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Dear Ken

**DAMPIER TO BUNBURY NATURAL GAS PIPELINE –  
WESTERN AUSTRALIAN GOVERNMENT SUBMISSION  
ON THE DRAFT DECISION**

The State has reviewed the draft decision and I am pleased to provide the State's submission on this matter.

Yours sincerely

A handwritten signature in black ink that reads "Eric Ripper".

**ERIC RIPPER MLA  
DEPUTY PREMIER; TREASURER;  
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**1 8 SEP 2001**



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Department of Treasury and Finance

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## **Dampier to Bunbury Natural Gas Pipeline – Western Australian Government Submission On the Regulator's Draft Decision**

### **Preface**

The Western Australian Government recognises the importance to the State's economy of independent and transparent infrastructure access regulation. With a large share of Australia's oil and gas reserves, the State is well positioned to realise the benefits that will flow from increased economic activity underpinned by the efficient use of these resources and facilities.

Naturally, access providers will argue for higher access prices just as informed access seekers will argue for lower prices. The Regulator has the difficult task of balancing the shorter-term stimulus to the economy of lower access prices with maintaining appropriate incentives for investment in infrastructure. The mitigation of monopoly power is fundamentally at odds with the desire of an investor to maximise profits. However, it must be consistent with allowing the investor to earn a reasonable return on their investment.

Fundamentally, gas pipeline access arrangements strive to underwrite more effective competition in gas production and supply. This can result in benefits for infrastructure owners by promoting growth in the market. Similarly, direct users benefit from an increased ability to choose a supplier most closely suiting their needs. Consequently, through efficient pricing the economy as a whole benefits from better value for money for key business inputs and more effective investment.

The intent of the access regime is to establish benchmark terms and conditions that guide commercial negotiation, recoup efficient costs and generate returns for the owner commensurate with the risk of their investment. At the same time efficient prices encourage optimal use and growth of the system.

Western Australia became a signatory to the CoAG Natural Gas Pipelines Access Agreement on 7 November 1997, following around five years of developing the Agreement through extensive consultation, public debate and discussion. The Agreement contained the following objectives, which were subsequently enshrined into the National Access Code for Natural Gas Pipeline Systems (“the Code”):

- facilitating the development and operation of a national market for natural gas;
- preventing abuse of monopoly power;
- promoting a competitive market for natural gas in which customers may choose suppliers, including producers, retailers and traders;

- providing rights of access to natural gas pipelines on conditions that are fair and reasonable for both Service Providers and Users; and
- providing for resolution of disputes.

The South Australian enactment of the Code became effective from 1 January 1997 presenting investors with a clear declaration of the future national framework. Western Australia's enactment of the Code became effective on 15 January 1999. From its inception, the overarching requirement has been that when Reference Tariffs are proposed, determined or reviewed, they should be based on the efficient cost (or anticipated efficient cost) of provision. At the same time, it recognises the need to balance a number of competing interests, which have been embodied in the Code as matters that the Regulator is required to take into account in his decision-making.

The Code provides a strong and robust national framework with which firms such as Epic Energy, operating in several jurisdictions, now have considerable experience. Importantly, it seeks to ensure that a coherent and consistent set of principles is applied to the regulation of gas pipeline infrastructure nationally. Adherence to its provisions ensures that certain key principles are reflected nationally and that investors and users alike are treated fairly. Through its focus on establishing a price based on efficient costs for a commonly used service, the regulatory process provides a fair reference point around which commercial negotiation can occur.

As experience with the Code's implementation grows, a body of precedent is emerging through which comparison of regulatory outcomes is possible. The State has every confidence that the Regulator will ensure that the Code's objectives are met and trusts that the Regulator can bring the outstanding matters to a closure in an expeditious fashion.

The Western Australian Government appreciates its first submission has been considered and addressed by the Regulator in the draft decision, but wishes to reiterate certain matters. Through this submission the State is seeking to underline its support for the regulatory regime, the sanctity of the independent Regulatory process and to participate in the process as an interested party.

