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Dear Dr Michael

DAMPIER TO BUNBURY NATURAL GAS PIPELINE

The Chamber of Minerals and Energy is pleased to respond to the request of Office of Gas Access Regulation (OffGAR) for public submissions on the proposed Dampier to Bunbury Natural Gas Pipeline (DBNGP) access undertaking and makes the following comments.

Importance of Competitive Energy

It is useful to reiterate the great importance to any modern economy and to WA in particular of competitively priced energy. The price of energy is a key input into virtually all production processes. In WA, with its reliance on minerals extraction and further processing, energy is particularly important. This link can be clearly seen in the boost to further processing provided when gas prices were reduced following renegotiation of supply contracts in the North West. Preliminary modelling work done by the University of WA's Economic Research Centre suggests that a 25% reduction in energy prices boosts employment by over 1%, exports by around 0.5% and GSP by a similar amount. Conversely, energy price increases will decrease economic growth to an equivalent degree. It is important to note that these results represent the impact of final delivered energy prices. Thus an increase (or decrease) in the cost of transportation has the same result as an identical increase in the cost of supply.

Role of Regulation

The Chamber's view on regulation is that by far the best way of delivering service at the best possible combination of price and quality is via the operation of competitive markets. In these circumstances economic regulation is not required and would actually be counter productive. Where there is market failure, however, regulation may be required to prevent inefficient outcomes. These instances include where natural monopolies operate such as the DBNGP.

Where regulation is required, the task of the regulator is to replicate the outcomes which would be delivered by a competitive market in terms of economic efficiency and incentives for innovation. A monopolist will not, as commonly supposed, charge as much as possible but will, however, charge a price which maximises profit. This profit maximising price will be set inefficiently high, causing damage to the economy as a whole. On the other hand, a competitive market will deliver lower prices and maximise customer benefit while at the same time delivering the supplier only a "normal" profit. The competitive pricing outcome will also produce overall economic efficiency as the right amount of the product will be consumed. In the case of pipeline services, a monopoly price will be higher and consumption restricted, with the impact that overall energy prices will be higher and energy use artificially constrained. A competitive market in pipeline services will see prices set at a level where users can consume pipeline space at a price which reflects the benefits to them. Overall energy prices are lowered and energy is consumed at an optimal level. It is the regulator's job artificially to replicate this outcome.

Customer Expectations

As part of the sale of the pipeline to Epic Energy in 1998, a transitional regime of tariffs was locked in so that usage costs would fall from \$1.19/GJ to \$1/GJ in 2000 (for delivery to zone 9 of the pipeline – upstream of Kwinana Junction). After this time the provisions of the National Access Code (NAC) apply and this is of course the context of the current proposal. It is important to note this decrease because it provides a benchmark for future prices and establishes an environment which customers might reasonably expect to be maintained into the future. While the Chamber acknowledges that no specific guarantees were given that future prices would remain at this level, the Government did establish a price that was seen as reasonable in the short term after the sale. Indeed the Government is on the record as saying that "the new owner has committed to lower gas tariffs, a condition of sale set down by the State Government."¹

In these circumstances, the Chamber submits that actual price outcomes under the NAC regulated regime should not exceed the regulated transition price in any significant way. It follows therefore that the reference tariffs (which represent both a benchmark for negotiation and an implicit maximum tariff) should be similarly constrained. In fact, it can be argued that the \$1/GJ figure itself is too high as an

¹ Premier/Minister for Energy, *Joint Media Statement*, 3 March 1998.

appropriately valued pipeline and cost of capital would deliver reference tariffs below this figure.

Proposed Reference Tariffs

Epic proposes a multi part reference tariff consisting of a gas receipt charge, a pipeline capacity charge, a compression capacity charge, compressor fuel charge and delivery point charge.

In its submission, Epic notes that application of the rules would see a full haul tariff of \$1.41/GJ for zone 9. Instead it proposes \$1.00/GJ for zone 9 – the current tariff. For zone 10 the appropriate figure would be \$1.62/GJ and Epic proposes to charge \$1.08/GJ. These tariffs will increase by 67% of the cpi annually. The difference between the reference tariff and the “real tariff” is to be absorbed in a deferred recovery account which can be recovered when demand for gas services grows in the future. It is envisaged that growth will eventually allow this deferred capital to be recovered.

A concern is that this deferred recovery would need to be offset against actual asset valuation, meaning that the scope for future tariff decreases as the asset value falls as economic life approaches zero is reduced.

