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**Subject:** FW: Energy Users Association of Australia Submission to QCA on Review of Queensland Gas Distribution Networks

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QUEENSLAND COMPETITION AUTHORITY REVIEW OF ACCESS  
ARRANGEMENTS FOR QUEENSLAND GAS DISTRIBUTION NETWORKS

ENERGY USERS ASSOCIATION OF AUSTRALIA SUBMISSION

11/01/2001

At this stage of the review we would like to limit our comments to the following central issues: Initial Capital Base, Rate of Return and Information Disclosure.

#### 1. INITIAL CAPITAL BASE

The initial capital base is the single most important item in any access review not only because of its effect on authorised revenue but also as it forms the base for all subsequent reviews of particular pipeline systems.

Initial asset base methodology and its determination has been a difficult issue for the Office of the Regulator General in Victoria and IPART in New South Wales. Each of these regulators has painstakingly analysed the options for asset base determination and been rigorous in their explanation of the rationale for choosing their particular 'line in the sand'. At this time considerable doubt exists as to the best methodology or combination of methodologies for fair and accurate estimation.

When the National Gas Access Code was developed it was recognised that initial capital base determination was a difficult issue and that a fair and accurate estimate would lie between Depreciated Actual Cost and Depreciated Optimised Replacement Cost. An incredible amount of debate and discussion has been heard since that time on this issue and the position of the various players in the argument has not moved very far at all.

It is not surprising that Allgas and Envestra have opted for an asset valuation methodology based upon DORC. This methodology maximises the value of the asset base compared with other methodologies and thereby maximises the level of tariffs applied for in the access arrangement application.

The experience of prior reviews has now demonstrated that economic arguments are not the core of this matter at all. It was considered that the DORC methodology was in fact a science and that its application would lead to a single 'hard' number. There have now been a number of well documented instances where experts in this field have been commissioned to provide DORC valuations and these have been found to result in widely differing estimates for particular pipeline systems. In Victorian gas access reviews conducted in 1998, Gutteridge, Haskins and Davies provided an analysis for the Energy Projects Division of State Treasury while Sinclair Knight also performed an analysis on the same pipeline system. The two estimates varied by some thirty percent! In discussion with the estimating organisations it was evident that a variation of this order was not unusual in an estimate of complex structures such as gas pipeline systems. Estimates of electricity assets in IPART access reviews in New South Wales have come up with similar discrepancies.

Not only is there difficulty in arriving at a reliable and accurate valuation but experience to date indicates that DORC valuations in some instances have been wildly overvalued.

It is recognised that Depreciated Actual Cost methodology is not a perfect methodology in all instances but

it does have a fundamental advantage over DORC - it does provide a single, verifiable and accurate figure. Certainly, this aspect alone should mean that it is to be the preferred methodology where the necessary historical information is available for analysis. It was noticeable in the Victorian gas access reviews that the lack of historical information was a problem and contributed to the acceptance of DORC as the preferred methodology of the Commission and the ORG in that instance.

In cases where historical information is not readily available it behoves the regulator to use means of arriving at an acceptable valuation other than DORC now that it has been shown to be seriously flawed and thereby discredited as an asset valuation methodology.

In the case of Allgas we would suggest that as the historical information is available that it be used as the basis of the initial asset valuation and any allowances considered necessary in this particular instance be applied to this 'hard' figure. In respect of Envestra we find it difficult to believe that the historical information is not available given the relationship that existed between Envestra and the Boral group of companies at the time the distribution system was purchased.

We are strongly of the view that the application of 100% DORC values will only serve to entrench monopoly rents in gas distribution network tariffs.

We disagree with the 'hole in the ground' approach suggested by Envestra. Maintenance expenditures can be used to extend the economic life of assets, and extend the duration of their investment with no cash input of their own. However, it also pushes up the initial capital base value through a lower level of depreciation. To be consistent in its treatment of assets the Authority would need to agree to the valuation of fixed assets on the basis of net realisable value rather than DORC.

We also disagree with any suggestion to have the Initial Capital Base revisited at any subsequent review to account for system utilisation. The Gas Code is quite explicit in this regard.