## **1. The Sale Process Embraced the Code**

In the period leading up to the draft decision, and since, there has been considerable public discussion on a so-called “regulatory compact” on gas transportation tariffs to apply post 1 January 2000. The draft decision said there was no evidence of a regulatory compact, which is consistent with the information provided by the State in its first submission. The State wishes to confirm again that it did not enter into an agreement or in Epic’s terminology a “regulatory compact” on gas transportation tariffs post 1 January 2000.

In light of its involvement in the development of, and its agreement to, a national access regime, the State has always expected, and legislated that the independent Regulator is to determine third party tariffs from January 2000 in accordance with the nationally adopted Code. It is clear that the Regulator is not to make decisions that reflect any “understanding” that the successful bidder has sought to imply from the

DBNGP sale process. This position was made clear to Epic, and all other bidders, in the sale documentation, and particularly in the State's Information Memorandum which has been referred to extensively in Epic's submissions and in the Regulator's Draft Decision.

The previous State Submission stated that in the sale process the question of future tariffs was only addressed between the vendor and the bidder by the vendor requiring the bidder to agree that the proposed tariff rates and path indicated by the bidder (Schedule 39) could at the vendor's discretion be disclosed in the course of any public inquiry or other determination process relating to tariff rates for gas transmission. The effect of such disclosure continues to be viewed by the State as providing the bidder's best estimate at the time of the bid of the maximum tariff rates for gas transmission, which the bidder might be able to sustain in a regulatory process conducted by an independent Regulator under the National Access Code taking into account, amongst all other evidence and relevant considerations, that best estimate of the bidder. Nothing in that requirement could create a binding obligation on the Regulator or any form of regulatory compact between the State and Epic Energy in relation to tariffs for third party use of the DBNGP.

It should be noted that the Auditor General issued a Special Report in May 1998 entitled "Sale of the Dampier to Bunbury Natural Gas Pipeline". This public report stated:

***Other Guarantees***

*This examination found no evidence of any other indemnities or guarantees given by the State. Legal advice on section 53 suggested that Parliament should be made aware of any favourable position on rates or taxes, any preferred bidder status on future projects or any concessions on tariffs which may have been given to the successful bidder.*

*This examination revealed no evidence of any such arrangements having been entered into with the successful bidder.*

Appendix B also stated:

*Commencing January 1, 2000, the National Third Party Access Code for Natural Gas Pipeline Systems (the Code) will be in existence and will be the mechanism for determining transmission prices throughout Australia.*

*The transmission price is to be set in accordance with the principles of the Code and approved by a yet to be appointed Gas Access Regulator. The Buyer's undertaking on tariffs will be available to the Gas Access Regulator when making the price determination. No evidence was disclosed of the State having given specific undertakings to any party regarding tariffs agreed by the Gas Access Regulator beyond 1 January 2000.*

## **2. Key Points From the Previous State Submission.**

Transitional regulated tariffs apply and govern the price some shippers pay for transporting gas on the DBNGP until an approved Access Arrangement is in place on the DBNGP. It should be noted, as previously submitted, that the State does not in any way regard the level of those transitional tariffs as having any particular importance as a factor in the Regulator's decision on the proposed Access Arrangement. They may be relevant in considering the reasonableness of the various parameters proposed by Epic Energy, but they in no way bind the Regulator to a particular tariff outcome.

It is also important to restate that the State supports in principle the "innovative" approach taken by Epic Energy on various aspects of its proposal and considers that in many of those aspects the proposed Access Arrangement is aimed at improving the former access regime applying to the DBNGP. Two examples are the introduction of a zonal structure for the Reference Tariff to more accurately reflect costs, and the development of a secondary market for transmission capacity.

It is noted that the Regulator has emphasised at the public forum that what he has released is a draft decision, based on the available information and submissions made to him at that point in time, and that he encourages further submissions to ensure that stakeholder concerns are appropriately considered and addressed before he makes his final decision.

The following additional comments are made in respect of some matters relating to the draft decision.