The Chamber is also concerned that focus on \$1.00/GJ as the headline reference tariff ignores that:

- Additional costs to be added to the tariff will make the effective reference tariff higher than the posted rate. These costs include swing and balancing charges and fuel gas.
- The proposed firm service differs from the current T1 service in some significant ways which impact on users. For instance, a new imbalance penalty of \$15/GJ will be introduced and the imbalance limit has been tightened from $\pm 8\%$ to $\pm 2\%$.
- Reference tariffs in some areas of the State will increase significantly as opposed to the full haul situation. For instance, in the Pilbara, some tariffs will increase by an order of magnitude – by 14 times according to one user. Major industrial users south of Kwinana also face significant increases.

The Regulator has a number of objectives in approving reference tariffs. Importantly, a reference tariff should provide a revenue stream to recover the efficient costs of delivering the service over the expected life of the asset and replicate the outcome of a competitive market.

In fact the tariff does not cover the efficient costs of delivering the service, at least until the deferred recovery account kicks in. Moreover, in spite of not recovering the full capital cost, there is still an increase in prices. By way of contrast, if the

asset value were \$1 billion and the WACC of 8.5% accepted, the annual revenue requirement would fall from \$328 million to around \$150 million and the reference tariff would be in the order of 75c/GJ. The scope for reductions in reference tariffs is clear.

Asset Base

Epic is requesting an asset base of \$2.57 billion, which is the actual purchase price of \$2.407 billion adjusted for new capital expenditure and depreciation since purchase.

As noted above, the asset base is not being used directly to determine the tariffs in the usual way of making a return equal to the expected return on capital. However, the NAC does work on the basis that this is how tariffs are generally calculated and having this asset base accepted must at least create the possibility that it could in future drive tariffs. If Epic has a permanent expectation that it is prepared to accept tariffs which, on its own calculation, do not meet its rate of return, then this should preferably be reflected in a lower asset base.

There are a number of factors the Regulator must consider in arriving at an asset base. It should be noted that they do include “the price paid for any asset” and, to that extent, Epic’s contention is not automatically excluded from consideration.

However, the NAC also provides that the range of values should not normally fall outside Depreciated Actual Cost (DAC) and Depreciated Optimised Replacement Cost (DORC). It is not clear what these values actually are, but AlintaGas’ 1997 annual report valued its transmission business (essentially although not completely the DBNGP) at \$937 million. This suggests that the DAC/DORC value should be much closer to \$1 billion than to \$2.5 billion.

Epic argues that the fact that the sale price arose from a competitive bidding process means that it should be accepted. While the NAC does make allowance for competitive bidding, it should generally be in the circumstances of *construction* of a new pipeline rather than bidding for an existing one. Where a Government has sought the highest possible sale price for an asset, it is not clear that it is in the public interest to allow that price directly to be translated into a revenue stream.

The Chamber submits that the price paid is not an appropriate basis for valuation and that the initial capital base should be limited to DORC. Notwithstanding that the tariffs do not derive strictly from the asset base, the Regulator should not accept Epic’s proposed asset value as this is not within the spirit of the NAC.

Cost of Capital

The cost of capital sought by Epic is 8.5%, based on the Weighted Average Cost of Capital (WACC) method. WACC is a method of calculating appropriate rates of

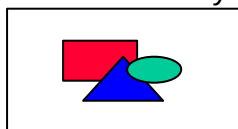
return based on a combination of a risk free rate of return combined with a risk premium to reflect the additional risk involved in the actual business.

The Chamber accepts that WACC is an appropriate method of calculating the rate of return but is concerned that the result may be too high. It is noted that regulated outcomes elsewhere have seen lower rates. In Victoria, for instance, the Office of the Regulator General (ORG) has approved 7.75% as applying to the gas industry in that State. Epic's submission, which discusses rates of return in the gas industry in the United States, does not address the rate set by ORG and it is not clear why the business risk from the DBNGP is higher than in the Eastern States. While not necessarily arguing that the rate applied in Victoria should also be enforced in WA, the Chamber submits that more information on the implicitly higher business risk is required to justify this higher rate.

The Chamber observes that these comments are based on information currently in the public domain. It is understood that further information on the costs and revenues associated with the DBNGP may become available at a later stage and the Chamber would appreciate an opportunity to consider making a further submission at such a time.

It is hoped that these comments are of assistance. Please contact Charles Crouch, Executive Officer, Economics at the Chamber if any further assistance is required. As requested, a copy of this letter has been e-mailed separately to OffGAR.

Yours sincerely



Ian Satchwell
Chief Executive Officer