

Worsley Alumina Pty Ltd

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Worsley Alumina Pty Ltd is the manager of the Worsley Joint Venture - Bauxite/Alumina Operation.
Liability and responsibility of the Joint Venturers is several in accordance with the following schedule of participating interests:
Bilinton Aluminium (RAA) Pty Ltd 56%, Bilinton Aluminium (Worsley) Pty Ltd 30%,
Kobe Alumina Associates (Australia) Pty Ltd 10%, Nissho Iwai Alumina Pty Ltd 4%.

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Mr R Pullella
Office of Gas Access Regulation
PO Box 8469
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Dear Mr Pullella

Worsley Alumina Pty Ltd (Worsley) welcomes the opportunity to comment on the Draft Decision on the proposed Access Arrangement for the DBNGP (Draft Decision) in the light of the decision of the Supreme Court of Western Australia (Court Decision).^{1,2}

In reconsidering its previous submissions with respect to the proposed access arrangement and the Draft Decision Worsley has had regard to the reasons given in the Court Decision but has not found reason to vary its previous conclusions. Worsley believes that the Initial Capital Base (ICB) is set at the upper extreme of the range normally allowed under the National Third Party Access Code for Natural Gas Pipeline Systems (Code) [that is, between Depreciated Actual Cost (DAC) and Depreciated Optimised Replacement Cost (DORC)]. As a consequence of the ICB set at DORC and the parameter choice used in calculating the allowable rate of return, Worsley believes that the indicative reference tariffs are also set at the upper limit of the range calculable in accordance with the Code.

The Court Decision made particular reference to the factors in s2.24(a)-(g) of the Code being given weight as fundamental elements in the assessment of the Independent Gas Pipelines Access Regulator in Western Australia (Regulator). This section can also serve to guide the Regulator in reconciling the objectives in s8.1(a)-(f) of the Code. The Court Decision also allowed the Regulator to take into account the actual investment of Epic in the DBNGP in determining tariffs and, in particular, in establishing the ICB. The Court Decision allows that the Regulator may properly take into account the circumstances of Epic's purchase of the DBNGP, including the price paid, and any value according to a recognised asset valuation methodology which may be revealed by the price paid in those circumstances.

The Court Decision explicitly recognised that the objectives in s8.1 are in tension and require that the elements of s2.24 be given weight, but not necessarily equal weight, in reconciling these objectives. Furthermore, the weighting to be given to these elements is at the Regulator's discretion. The nub of the matter appears to be whether the ICB has been set at a level that achieves the s8.1 objectives as reconciled in the light of s2.24.

Elements of s2.24

S2.24(a) requires that the Regulator take into account "the Service Provider's legitimate business interests and investment in the Covered Pipeline". This clearly requires the Regulator to have regard for Epic's ability to recover the purchase price over the life of the pipeline. This is Epic's private interest and must be weighed together with, *inter alia*, the public interest tests in s2.24(e)&(f). Furthermore, "investment" must be qualified to exclude folly or mistake.

S2.24(b) allows existing contractual obligations to be taken into account. Worsley notes that its long term contract for pipeline access commenced prior to the sale but explicitly recognises that pricing is to be renegotiated following the approval of an access arrangement under the Code. That is, there was explicit prior recognition of an expectation that the price prevailing prior to an access arrangement would likely not continue.

S2.24(c) requires the Regulator to take into account the expenditure necessary for the safe and reliable operation of the pipeline. In broad terms the indicative reference tariff in the Draft Decision is in two parts: that to cover the operating cost of the pipeline; and that which constitutes a return on and of capital. There does not appear to be any dispute that the tariff in its totality is adequate to assure the safe and reliable operation of the DBNGP, that is, it is more than adequate to cover the operating costs over the life of the pipeline. It remains to be assessed whether it

¹ In this submission 'Epic' refers generally to the owner and operator of the DBNGP

² Re Dr Ken Michael AM; ex parte Epic Energy (WA) Nominees Pty Ltd & Anor [2002] WASCA 231

allows a return of and on capital as well. Note that the “capital” in this context is the regulated asset base. As argued elsewhere, this is not the purchase price.