## **3. Services Offered in the Proposed Access Arrangement as Amended by the Regulator's Draft Decision.**

It is noted that the single reference service (the "Firm Service"), as amended by the Regulator's draft decision, remains different from the firm service which was offered under the *Gas Transmission Regulations 1994* and the Transitional Regime under the *Dampier to Bunbury Pipeline Act 1997* (i.e. the "T1 Service"). The T1 Service is presently used by "a significant part of the market", under contracts which are grandfathered under section 96 of the *Gas Pipelines Access (Western Australia) Act 1998* as to terms and conditions, but not necessarily price.

A number of stakeholders have indicated to the Regulator in their submissions that they require the T1 Service to be a reference service in the future, (for example, the Joint Submission of 15 August 2001 by AlintaGas Sales Pty Ltd, Apache Energy, North West Shelf Gas Pty Ltd, Wesfarmers CSBP Limited, WMC Resources Ltd, Western Power Corporation, and Worsley Alumina Pty Ltd, on the T1 Equivalent Reference Service).

The Regulator would be aware that the value of a service is measured not just in terms of the service per se but also in terms of its quality. In respect of gas transportation, a significant aspect of quality is its reliability. As noted by the Regulator, reliability as defined for the Firm Service and the T1 Service are very different. Reliability remains a significant source of difference in value between the two services that could not be treated in the same way that the Regulator has treated seasonal service, authorised overrun and spot service as minimising the gap.

In the draft decision the Regulator considered that the amended Firm Service as per his draft decision in combination with various other non-reference services offered by Epic Energy will provide the opportunity to obtain a service similar to the T1 Service. However, as noted above, reliability remains a significant source of difference for which a valuation or assignment of cost may not be readily determined. As such, it is considered that the Regulator has not gone far enough in addressing the issue.

Accordingly, it is considered important that the Regulator require Epic Energy to propose a reference tariff (for approval by the Regulator) for a generic T1 Service as a Reference Service which would provide sufficient guidance and detail on:

- the value of the combination of services that would comprise that Reference Service, including reliability; and
- the valuation or assignment of cost to the different components that would comprise that Reference Service.

This would assist existing Shippers and Epic Energy ascertain the price that existing grandfathered T1 Service contracts are liable to pay and in their subsequent consideration and decision-making to either:

- stay with their grandfathered T1 Service at the Regulator determined T1 Service type Reference Service price; or
- move to the Firm Service at the Regulator determined Firm Service Reference Tariff (presumably lower than the T1 Service type Reference Tariff), or
- negotiate on the services and price best suited to each shipper using these two Reference Tariffs as a clear starting point for the negotiations.

In doing so, the Regulator would facilitate negotiations between parties to enable transition of grandfathered contracts to new contracts that gives effect to the terms and conditions of a service under the proposed Access Arrangement. It would therefore also reduce substantially the likely arbitrations and litigation and the corresponding substantial costs, which is an aim of the Code<sup>1</sup>. The Regulator would note that the Standard Contract under the *Dampier to Bunbury Pipeline Regulations 1998* access regime provides for negotiations in respect of the price applicable to the contract following approval of the DBNGP Access Arrangement prior to resorting to arbitration under the Code.

The economically efficient operation of the pipeline (one of the factors required to be considered by the Regulator) may be enhanced by grandfathered contracts transitioning to the proposed Access Arrangement and this would also mean that one less regime would have to be managed by Epic Energy. This is supported by the

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<sup>1</sup> Introduction to the Code “The aim of the Code is to provide sufficient prescription so as to reduce substantially the number of likely arbitrations.”

desire of Epic Energy to introduce the new regime, which it considers will improve the operation of the pipeline. The longer term benefits of the proposed Access Arrangement regime include the changed method of determining capacity which enables better utilisation of the capacity of the DBNGP.

These two issues discussed above - the varied terms and conditions and the increased effective pipeline capacity they create - do not appear to have been underlined during the public debate. The key points are that it is therefore not possible without the determination of a T1 Service type Reference Service to directly compare the prices for a T1 type Reference Service and the Firm Service. Moreover, there could be expected to be a favourable volume effect on Epic Energy's expected revenue by moving to the Firm Service regime.

## **4. Reference Tariff Determination**

### **4.1 Initial Capital Base (ICB)**

There will be considerable precedent significance attached to the Regulator's final decision on the regulatory asset base for the DBNGP, extending beyond the owners and users of this pipeline.

