the market valuation of the Pipeline that was missing at the time Price Waterhouse reported to the Government. That market valuation can now be used to derive an initial capital base, and a reference tariff, which will permit Epic Energy's shareholders to recover their investment in the Pipeline provided the growth in demand for gas transportation service forecast at the time of sale is realised. It will also allow Epic Energy to deliver to the State, the tariff and tariff path sought by the Government at the time of sale, together with the enhancement of the Pipeline which the Government considered, at the time, to be essential to future economic development in Western Australia.

Integral to this approach to establishing the initial capital base and delivering the reference tariff is The Brattle Group regulatory model. Epic Energy's proposal to adopt this model for its

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<sup>22</sup> Price Waterhouse, *Dampier to Bunbury Natural Gas Pipeline Regulatory Report on Revenue Requirement and Future Price Path*, August 1997, page 26.

<sup>23</sup> Price Waterhouse Report, p. 25.




*Epic Energy*  
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regulated asset accounting permits clear identification of the extent to which its shareholders have either recovered, or failed to recover, their investment with gas transportation services priced in accordance with the tariff and price path sought by the State.<sup>24</sup>

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We trust this is of assistance to Epic Energy. If KPMG can assist further, or clarify any of the matters raised above, please do not hesitate to contact John Williams on (08) 9263 7491.

Yours sincerely

  
Graham I Holdaway  
Partner

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<sup>24</sup> Epic Energy, *Proposed Access Arrangement*, Submission Version, 15 December 1999, paragraphs 7.3–7.6. and *Proposed Access Arrangement Information*, Submission Version, 15 December 1999, pages 16–17.