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21 March 2005

Review of AGL Gas Networks revised access arrangement
Independent Pricing and Regulatory Tribunal
PO Box Q290
QVB Post Office NSW 1230

To Whom It May Concern:

EUAA Submission on Revised Access Arrangement for AGL Gas Networks

The Energy Users Association of Australia (EUAA) appreciates the opportunity to provide a submission to the Independent Pricing and Regulatory Tribunal (IPART) on the Draft Decision Revised Access Arrangement for AGL Gas Networks (Draft Decision).

The EUAA is a non-profit organisation focused entirely on energy issues. Members determine EUAA policy and direction. Currently, the EUAA has 11 members with business operations in NSW, including many of the State's largest gas users. EUAA activities cover both national and sub-national issues. [See http://www.euaa.com.au/ for more information on the EUAA.]

The EUAA has, in forming comments to IPART's Draft Decision, consulted with a number of our members in NSW. This will help to ensure that IPART is provided with a view on the Draft Decision, which is relevant to large gas users in NSW. This should be important to IPART, given its charter of promoting both competition and consumer oriented outcomes, and given the profile of gas use in NSW, which is heavily weighted towards business use.

<u>AGLGN's Response to Draft Decision</u>

The EUAA understands that AGL Gas Networks (AGLGN) have responded to a number of IPART's required amendments to the proposed Access Arrangement. The EUAA would like to address two main issues AGLGN have raised in response to the Access Arrangement:

- Rate of Return; and
- Proposed write down of Wilton/Wollongong pipeline.

Rate of Return

IPART have proposed a pre-tax real rate of return of 7.00 per cent. IPART in determining the appropriate rate of return considered the impact of alternative rates of return on users and prospective users, and assessed their financial impact on AGLGN and its implications for investment decisions.

AGLGN have, since the release of the Draft Decision, proposed a pre-tax real rate of return of 7.90 per cent, based on new evidence from Monte Carlo analysis. However, AGLGN initially proposed a pre-tax real rate of return of 7.85 per cent.[1]

AGLGN adopted standard Monte Carlo stimulation techniques to construct a full probability distribution (range) around the WACC estimate. In determining where the true cost of capital lies within this range (probability distribution), AGLGN have adopted an 80 per cent confidence interval. AGLGN claim that a confidence interval of 80 per cent is appropriate as any confidence interval less than this will run the risk of underestimating the true cost of capital and deterring efficient investment.

The EUAA considers this statistical analysis is just a method of manipulating the data to best suit AGLGN's end objective of a higher WACC. The EUAA considers that the WACC levels set by the regulators are more than sufficient in ensuring appropriate levels of investment. This view is confirmed by looking at numerous sources and research:

- International benchmarking shows Australian regulators are using higher WACC parameters (such as market risk premium) compared with overseas counterparts;[2]

- A recent study by the Allens Consulting Group (ACG) found that the WACC determined by Australian regulators for gas and electricity businesses is more than sufficient to ensure appropriate levels of investment, especially given the low risk nature of energy networks[3]; and

- A recent study by ACG[4], on behalf of BHP Billiton, found that the Tobin's 'q'[5] for regulated entities was consistently above the value of one, which suggested that the rates of return were more than sufficient for new investment. This is re-enforced by responses of the financial markets to the decisions of Australian regulators, which consistently show that these decisions provide rates of return that are more than enough to continue to attract investment.

The EUAA urges IPART to determine a rate of return that is commensurate with prevailing conditions in the market for funds and the risk involved in delivering the service. The best way to achieve this is by looking and comparing comparable

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1 AGLGN did not use the Monte Carlo analysis to determine its initial proposed WACC.
2 Expected returns and volatility in 135 countries, C. Erb, C. Harvey, T. Viskanta, Journal of Portfolio management, Spring 1996, pp. 46-58.

3 Allen Consulting Group, Review of studies comparing international regulatory determinations, March 2004.

4 Allen Consulting Group, Review of the Gas Code, Commentary on Economic Issues, August 2003.

5 Tobin's q is a ratio of the market value of a firm's assets to their replacement value. It provides an indication of future investment needs.

overseas and domestic firms' performance in the market rather than arguing over statistical techniques that can easily be manipulated to achieve any desired result.

All the available information from independent sources and the comments of Australian regulators consistently show that rates of return being set for energy network businesses in Australia are not only sufficient but overly generous to the regulated entities. This point applies equally to the AGLGN draft decision.

IPART needs to keep firmly in mind that gas users will pay for this generosity in their gas distribution charges and that it will have a negative impact on the cost competitiveness of business gas users in NSW. The EUAA continues to oppose such generosity, believing it to be inappropriate, unnecessary and contrary to the objective of incentive regulation, which is to "mimic" the outcomes of a competitive market place.

Proposed write down of Wilton/Wollongong pipeline

IPART have identified redundant capital[6] on the Wilton to Wollongong pipeline with a value that equates to 20 per cent of the value of the capital base of the pipeline.

IPART noted that section 8 of the Gas Code (Code) does not permit a 'revaluation' of the capital base but simply rolls it forward at each review. It considered that the Code requires that the change in value should be that resulting only from the decline in utilisation or in the volume of sales.

IPART calculated the reduced value of the pipeline by determining the appropriate diameter of the pipeline, given the reduction of utilisation. IPART stated that by applying the unit rates that were used to value the initial diameter for the pipeline, it would *not* be revaluing the capital base but simply determining the decrease in value resulting from a decline in utilisation.

AGLGN submitted that the unit rates used to determine the value of the reduced diameter should be higher than those applied in the valuation of the initial capital base.

The EUAA supports IPART's technique of calculating the value of the reduced diameter based on unit rates that were used to value the initial capital base.
The EUAA considers a revaluation of the asset base to be a bottom up approach. Therefore, if IPART used different unit rates other than those used to determine the capital base than it will be revaluing the asset base. If IPART subtracted the value of the excess capacity of the pipeline it is not revaluing the capital base but simply optimising the pipeline to reflect the decreased utilisation. This is an important distinction that should be recognised and applied. It is also consistent with 'good;' regulatory practice and the Code.

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6 Clause 8.2 of the Code states that a reference tariff policy may include (and the Relevant Regulator may require that it include) a mechanism that will, with effect from the commencement of the next Access Arrangement Period, remove an amount from the Capital Base for a Covered Pipeline so as to: ensure that assets which cease to contribute in anyway to the delivery of Services are not reflected in the Capital Base; and share costs associated with a decline in the volume of sales of Services between the Service Provider and Users.

Conclusion

In conclusion, the EUAA is strongly supportive of IPART's Draft Decision and in particular commends IPART for recognising the role of Demand Management (DM). We oppose any increase in the Rate of Return for AGLGN provided in the Draft Decision and we support the approach to revaluation of the Wilton/Wollongong pipeline provided for in the Draft Decision.

If you have any queries regarding our comments you can contact Renate Vogt, Manager, Policy and Regulation on telephone number (03) 9898 3900 or e-mail renate.vogt@euaa.com.au.

Yours sincerely

Roman Domanski
Executive Director