We note that the Regulator has considered a wide range of asset valuation methodologies in his draft decision. We also note that in respect of some of these methodologies the Regulator has considered Epic Energy has not provided sufficient evidence or information to warrant the application of those methodologies to the matter at hand. We assume that Epic Energy will further consider those matters it has not adequately addressed and the Regulator will further consider these other valuation methodologies to ensure that the legitimate business interests of Epic Energy are adequately considered.

It would also add some useful definition and clarity to the regulatory environment if the Regulator were to ensure that detailed assumptions and calculations relating to the various estimates of the initial capital base are presented. A more detailed exposition of the methodologies and economic rationale for their use would appear to be of significant benefit and might serve to inform future regulatory approaches. Specifically, given the importance ascribed to the DORC valuation, the Regulator is encouraged to further enumerate the assumptions pertaining to the methodology.

A considerable body of work is emerging in this field with the approaches taken by the ACCC and other State regulators in utilities access regulation. It would be useful to demonstrate that the Western Australian approach entails an appropriate degree of consistency and comparability, despite the observation that there may be no unique method of deriving such subjective estimates.

The cost to Epic Energy of commissioning an independent expert's DORC valuation could, subject to the Regulator's views, potentially be rolled in to the asset base for the pipeline for recovery over its economic life. It is understood that reasonably incurred regulatory costs have been accommodated in this way in other access arrangements.

## **4.2 Claims that the Regulatory Framework may Result in Financial Distress**

The State and its agencies have not been provided access to sufficient information to develop an informed opinion on Epic Energy's financial position. The State would be concerned were financial distress to arise by virtue solely of the final decision of the Regulator, particularly given the Code's general principles for reference tariffs. Any analysis would be complicated by the fact that there are a range of factors that impact upon Epic Energy's financial position, most of which will be irrelevant to the Regulator's decision making under the Code. Given information asymmetries, the onus must be upon Epic Energy to demonstrate to the Regulator that any regulatory decision alone could have such an effect, through the provision of detailed information and analysis, and for the Regulator to decide whether this would be relevant.

This is a difficult matter for the Regulator to assess without access to full financial information and analysis. The Regulator is therefore placed in a difficult position, given our understanding (based on a typical profile of infrastructure investment) that the pipeline owners would have, in the ordinary course of business, already faced the prospect of further capital injections. Such injections would be expected to sustain the business through its development and to fund the additional investment necessary to realise its full earning potential through volume growth.

The Code is quite clear that the Regulator needs to consider the legitimate business interests of Epic Energy in balancing the interest of the various parties. This amounts to Epic Energy being permitted to recover reasonable costs including depreciation and earn a reasonable risk-adjusted rate of return on an efficient level of investment, and to be advantaged or otherwise by any reasonable incentive mechanisms that the Regulator may accept or determine.

Other broader considerations might be the degree to which the business earns revenue from the pipeline outside of the Reference Tariff framework (eg. for interruptible services) and the increased effective capacity from using Reference Services above the existing T1 specification. The State considers that the Regulator's role is not to underwrite or mitigate the ordinary risk of investment in, and operation of the pipeline.

Given the above, the State would encourage Epic Energy and its financiers to provide the fullest possible information to the Regulator to allow his informed consideration of its legitimate business interests.

## **4.3 Initial Reference Tariff for Carnarvon and the Pilbara**

The Regulator in considering past part-haul tariffs has decided to require Amendment 63 as presented below.

### ***Amendment 63***

*The cost allocation and tariff structure should be amended to ensure that for Users or Prospective Users with Delivery Points in any zone of the DBNGP, there is no increase in the total gas transmission charges under the Reference Tariff relative to the total charge that Users or Prospective Users would have*



*paid under a contract for the T1 Service entered into under the Gas Transmission Regulations 1994 or Dampier to Bunbury Pipeline Regulations 1998.*

It is noted that the Regulator has considered the tariffs proposed for the Carnarvon lateral (zone 4a) and the Pilbara (zone 1a) of the DBNGP and provided Epic Energy with latitude in addressing his concern over tariffs in these zones by requiring Amendment 63, as above.

