PROPOSED ACCESS ARRANGEMENT FOR

THE DAMPIER TO BUNBURY NATURAL GAS PIPELINE

Submission by AlintaGas Sales Pty Ltd
to the Western Australian Independent Gas Pipelines Access Regulator

8 November 2002

EXECUTIVE SUMMARY[1]

AlintaGas has a significant interest in the outcome of the regulatory process applying to the DBNGP and was a party to the recent Court case on the Regulator's Draft Decision on the DBNGP Access Arrangement. It therefore welcomes this opportunity to make a submission to the Regulator on the implications of the Court's decision.

AlintaGas submits that:

- after taking into account the factors and requirements of sections 8.10 and 8.11 and the 8.1 objectives, together with section 2.24 if required; and
- considering the price paid by Epic for the DBNGP in the circumstances of that sale and the decision of the Supreme Court,

the Regulator should not approve the establishment of an ICB at a value greater than the DORC value set out in the Draft Decision.

There is no reason therefore for reference tariffs to be changed from the indicative reference tariffs set out in the Draft Decision.

Applying the sale price:

- would be contrary to the public interest and the promotion of the competition objectives of the Code;
- ignores the well established fact that purchase prices for regulated assets often include regulatory premiums over regulated asset bases; and
- does not take account of the mistaken assumptions by Epic in arriving at its price.

AlintaGas therefore submits that in considering the factors identified by the Court as requiring further attention, including the requirements of the Code and the circumstances of the sale, the Regulator can and should legitimately maintain the position established in the Draft Decision.

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[1] Terms used in this Executive Summary have the meanings given to them in the Submission.

Based on the Court's findings on the correct interpretation of the Code, AlintaGas makes the following submissions on the factors the Regulator needs to consider under sections 8.10, 8.11, 8.1 and, to the extent necessary, 2.24.

8.10 factors

AlintaGas's consideration of the 8.10 factors in light of the Court's decision indicates the following key points:

- The DAC value of the DBNGP is $874 million.
- The upper limit of the DORC value of the DBNGP is $1,234 million.
- The optimised deprival value of the DBNGP is $1,528 million.
- The imputed value of the DBNGP is in the range of $1,200 million to $1,300 million.
- Epic has argued that the purchase price of $2,407 million should become the asset base, but there are serious questions about this purchase price.
- To address these questions the Regulator must consider the nature of the tender process. This would include whether Epic erred in its assessment of value, had unreasonable expectations or had reason to pay higher than true market value.
- Valuation methodologies have advantages and disadvantages, but:
    - the DORC methodology has considerable economic advantages and is consistent with decisions elsewhere; and
    - the purchase price value methodology suffers from disadvantages associated with paying too much for an asset and must take account of any regulatory premium that forms part of a purchase price.
- International best practice in valuing pipelines is consistent with the establishment of an ICB at or below the DORC value.
- The reasonable expectations of Epic and users under the previous access regime would have been for consistency with the rules under the that regime. This would result in an asset base of $1,270 million. Tariffs under that regime would decrease beyond $1/GJ after 1 January 2000.
- If the Regulator determines that the ICB is to be set at a level that exceeds economically efficient levels, this will retard the economically efficient utilisation of gas resources.
- Valuing the DBNGP at no more than the DORC valuation will prevent inefficient construction of a second pipeline.

Section 8.11

- The ICB should not fall outside the range of DAC and DORC values.

8.1 objectives

AlintaGas's consideration of the 8.1 objectives suggests that the Regulator must consider that:

- The use of a DORC value will provide Epic with the opportunity to earn a stream of revenue that recovers the efficient costs of delivering its reference service over the life of the DBNGP.

- The use of a DORC value will assist in achieving the objective of replicating the outcome of a competitive market.

- It is unnecessary for the Regulator to establish the ICB above a DORC value to achieve the objective of ensuring the safe and reliable operation of the DBNGP.

- The objective of not distorting investment decisions in pipeline transportation systems or in upstream or downstream markets again guides the Regulator toward the use of DORC.

2.24 factors

The Court held that section 2.24 should, in the context of establishing the ICB, only be considered to the extent necessary to guide the Regulator in determining the manner in which any conflicting 8.1 objectives can be reconciled, or which of them should prevail. AlintaGas submits that this is not required as the 8.1 objectives do not conflict in relation to the ICB. However, to the extent that the Regulator does consider it necessary to examine and be guided by the 2.24 factors in the exercise of his discretions under section 8.1, the following key points must be considered:

- Epic's interest in recovering its investment of $2,407 million and a return on that investment should be taken into account to the extent that it is a legitimate business interest and investment.

- AlintaGas and other users are already using the DBNGP and have firm and binding contractual obligations with Epic.

- The Regulator must take into account the operational and technical requirements necessary for the safe and reliable operation of the DBNGP. However, the use of a DORC value will be sufficient for that purpose.

- The Regulator must take into account the economically efficient operation of the DBNGP. This should be done by establishing the ICB no higher than DORC.

- The Regulator must also take into account the public interest, including the public interest in having competition in markets. The public interest in having competition in markets also requires an ICB no higher than DORC.

- The interests of users and prospective users must also be taken into account by the Regulator. Those interests are in the establishment of sustainably low prices for access to the DBNGP. This again guides the Regulator towards establishing the ICB at no higher than DORC.

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1. INTRODUCTION

On 23 August 2002, the Full Court of the Western Australian Supreme Court (the "**Court**") handed down its decision[2] on a legal challenge by Epic Energy (WA) Nominees Pty Ltd and Epic Energy (WA) Transmission Pty Ltd (collectively referred to as "**Epic**") to the draft decision ("**Draft Decision**") of the Western Australian Independent Gas Pipelines Access Regulator ("**Regulator**") on the proposed access arrangement ("**Access Arrangement**") for the Dampier to Bunbury Natural Gas Pipeline ("**DBNGP**"). The Regulator issued his Draft Decision on 21 June 2001.

Epic had applied to the Court, on various grounds, for a writ of *certiorari* to quash the Draft Decision, a writ of prohibition to prevent the Regulator proceeding further with the Draft Decision, and a writ of *mandamus* to direct the Regulator to again consider the Access Arrangement according to law. Epic further, or alternatively, applied for declarations.[3] AlintaGas Ltd and AlintaGas Sales Pty Ltd ("**AlintaGas**") appeared as a contradictor in the proceedings.

For reasons indicated in its judgment, the Court held that Epic had made good a case for the prerogative relief claimed and, in the alternative, declaratory relief.[4] It found that the Regulator's determinations in the Draft Decision in relation to the "reference tariff" and "initial capital base" for the DBNGP ("**ICB**")[5] were "affected by errors of law and required reconsideration".[6]

However, the Court decided, as a matter of discretion, that a grant of prerogative relief was unnecessary[7] and that it would provide declaratory relief.[8] The Court proceeded on the basis that, following its decision, the Regulator would allow Epic and other interested parties a reasonable time to prepare, and provide to the Regulator, submissions that have regard to the Court's reasons for decision and their effects on the matters identified in the

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[2] *Re Dr Ken Michael AM; ex parte Epic Energy (WA) Nominees Pty Ltd & Anor* [2002] WASCA 231.
[3] *Ibid*, paras 3 and 9.
[4] *Ibid*, para 218.
[5] In this Submission the term "initial capital base" refers to that term as defined in section 10.8 of the Code, whereas "ICB" is used to specifically refer to the initial capital base for the DBNGP.
[6] *Supra* n. 2, para 223.
[7] *Ibid*, para 220.
[8] *Ibid*, para 225. At the time of writing, the Court had not issued any declaratory orders. However, refer to para 223, which sets out orders that the Court indicated may be appropriate.

Draft Decision as being the reasons for requiring amendments to the Access Arrangement.[9] The Court's approach was reached especially having regard to the public statutory function of the Regulator and the Regulator's unequivocal indication that he would act, in his ongoing assessment of the Access Arrangement, in accordance with the Court's decision.[10]

On 2 September 2002, the Regulator issued an "Information Paper" setting out the procedure that the Regulator intends to follow, in light of the Court's decision, to finalise his decision on the Access Arrangement. In the Information Paper the Regulator invited interested parties to prepare and provide written submissions which have regard to the reasons in the Court decision and their effects on matters identified in the Draft Decision as being the reasons for requiring amendments to the Access Arrangement.

AlintaGas makes this submission ("**Submission**") in response to the Regulator's invitation. As indicated by the Court and the Regulator, the Submission discusses the Court's decision and its effect on the matters identified in the Draft Decision as being the reasons for requiring amendments to the Access Arrangement. In this regard, the Submission particularly addresses the effect of the Court's decision in relation to certain issues in the Draft Decision that were fundamental to Epic's legal challenge,[11] namely:

- the determination of the ICB;
- the proper determination and design of a reference tariff; and
- the assessment and approval by the Regulator of the Access Arrangement.

To undertake that examination, this Submission is divided into the following parts:

- Part 1, which consists of this introduction;
- Part 2, which addresses the Court's decision on the interpretation of the *National Third Party Access Code for Natural Gas Pipeline Systems* ("**Code**");
- Part 3, which addresses the establishment of the ICB under sections 8.10 and 8.11 of the Code;
- Part 4, which addresses the design of a reference tariff and reference tariff policy under section 8.1 of the Code;
- Part 5, which addresses the factors to be taken into account under section 2.24 of the Code in assessing the Access Arrangement; and
- Part 6, which concludes by summarising AlintaGas's views on what the Regulator should decide regarding the establishment of the ICB.

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[9] *Ibid*, para 222.
[10] *Ibid*, para 221.
[11] While the scope of this Submission is limited to the issues specified, AlintaGas acknowledges that the Court's decision may also have effects in relation to other matters identified in the Draft Decision as being reasons for requiring amendments to the Access Arrangement. AlintaGas's comments also apply, with appropriate modification, to those issues to the extent that they are capable of being so applied. If required, AlintaGas is willing to provide further information and submissions on such other matters.

Having examined the effects of the Court's decision, AlintaGas submits that the Regulator should, in progressing his assessment of the Access Arrangement, issue a "Final Decision" which does not significantly differ in its conclusions from those set out in the Draft Decision. In particular, the Regulator should establish as the ICB a value that does not exceed the value for the ICB that is specified in the Draft Decision. AlintaGas also submits that there is no reason for the Regulator to change from the views he expressed in the Draft Decision in relation to the rejection of the use of a "deferred recovery mechanism".

2. THE COURT'S DECISION ON THE INTERPRETATION OF THE CODE

2.1 The Court's decision

The Court's decision provides important guidance on the proper interpretation of the Code, especially in relation to the role of provisions that are critical to the establishment of an initial capital base for a "covered pipeline", the determination and design of a reference tariff, and the approval and assessment of a proposed access arrangement. The critical provisions, which were at the heart of Epic's legal challenge, are sections 2.24, 8.1, 8.10 and 8.11 of the Code.[12]

AlintaGas submits that the Court's decision establishes the following principles of law with respect to the establishment of an initial capital base and to the approval and assessment of a reference tariff and an access arrangement generally.[13]

(a) **Approval of an access arrangement**

The following principles of law apply to the assessment and approval of a proposed access arrangement by the Regulator.

(i) By virtue of section 2.24, the Regulator may only approve a proposed access arrangement if he is satisfied that it contains the elements and satisfies the principles set out in sections 3.1 to 3.20. He must not refuse to approve a proposed access arrangement solely for the reason that it does not address a matter that sections 3.1 to 3.20 do not require the access arrangement to address. In assessing a proposed access arrangement, including the consideration of sections 3.1 to 3.20, the Regulator is required to take into account the factors set out in sections 2.24 (a) to (g) ("**2.24 factors**").[14] Section 2.24 provides for a single "assessment" process to decide whether or not to approve a proposed access arrangement.[15]

(ii) When the 2.24 factors are taken into account, they should be given weight as fundamental elements in the Regulator's assessment of a proposed access arrangement.[16] However, the Court found that, as a matter of language, "take into account" appears to have little difference to "have regard to".[17]

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[12] From this point, unless otherwise indicated, all references to sections are references to sections of the Code.
[13] Other principles of law arising from the Court's decision are discussed in subsequent parts of this Submission.
[14] *Supra* n. 2 paras 40, 58 and 61.
[15] *Ibid*, para 58.
[16] *Ibid*, para 55.
[17] *Id*.

