

Submission to the Western Australian Gas Regulator on  
Proposed Access Arrangement  
Dampier to Bunbury Natural Gas Pipeline Licence WA: PL40

by

Hon Mark Nevill MLC Member for Mining & Pastoral Region

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Epic Energy submitted their proposed Access Arrangement for the Dampier to Bunbury Natural Gas Pipeline on the 15 December 1999 and it was posted on the OFFGAR Web site on 24 December 1999.

*Background:*

Epic Energy's successful bid for the DBNGP of \$2.407 billion under an interim access arrangement which committed Epic Energy to:

- (i) A tariff from 1 January 2000 of \$1.00 /GJ for gas transportation to Kwinana Junction
- (ii) A tariff from 1 January 2000 of \$1.08 /GJ to delivery points downstream from Kwinana Junction; and
- (iii) A price path that would see tariffs rise by no more than 67% of increases in CPI.

The Access Arrangement is for five years and commences on the 1 January 2000 or on a later date that the Gas Regulator approves the Access Arrangement.

Epic Energy has used the purchase price paid to the State of Western Australia plus acquisition costs (\$42.49 million) in determining the initial capital base for the DBNGP which is determined to be \$2,449.49 million. (Table 3.1a, page 14). The actual transmission tariffs are calculated by using the Capital Base which is a substantially higher amount of \$2570.34 million (Table 3.3, page 16) for determining tariffs at the beginning of the Access Arrangement Period. The extra amount in the Capital Base includes a further amount of “economic depreciation” referred to as the deferred recovery account.

The use of purchase price to determine tariffs is unprecedented in Australia. Overseas Regulators will not allow acquisition premiums to be considered. Pipeline valuations for setting tariffs are based on, and usually lie somewhere between the Depreciated Actual Cost (DAC ie historical cost) and the Depreciated Optimised Replacement Cost (DORC). The ACCC and Eastern States Regulators usually use a valuation of 85 – 90% of DORC. The DORC is used as the absolute cap to calculate tariffs by the ACCC. The use of the purchase price plus acquisition costs will greatly inflate tariffs.

One of the factors under S 8.10 of the National Gas Code which the Regulator should consider when establishing the value of the initial capital base is the price paid for any asset recently purchased by the service provider and the circumstances surrounding that purchase. However the Regulator is under no obligation to accept the sale price as the value of the initial capital base. Furthermore under S 8.11 of the National Gas Code the value of the initial capital base should not normally fall outside the range of values determined by the DAC and DORC.

The return on assets is determined by multiplying the capital base by the rate of return. The rate of return is a weighted average of returns applicable to debt and equity or the Weighted Average Cost of Capital (WACC). The ACCC and other State Regulators have only allowed a WACC of about 7.5% to 7.75%. The 8.6% proposed by Epic Energy is very high and will considerably inflate tariffs.

Further to my earlier comment on “economic depreciation”, the use of economic depreciation as a means of recovery of excessive sales prices is unprecedented. There is no economic logic to support the use of so called economic depreciation and to roll that over into the asset base in this situation. It seems that the DBNGP would end up with a \$3 billion valuation, which is nonsense.

Depreciation on the assets is not clear in the proposed Access Arrangement nor is it clear how they arrived at their various figures. In order to bypass the gobbledygook I have used two different scenarios, depreciation of the capital base over 45 years and 65 years.

With Depreciation Over 65 Years.

The Weighted Average Cost of Capital (WACC)	=	8.60%
Asset Value (Capital Base)	=	\$2,570.34 Mill
A	WACC x Asset value	= \$ 221.05 Mill
B	Depreciation over 65 years on Capital Base	= \$ 39.59 Mill
C	Overheads and Maintenance (Table 2.2, page 9)	= \$ 39.12 Mill
D	Total A + B + C	= \$ 299.76 Mill
E	Delivered Volumes for 2000 (365 days x 532.8 TJ/day p 40 Table 6.4) (Forecast System Volume S9.2 page 14)	about 194 PJ
<b>Operating Revenue</b> (D divided by E)		= <b>\$1.55/GJ</b>

With Depreciation Over 45 Years.

The Weighted Average Cost of Capital (WACC)	=	8.60%
Asset Value (Capital Base)	=	\$2,570.34 Mill
A	WACC x Asset value	= \$ 221.05 Mill
B	Depreciation over 45 years on Capital Base	= \$ 57.19 Mill
C	Overheads and Maintenance (Table 2.2 page 9)	= \$ 39.12 Mill
D	Total A + B + C	= \$ 317.36 Mill
E	Delivered Volumes for 2000 (365 days x 532.8 TJ/day p 40 Table 6.4) (Forecast System Volume S9.2 page 14)	about 194 PJ
<b>Operating Revenue</b> (D divided by E)		= <b>\$1.64/GJ</b>

Comment:

It is not clear what annual volume of throughput is required before rebates on charges apply, but these rebates are limited to only some services.