It is noted that the above amendment would be welcome by Users (or Prospective Users) in Carnarvon and the Pilbara. It is understood that the sentiment behind Amendment 63 is aimed at addressing what the Regulator terms “inequitable anomalies”. However, it is unclear, on the basis of the requirements of the Code (such as economic efficiency, balancing of different interests etc.), how the Regulator came to the conclusion that there is to be no increase in gas transmission costs under the Reference Tariff relative to the tariff that Users or Prospective Users would have paid under a contract entered into under the Dampier to Bunbury Pipeline Regulations 1998.

For instance, in the case of the Carnarvon lateral, the Regulator may wish to look at the lateral as a distinct asset under section 8.10 of the Code to see if an asset value and therefore a derived reference tariff can be obtained using whatever valuation methodology the Regulator considers appropriate, including taking into consideration public information contained in the Carnarvon lateral contract (which includes an asset valuation) and submissions made by relevant parties.

#### **4.4 Foundation Contracts**

It could be strongly argued that it is in the legitimate business interests of pipeliners to have foundation contracts, and the Code specifically recognises and protects such contracts. These contracts may well have an element of a “prudent discount” as recognised in section 8.43 of the Code, and therefore contribute in the longer term to a lower overall transportation price. The Regulator may wish to look at the foundation contracts on the DBNGP and consider if such prudent discounts exist and if so whether he could or should make any allowance in the final Access Arrangement for these contracts. It is understood that Epic Energy has not proposed such a mechanism in its Access Arrangement or in the public information currently presented to the Regulator. It would again be important to balance the legitimate business interests of all stakeholders (current and future) if such prudent discounts are to have any effect on the final Access Arrangement.

#### **4.5 Possible Tariff Paths Associated with Further Development of the Pipeline**

Views have been expressed to the Regulator that the draft decision's tariffs might undermine the future development of the pipeline and act as impediment to further industrial and regional development. Such claims are of concern to the State and it would be desirable that the Regulator address carefully these concerns. In particular, it is vital that the Regulator outline how future investment in DBNGP infrastructure could be affected (or not affected) by this decision. It would not be in the State's interest were investment in expanded capacity not to occur. For example, it might be possible to present indicative estimates of the pipeline's longer term cost structure and tariffs

reflecting various longer-term investment and volume growth assumptions. It is expected that further investment in expanding the pipeline necessitated by load growth would produce on average a declining unit cost, with both the pipeline owner and pipeline users benefiting.

On the information available, it is difficult to see how the current Regulator's draft decision would work against expansion of the natural gas industry and the State would be concerned were this to occur. A major increase in throughput on the pipeline will require further capital investment, and there are various mechanisms under the Code that could enable this investment to earn the regulated rate of return. It is noted that the rate of return on investment, the Weighted Average Cost of Capital (WACC), proposed by the Regulator is very close to that put forward by Epic Energy with the only adjustment of any significance being due to changes in market conditions such as inflation expectations and interest rates.

#### **4.6 Epic's Ability to Ensure the Pipeline's Reliable and Efficient Operation.**

There are legal obligations under the Petroleum Pipelines Act (1969) and the conditions of Epic Energy's pipeline licenses to operate and maintain the DBNGP pursuant to an objective-based Safety Case which is administered by the Department of Mineral and Petroleum Resources (MPR) and in compliance with the relevant Australian Standards. As part of its role as a technical regulator, MPR conducts or participates in audits and investigates incidents to monitor performance against the Safety Case.

The decision of the Regulator on the inspection and maintenance costs should not result in compromising the safety of the Pipelines through inadequate spending on these activities. It is noted the Regulator accepted Epic Energy's proposed costs in this area.

Epic Energy must meet required safety, inspection and maintenance activities, or it will be in breach of its obligations under the *Petroleum Pipelines Act (1969)* and conditions of its licences and may jeopardise its pipeline licences, regardless of the Regulators final decision on the Access Arrangement.



**LES FARRANT  
COORDINATOR OF ENERGY**



**J L LANGOULANT  
UNDER TREASURER**

17 September 2001