(iii) In every instance where the Regulator is required to take into account a "service provider's" legitimate business interests and investment in the pipeline under section 2.24(a), he must also take into account the other factors in section 2.24(b) to (g).[18]

(iv) Many of the subsections of sections 3.1 to 3.20 require evaluation, the exercise of judgment, the formation of opinion or other exercises of judgment by the Regulator.[19] In the exercise of such discretions the Regulator needs guidance - an obvious purpose and function of the 2.24 factors is to provide that guidance.[20] However, it does not follow that the 2.24 factors are intended to be, or are capable of being, applied to every issue presented by sections 3.1 to 3.20.[21] The precise nature of the elements and principles set out in sections 3.1 to 3.20 will determine whether there is scope for the application of the 2.24 factors to guide the exercise of discretion by the Regulator.[22]

(b) **Determination of a reference tariff**

The following principles of law apply in relation to the determination of a reference tariff.

(i) By virtue of section 3.4, the Regulator must be satisfied that an access arrangement and any reference tariff comply with the "reference tariff principles" described in section 8.[23] Section 8 is "suggestive of an essentially self-contained and exhaustive statement of principles relevant to reference tariffs and reference tariff policies".[24]

(ii) Compliance with the section 8 principles requires, among other things, that a reference tariff should be designed with a view to achieving the objectives specified in section 8.1 ("**8.1 objectives**"); the establishment of "total revenue" consistently with the principles and according to one of the methodologies in section 8; and the design of a reference tariff that is consistent with the principles in section 8.[25]

(iii) Where a service provider selects a "cost of service methodology" for the establishment of total revenue, that value is to be calculated on the basis of a return on, and depreciation of, the initial capital base for the pipeline and "non-capital costs".[26] Sections 8.10 and 8.11 provide principles for establishing the initial capital base for a pipeline that was in existence at

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[18] *Id*.
[19] *Ibid*, para 59.
[20] *Id*.
[21] *Ibid*, para 62.
[22] *Id*.
[23] *Ibid*, paras 43 and 70. Although sections 3.4 and 8 are separate provisions, that is only a matter of drafting convenience and the effect of section 3.4 is as though the provisions of the section 8 principles were set out fully in section 3.4: para 66.
[24] *Ibid*, para 72.
[25] *Ibid*, para 44, which sets out section 8.2.
[26] *Ibid*, para 46, explaining the effect of section 8.4.

the commencement of the Code.[27] Section 8.6 has the effect of ensuring that one single figure or value is arrived at for the total revenue.[28]

(iv) There are many points at which the section 8 principles call for evaluation, the exercise of judgment, the formation of opinion and other exercises of discretion by the Regulator.[29] Sections 8.10 and 8.11 - which deal with the establishment of an initial capital base - provide ready examples of this.[30]

(v) The 8.1 objectives, rather than the 2.24 factors, guide the Regulator in the exercise of his discretions under section 8.[31] However, where the 8.1 objectives are in conflict and the Regulator is required to determine (under the last paragraph of section 8.1) the manner in which they can best be reconciled, or which of them should prevail, the Regulator should take into account and be guided by the 2.24 factors.[32] In this regard, the 2.24 factors are to be taken into account "if necessary".[33] Accordingly, other than in situations of conflict between the 8.1 objectives, the Regulator should not apply the 2.24 factors when assessing whether the requirements of section 8 have been met.

(c) **Establishment of an initial capital base**

Consistent with the principles set out above, the following principles apply in relation to the establishment of an initial capital base for a covered pipeline.[34]

(i) Sections 8.10 and 8.11 provide principles for establishing the initial capital base for a pipeline that was in existence at the commencement of the Code.[35]

(ii) Section 8.10 sets out various factors ("**8.10 factors**") that should be considered in establishing an initial capital base.[36] In making a decision in establishing the initial capital base, the Regulator is required by section 8.10 to take the 8.10 factors into account and to give them weight as fundamental elements.[37] This is similar to the approach for taking into account the 2.24 factors.[38]

(iii) Sections 8.10 and 8.11 call for the exercise of judgment, the formation of opinions and other exercises of discretion by the Regulator.[39] The 8.1 objectives, rather than the 2.24 factors, guide the Regulator in the exercise of those discretions.[40] However, where the 8.1 objectives are in conflict and

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27 *Ibid*, para 47.
28 *Ibid*, para 48.
29 *Ibid*, para 73.
30 *Id*.
31 *Ibid*, paras 76, 78, 83 and 84.
32 *Ibid*, paras 85, 136 and 203.
33 *Ibid*, para 223, third bullet point.
34 Refer to part 3 of this Submission for a discussion of other principles that apply to sections 8.10 and 8.11.
35 *Supra* n. 2, para 47.
36 *Ibid*, para 56.
37 *Id*.
38 *Id*.
39 *Ibid*, para 73.
40 *Ibid*, paras 76, 78, 83 and 84.

the Regulator is required to determine (under the last paragraph of section 8.1) the manner in which they can best be reconciled, or which of them should prevail, the Regulator should take into account and be guided by the 2.24 factors as outlined above in relation to the design of a reference tariff.[41] Accordingly, other than in situations of conflict between the 8.1 objectives, the Regulator should not apply the 2.24 factors when assessing whether the requirements of sections 8.10 and 8.11 have been met.

(iv) Therefore, in assessing whether an initial capital base has been established in accordance with the requirements of section 8.10 of the Code, and particularly in assessing whether the initial capital base should fall outside the range of values determined under sections 8.10(a) and (b) and to the extent the Regulator requires guidance in exercising judgments, forming opinions and exercising discretions for the purposes of section 8.10, the Regulator is to be guided by the 8.1 objectives.

(v) Where the 2.24 factors are to be taken into account, it is the duty of the Regulator to take into account and appropriately weight all of the 2.24 factors. In particular, the factors in sections 2.24(d), (e) and (f) should be taken into account and given appropriate weight by the Regulator in addition to, and as a balance to, section 2.24(a) wherever the Regulator proposes to take into account and give weight to section 2.24(a) in reconciling the 8.1 objectives.

2.2 Significance of the objects of the Act and the Hilmer Report

Based on the principles established by the Court, it is clear that the Regulator is to be guided by the 8.10 factors, the 8.1 objectives and (only with very limited potential application) the 2.24 factors in exercising his discretions in establishing an initial capital base.

Without the 2.24 factors, the 8.1 objectives and the 8.10 factors, the Regulator would look to the scope and objects of the *Gas Pipelines Access (Western Australia) Act 1998* (WA) ("**Act**") for guidance.[42]

That, however, does not mean that the objects of the Act are deprived of a role in relation to the interpretation and application of the Code and Act. AlintaGas submits that the role of the objects of the Act, when viewed consistently with the Court's decision, may include, but is not limited to:

- providing guidance to the Regulator in taking into account the "diverse" 2.24 factors whenever they are required to be taken into account;[43] and
- interpreting the true purpose and meaning of sections and terms used in provisions of the Act and Code.[44]

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[41] *Ibid*, paras 85, 136 and 203.
[42] *Ibid*, para 59.
[43] *Ibid*, para 129. For example, also refer to para 133, where the Court discusses sections 2.24(a) and (d) and states: "It is for the Regulator to consider both, having regard to the scope and objects of the Act". [Emphasis added]
[44] *Wacando v Commonwealth* (1981) 37 ALR 317 at 333, per Mason J.

The Court stated that the 2.24 factors "reflect different aspects of the objects of the Act as revealed in the preamble" to the Act. They "reflect in a more precise context, and for the particular purposes of section 2.24, the general objectives of the Act and the Code...".[45] It follows that the objects of the Act provide guidance to the Regulator in relation to the meaning of the Act and, in particular, the 2.24 factors.[46]

In this regard, the Court found that the Act expressly identifies the relevance of the objectives of the Council of Australian Governments' Agreement dated 25 February 1994. The Court recognised that that Agreement had its origins in the "National Competition Policy Review" chaired by Professor Fred Hilmer and the report known as the "Hilmer Report". That heritage and the Hilmer Report are relevant to the task of understanding the objects and principles of the Code[47] and may be used to assist in understanding the meaning of the Code.[48]

It is, therefore, open to the Regulator to obtain guidance from the objects of the Act and the Hilmer Report. It is not intended to discuss the objects of the Act or the Hilmer Report in detail in this Submission, other than to note that:

- the objects of the Act are set out in its preamble and include the enactment of a uniform national framework for third party access that applies to all gas pipelines which —

  (a) facilitates the development and operation of a national market for natural gas;

  (b) prevents abuse of monopoly power;

  (c) promotes a competitive market for natural gas in which customers may choose suppliers, including producers, retailers and traders;

  (d) provides rights of access to natural gas pipelines on conditions that are fair and reasonable for the owners and operators of gas transmission and distribution pipelines and persons wishing to use the services of those pipelines; and

  (e) provides for resolution of disputes; and

- the Court's decision discussed the objects of the Act and provided a "potted history" of the Hilmer Report.[49]

2.3 The Regulator's discretion

As noted above, the Court found that the Regulator's determinations in the Draft Decision of the reference tariff and the ICB for the DBNGP were "affected by errors of law and require reconsideration".[50] Further, the Court stated that it is now for the Regulator - not

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[45] *Supra* n. 2, para 129.
[46] For examples of the Court's reference to the objects of the Act, refer to *ibid*, paras 133, 134, 169 and 177.
[47] See *ibid*, paras 88 to 99.
[48] For examples of the Court's reference to the Hilmer Report in interpreting the Code, refer to *ibid* paras 107, 115, 119 to 122, 130, 143, 144 and 149.
[49] *Ibid*, paras 88 to 99, and para 119.
[50] *Ibid*, para 223.

the Court - to consider and weight the 2.24 factors, 8.1 objectives and 8.10 factors and to exercise the discretions that are committed by the Code to him.[51] The Court provided the following guidance for undertaking this task:

> "....there is...an underlying harmony and consistency in the general policy objectives of the Act stated in the preamble, and s 2.24, s 8.1, s 8.10 and 8.11 of the Code. At every one of these points, however, there is also the tension of potentially conflicting considerations or objectives....the scheme of the Act and Code is to leave this potential conflict which, in part, is between the interests of a service provider in achieving a return on its investment in the pipeline and the interests of users or consumers in achieving a lower price and indeed, perhaps in the achievement in the public interest of greater competitiveness or the effects of competition, to be resolved by the Regulator in accordance with the Act and the Code and the circumstances of each particular case."[52] [Emphasis added]

It is also instructive to note the Court's comments on Epic's detailed grounds of application. The Court stated that:

> "While the grounds of the application are set out at a length and in a detail which provided a useful reference to the nature and breadth of Epic's objections to the draft decision, in a number of respects they, or the submissions in support of them, appeared to invite this Court to consider aspects of the factual merits of Epic's case. Save to the limited extent, and for the purposes, identified in these reasons it is not appropriate to enter into a consideration of the factual merits of Epic's position".[53]

The Regulator must, therefore, reconsider the matters identified in the Draft Decision as being the reasons for requiring amendments to the Access Arrangement, particularly in relation to the determination of the ICB and the determination and design of a reference tariff.