S2.24(d) requires the Regulator to take into account the economically efficient operation of the pipeline. As pointed out in the Court Decision this relates to the objective of “the promotion of a competitive market and, perhaps, also to the prevention of the abuse of monopoly power”.³ This consideration is clearly in conflict with that in s2.24(a) in any sense that Epic’s “legitimate business interests” may include the extraction of monopoly rents.

S2.24(e) is a broad ‘public interest’ test that is, again, in opposition to the ‘private interest’ of Epic as taken into account in s2.24(a).

S2.24(f) is a narrower ‘public interest’ interest test with respect to the users of the pipeline. Again, this is in opposition to s2.24(a) and Worsley argues that the interests of users are best met if Epic recovers enough to assure the safe and efficient operation of the pipeline over its life, and no more.

As noted above, the elements of s2.24 are not to be equally weighted when taken into account by the Regulator. While Worsley respects that it is for the Regulator to decide the appropriate weight to be given to each element the preponderance of elements of s2.24 suggests that s2.24(a), Epic’s private interest, should not prevail.

Reference Tariff objectives

S8.1(a) of the Code requires that a reference tariff be designed to allow Epic “... the opportunity to earn a stream of revenue that recovers the efficient costs of delivering the Reference Service over the expected life of the assets used in delivering that Service”. Worsley believes that a key element in understanding what Epic purchased is this “opportunity”. Worsley argues that Epic’s purchase price includes consideration for potential future revenue streams. To the extent that these did not eventuate the purchase price overstates the value of this opportunity and is unsafe as an estimate of the ICB. [Worsley believes that the purchase price is inappropriate as an estimate of ICB for other reasons also. Worsley does not suggest that an estimate of the ICB can be found by discounting the purchase price to the extent of unrealised forecast revenues.]

S8.1(b) of the Code requires that a reference tariff be designed to replicate the outcome of a competitive market. From the perspective of textbook economics, the ICB that replicates perfect competition is the DORC value. The DORC value represents the capital cost another party would incur to replicate the service provided by the pipeline.

S8.1(c) of the Code is designed to assure that the Reference Tariff is adequate so that “... the revenue stream will be sufficient to meet safety and reliability needs as and when that is necessary”.⁴ As noted above, there are two parts to the tariff. So long as the tariff exceeds the costs necessary to maintain and operate the pipeline over its full life this objective is met. It remains to be determined whether the remainder is adequate to give a return on and of capital. This is dependent on the ICB and rate of return. A tariff based on an ICB equal to the DORC will meet this objective.

S8.1(d) is designed to promote equity between the pipeline owner and parties dependent on it. An ICB that is set too low will under-reward pipeline ownership and discourage investment in pipelines. It will underprice the delivered cost of gas and distort gas’ competitive position in its market. An ICB that is set too high will increase the delivered cost of gas and discourage gas production and consumption. The “true” price of gas, in an allocative sense, is arrived at with the ICB set at the DORC value. An ICB set at any value other than DORC will either discourage investment in pipelines, to the long-term detriment of the public, or encourage “uncommercial, mistaken or reckless”⁵ prices being paid for pipelines and discourage investment in gas-based industries.

S8.1(e) & (f) of the Code are not dealt with in the Court Decision and Worsley makes no comment beyond its earlier submissions.

Initial Capital Base

S8.11 of the Code states that the ICB should not normally fall outside the range of DAC and DORC. The Code was not enacted in Western Australia at the time of the sale of the DBNGP but the states had agreed to adopt the drafting of the Code as it appeared in the relevant South Australian legislation. Epic should have had a high degree

³ *ibid*, para 133

⁴ *ibid*, para 146

⁵ *ibid*, para 155

of certainty with respect to the Code at the time of sale and, in particular, the operation of s8.11 of the Code. Worsley is not aware of any caveat expressed by Epic with respect to the Code at the time of the sale. As part of the sale process Epic was provided with DAC and DORC valuations and would, presumably, have made its own DAC and DORC valuations as part of its due diligence. If Epic had intended that the ICB for regulatory tariff determination should lie outside the range of DAC and DORC it was open for it to do so. Insofar as there may have been a 'regulatory compact' it refers to the process to be followed, that is, following the Code, and not any agreed outcome. If there were any compact with respect to process surely it would have made explicit that the ICB was to lie outside the range DAC to DORC or that Epic's own estimated DORC value differed greatly from that provided. Worsley is not aware of any reasons put forward by Epic that the circumstance of the sale made the application of the Code not "normal", justifying an ICB outside the normal range.