## 2. RATE OF RETURN

Determination of the Weighted Average Cost of Capital (WACC) to be used is another key determinant of any access decision and has once again been the subject of much input to regulators over the past three years. It is of less importance than the initial capital base but only because it is re-calculated at each access review.

We remain strongly of the view that the assessment of risk associated with the class of business under review is crucially important. Regulated businesses are by definition low risk and this should be central to the determination of appropriate risk.

Over the past three years a considerable amount of effort has been made by regulators and others involved in the gas industry in attempting to generate a theoretical figure or range of figures that could be seen to be appropriate to monopoly regulated businesses such as those engaged in gas transmission and distribution.

This has been done now a number of times for gas and power businesses and regulators have typically arrived at a real pre-tax rate of return in the range of 7.0 to 7.75%. Allgas and Envestra have suggested that a figure of 7.75% would be appropriate in their view while our Group representing the large end of the demand side of the market would suggest that a figure of less than 5% would be more suitable.

The object of the exercise is to arrive at a figure that represents a fair return on the capital that is invested in these monopoly regulated businesses. Our approach in recent times has been focussed on an assessment of relative rates of risk for classes of investment in Australia and rates that have been applied in similar businesses in other parts of the world.

It is generally accepted that one of the riskiest classes of investment is buying company shares in the share market. We have obtained information that indicates that over the past thirty years the real rate of return from investing in the share market is just over six percent and has been somewhat higher over the past ten years - between eight and nine percent. The records in this country go back for about seventy years and over this period the real rate of return from the share market has been 5.8%. We consider this sets one of the upper bounds for what would be considered as high risk investments.

At the other end of the scale is the return one would expect on ten year bonds which are generally classed as a no-risk investment. Again, over the past thirty years the real rate of return has been about 2.8% which is considerably lower than is generally believed. Nevertheless, this is what investors have typically been gaining as a REAL return for a no-risk investment. Ten year bonds over the past ten years have been a little higher than this, but not much higher, and over the full seventy year period of records the returns are a little lower than 2.8% real.

Our Group has spent some time investigating rates of return that have been proposed by local and overseas regulators for regulated monopolies. IPART and the ORG have used rates of 7.25 to 7.75% for gas assets. Our view is that this range is much too high. In Victoria the State Government as owner of the gas distribution assets requested a real pre-tax rate in excess of ten percent and while the regulator severely discounted this, he still did not finish with a figure that is consistent with a rate that falls sensibly within the no-risk bond rate and the high risk share market rate.

In the United Kingdom regulators have been using rates of about 6 to 6.5% for both electricity and gas assets. Once again we feel this range is not consistent with returns in companies carrying comparable risk ratings.

We would strongly recommend that the authority carry out benchmarking studies in this area to validate a fair rate of return and accord this a priority as it is fundamental to the achievement of justifiable reference tariffs.

### 3. INFORMATION DISCLOSURE / ATTACHMENT A INFORMATION

Attachment A to the National Gas Code was one of the most debated issues during the formulation of the Code. It details what is to be disclosed to interested parties and defines the extent of break-out of the data. Unless this information is available it is not possible to assess the full impact of the undertaking, the fairness of allocations nor the credibility of forecasts.

Allgas and Envestra have not complied with the Attachment A requirements in a significant number of areas including the following:

#### Category 1: Information Regarding Access and Pricing Principles

- \* Incentive structures

#### Category 2: Information Regarding Capital Costs

- \* Asset values for each pricing zone, service or category of asset
- \* Depreciation
- \* Accumulated depreciation
- \* Description of nature and justification for planned capital investment

#### Category 3: Information Regarding Operations and Maintenance

- \* Cost allocation between zones, services or categories of asset and between regulated/unregulated
- \* Wages and salaries - by pricing zone, service or category of asset

#### Category 4: Information Regarding Overheads and Marketing Costs

- \* Total service provider costs at corporate level
- \* Allocation of costs between regulated/unregulated segments
- \* Allocation of costs between particular zones, services or categories of asset

#### Category 6: Information Regarding KPI's

- \* Service provider KPI's for each pricing zone, service or category of asset

We would strongly recommend that the Authority vigorously pursue this matter so that the review can be completed to the satisfaction of all interested parties.