In this regard, it is clear from the Court's decision that establishing or approving a proposed access arrangement involves a "process".[54] Although the process may be a single process (particularly in the context of assessment), it is also clear that, in practical terms, it has a starting point and end point. In so far as an initial capital base and a reference tariff is concerned, that process involves (among other things) the establishment of the initial capital base and ends with consideration of the reference tariff against the 8.1 objectives.[55]

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[51] *Ibid*, paras 187 and 185.
[52] *Ibid*, para 185.
[53] *Ibid*, para 215.
[54] *Ibid*, eg. refer to the Court's observations at paras 58 and 78, and to the language used in para 205.
[55] Refer to *ibid*, para 78, where the character of this process is adverted to by the Court when it states:

> "While this does not require that, in exercising discretions to establish the initial Capital Base, the Regulator must have regard to s 8.1, s 8.6 does suggest that, at the end of the process of which the establishment of the initial Capital Base is part, s 8.1 is the controlling provision rather than s 2.24(a) to (g)." [Emphasis added]

AlintaGas submits that the Court's decision does not require the Regulator to come to different conclusions to those reached in relation to the Draft Decision. The Court made this clear in discussing Epic's purchase price for the DBNGP and the proper role of the 2.24 factors, the 8.1 objectives and the 8.10 factors. It stated that:

> "Whether this will lead to any different outcome is a matter for Epic's further submission, if any, and the Regulator's reassessment and decision."[56]

3. THE INITIAL CAPITAL BASE - SECTIONS 8.10 AND 8.11

3.1 Role of sections 8.10 and 8.11

As discussed above, compliance with the principles in section 8 requires that an initial capital base be established for a covered pipeline. To that end, section 8.10 deals with the establishment of the initial capital base for a covered pipeline that was in existence at the commencement of the Code ("**Existing Pipeline**").[57] It states that when a reference tariff is first proposed for a reference service provided by an Existing Pipeline, the factors set out in sections 8.10(a) to (k) - the 8.10 factors referred to above - should be considered in establishing the initial capital base.

Section 8.11 provides that the initial capital base for an Existing Pipeline normally should not fall outside the range of values determined under paragraphs (a) and (b) of section 8.10.

Consistent with what is stated above, the Regulator is required to take the 8.10 factors into account and to give them weight as fundamental elements in establishing the initial capital base. Further, the Regulator must be guided in the exercise of his discretions under sections 8.10 and 8.11 by the 8.1 objectives.

The task of the Regulator under section 8.10 is "not simply one of valuation". Rather, the 8.10 factors bring into account a number of matters which are not related to the value of a pipeline "in the ordinary sense, and which by their nature require the consideration of disparate issues which may well tend in different directions".[58]

This part of the Submission provides AlintaGas's submissions on the 8.10 factors, the operation of section 8.11 and how the Regulator should weight the 8.10 factors in the context of the Access Arrangement proposed by Epic for the DBNGP. The Submission examines each factor in turn, the relevant provision of the Code, the Court's findings and AlintaGas's views as to how the Regulator should deal with the factor.

3.2 Factor (a) - actual capital cost

(a) The law

Section 8.10(a) states that the Regulator should consider the value that would result from taking the "actual capital cost" of a covered pipeline and subtracting the accumulated depreciation for those assets charged to users (or thought to have been charged to users) prior to the commencement of the Code.

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[56] *Ibid*, para 78.
[57] The DBNGP is an Existing Pipeline.
[58] *Supra* n. 2, para 74. Also refer to para 75.

In its decision, the Court said that section 8.10(a) may be referred to as the "depreciated actual cost" ("**DAC**") methodology. The Court accepted expert evidence which suggested that, for the purposes of this factor, it is usual to take the net book value of the pipeline and depreciate it in line with accounting standards. An allowance is also required to be made for inflation. This is commonly done separately to the establishment of the initial capital base by allowing for inflation in the "rate of return" element of the "cost of service".[59]

(b) **Application of the law**

In the Draft Decision, the Regulator estimated that the DAC methodology value for the DBNGP, based on actual capital expenditure and recovery, was $874.0 million as at 31 December 1999. This value was expressed as approximate because it was based on general assumptions as to, amongst other things, the interest rate underlying annuity charges for capital returns, the timing of capital expenditures and pipeline throughput. Also, calculations of capital recovery excluded amounts relating to some laterals and metering facilities.[60]

At this time, AlintaGas does not see anything in the Court's decision that affects the Regulator's reasoning in relation to the DAC methodology value. Accordingly, the DAC value should remain as $874 million as at 31 December 1999.

3.3 **Factor (b) - depreciated optimised replacement cost**

(a) **The law**

Section 8.10(b) states that the Regulator should consider the value that would result from applying the "depreciated optimised replacement cost" ("**DORC**") methodology in valuing the covered pipeline.

In its decision, the Court stated that, under the DORC methodology, assets are valued at the cost of replacing them or, more accurately, at the cost of replacing the remaining service potential of the asset, not the cost of replacing the asset itself. The Court further held that, as the remaining service potential is to be theoretically replaced, alternative and cheaper methods of replacing that service potential will be applied so that it may be described as a "reproduction cost" rather than a "replacement cost". The Court also accepted that a DORC valuation will usually provide a good proxy for the price that a pipeline would realise had the owner faced workable competition at the time of its sale, and stated that the actual or historic capital investment of the pipeline owner has no relevance under a DORC methodology.[61]

The Court also accepted that expert evidence indicated that it is almost universally the case for gas transmission pipelines that the DORC methodology will produce a higher value than the DAC methodology.[62]

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[59] *Ibid*, para 163.
[60] Draft Decision, Part B: 128.
[61] *Supra* n. 2, para 164.
[62] *Ibid*, para 165.

(b) **Application of the law**

In the Draft Decision, the Regulator estimated a DORC methodology value for the DBNGP of $1,233.7 million as at 31 December 1999. [63] This value was based on the optimised replacement cost and the DORC values calculated in 1997 for the purposes of providing information to prospective purchasers of the DBNGP as to the possible valuation of the DBNGP under the Code.[64] The Regulator did not undertake an independent DORC valuation of the DBNGP.

Although the Court's decision did not call into question the DORC valuation adopted by the Regulator, AlintaGas submits that the Regulator must nevertheless determine a DORC value consistently with the guidance provided by the Court in its decision (as summarised above). Importantly, the Regulator must endeavour to establish the cost of replacing the remaining service potential of the asset, not the cost of replacing the asset itself.

In this regard, AlintaGas submits that the DORC value of $1,233.7 million adopted by the Regulator in the Draft Decision is at the upper limit of the range of values that could be properly calculated under the DORC methodology. AlintaGas has previously raised this with the Regulator and has submitted that an appropriate DORC value is more likely to be in the vicinity of $1,000 million.[65]

AlintaGas submits that there is no justification for a higher value under the DORC methodology than that adopted in the Draft Decision and that there is a strong case for lessening the DORC value below that adopted in the Draft Decision.

3.4 **Factor (c) - other well recognised valuation methodologies**

(a) **The law**

Section 8.10(c) states that the Regulator should consider the value that would result from applying "other well recognised asset valuation methodologies" in valuing the covered pipeline.

In its decision, the Court did not deal in detail with what might constitute an "other well recognised asset valuation methodology". It merely stated that expert evidence confirmed that there are other methodologies (ie other than the DAC and DORC methodologies) and that the Regulator had considered "optimised deprival value", "imputed value" and "purchase price value" methodologies. It also noted that Epic had contended for the use of a purchase price value methodology, and that the Regulator had not rejected the use of such a methodology but had determined that its use was not appropriate for the DBNGP.[66]

The Court also stated that, where a purchase price is advanced as reflecting a market valuation of a pipeline for the purposes of section 8.10(c), factors of the type identified by the Court as relevant to the circumstances of purchase for the

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[63] Supra n. 60, Part B: 134 and 154 - 156.
[64] *Ibid*, Part B: 131.
[65] AlintaGas, *AlintaGas's Third Submission to the Regulator on Epic Energy's DBNGP Access Arrangement*, 17 March 2000, p 15; AlintaGas Sales Pty Ltd, DBNGP Draft Decision: Submission to the Gas Access Regulator, 21 September 2001, p 1.
[66] *Supra* n. 2, para 72.

purposes of section 8.10(j) are equally relevant to the application of section 8.10(c).[67] Those factors require:

- "an examination of the price paid according to the standards of reasonable commercial judgement as to value";
- "the examination of the extent to which that price might have been influenced by considerations such as the prospect of monopoly profits"; and
- "the scrutiny of transactions between related entities or transactions which may involve motivations unrelated to value which might affect the price paid".[68]

In relation to the DBNGP, an application of the purchase price value methodology will require consideration of the nature of the tender process by which the State sold and Epic purchased the DBNGP; of the basis upon which Epic assessed the amount it was prepared to pay to purchase the DBNGP; and of the factors Epic took into account in assessing that amount.[69]

(b) **Application of the law**

As noted above, the Regulator considered the optimised deprival value, imputed value and purchase price value methodologies in the Draft Decision.[70] The Court did not find anything wrong in the Regulator's consideration of those methodologies.

At this time, AlintaGas does not make any comment on the Regulator's reasoning in relation to the optimised deprival value and imputed value methodologies. It does, however, make the following submissions on the application of the purchase price value methodology in light of the Court's decision.

(i) **The Regulator's task in considering a purchase price methodology**

Section 8.10(c) requires that the Regulator consider "well recognised" valuation methodologies. Accordingly, the Regulator is not free to develop or use a purchase price value methodology that is not "well recognised". AlintaGas submits that the Regulator should consider this in establishing the ICB.

In considering the nature of a purchase price value methodology, the Court indicated that it essentially involves determining a value based on the present value of anticipated net revenue from the future operation of the pipeline.[71] Accordingly, the key issue for the Regulator to consider is whether the price of $2,407 million that Epic paid to the State reflects the

[67] *Ibid*, para 173.
[68] *Ibid*, para 172.
[69] *Ibid*, para 173.
[70] *Supra* n. 60, Part B: 135 to 136. The Optimised Deprival Value was estimated as $1,527.9 million and the Imputed Value was estimated as being in the range of $1,200 million to $1,300 million. However, these figures appear to have been relatively untested by the Regulator.
[71] *Supra* n. 2, para 166.

present value of the then anticipated net revenue from the operation of the DBNGP.

As indicated above, this requires the Regulator to examine the circumstances of the sale of the DBNGP to ascertain:

- whether the price of $2,407 million is in accordance with standards of reasonable commercial judgement as to value;
- the extent to which the price of $2,407 million might have been influenced by considerations such as the prospect of obtaining monopoly profits; and
- the nature of the sale process.

In undertaking this task, the Regulator must essentially form a view as to whether the purchase price represented a sound commercial assessment of the DBNGP in the circumstances that prevailed at the time of the purchase, and which were then reasonably anticipated, or reflected the reasonable expectations of the purchaser.[72]

(ii) **The onus is on Epic to establish commercial soundness**

AlintaGas submits that the Regulator must require Epic to establish that the purchase price of $2,407 million reflected, in the sense described above, the value that would arise under a purchase price value methodology. Further, the onus of justifying the purchase price squarely falls on Epic.[73]

If Epic cannot justify that the purchase price represented a sound commercial assessment of the DBNGP in the circumstances that prevailed at the time of the purchase, and which were then reasonably anticipated, or reflected its reasonable expectations, AlintaGas submits that the Regulator may not take that investment into account for the purposes of section 8.10(c).

(iii) **Court's findings on commercial soundness and regulatory compact**

The Court dealt with the issue of the commercial soundness of Epic's purchase price in some detail in its decision.[74] It also addressed the "regulatory compact" argument upon which Epic based many of its arguments in support of the use of the purchase price as the ICB and $1.00/GJ as the reference tariff for its proposed "firm service".

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[72] *Ibid*, para 188.
[73] *Ibid*, para 200.
[74] *Ibid*, paras 188 to 200.

In summary, the Court's findings on these matters were as follows.