The Court Decision has reasoned that: "At least in cases where an investment in a pipeline before the Code applied is made in the course of an arm's-length commercial transaction and is based on a sound commercial assessment of the value of the pipeline in the circumstances then prevailing and anticipated, it is not apparent from the terms of the Act and the Code that the intention is, automatically and necessarily, to preclude consideration of the investment, or the interests of the service provider in recovering it together with a reasonable return, or the reasonable expectations under the preceding regulatory regime of such a service provider."⁶ The sale process resulted in an "arm's-length commercial transaction". Worsley contends that the sale price was not based on "a sound commercial assessment of the value of the pipeline in the circumstances then prevailing and anticipated". The danger in relying only on the value of the successful bid in determining ICB is that "... reckless, mistaken or highly speculative investment decisions should be accepted for this purpose."⁷ The Court Decision also noted that "Such decisions, of course, would be likely to be recognised by other investors".⁸ Worsley suggests that a better "market valuation" of the pipeline is obtainable by considering what all parties were prepared to pay for it and not simply the winning bid. The extent to which there is a divergence between the winning bid and the remaining bids is a measure of the "reckless or mistaken" component of the winning bid.

While not a 'recognised valuation technique' there is a rule of thumb that the purchase price for an asset earning a regulated return should be in the range 1.4 to 1.6 times DORC. The extent to which there is consistency between this rule of thumb and the other bids will endorse the commercial judgement of Epic's market peers that the purchase price should be based on an ICB of DORC.

Worsley contends that the 'purchase price' itself is not a valuation technique. It is the methodology used to arrive at that end result that is the valuation technique. It is open to Epic to detail the methodology used in its calculation of the price it paid. The assumptions used in this can be critiqued with respect to "sound commercial assessment", not with the benefit of hindsight, but in the context of the "circumstances then prevailing". Epic has conceded that its forecast volumes did not eventuate but the commercial judgement is based not on whether these additional sales eventuated but on whether they should have been included in the first place, or, if so, with what weight. The Regulator can make his own judgement as to whether the sales forecast used by Epic constituted 'sound commercial assessment'. It may be possible for the Regulator to ascertain if other bidders included these additional volumes in their valuations. If not, then Epic's purchase price includes a "reckless, mistaken or highly speculative" component and is unsafe as a basis for estimating ICB.

In considering the general "circumstances then prevailing" the Regulator should be mindful of the then-prevailing zeitgeist of 'irrational exuberance' in the capital markets. In considering the "reasonable expectations under the preceding regulatory regime" the Regulator should be mindful of the reductions in tariff that were enacted in the lead up to the sale and the expectations that tariffs would continue to decrease. Furthermore, Worsley understood that lower tariffs were a condition of the sale. For customers such as Worsley, whose delivery point is south of Kwinana, this condition is not met in Epic's proposed access arrangement but is met in the Draft Decision.

Conclusion

Worsley has reexamined its earlier submissions in the light of the Court Decision. Worsley has reconsidered its view as to whether the ICB should lie outside the range of DAC and DORC but can find no sound reason why ICB should exceed DORC. Worsley contends that there is ample evidence to suggest that the actual price paid is unsafe as an estimate of ICB for the purposes of the Code. Worsley supports the Regulator's Draft Decision and recommends that it be finalised and implemented as soon as practicable.

WORSLEY ALUMINA

⁶ *ibid*, para 179

⁷ *ibid*, para 154

⁸ *ibid*, para 154