5 October 2001

Submission by Deutsche Asset Management (Australia) Limited to the Office of Gas Access Regulation, Western Australia

Proposed Access Arrangement for the Dampier to Bunbury Natural Gas Pipeline, Draft Decision

Deutsche Asset Management

Deutsche Asset Management is the asset management division of Deutsche Bank AG. Globally, Deutsche Asset Management currently manages A$1.1 trillion on behalf of clients in more than 60 countries and in over 20 currencies. On 24 September 2001, Deutsche Asset Management announced that it had reached agreement to acquire the operations of Scudder from Zurich Financial Services. The combined group will be the fourth largest asset manager in the world with over A$1.7 trillion in assets under management.

In Australia, Deutsche Asset Management currently manages over A$35 billion on behalf of Australian-domiciled clients in listed and unlisted equity, debt, cash and property. This figure will grow to approximately A$46 billion following completion of the Scudder acquisition.

The private equity arm of Deutsche Asset Management, known as DB Capital Partners, is one of the Australia's premier private equity houses, with in excess of A$1.5 billion in funds under management. Our clients include well known Australian and international institutions and major State and Commonwealth public sector superannuation funds. We are a significant and long-standing investor in Australian infrastructure – in addition to our one ninth interest in Epic, we currently manage major investments in Melbourne and Launceston airports, Yallourn Power station and the Nextgen national fibre optic cable network.

Purpose of Submission

The purpose of this submission is to express our grave concern at the draft decision in relation to the proposed access arrangement for the Dampier to Bunbury Natural Gas Pipeline ("DBNGP"). This decision, if implemented, will impact negatively on Deutsche Asset Management's future investment decisions in Western Australia, and those of other major Australian and international investors.

The Australian Council for Infrastructure Development and other interested parties have already drawn to the Regulator's attention the far-reaching implications of the draft decision for future development in Western Australia, particularly the future growth of the gas industry. In particular, the barriers to competition created by the decision and the failure to balance short term benefits to consumers with long term gains to the community have been noted. The sizeable investment made by Epic since privatisation in expanding the pipeline and the significant reductions in tariffs which have already occurred are also well known.

We understand that Epic has provided detailed financial information to the Regulator demonstrating the disastrous financial effect which this decision would have on Epic and its investors if implemented and that Epic has or will provide information regarding the decision's impact on Epic's ability to finance future expansion of the pipeline. In our case, the funds at risk are part of the superannuation savings of hundreds of thousands of past and present Australian public sector employees. We strongly submit that the Regulator should, indeed must, pay serious regard to this. We also note that the Western Australian Government, in its submission dated 17 September 2001, has expressed similar concerns.

As a major investor in Australian infrastructure, we wish to focus in this submission on the draft decision:

(i) as it relates specifically to our investment in Epic; and

(ii) as it sits within the wider regulatory environment.

Epic Energy

In relation to the former, we refer to the circumstances surrounding Epic's decision to invest in the DBNGP. It is a matter of public record that the Western Australian Government structured the privatisation of the pipeline through a competitive bid process to achieve three clearly-stated policy objectives. Those objectives were:

(i) to maximise the sale price;

(ii) to achieve a reduction in tariffs to Perth to $1.00/GJ (from $1.18/GJ at the time of the sale and $1.27/GJ the previous year); and

(iii) to secure a commitment to expand the pipeline's capacity.

We believe that Epic and its shareholders had a legitimate expectation arising out of the sale process for the DBNGP that Epic would receive the tariffs set out in schedule 39 of the asset sale agreement and reflected in the proposed Access Arrangement submitted to the Regulator. The Regulator's apparent failure to take account of that expectation must inevitably raise serious concerns in the investment community about the risk inherent in investing in Western Australia.

We would like to provide you with details of the sale process and the analysis we undertook at that time. However we are still seeking clarification from the State as to the continuing confidentiality obligations covering the DBNGP sale process. We are hopeful that, in the interests of an open and transparent regulatory process, this issue will shortly be resolved and that we will then be in a position to make a more detailed public submission concerning the manner in which the sale process was conducted and our expectations arising out of that process.

Regulatory Environment

In addition to the specific points discussed above in relation to the draft decision and its potential impact on Epic and its investors, we wish to record our in principle disagreement with the "cost of service" approach to price setting adopted by the Regulator. Although frequententy adopted by Australian regulators, we consider that this methodology is fundamentally flawed. In short, under this approach the initial capital base is routinely set at an assessed depreciated optimised replacement cost ("DORC") and a weighted average cost of capital ("WACC") appropriate to a mature asset is applied. Consequently, any purchaser of a regulated asset is unable to make a reasonable return on its investment unless it can acquire the asset for no more than its DORC value. One difficulty posed by this approach is that the original developer of the asset may not, in practice, be able to build the asset for a cost equal to DORC. More importantly, however, even if an asset can be built for DORC, the original developer will certainly not be able to recover a return on its investment commensurate with the risk of a greenfield project if the asset is sold for DORC.

The developer of a new asset will often expect a return in excess of 20% pa on its actual investment to compensate for development, construction and market risks. Accordingly, it will necessarily seek a price for the completed asset well in excess of its construction cost (let alone its "optimised" construction cost). The buyer, as owner of a mature asset, may well accept a lower return but will also seek that return on its <u>actual</u> investment, not on the theoretical DORC value. Further to that point, apparently favourable comparisons between headline "returns" mandated by regulatory decisions and those available on similar assets in the listed market are fallacious on two counts: first, because of differences in liquidity between listed and unlisted investments and, secondly, because returns on listed shares are calculated on investors' actual funds invested, not on a theoretical "efficient" cost of the physical assets of the business.

Until regulators adopt a realistic “whole of asset life” approach reflecting the investment and return requirements of different parties discussed above, infrastructure investment in this country will suffer and decline. Deutsche Asset Management has made only one investment in a significantly regulated asset (i.e. 50% or more of revenue from regulated sources) since the acquisition of the DBNGP in 1998. In that case, the relevant regulator had determined that sufficient competition existed and adopted a largely “hands off” approach.

Conclusion

We would urge the regulator to reconsider his draft decision and, in doing so, to give substantial weight to the matters raised above.