- **Commercial soundness**

  The mere fact that the purchase price was paid in a public tender is not determinative of the issue of commercial soundness. Epic may have erred in its assessment of value, had unreasonable expectations, or had reason to pay higher than true market value. It is for Epic to justify to the Regulator that the purchase price represented market value at the relevant time and to establish its reasonable expectations under the previous access regime. The manner in which Epic previously sought to demonstrate that it had paid market value has "shown itself...to be well capable of being misunderstood in more than one material respect....".[75]

- **Regulatory compact**

  Epic's position on the effect of any regulatory compact has not always been clear. However, it appeared to the Court that Epic had not intended to suggest that "there was a legally binding force to the $1 per GJ tariff figure which the Regulator was bound to accept". Rather, Epic's submission, as understood by the Court, was that "the Regulator might properly have regard to the price paid by Epic, and in the circumstances he ought to have reflected it in his establishment of the initial Capital Base".[76]

  The Court did not accept Epic's argument. Importantly, it concluded that material put before the Regulator:

  > "...appears to fall short of establishing the proposition that the State and Epic contracted on the basis, or in the expectation, that the primary Dampier to Perth tariff under the Code would be in the order of $1 per GJ from 1 January 2000. It has not been shown that the Regulator erred in law in failing to accept and act on Epic's submissions in this respect or in failing to give them the relevance and weight for which Epic contended."[77]

  The Court also held that Schedule 39 of the sale contract for the DBNGP had no contractual force for purposes relevant to the determination of a reference tariff under the Code. In this context, the Court stated that Schedule 39:

  > "... was a statement by Epic of what it hoped to achieve under the Code, the risk lying with Epic whether it did so."[78]

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[75] *Ibid*, para 189.
[76] *Ibid*, para 195.
[77] *Ibid*, para 200.
[78] *Ibid*, para 199.

On the "information memorandum" that was issued by the State Government during the tender process for the sale of the DBNGP, the Court held that:

- "on a fair reading...the information memorandum appears to have been directed...to alerting tenderers that the existing tariff levels in 1997 could not be expected to be maintained and, by January 2000 when the introduction of the Code was expected, could well be down to $1 per GJ. It is not apparent that this was a reference to what would occur under the Code, rather than by the anticipated time of the Code's advent";[79]

- "[m]ore fundamentally, it was made clear that a feature of the anticipated Code was that tariff levels were to be fixed by an independent regulator. That fixing of tariff levels would then be out of the government's control";[80] and

- "...there were clear and express disclaimers...and given the anticipated role of an independent regulator it is not apparent that information of the nature indicated as to tariffs at or from 1 January 2000 had any level of assurance or provided a reasonable basis for expectation. Indeed, the range indicated by Price Waterhouse [$0.88/GJ to $0.98/GJ] ought to have made evident that there was uncertainty as to what might be expected under the Code, even were the independent regulator to apply a DORC type valuation."[81]

The Regulator should pay particular attention to the Court's findings on these matters. Accordingly:

- the Regulator should not consider Epic's purchase price as being consistent with a well recognised valuation methodology under section 8.10(c) (or under any other provision of section 8.10), unless Epic can clearly and unequivocally establish that it did not err in its assessment of value, had reasonable expectations and did not have reason to pay higher than true market value;

- it is not open to the Regulator to accept that a regulatory compact existed between Epic and the State unless Epic provides clear evidence (which the information memorandum and public tender process does not provide, and in fact provides or indicates, through a number of provisions, to the contrary) that establishes an "adequate factual foundation"[82] for concluding that it existed and as to the terms of its existence[83];

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[79] *Ibid*, para 196.
[80] *Ibid*, para 198.
[81] *Id.*
[82] *Ibid*, para 196.
[83] AlintaGas notes that, to the best of its knowledge, the State Government has never acknowledged the existence of a regulatory compact between the State Government and Epic.

- it is not open to the Regulator to act on the basis that schedule 39 of the asset sale agreement for the DBNGP has contractual force for purposes relevant to the determination of a reference tariff under the Code;[84] and

- the Regulator must construe the information memorandum as having alerted bidders for the DBNGP that tariffs could well be reduced to $1/GJ by 1 January 2000, that tariffs would be set by an independent regulator under the Code after 1 January 2000, and that there was significant uncertainty as to what might be expected under the Code, even were the independent regulator to apply a DORC type valuation.

(iv) **Court's findings on purchase price - allowance for capital expenditure**

The Court found that the evidence before the Regulator was not capable of supporting the Regulator's view that Epic had not allowed for the capital expenditure necessary to increase the capacity of the DBNGP to accommodate the throughput quantities on which Epic's forecasts were based.[85] The Court identified this aspect of the Draft Decision as the "primary reason" for the Regulator's decision "not to accept that the price paid by Epic for the DBNGP represented a reasonable market valuation...".[86]

In making this finding, the Court stated that Epic had expressly put the position that it had accommodated the necessary capital expenditure and that the Regulator may have:

> "understood wrongly that illustrative asset valuation sheets, prepared by KPMG Consulting and submitted by Epic, recorded actual figures whereas very explicitly they were merely 'very simple versions' of financial models and were offered to illustrate methodology."[87]

In light of the Court's findings on this matter, AlintaGas makes the following comments.

- The Court's decision does not affect the validity of the issue raised by the Regulator. It only establishes that the Regulator came to a factual conclusion without sufficient evidence.

[84] *Supra* n. 2, para 199.
[85] *Ibid*, para 209.
[86] *Ibid*, para 211.
[87] *Ibid*, para 210.

- The issue raised by the Regulator remains. Is the purchase price consistent with the value under a well recognised purchase price value methodology? In particular, was allowance made for the capital expenditure necessary to accommodate the forecast throughput quantities?

- The Regulator must undertake further examination of this question and actively seek further information. Epic's assertions of having made appropriate provision for capital expenditure are insufficient for this purpose and, based on the Court's decision, so are the illustrative KPMG Consulting models previously provided by Epic.

- In undertaking his examination, it is essential that the Regulator has access to all, rather than just some, of the relevant information.

(v) **Supplementary observations regarding Epic's purchase price**

In AlintaGas's view, there is a significant question about whether Epic "paid too much" for the DBNGP, in the sense that it may have paid more than a sound commercial assessment of the DBNGP in the circumstances that prevailed at the time of the purchase, and which were then reasonably anticipated, or reflected the reasonable expectations of the purchaser, would have suggested that it should pay. AlintaGas believes that a number of factors indicate that there are compelling reasons to raise the issue for the consideration of the Regulator.

The factors that raise the issue of whether Epic may have paid too much for the DBNGP are as follows.

(A) **Erroneous assumptions by Epic regarding the DBNGP sale process**

The findings of the Court (as outlined above) in relation to the commercial soundness of the purchase price and the regulatory compact argument, especially the findings regarding the information memorandum[88], indicate that Epic erred in its assessment of the value of the DBNGP or had unreasonable or mistaken expectations, particularly in relation to the circumstances surrounding the sale of the DBNGP.

(B) **Significant excess of purchase price over historic and previous regulatory values**

The material extent to which the purchase price exceeded the historic value of the DBNGP and the regulatory value of the DBNGP under the previous access regime raises the question of whether Epic erred in its assessment of the value of the DBNGP or had unreasonable expectations. Prior to the sale, there was an

[88] That it only alerted bidders for the DBNGP that tariffs could well be down to $1/GJ by 1 January 2000, that tariffs would be set by an independent regulator after 1 January 2000, and that there was significant uncertainty as to what might be expected under the Code, even were the independent regulator to apply a DORC type valuation.

established capital base for the DBNGP which had been utilised for the purposes of tariff calculations for the third party pricing regimes which preceded the Act and the Code. This capital base effectively represented the historic cost of the DBNGP.

(C) **Incorrect or unreasonable business assumptions**

Based on publicly available information, it appears that Epic may have relied upon incorrect or unreasonable business assumptions in valuing the DBNGP, which therefore inflated its perception of the pipeline's underlying value. For example:

- It appears that Epic assumed that future tariffs would be $1/GJ to Perth and $1.08/GJ downstream of Kwinana junction indefinitely, rather than transitional tariffs pending the introduction of tariffs determined according to the principles of the Code. Epic apparently used these erroneous (or at least highly optimistic) assumptions about future tariffs from which to derive a purchase price which, in turn, it has sought to convert to the ICB.

- By its own admission, Epic had highly optimistic assumptions about future volume growth. Epic has publicly acknowledged[89] that these were mistaken assumptions.

(D) **Significant excess of purchase price over indicative valuation provided by the State at the time of the sale of the DBNGP**

As established by the Court, a DORC methodology valuation was provided by the State Government to all bidders for the DBNGP at the time of the sale. Even though that valuation was not, and is not, determinative, it provided an indication of what the State Government, through its expert advisers, anticipated might be the DBNGP's regulatory value under the Code. The fact that Epic paid considerably more than that valuation raises the question of whether it erred in its assessment of value, had unreasonable expectations, or had reason to pay higher than true market value. In AlintaGas's view, a response which argues that the State Government's DORC valuation was of no significance because it was not prepared taking into account other interests, such as the service provider's legitimate business interests and investment, cannot be sustained. Such an argument effectively asserts that a regulatory value under the Code could never have been estimated for the DBNGP for the purpose of calculating a sale or purchase price because the sale or purchase price determines the regulatory value - despite the abundance of other factors to be taken into account and weighted as fundamental elements under sections 8.10 and 8.11 of the Code.

[89] Epic Energy, *Fact Sheet*, p 3.

Ultimately, however, the State Government's DORC valuation provided a reasonable and independent estimate of the value of the DBNGP under the Code, and raises the question of why a bidder would have reasonably paid approximately $1,000 million in excess of it. Indeed, the fact that Epic's purchase price substantially exceeds the amount of any reasonably calculated DORC value (including Epic's own DORC valuation) raises the same question. AlintaGas notes that the State Government's DORC valuation was of the same order of magnitude as the Regulator's DORC valuation (as discussed in section 3.3(b) above).

AlintaGas submits that the Regulator should endeavour to estimate the effect of these matters on the purchase price that Epic paid for the DBNGP so that the Regulator can assess what a commercially sound purchase price valuation of the DBNGP would have been at the time of the sale of the DBNGP and in the circumstances that then prevailed.

AlintaGas believes that it would be extremely difficult for the Regulator to reasonably determine that the purchase price represented a sound commercial assessment of the value of the DBNGP in the circumstances that prevailed at the time of the purchase, and which were then reasonably anticipated or reflected the reasonable expectations of the purchaser. AlintaGas submits that the Regulator must conclude that the purchase price of $2,407 million is not consistent with a valuation carried out consistently with a well recognised purchase price value methodology. The purchase price is, accordingly, irrelevant in the Regulator's task of taking into account the section 8.10(c) factor or, indeed, any of the 8.10 factors.

3.5 Factor (d) - disadvantages and advantages of valuation methodologies

(a) The law

Section 8.10(d) states that the Regulator should consider the advantages and disadvantages of each valuation methodology applied under paragraphs (a), (b) and (c) of section 8.10. The Court did not deal at length with the law concerning section 8.10(d) generally.

(b) Application of the law

In the Draft Decision, the Regulator discussed the advantages and disadvantages of each valuation methodology discussed under sections 8.10(a) to (c).[90]

At this time, AlintaGas submits that there are three relevant matters in relation to the effect of the Court decision on the Regulator's reasoning on section 8.10(d) and on section 8.10(d) itself. They concern the Court's findings in relation to the Regulator's function under section 8.10(d), the Court's findings on allowances for capital expenditure and the advantages of a DORC valuation methodology and disadvantages of a purchase price value methodology.

[90] *Supra* n. 60, Part B:137 - 145.

