

19 August 1999

Our Reference: RD062RD

Mr Robert Pullella
Office of Gas Access Regulation
PO Box 8469
Perth Business Centre 6849

Dear Mr Pullella,

**SUBJECT: Submission on the Proposed Access Arrangement for the AlintaGas
Mid and South West Distribution Network**

North West Shelf Gas Pty Ltd has the following comments on the proposed subject Access Arrangement.

There is a vast amount of information and data now available from the Office of the Regulator-General, Victoria (ORGV) with respect to onshore gas reticulation and onshore gas transmission pipeline system tariff determination methodology including the cost of capital. The process of tariff determination during the course of 1997 and 1998 attracted submissions and commentary from some of the world's most highly recognised financial experts including Professor Bob Officer from Melbourne University and Australia's leading banks, practitioners and corporates. It is not our intention to duplicate this body of work, as OffGAR would be well aware of the work and its relevance to AlintaGas' proposed Access Arrangement.

Similarly, if one reads the publicly available submissions with respect to the access arrangements for the Parmelia Pipeline, one can see how the work undertaken for the Victorian onshore gas transmission pipeline and onshore distribution assets can provide a sound theoretical base for comparison with the tariff determination methodologies proposed.

COST OF CAPITAL

With respect to the cost of capital the majority of submissions and consensus of opinion seems to suggest that for onshore gas reticulation or onshore gas transmission pipeline assets, the WACC should be no greater than 7% real, pre tax. Furthermore, there would seem to be no strong qualitative reasons that suggest that the systematic risk of the Western Australian assets would be any different to those in other parts of Australia or for that matter the world. That is, there is no basis for Western Australian onshore gas transmission pipeline assets' WACC to be greater than the rates determined in Victoria.

In fact, there is a view that the equity betas used in the determination of the WACC for Victorian onshore gas transmission and gas distribution assets were high. Our own work suggests that when appropriate weighting was given to the historic betas of the gas distribution companies in the United States, particularly companies with market

capitalisation over US\$1,000 million and with reasonable trading histories, more stable levered equity betas of less than 0.65 can be observed. This does not seem unreasonable purely on a common sense basis when one considers the nature of the systematic risk inherent in a statutory authority's cashflows. This compares with the equity beta used by ORGV of 0.85 which is the same equity beta used by KPMG for the AlintaGas distribution network. A lower equity beta reduce the required returns on equity utilising the CAPM from levels of greater than 11% to between 9 and 10%. This would seem to suggest that the 7% WACC as determined by ORGV could be viewed as "fairly generous" when compared to the returns that the global markets would expect from these types of infrastructure assets.

Other factors that may contribute to KPMG's higher 8 % WACC value for the AlintaGas distribution network include:

Market Risk Premium

Work undertaken by Professor R.R. Officer and Professor N Hathaway (Melbourne University) tracking the long term average Market Risk Premium, suggests that the Market Risk Premium is closer to 6%. KPMG have used 6.5%.

Cost of Debt

ORGV work suggested that the cost of debt should be in the order of 75 to 100 basis points greater than the risk free rate. The Commonwealth Bank, Westpac Bank and CSFB confirmed this opinion. KPMG are utilising a lending margin range of 100 to 200 basis points over the risk free rate.

Gamma

Again the consensus view in the of ORGV work was that a good approximation for gamma was 0.50. KPMG have used 0.30.

All these factors contribute to KPMG's WACC estimate of 8% being higher than the consensus view that it should be no greater than 7% real, pre tax.

ASSET VALUATION METHODOLOGY

There has been divided opinion on the appropriateness of Depreciated Optimised Replacement Cost (DORC) valuation methodology. There has been concern that the economic theory does not produce a reasonable and/or acceptable competitive tariff. For example, it has been argued that abnormal historical returns may have adequately compensated for the economic costs of the infrastructure and the continued use of replacement cost in markets with limited competition or where natural monopolies exist in fact sustains high and non-competitive tariffs. In other words, incumbents are able to 'double dip' economic value.

We believe that these abnormal historical returns were derived from factors such as:

- using inappropriately high discount rates to determine the original tariffs;
- assets having far outlived their originally estimated economic life;
- assets have outperformed their initial design specification;

- assets were built with uneconomic excess capacity which continues to ward off the threat of new competition.

We believe AlintaGas' access arrangement proposal confirms the concerns held by the users of onshore gas transmission pipelines and onshore gas distribution assets and we would encourage OffGAR to ensure they note this for future determinations. That is, AlintaGas have found that the tariff derived by using the DORC method would render their transportation tariff non-competitive and have settled for an asset valuation somewhere in between DORC and depreciated value. This would seem to be consistent with the realities of a competitive market place where the pricing point is never a precise formula driven number but rather, a market driven price, sitting somewhere in between the short term marginal cost and the long run economic average cost as determined by the mechanisms such as DORC.

Indeed the rather circular method for determining the asset value proposed by KPMG would suggest that had they used a lower WACC estimate of 7% real, after tax as explained above, that at the proposed tariff levels, the resultant asset value would have been higher than the A\$530.3 million stated but still less than the estimate based on DORC.

EFFICIENCY FACTOR

We note and approve of AlintaGas' proposed arrangement whereby average tariff levels will be constrained to reduce in real terms (the *CPI-X* constraint) over the term of the proposed Access Arrangement . We believe that such a mechanism will promote efficiency and help lead to lower delivered prices for customers. We would encourage OffGAR to consider whether the 0.79% target for *X* is sufficient and suggest that a higher value would provide a greater incentive for the onshore gas transmission pipeline or distribution network operator to reduce costs and increase volumes. If the efficiency improvement target is too small there is the potential for the operator to capture an inappropriate share of the efficiency gains. We suggest that OffGAR look to the historical performance of these asset types following privatisation as a guide for what might be achieved for the AlintaGas network and other Western Australian onshore gas transmission pipelines.

North West Shelf Gas welcomes this opportunity to comment on the proposed Access Arrangement. If you have any questions please contact Mr Rod Duke of our office.

Yours truly,

AKOS GYARMATHY
General Manager