THE AUSTRALIAN GAS USERS GROUP

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DAMPIER/BUNBURY NATURAL GAS PIPELINE PROPOSED ACCESS ARRANGEMENT

Dear Mr Pullella,

The Australian Gas Users Group is pleased to present the following views to the Office on the proposed access arrangement for the Dampier/Bunbury gas pipeline.

Our Group represents the interests of major gas users (annual consumption greater than 0.5 petajoules) and has a number of members with operations in Western Australia. We have had extensive involvement in gas pipeline access reviews in Victoria, New South Wales and South Australia.

At this stage our comments are limited to the main issues only and we look forward to participating further as the review progresses.

1. INITIAL CAPITAL BASE

Our Group strongly advocates the use of Depreciated Actual Cost @DAC) as the preferred methodology for the valuation of the initial asset base. It is recognised that this is not a perfect methodology in all instances but it does have a fundamental advantage over Depreciated Optimised Replacement Cost (DORC) methodology in that it does provide a single, accurate and verifiable figure. It should be the preferred methodology where the necessary historical information is available for analysis.

While the National Gas Code requires that consideration be given to a range of estimates for the initial capital base between DAC at the lower end and DORC at the upper and a considerable body of evidence has been presented to access arrangement reviews in other states over the past two years showing that the DORC methodology is seriously flawed and discredited.

It is noted that the applicant has chosen the purchase price of the assets as the initial capital base. This is contrary to the requirements of the Code and is seen as an attempt by the applicant to maximise the revenue requirement under the application and thereby the determination of relevant reference tariffs. The Code is quite clear on the range of estimates to be provided in the application. Reference tariffs derived from the use of the purchase price in this instance would seriously affect prospects for new investment and reinvestment in those industries currently serviced as well as those looking to locate facilities in the area serviced by this pipeline.

2. RATE OF RETURN

Over the past two years a considerable amount of effort has been made by regulators and others involved in the gas industry in attempting to generate a theoretical figure or range of figures that could be seen to be appropriate to MONOPOLY REGULATED BUSINESSES such as those engaged in gas transmission and distribution.

This has been done now a number of times for gas and power businesses and regulators have typically arrived at a real pre-tax rate of return in the range of 7.25 to 7.75%. Epic have suggested that a figure of 8.6% real pre-tax would be appropriate in their view while our Group representing the large end of the demand side of the market would suggest that a figure less than 5% would be more suitable.

The object of the exercise is to arrive at a figure that represents a fair return on the capital that is invested in the monopoly regulated business. Our Group's approach in recent times has been focussed on relative rates of risk for classes of investment in Australia and rates that have been applied to similar businesses in recent years in other parts of the world.

It is generally accepted that one of the riskiest classes of investment is buying company shares in the share market. We have obtained information indicating that over the past thirty years the real rate of return from investing in the share market is just over six percent and has been somewhat higher over the past ten years - between eight and nine percent. The records in this country go back for about seventy years and over this period the real rate of return from the share market has been 5.8%. We consider that this sets one of the upper bounds for what could be considered as high risk investments.

At the other end of the scale is the return one could expect on ten year bonds which are generally classed as a no risk investment. Again, over the past thirty years the real rate of return has been about 2.8% which is considerably lower than is generally believed. Nevertheless, this is what investors have typically been gaining as a real return for a no risk investment- Ten year bonds over the past ten years have been a little higher than this, but not much higher, and over the full seventy year period of records the returns are a little lower than 2.8% real.

Our Group has also spent some time investigating rates of return that have been proposed by local and overseas regulators for regulated monopolies. The ACCC, IPART and the ORG have used rates of 7.25 to 7.75% for gas assets. Our view is that this range is much too high. In Victoria the state government requested a rate in excess of ten percent and while the regulator severely discounted this, they still did not finish with a figure that is consistent with a rate that falls sensibly within the no risk bond rate and the high risk share market rate.

In the United Kingdom regulators are using rates of about 6 to 6.5% for both electricity and gas assets. Once again we feel this range is not consistent with returns in companies carrying comparable risk ratings - too high.

We would strongly recommend that the Office carry out benchmarking studies in this area to validate a fair rate of return and accord this a priority as it is fundamental to the achievement of justifiable reference tariffs.

Yours sincerely

Alan J Reichel
Executive Director