(i) **Court's findings on the Regulator's function under section 8.10(d)**

In its decision, the Court found that the Regulator appeared to have misunderstood his function under section 8.10(d) in that he incorrectly took it as requiring that he was to establish the value of the DBNGP on the assumption that it was subject to the Code, a feature of which was that it only allowed recovery of "efficient" capital investment and "regulated revenues".[91] It stated that:

> "The Regulator appears to be allowing an assumed narrow outcome of the statutory scheme to affect the relevance and weight to be attached to factors which the statutory scheme requires to be considered as part of the process of reaching an outcome."[92]

The Court concluded that this was a significant misapprehension of the Regulator's statutory function.[93]

The reasons set out in the Draft Decision must be disregarded to the extent that they conflict with the Court's finding. The Regulator must interpret and apply section 8.10(d) as it is stated and on the basis that it does not only allow the recovery of efficient investment and regulated revenues. As such, section 8.10(d) does not operate as a cap on the value of the initial capital base. However, if other factors require the Regulator to take into account economic objectives, those factors should be also taken into account. The Court did not find that such economic objectives were inappropriate, or irrelevant; just that they were not a limit on the final outcome.

In saying this, AlintaGas submits that much of the Regulator's discussion on the merits of different valuation methodologies does not appear to be affected by the Court's decision in this regard. Subject to any inconsistencies with what is stated below, AlintaGas agrees with that discussion to the extent that it is consistent with the Court's decision.

(ii) **Court's findings on purchase price - allowance for capital expenditure**

As noted above in relation to section 8.10(c), the Court concluded that the Regulator made an error of law in coming to the view that Epic had not allowed for the capital expenditure necessary to increase the capacity of the DBNGP to accommodate the throughput quantities on which Epic's forecasts were based. The Court indicated that the error was also material to the Regulator's evaluation of section 8.10(d).[94] AlintaGas's comments in relation to this matter in the context of section 8.10(c) also apply to the Court's finding in relation to this section.

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[91] *Supra* n. 2, para 205.
[92] *Ibid*, para 206.
[93] *Ibid*, para 207.
[94] *Ibid*, para 211.

(iii) **Supplementary comments - advantages and disadvantages**

In addition to the Regulator's discussion in the Draft Decision regarding the advantages and disadvantages of the different, well recognised valuation methodologies, AlintaGas makes the following supplementary comments.

(A) **Economic advantages of a DORC valuation methodology**

There are substantial advantages associated with a DORC valuation methodology. While many were touched on in the Draft Decision, AlintaGas also draws the Regulator's attention to the testimony and written statement of AlintaGas's expert witness in the legal proceedings, Dr Henry Ergas. Dr Ergas's statement sets out in clear terms the advantages of using a DORC valuation methodology from an economic perspective.

One of the key advantages is that there are sound economic reasons for using a DORC methodology in the context of infrastructure regulation. As discussed below, one of the 8.1 objectives is that a reference tariff should be designed with a view to achieving the objective of replicating the outcome of a competitive market. In basic terms, from an economic perspective a DORC valuation provides the best method for determining the value that would arise in a competitive market. This feature is an important advantage of a DORC valuation methodology and is, AlintaGas submits, a primary reason as to why regulators of infrastructure have a demonstrated preference for using it.

(B) **DORC valuation methodology and regulatory consistency**

A further advantage of using a DORC valuation methodology is that doing so is generally consistent with the approach taken by other regulators. Aside from the DBNGP, an examination of the various initial capital bases set by regulators in Australia reveals very few cases where the regulator has set an initial capital base in excess of the DORC value for the pipeline and none where there is a significant margin - certainly nothing approaching the 200%+ envisaged by Epic. The table below compares the initial capital base to the DORC value for a range of Australian pipelines. AlintaGas submits that this range reflects an appropriate application of the Code.

Pipeline	Initial capital base as % of DORC
Multinet	100
Westar	92.1
Stratus	96.2
Vencorp	100
Great Southern Energy	82.4
Albury, Jindera	94.1
Marsden-Dubbo[95]	111
Parmelia[96]	55
AlintaGas	75
Unweighted average	*89.5*

Source: Regulators (ACCC, ESC, IPART and OffGAR)

(C) **Purchase price value methodology - the "winner's curse"**

There is a well established branch of economic theory that examines auction processes. That branch of theory demonstrates that a frequent result of "first price, sealed bid auctions" (which was the method used for the sale of the DBNGP) is that the successful bidder will usually "pay too much". This is known as the the "winner's curse". For that reason, economic theory throws doubt upon the use of the highest (and usually successful) price in a first price, sealed bid auction.

The use of a value derived from a first price, sealed bid auction suffers from the disadvantage that it is not, from an economic perspective, reflective of an efficient value. In short, it suffers from the winner's curse. AlintaGas draws the issue of the winner's curse to the Regulator's attention as a disadvantage of the use of a purchase price value methodology. It is one of a number of advantages and disadvantages of valuation methodologies that the Regulator should take into account for the purposes of section 8.10(d).

[95] This asset – unusually for gas pipelines - had a DAC value higher than DORC so the 111% of DORC equated to a DAC valuation plus minor ($0.2 million) allowances for: differences in construction capitalisation costs between the ACCC and the pipeline owner; the fact that the pipeline was very close (it missed out by 10 days) to being considered a new, rather than existing, pipeline; and the use of optimised rather than non-optimised valuation methods. ACCC, *Marsden to Dubbo (Central West) Pipeline: Final Decision, June 2000*, p 63.
[96] Coverage since revoked.

(D) **Purchase price value methodology - "regulatory premiums"**

There is a further disadvantage associated with the use of a purchase price value methodology for the purposes of establishing a regulated asset base, even if the purchase price represents a sound commercial assessment in line with the criteria specified by the Court.

The disadvantage is that equity markets typically value regulated infrastructure assets (and, therefore, determine purchase prices) at a 50% premium to the actual or anticipated regulatory value of those assets. That occurs because investors perceive the underlying value of the asset to be considerably in excess of that which is or is likely to be set by a regulator due to factors such as perceived strategic benefits, growth potential and assumptions as to efficiency potential.

The following table demonstrates the premiums on regulated asset values for a range of regulated businesses:

Business	**Ratio of enterprise value to regulated value**
United Energy	1.53
Australian Pipeline Trust	1.48
Envestra	1.43
GasNet	1.55
Weighted average	*1.48*

Source: JP Morgan Securities Australia Equity Research, September 2002

It follows that the business value of an asset (ie the perceived value of the asset to an actual or prospective owner) is usually significantly greater than the actual or anticipated regulated asset base. As owners typically factor this into their purchase prices for assets, a disadvantage of using a purchase price value methodology is that there is a real risk of allowing the owner to recover this regulatory premium via regulated tariffs. From an economic perspective, such a result would be inefficient and may provide a "wind-fall gain" to the asset owner. AlintaGas, therefore, submits that in any decision to apply Epic's purchase price as the ICB (and AlintaGas reiterates that this would not be appropriate) the Regulator must discount the value properly assessed to be the commercially prudent purchase price to take account of the regulatory premium.

3.6 Factor (e) - international best practice

(a) The law

Section 8.10(e) states that the Regulator should consider the "international best practice of Pipelines in comparable situations and the impact on the international competitiveness of energy consuming industries".

The Court's decision did not deal with this factor in any detail, other than to say that the Regulator had dealt with the first limb on the basis that it required consideration of the international best practice in pipeline valuation and that no submission had been made as to any error.[97]

(b) Application of the law

The Regulator discussed section 8.10(e) in the Draft Decision and concluded that there was not any established or generally accepted international best practice that could be applied to the DBNGP. The Regulator did, however, indicate that there is precedent for not valuing in excess of a DORC value and for considering values at less than a DORC value. He specifically rejected the idea that there was precedent for the use of a purchase price value methodology where the cost of purchase is well in excess of an estimated DORC value.[98]

At this time, AlintaGas does not believe that anything in the Court's decision disturbs the Regulator's findings. However, in support of the Draft Decision, AlintaGas submits that the problem of the winner's curse is internationally well understood and that establishment of an ICB at or below a DORC valuation would be consistent with international best practice.

3.7 Factor (f) - basis for past tariffs, economic depreciation and historical returns

(a) The law

Section 8.10(f) states that the Regulator should consider the basis on which tariffs have been (or appear to have been) set in the past, the economic depreciation of the covered pipeline and the historical returns to the service provider from the covered pipeline.

In its decision, the Court observed that, without undertaking an exhaustive analysis of the factor, each of the considerations raised by section 8.10(f) has a potential relevance to past investment decisions, particularly in a case where there has been a sale of a pipeline before the commencement of the Code.[99]

The Court also stated that section 8.10(f), along with section 8.10(g), "may be seen to reflect that part of the general objective of the Act and Code that rights of access to third parties would be on conditions that are fair and reasonable for owners and operators of pipelines". It is also consistent with the more precise expression of that objective in section 2.24(a). Further, the existence of section 8.10(f) appears to

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[97] *Supra* n. 2, para 168.
[98] *Supra* n. 60, Part B: 147.
[99] *Supra* n. 2, para 169.

preclude the view that the Code is concerned only with "forward-looking" considerations in respect of the establishment of an initial capital base.[100]

(b) **Application of the law**

The Regulator addressed this factor in the Draft Decision in fairly short terms by referring to his analysis in relation to the DAC valuation methodology under section 8.10(a).[101]

At this time, AlintaGas does not believe that the Court's decision affects or calls into question the reasoning in the Draft Decision in relation to section 8.10(f). The Court's discussion of this matter was limited to using it to support the Court's view that past investment decisions were intended to be considered under the Code, consistently with the need to structure fair and reasonable conditions for service providers.

Having said that, AlintaGas submits that the Court's decision is not and was not intended to be an exhaustive statement of the matters with which section 8.10(f) is concerned. It does not detract from the fact that the plain wording of the provision requires the Regulator to consider the basis for setting past tariffs, economic depreciation and historical returns to the service provider.

Further, the Court's decision should not be taken as indicating that section 8.10(f) is only concerned with the those parts of the general objective of the Act and Code that are concerned with conditions that are fair and reasonable or the objective in section 2.24(a). The provision is also concerned with those parts of the general objective and section 2.24 that supply as objectives things such as the interests of users and prospective users and the public interest, including the public interest in having competition in markets. In addition, it is clear from the very wording of the preamble to the Act that the object of fair and reasonable terms and conditions means not only fair and reasonable for a service provider, but also fair and reasonable for users.

The Regulator should construe the provision accordingly. In doing so, he should have regard to the fact that, prior to the sale of the DBNGP, there was an established capital base for the DBNGP, which had been utilised for the purpose of calculating tariffs for previously applying third party access pricing regimes for the DBNGP and which effectively represented the historic cost of the DBNGP. AlintaGas submits that the Regulator should identify, quantify and consider these matters with a view to ascertaining the past basis for valuing and pricing on the DBNGP, which is useful as an indicator of established arrangements for the owner and users of the DBNGP, and to obtain an appreciation of the extent to which the value of the DBNGP has already been recovered by its owners.

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[100] *Ibid*, para 169.
[101] *Supra* n. 60, Part B: 148.

3.8 Factor (g) - reasonable expectations

(a) The law

Section 8.10(g) states that the Regulator should consider the "reasonable expectations of persons under the regulatory regime that applied to the Pipeline prior to the commencement of the Code".

In its decision, the Court said that the provision appears to include users as well as service providers. In considering the reasonable expectations of a service provider, the Court observed that it is the expectations under the regime that applied before the commencement of the Code that are material. If the previous regime was more favourable than the Code, the reasonable expectations of the service provider would be, relevantly, for a more favourable return on the investment of the service provider in the pipeline.[102]

The Court also stated that section 8.10(g), along with section 8.10(f), "may be seen to reflect that part of the general objective of the Act and Code that rights of access to third parties would be on conditions that are fair and reasonable for owners and operators of pipelines". It is also consistent with the more precise expression of that objective in section 2.24(a). The existence of section 8.10(g) appears to preclude the view that the Code is concerned only with "forward-looking" considerations in respect of the establishment of an initial capital base.[103]

(b) Application of the law

The Regulator addressed section 8.10(g) in the Draft Decision on the basis that he was required to consider the expectations that a person may reasonably hold as to the value of tariffs and the value of pipeline assets "if those expectations were based solely on an assumption of the previous regulatory regime continuing into the future". On that basis, the Regulator reasoned that, under the previous regulatory regime, tariffs would have been set on the basis of an asset valuation resembling a DAC value, which he estimated would have been $1,270 million.[104]

AlintaGas submits that both the owner of the DBNGP and users would reasonably have had expectations, had the previous regime continued, for the DBNGP to be valued consistently with the rules under that regime. On that basis, for the purposes of the Court's decision, AlintaGas submits that Epic had no reasonable ground for having an expectation that it would would have been able to recover more than, to use the Regulator's figure, $1,270 million if the previous regime had continued - despite the fact that it paid $2,407 million. Users also had the same basis for expecting that Epic would recover no more than $1,270 million.