The capital base requested by Epic needs to be wound back dramatically. This will require some independent assessment of the replacement cost of the assets that make up the DBNGP. The weighted average cost of capital used, needs to be reduced. Gas transmission tariffs to Perth should be in the \$0.75 to \$0.85 range. The fact that they are ridiculously higher is for two reasons. Firstly the requirement to cap tariffs at \$1.00 from 1 January 2000 under the sale rules inflated the price of the pipeline and the successful bid must have assumed early growth in the market, which hasn't materialised.

One of the principles of the National Gas Code is to keep the gas industry internationally competitive and it is the duty and task of the Regulator to ensure that outcome. I don't believe the proposed Access Arrangement achieves that competitiveness.

The other duty of the Regulator is to ensure that consistent principles are used Australia wide.

If industry wants to get into a bidding war over the purchase of Government assets that is their problem, they should not then expect the consumers to guarantee or underwrite their largess or to bail them out. The regulatory regime and asset valuations are not meant to provide insurance for corporate mistakes.

In selling the DBNGP at such an inflated price the State Government has built in pressures for substantial rises in future transportation costs unless there is a significant increase in pipeline throughput very soon, which looks unlikely.

## Operating Revenues Using Estimates Based on Previous Rulings

Based on previous rulings (WACC of 7.5%) and two more realistic estimates of the replacement cost (say \$1.0 B or \$1.2 B), the tariffs should be in the order of:

1 With a replacement cost of \$1.0 billion and a Weighted Average Cost of Capital (WACC) of 7.5%:

### With Depreciation Over 65 Years.

The Weighted Average Cost of Capital (WACC)	=	7.50%
Asset Value (Capital Base)	=	\$1000 million
A WACC x Asset value	=	\$75.00 million
B Depreciation over 65 years on Capital Base	=	\$15.38 million
C Overheads and Maintenance	=	\$39.12 million
D Total A + B + C	=	\$129.50 million
E Delivered Volumes for 2000 (365 days x 532.8 TJ/day p 40 Table 6.4) (Forecast System Volume S9.2 page 14)		about 194 PJ
<b>Operating Revenue (D divided by E)</b>	<b>=</b>	<b>\$0.67/GJ</b>

### With Depreciation Over 45 Years.

The Weighted Average Cost of Capital (WACC)	=	7.50%
Asset Value (Capital Base)	=	\$1000 million
A WACC x Asset value	=	\$75.00 million
B Depreciation over 45 years on Capital Base	=	\$22.22 million
C Overheads and Maintenance	=	\$39.12 million
D Total A + B + C	=	\$136.34 million
E Delivered Volumes for 2000 (365 days x 532.8 TJ/day p 40 Table 6.4) (Forecast System Volume S9.2 page 14)		about 194 PJ
<b>Operating Revenue (D divided by E)</b>	<b>=</b>	<b>\$0.70/GJ</b>

2 With a replacement cost of \$1.2 billion and a Weighted Average Cost of Capital (WACC) of 7.5%:

With Depreciation Over 65 Years.

The Weighted Average Cost of Capital (WACC)	=	7.50%
Asset Value (Capital Base)	=	\$1200 million
A WACC x Asset value	=	\$90.00 million
B Depreciation over 65 years on Capital Base	=	\$18.46 million
C Overheads and Maintenance	=	\$39.12 million
D Total A + B + C	=	\$147.58 million
E Delivered Volumes for 2000 (365 days x 532.8 TJ/day p 40 Table 6.4) (Forecast System Volume S9.2 page 14)		about 194 PJ
<b>Operating Revenue (D divided by E)</b>	<b>=</b>	<b>\$0.76/GJ</b>

With Depreciation Over 45 Years.

The Weighted Average Cost of Capital (WACC)	=	7.50%
Asset Value (Capital Base)	=	\$1200 million
A WACC x Asset value	=	\$90.00 million
B Depreciation over 45 years on Capital Base	=	\$26.67 million
C Overheads and Maintenance	=	\$39.12 million
D Total A + B + C	=	\$155.79 million
E Delivered Volumes for 2000 (365 days x 532.8 TJ/day p 40 Table 6.4) (Forecast System Volume S9.2 page 14)		about 194 PJ
<b>Operating Revenue (D divided by E)</b>	<b>=</b>	<b>\$0.80/GJ</b>

The outcome of this estimate is a tariff to Perth of between \$0.67 and \$0.80/GJ a tariff well below the \$1.55 to \$1.64/GJ that I calculate under the proposals by Epic Energy.

What can be seen from the above estimates is how crucial this proposed Access Arrangement is to delivered gas prices to the South West of Western Australia and the importance of the competition that will be generated by a second gas pipeline. Both Julian Grill MLA the Opposition Spokesperson on Resources and myself have been stressing this point for years.

Facilitating a second pipeline and removing any impediments to a second pipeline has been the main thrust of my support of the sale of AlintaGas.

Submission Ends.