It is also clear, based on the Court's findings on the statements made in the information memorandum at the time of the sale of the DBNGP and on the *Dampier to Bunbury Pipeline Regulations* 1998 (WA) (as discussed above in relation

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[102] *Supra* n. 2, para 169.
[103] *Ibid*, para 169.
[104] *Supra* n. 60, Part B:148 - 150. This value was determined by the Regulator as the value that would have arisen under the previous regime had it continued. It exceeds the DAC value calculated for the purposes of section 8.10(a). AlintaGas notes that this value is consistent with the range of values contemplated by section 8.11.

to section 8.10(c)), that an owner of the DBNGP could only have reasonably formed the expectation that tariffs for the DBNGP would decrease to $1/GJ by 1 January 2000 and that they were likely to decrease beyond that following 1 January 2000. That was certainly the expectation of AlintaGas and, so far as AlintaGas is able to discern, of other major users of the DBNGP.

In addition, Alinta submits that the Court's reasoning in relation to section 8.10(g) makes it clear that, if the previous regime was more favourable to users than the Code, then the reasonable expectations of users would be, relevantly, for more favourable tariffs for use of the DBNGP.

As such, there is no reasonable basis upon which the Regulator could conclude that the reasonable expectations of Epic would have been for a "more favourable return on the investment of the service provider in the pipeline".

AlintaGas's submissions in relation to section 8.10(f) about the Court's discussion of section 8.10(f) and (g) supporting the view that past investment decisions were intended to be considered under the Code also apply here.

3.9 Factor (h) - impact on economically efficient utilisation of gas resources

(a) The law

Section 8.10(h) states that the Regulator should consider the "impact on the economically efficient utilisation of gas resources". In its decision, the Court said that this contemplates the principles of economic efficiency and does so "in the broader context of the utilisation of gas resources, rather than the more limited focus on the operation of a natural gas pipeline".[105]

(b) Application of the law

The Regulator's discussion of section 8.10(h) in the Draft Decision[106] appears to be unaffected by the Court's decision. The discussion takes into account the "broader context of the utilisation of gas resources" cited by the Court.

In relation to this factor, it is appropriate to recognise that Western Australia is relatively well placed in comparison to elsewhere in Australia because it enjoys abundant supplies of gas from competing suppliers. While there are limited supplies of gas in the Perth basin, the majority of Western Australia's gas is located on the North West Shelf. As such, gas use in Perth is overwhelmingly dependent on the DBNGP.

DBNGP tariffs are a significant determinant of the cost of delivered gas to the south west of the State. Given that it is the full price of delivered gas that is significant to energy users, AlintaGas submits that a decision which "over values" the DBNGP (ie values it above economically efficient levels) and, hence, raises the reference tariff to accommodate that over-valuation, will have a negative impact on the competitiveness of gas as against other fuels. By making gas less competitive, other fuels will be used in preference, meaning that Western

[105] *Supra* n. 2, para 170.
[106] *Supra* n. 60, Part B: 150 to 151.

Australia's gas resources are used at sub-optimal efficiency. In an energy intensive economy such as Western Australia's, this will have a negative impact on the economically efficient utilisation of gas resources and an adverse effect on the wider economy.

3.10 Factor (i) - cost structure comparability

(a) The law

Section 8.10(i) states that the Regulator should consider "comparability with the cost structure of new Pipelines that may compete with the Pipeline in question (for example, a Pipeline that may by-pass some or all of the Pipeline in question)".

The Court held that no issue had been raised in the legal proceedings in relation to this factor, but noted that it had some consistency with the theory of economic efficiency.[107]

(b) Application of the law

The Regulator addressed section 8.10(i) in the Draft Decision by discussing its economic rationale and the need to avoid inefficient duplication of pipeline assets. At this time, AlintaGas does not believe that the Court's decision affects the substance of that discussion.[108]

AlintaGas makes the following additional comments in relation to this factor.

- While gas markets in the south west of the State are also served by the Parmelia Pipeline, the disparity in capacity between that pipeline and the DBNGP (65 TJ/d as opposed to 595 TJ/d) means that, at present, there is little effective inter-pipeline competition.

- The prospect of a second pipeline from the north west to the south west of the State has been raised and the DBNGP corridor created under the *Dampier to Bunbury Pipeline Act* 1997 (WA) can accommodate a second pipeline, with some expansion in some sections. While a second pipeline would allow direct competition, it would only produce a net economic benefit if it is the most efficient way of delivering gas. The key characteristic of natural monopoly infrastructure is that one facility can meet market demand more efficiently than two. Replicating *natural monopolies* is, therefore, inefficient and should be discouraged as a less efficient use of resources. This is a central thrust of the Hilmer Report, and is one of the foundation stones of the Code. Achieving third party access to a monopoly asset on terms, conditions and prices which are fair to owners and users will lead to a better economic outcome for society than building a competing pipeline. A competing pipeline will put competitive pressure on tariffs, but that outcome can be significantly replicated by setting economically efficient prices under the Code for an existing pipeline.

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[107] *Supra* n. 2, para 170.
[108] *Supra* n. 60, Part B: 151.

- An asset valuation is required that does not promote inefficient duplication while at the same time allowing for future construction as and when economic conditions support it as an economically efficient outcome.

- Inefficient construction of a competing pipeline will be spurred by "over-valuation". Higher reference tariffs caused by over-valuation will mean that a second pipeline may offer the prospect of lower prices. This will not be the case if the DBNGP is appropriately valued.

- AlintaGas submits that the appropriate valuation to deter inefficient construction of a second pipeline is a DORC value. This is because the DORC value explicitly incorporates the optimised replacement cost – that is, the figure at which the service could be replicated today. Thus, if a DORC value is used, the price signals of the resulting reference tariffs will not be so high as to encourage development of a second pipeline with cheaper tariffs.

3.11 **Factor (j) - price paid for any asset recently purchased**

(a) **The law**

Section 8.10(j) states that the Regulator should consider "the price paid for any asset recently purchased by the service provider and the circumstances of that purchase".

In its decision, the Court held that the term "asset" extends to a complete pipeline.[109] Accordingly, section 8.10(j) requires the Regulator to consider the price paid for, among other things, a complete pipeline system and the circumstances of that purchase.

The Court also held that what must be considered is the price paid (in the case of the DBNGP, $2,407 million) and, "significantly", the circumstances of the purchase. This requires:

- "an examination of the price paid according to the standards of reasonable commercial judgement as to value";

- "the examination of the extent to which that price might have been influenced by considerations such as the prospect of monopoly profits"; and

- "the scrutiny of transactions between related entities or transactions which may involve motivations unrelated to value which might affect the price paid".[110]

In the particular context of Epic's acquisition of the DBNGP, the Court stated that:

- the acquisition, which occurred in March 1998, was made "recently" for the purposes of section 8.10(j);[111] and

[109] *Supra* n. 2, para 171.
[110] *Ibid*, para 172.

- "the nature of the tender process by which the State sold and Epic purchased the DBNGP might be circumstances which might properly be considered under 8.10(j)".[112]

(b) **Application of the law**

The Regulator dealt with the price paid by Epic for the DBNGP in some detail in the Draft Decision.[113] AlintaGas makes the following comments in relation to the application of the Court's findings to the reasoning set out in the Draft Decision.

(i) **Relevance to the purchase of the DBNGP**

In line with the Court's decision, section 8.10(j) requires the Regulator to consider the price that Epic paid for the DBNGP when it acquired the pipeline in March 1998.

(ii) **The Regulator's task in considering the price paid**

It is clear from the Court's decision, that the Regulator is required to consider the price that Epic paid of $2,407 million and the circumstances of the sale. AlintaGas submits that, consistent with the Court's decision, this consideration includes:

- an examination of the price paid according to the standards of reasonable commercial judgement as to value;
- an examination of the extent to which that price might have been influenced by considerations "such as the prospect of monopoly profits";
- the scrutiny of transactions between related entities or transactions which may involve motivations unrelated to value which might affect the price paid; and
- an examination of the nature of the tender process by which the State sold and Epic purchased the DBNGP.

(iii) **The onus is on Epic to establish commercial soundness**

AlintaGas submits that the Regulator must require Epic to establish the commercial soundness, in the sense outlined above, of the purchase price of $2,407 million. The onus of doing so squarely falls on Epic.[114]

If Epic cannot justify that the purchase price represented a sound commercial assessment of the DBNGP in the circumstances that prevailed at the time of the purchase, and which were then reasonably anticipated, or reflected its reasonable expectations, the Regulator may not take that

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111 *Ibid*, para 171.
112 *Ibid*, para 173.
113 *Supra* n. 60, Part B: 151 to 154.
114 *Supra* n. 2, para 200.

investment into account for the purposes of section 8.10(j). AlintaGas also submits that, if Epic cannot justify the soundness of its commercial assessment, the purchase price cannot be taken into account under any of the 8.10 factors, as explained below.

(iv) **The submissions in relation to section 8.10(c) also apply here**

There is an obvious relationship between the task that the Court indicated that the Regulator should undertake in relation to section 8.10(c) and this provision, section 8.10(j). To that end, the submissions that AlintaGas made under the following headings in this Submission in relation to section 8.10(c) are repeated *mutatis mutandis*[115] in respect of section 8.10(j):

- 3.4(b)(iii) – Court's findings on commercial soundness and regulatory compact;
- 3.4(b)(iv) – Court's findings on purchase price - allowance for capital expenditure;[116] and
- 3.4(b)(v) - Supplementary observations regarding Epic's purchase price.

(v) **Court's findings on Regulator's function under section 8.10(j)**

As discussed above, the Court found that the Regulator appeared to have misunderstood his function under section 8.10(d) in that he incorrectly took it as requiring that he was to establish the ICB on the assumption that it was subject to the Code, a feature of which was that it only allowed recovery of "efficient" capital investment and "regulated revenues".[117] The Court concluded that this was a significant misapprehension of the Regulator's statutory function[118] and that the error also occurred in relation to the Regulator's consideration of section 8.10(j).[119]

AlintaGas's submissions above in relation to section 8.1(d) under the heading "Court's findings on the Regulator's function under section 8.10(d)"[120] also apply *mutatis mutandis* in relation to section 8.10(j).

3.12 **Factor (k) - other factors the Regulator considers relevant**

(a) **The law**

Section 8.10(k) states that the Regulator should consider any other factors the Regulator considers relevant. In its decision, the Court noted that the Regulator did not identify any other relevant factors.[121]

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115 That is, the necessary changes being made.
116 The Court stated that the error concerning section 8.10(c) that is discussed under this heading had also been material to the Regulator's discussion of section 8.10(j): see *ibid*, para 211.
117 *Ibid*, para 205.
118 *Ibid*, para 207.
119 *Ibid*, para 204.
120 Set out in part 3.5(b)(i) of this Submission.
121 *Supra* n. 2, para 174.

(b) **Application of the law**

AlintaGas is not aware of any relevant issues that should be considered in relation to this section.

3.13 **The role of section 8.11**

(a) **The law**

In analysing the 8.10 factors the Regulator must have regard to section 8.11, which provides that the initial capital base for an Existing Pipeline normally should not fall outside the range of values determined under paragraphs (a) and (b) of section 8.10 (ie the DAC and DORC values).

Based on the Court's decision, section 8.11 does not operate as an overriding limit or "kerb" on the operation of section 8.10. Section 8.11 does not legislate an overriding intention to achieve an outcome for an initial capital base that is consistent with the principles of economic efficiency and a competitive market.[122]

Rather, section 8.11 is "to be read for what it says, rather than seeking by implication to read much more into it".[123] It appears that, in the Court's view, section 8.11 effectively does no more than state, consistently with the nature of the DAC and DORC methodologies, that the value of an Existing Pipeline would normally fall within the range of values suggested by the DAC and DORC methodologies.[124]

The Court further stated that the acquisition of a pipeline on the open market before the commencement of the Code "may" be a circumstance that:

> "takes the application of section 8.10 outside of what is normal within the meaning of section 8.11, because a sale at market value may well involve the capitalisation of monopoly returns".[125]

The Court stated that, even though economics may not recognise such a consideration as relevant, a sale in such circumstances introduces for consideration the additional factor of the legitimate business interests and investment of the service provider. Further, such an investment has social, political and public interest dimensions that the Act and Code seek to accommodate.[126]

According to the Court, it is not apparent from the terms of the Act and the Code (and, thereby, section 8.11) that the intention is, automatically and necessarily, to

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122 *Ibid*, paras 175 to 179.
123 *Ibid*, para 178.
124 *Ibid*, para 178. The Court's ruling here appears to be that section 8.11 is merely declaratory. It merely declares what is normally the case (ie. a pipeline's value would normally fall between DAC and DORC). The use of the word "would" is an interesting gloss on section 8.11, which does not use it. Rather, section 8.11 states that the initial capital base "normally should not" be outside the DAC to DORC range of values, suggesting that the provision is directive rather than merely declaratory of a usual state of affairs. It is also interesting as to why Parliament would have intended to include a provision which does nothing more than say what the usual case will be.
125 *Ibid*, para 178.
126 *Id.*

preclude consideration of a service provider's investment in a pipeline under the Code:

> "[a]t least in cases where [the investment] 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..."[127]

Accordingly, it is apparent that such a purchase *might* (subject to it being established as consistent with a sound commercial value) constitute a circumstance that takes the determination of an initial capital base under section 8.10 outside the range of values suggested by the DAC and DORC methodologies. Whether it does or not will depend on a number of factors.

(b) **Application of the law**

The Regulator considered the role of section 8.11 in the Draft Decision[128] and concluded that he did not consider there to be any reason to value the ICB outside the range of values contemplated by section 8.11.

Based on the Court's decision, AlintaGas submits that the Regulator should consider the following matters in relation to section 8.11.

(i) **Not an overriding limit**

First, the Regulator should not read section 8.11 as requiring that the ICB be consistent with the principles of economic efficiency and a competitive market. Rather, it should be read as stating that normally an initial capital base would fall between the range of value produced by applying the DAC and DORC valuation methodologies.

(ii) **The acquisition may take the DBNGP outside the section 8.11 range**

Second, the sale of the DBNGP occurred on the "open market" before the commencement of the Code. As such, Epic's acquisition of the DBNGP at $2,407 million may be a circumstance that takes the value of the ICB outside the range of values suggested by section 8.11 (ie the DAC value of $874 million and DORC value of $1,234 million).

(iii) **The acquisition must be commercially sound**

Third, consistently with its findings in relation to sections 8.10(c) and (j), as noted above, the Court's comments in relation to such an acquisition taking the ICB outside the range of DAC and DORC are limited to cases where an investment in a pipeline:

- occurred before the Code applied in the course of an arm's length transaction; and

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[127] *Id.*

[128] *Supra* n. 60, Part B: 95, 103 - 113 and 154.

- was based on a sound commercial assessment of the value of the pipeline in the circumstances then prevailing and anticipated.

Accordingly, as with the application of sections 8.10(c) and (j), the Regulator must be satisfied that the purchase price paid by Epic for the DBNGP was based on a sound commercial assessment of the value of the pipeline. The onus of establishing that falls on Epic.

There is an obvious relationship between this finding and the Court's findings in relation to section 8.10(c) and section 8.10(j). To that end, the submissions that AlintaGas made under the following headings in this Submission in relation to section 8.10(c) are repeated *mutatis mutandis* in respect of section 8.11:

- 3.4(b)(iii) - Court's findings on commercial soundness and regulatory compact;
- 3.4(b)(iv) - Court's findings on purchase price - allowance for capital expenditure;[129] and
- 3.4(b)(v) - Supplementary observations on Epic's purchase price.

(iv) **Whether the ICB is taken outside the section 8.11 range is discretionary**

Fourth, it is clear that even if the purchase price of the DBNGP was one that was commercially sound in the sense discussed above, it is for the Regulator to determine - under the Code and consistently with the Court's decision - whether or not to establish the ICB outside the range of DAC and DORC. Nothing in the Court's decision requires him to do so; it merely makes it clear that he is not precluded from doing so by a perceived intention of the Code that the initial capital base be necessarily consistent with the principles of economic efficiency and a competitive market.

AlintaGas's submissions on the appropriate ICB and whether it should be taken outside the normal range identified by section 8.11 are set out in the following parts of this Submission.

3.14 **Analysis of 8.10 factors**

As noted above, the Regulator is required in establishing the ICB to take into account and give weight as fundamental matters all of the 8.10 factors. In undertaking that task, the Regulator is to be guided by the 8.1 objectives.

In summary terms, AlintaGas's consideration of the 8.10 factors in light of the Court's decision indicates the following things.

(a) The DAC value of the DBNGP is $874 million.

[129] The Court stated that the error concerning section 8.10(c) that is discussed under this heading had also been material to the Regulator's discussion of section 8.11: see supra n. 2, para 211.

(b) The DORC value of the DBNGP is the value of $1,234 million, although that valuation is at the upper limit of the range of permissible values and it is arguable that it should be reduced below that value (possibly to around $1,000 million).

(c) The optimised deprival value of the DBNGP is $1,528 million.

(d) The Imputed Value of the DBNGP is in the range of $1,200 million to $1,300 million.

(e) Epic contends that the purchase price of $2,407 million reflects a purchase price value, but there are serious questions about whether the purchase price:

(i) reflects a reasonable commercial judgment; and

(ii) was influenced by considerations such as the prospect of obtaining monopoly profits and an increase in transport volumes which did not materialise.

(f) To address the questions about the purchase price the Regulator must consider the nature of the tender process under which Epic acquired the DBNGP. This would include considering whether Epic erred in its assessment of value, had unreasonable expectations or had reason to pay higher than true market value, particularly in light of the Court's rejection of Epic's arguments as to the existence of a regulatory compact between it and the State.

(g) Each of the valuation methodologies has advantages and disadvantages, but:

(i) the DORC methodology has considerable economic advantages and its use will maintain regulatory consistency; and

(ii) the purchase price value methodology suffers from disadvantages associated with the winner's curse and compensating an asset owner for any regulatory premium that forms part of a purchase price.

(h) International best practice in valuing pipelines recognises the economic difficulties associated with the winner's curse and would be consistent with the establishment of an ICB at or below the DORC value.

(i) The basis on which tariffs have been set in the past, economic depreciation and historical returns to the service provider should be considered but are not particularly instructive in the context of the DBNGP.

(j) The reasonable expectations of Epic and users under the previous access regime for the DBNGP, if it had continued, would have been that the asset base would be established consistently with the rules under that regime. According to the Regulator, this would have resulted in an asset base of $1,270 million. The owner of the DBNGP should have foreseen the risk that tariffs would fall beyond $1/GJ after 1 January 2000.

(k) If the Regulator determines that the ICB is to be set at a level that exceeds the economically efficient level, this will have a negative impact on the economically efficient utilisation of gas resources. It will adversely affect energy intensive gas

users such as minerals processors which compete internationally, in part, on the basis of energy prices.

(l) Consideration of the possibility of the construction of an inefficient competing new pipeline, such as a pipeline in the statutory pipeline corridor, suggests that it is appropriate to value the ICB at no more than the DORC valuation.

(m) The Regulator must consider Epic's purchase price for the DBNGP and the matters noted above in relation to the purchase price value methodology.

In considering these factors, it is instructive that section 8.11 states that the initial capital base for an Existing Pipeline normally should not fall outside the range of the DAC and DORC values. In this case, that suggests that the range is between $874 million and $1,234 million. It is also notable that the optimised deprival value is $1,528 million and the imputed value is in the range of $1,200 to $1,300 million.

Thus, under those methodologies it is clear that the value of the DBNGP would reasonably be somewhere in the range of $1,000 million to $1,300 million. This, of course, is considerably less than the purchase price based ICB of $2,570 million for which Epic contends. This difference of over $1,000 million is extremely significant and certainly material.

At the same time, there are considerable difficulties associated with using the purchase price that Epic paid for the DBNGP to determine the ICB. In particular, important questions raised above about the commercial soundness of the purchase price suggest that it should not be relied upon and that it does not represent a purchase price value.

Even if Epic could establish the commercial soundness of its purchase price, there are considerable disadvantages associated with its use (as noted above). In contrast, the DORC value of $1,234 million is economically sound and its use is consistent with regulatory precedent and, in AlintaGas's submission, international best practice. It would also be consistent with the expectations of persons under the existing regime, have an optimum effect on the economically efficient utilisation of gas resources and be comparable to the cost structure of a potential new competing pipeline, thereby avoiding inefficient investment.

AlintaGas notes that the Court's decision recognised that either of sections 8.10(f) and (g) might suggest a lower or higher ICB. It further stated that where the factors in sections 8.10(f) and (g) suggest a higher ICB, their effect must necessarily be considered.[130] Consistent with the preceding parts of this Submission, AlintaGas submits that sections 8.10(f) and (g) do not have such an effect.

Accordingly, subject to such guidance as the 8.1 objectives and 2.24 factors provide, AlintaGas submits that consideration of the 8.10 factors suggests that the ICB should be set at a value that does not exceed the DORC value. At most, the DORC value should be $1,234 million, and this is not a case in which the ICB should be outside the range of values identified in section 8.11.

[130] *Supra* n. 2, para 169.

4. DESIGN OF THE REFERENCE TARIFF AND REFERENCE TARIFF POLICY - SECTION 8.1

4.1 Overview of this part of the Submission

As discussed above, section 8.1 states that a reference tariff and a reference tariff policy should be designed with a view to achieving the 8.1 objectives. The Court's decision indicates that the 8.1 objectives guide the Regulator in the exercise of his discretions under sections 8.10 and 8.11. Importantly, however, the Court found that inconsistencies between 8.1 objectives and 8.10 factors are not to be resolved by 8.1 prevailing[131].

Section 8.1 provides that, to the extent that any of the 8.1 objectives conflict in their application to a particular reference tariff determination, the Regulator may determine the manner in which they can best be reconciled or which of them should prevail. The Court held that in exercising that discretion, the Regulator should be guided by the 2.24 factors.

This part of the Submission deals with the guidance that the 8.1 objectives provide to the Regulator in exercising his discretion under sections 8.10 and 8.11 in establishing an initial capital base. AlintaGas notes that the Draft Decision did not explicitly and separately consider the application of the 8.1 objectives in the context of sections 8.10 and 8.11.

4.2 Stream of revenue that recovers efficient costs

(a) The law

Section 8.1(a) states that a reference tariff and reference tariff policy should be designed with a view to achieving the objective of providing the service provider with 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.

The Court addressed section 8.1(a) at some length and reached the following conclusions.

(i) The term "efficient costs" is "a construct of the relevant economic concept of efficient, together with the ordinary notion of costs".[132] It is not a phrase in respect of which there was a generally accepted usage and meaning among economists as at December 1997.[133] The economic concept of efficiency refers to technical or productive, allocative and dynamic efficiency.[134]

(ii) In economic theory, there is some support for the view that economic efficiency only looks at costs on a "forward looking basis" (ie past investments are not taken into account). On this view, "a past purchase price, especially if it included a monopoly profit component, would not be included for the purposes of section 8.1(a)". The application of the term "efficient costs" in this case is a matter for the Regulator.[135]

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131 *Ibid*, para 186.
132 *Ibid*, para 139.
133 *Ibid*, para 138.
134 *Ibid*, para 139. For the Court's discussion on the concept of economic efficiency see paras 112 to 115.
135 *Ibid*, para 141.

(iii) The focus of section 8.1(a) is on the efficient costs of the transportation of gas from and to various locations, not with the efficient costs of the gas market.[136]

(iv) Section 8.1(a) is concerned with providing the service provider with the "opportunity" to earn a "stream of revenue" (not the defined term "Total Revenue") that recovers the efficient costs over the life of the assets. It does not require the stream of revenue to be constant over that life.[137]

(v) Section 8.1(a) does not fix a ceiling or a floor on the revenue stream that might be earned.[138] Further, despite what is said in the overview to section 8, section 8.1(a) does not have an "overarching effect" on section 8.[139]

(b) **Application of the law**

The Court's decision provides the Regulator with important guidance in relation to the interpretation of section 8.1(a). Most importantly, it establishes that "efficient costs" is a construct of the meaning of "efficient" as it is understood by economists and of the ordinary meaning of "costs", and confirms that there is some support for the view that economic efficiency only takes into account "forward looking" costs and does not take into account past costs.

Significantly, the Court's decision also establishes that the application of section 8.1(a) and, in particular, of the term "efficient costs" in this case is a matter for the Regulator.

In this context, AlintaGas submits that it is well recognised that economically efficient costs can best be obtained by the consistent application of a forward looking valuation methodology. Of the methodologies discussed in relation to the 8.10 factors, the DORC methodology is economically preferable for this purpose because its use promotes allocative, productive and dynamic efficiency, as those terms were explained in the Court's decision.

Accordingly, AlintaGas submits that section 8.1(a) guides the Regulator toward the use of a DORC valuation methodology. The use of a DORC value as the ICB will assist in achieving the objective of providing Epic with the opportunity to earn a stream of revenue that recovers the efficient costs of delivering its reference service over the expected life of the DBNGP.[140] While the 8.1 objectives do not prevail over the 8.10 factors in an ultimate sense, if the Regulator needs to exercise discretions about what is appropriate in the circumstances, the Court has made it clear he should be guided by the 8.1 objectives.

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136 *Id.*
137 *Id.*
138 *Ibid*, para 142.
139 *Ibid*, para 160.
140 As the Code calls for allowable costs to include a return on, and depreciation of, the ICB.

4.3 Replicating the outcome of a competitive market

(a) The law

Section 8.1(b) states that a reference tariff and a reference tariff policy should be designed with a view to achieving the objective of replicating the outcome of a competitive market.

The Court examined this objective in detail and came to the following conclusions.

(i) The reference to a "competitive market" is a reference to a workably competitive market.[141]

(ii) Section 8.1(b) contemplates a competitive market in the field of gas transportation. As the Court stated:

> "the objective is to replicate what would be the outcome if there was competition for the transportation of gas by the pipeline in question, even though it is the premise of the Act and the Code that the pipeline is in a monopoly situation and it would be uneconomic to construct another."[142]

This is directed to the outcome of a workably competitive market.[143]

(iii) It is the task of the Regulator to explore the implications of section 8.1(b). However, a workably competitive market is "not a fixed and immutable condition", but "a process which involves rivalrous market behaviour". It may well "tolerate a degree of market power, even over a prolonged period". However, the underlying theory and expectation is that "with workable competition market forces will increase efficiency beyond that which could be achieved in a non-competitive market, although not necessarily achieving theoretically ideal efficiency".[144]

(iv) There is a close relationship in economics between the role of a competitive market (per section 8.1(b)) and the achievement of economic efficiency (per section 8.1(a)), which suggests that sections 8.1(a) and (b) are "more complementary than antithetical". Over time, a workably competitive market is likely to lead to economic efficiency. This suggests that, over time, the revenue earned from a reference service in a workably competitive market will "approximate the efficient costs of delivering the service".[145]

(v) Although economic theory is evolving, a workably competitive market may permit the recovery of prices above the efficient level in recognition of past investments and risks taken. There is a "growing awareness" of the disadvantages of "placing too great an emphasis on the interests of

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141 *Supra* n. 2, para 143. For the Court's discussion on a workably competitive market, refer to paras 122 to 126.
142 *Ibid*, para 127.
143 *Id.*
144 *Ibid*, para 128.
145 *Ibid*, para 143.

consumers in securing lower prices, and without due regard to the interest of the service provider in recovering higher prices and its investment".[146]

(b) **Application of the law**

The Court's decision provides the Regulator with guidance on the interpretation of section 8.1(b). Most importantly, it establishes that the objective is concerned with replicating what would be the outcome if the market in which the services are provided was a workably competitive market and notes the linkage between this and the achievement of economic efficiency. In addition, it raises for consideration the possibility that a workably competitive market may permit, for a period, the recovery of prices above economically efficient levels in recognition of past investments.

The Regulator must take the Court's decision into account when interpreting section 8.1(b). However, it is for the Regulator to explore fully its implications. In this regard, AlintaGas makes the following comments and submissions.

(i) The Regulator should consider the tariffs that a workably competitive market would deliver. A key issue will be how such a competitive market would value assets.

(ii) As a matter of economic theory and practice, a DORC valuation reflects the manner in which asset values will be determined in a workably competitive market, provided there is sufficient demand. In a market in which there is only one supplier of the asset in question, a price based on a DORC value will provide a good proxy for the price which would have been realised had the supplier faced workable competition.

(iii) A DORC value represents the cost of replicating the assets using the best currently available technology. This will either be the lower of the actual cost of rebuilding an asset or the net present value of the expected future earnings, remembering that these earnings will themselves be constrained by the assumed competition. This becomes clear when the prospect of a sale is examined. No one will pay more for the asset than it costs to build. But nor will anyone buy it for more than their assessment of the net present value of expected future earnings. Instead, a buyer in a competitive market will pay the lower of these two amounts.

AlintaGas submits that these factors lead inexorably to the conclusion that the appropriate valuation for an initial capital base, where what is sought is the replication of a competitive market, is a DORC valuation. This relates directly to the value a prudent purchaser would place upon a pipeline in a competitive market.

AlintaGas submits that the use of a DORC valuation does not place undue emphasis on the interests of consumers in securing lower prices. Nor does it fail to have due regard to the interests of a service provider in securing higher prices and recovering its investment. Instead, it seeks to provide a valuation that, according to economic theory, replicates the value that a purchaser would pay for a pipeline

[146] *Ibid*, para 144 and 145.

in a workably competitive market and thereby strikes a balance between the interests of service providers and consumers. In contrast, it might be argued that the utilisation of a DAC value (in this case $874 million) could be criticised as unduly favouring users and leading to an inefficiently low valuation. Similarly, it could also be argued that the use of a purchase price value (were it accepted) that significantly exceeds a DORC value, in fact places undue emphasis on the interests of a service provider in securing higher prices and its investment, without due regard to the interests of consumers in securing lower prices.

Finally, competitive markets generally do not allow the costs of business mistakes to be passed on to consumers. Establishing the ICB in excess of DORC would, however, do just that as AlintaGas submits (as argued elsewhere in this Submission) that Epic's purchase price was based on a number of mistaken assumptions.

For these reasons, AlintaGas submits that section 8.1(b) guides the Regulator toward the establishment of an ICB that is equal to a DORC value.

4.4 Safe and reliable operation

(a) The law

Section 8.1(c) states that a reference tariff and a reference tariff policy should be designed with a view to achieving the objective of ensuring the safe and reliable operation of the pipeline.

The Court dealt with this objective very briefly in its decision. It observed that it is increasingly understood in economics that there is a need to provide for "proper maintenance and technical improvement in the longer term, even though this might detract from the lowest level of pricing".[147]

(b) Application of the law

In AlintaGas's view, the Court's decision does not have a material effect in relation to the interpretation of section 8.1(c). It merely provides the Court's brief view on what the section is designed to achieve.

AlintaGas agrees that there is a need to ensure the safe and reliable operation of the DBNGP. The real issue concerns how that objective can best be achieved, when considered along with the other 8.1 objectives, in the context of establishing a reference tariff and the initial capital base.

[147] *Ibid*, para 146.

In this respect, it is not obvious that the higher the ICB the more that Epic would theoretically have available to spend in ensuring the safe and reliable operation of the DBNGP. Were a higher ICB to lead to increased tariffs, these higher tariffs would fund the increased return necessary to cover any over-investment by Epic in the DBNGP rather than additional expenditure on safety and reliability. The Regulator's task, however, is not to use section 8.1(c) as providing justification for the establishment of an extremely high value for the DBNGP. Rather, it should be seen more as a task of ensuring that the minimum amount necessary for ensuring safe and reliable operation is available.

As the Draft Decision allows for forward operational, maintenance and capital expenditure, AlintaGas submits that the Regulator has made appropriate allowance for the considerations raised by section 8.10(c). AlintaGas acknowledges that there are well established circumstances in economic theory where reliability can be threatened by regulated price outcomes. However, those circumstances arise in the case of setting prices so that marginal revenue equals marginal cost. While setting prices in such a way leads to the most efficient outcome, it also means that capital costs are not recovered, thereby threatening adequate capital maintenance. However, AlintaGas submits that the Draft Decision does not do this and that a reference tariff based on a DORC valuation is well in excess of marginal cost.

AlintaGas notes that Epic has stated that:

> "the draft decision, if implemented, would create severe financial distress to Epic Energy. This has the potential to impact on Epic's ability to continue its maintenance and capital program to ensure the pipeline's reliability and efficient operation."[148]

However, AlintaGas submits that the suggestion that the reliability and safety of the DBNGP is at risk is unfounded. In establishing an ICB equal to the DORC value, the Regulator would allow Epic to recover its reasonable operating costs. Provided Epic incurs those costs in operating and maintaining the DBNGP, reliability and safety should not be compromised. Certainly, maintaining the ICB at the DORC Value would not have any impact on this criterion.

Further, AlintaGas submits that the Regulator should satisfy himself as to, firstly, the veracity of the claim of financial address and, secondly, in the case of such financial distress, whether it will have the effect claimed by Epic.

4.5 Not distorting investment decisions

(a) The law

Section 8.1(d) states that a reference tariff and a reference tariff policy should be designed with a view to achieving the objective of not distorting investment decisions in pipeline transportation systems or in upstream and downstream industries.

[148] Epic Energy, *Epic Energy's Position on the Draft Decision on the DBNGP,* p 3.

The Court dealt with this provision in some detail, but only in relation to that part of the objective that relates to not distorting investment decisions in pipeline systems. It noted, however, that the Regulator will need to consider the objective in relation to upstream and downstream industries.[149]

The Court made the following observations in relation to distorting investment decisions in pipeline systems.

(i) The public interest requires that future investment in significant infrastructure, such as a natural gas pipeline, be maintained and encouraged. This, in turn, requires that regard be had to the need for investor confidence that substantial investment decisions:

> "...which are required, and which were sound when judged by the commercial circumstances at the time of the investment, are not rendered loss-making, or do not result in liquidation, by virtue of governmental intervention."[150] [Emphasis added]

(ii) As a matter of economic theory, where a significant infrastructure asset (such as a pipeline) becomes subject to regulation it may be necessary for the asset owner to "vacate the market" in order to achieve economic efficiency. In such an event, another party will enter the market in place of that owner.[151] Against this, there is a "growing awareness" that such an outcome "could be" contrary to the public interest in the long term "because of the adverse effect on necessary future investment in such assets of any adverse outcomes of past investments".[152] The Court indicated that the extent to which that growing concern is accommodated into economic theory and practice is an issue.[153]

(iii) The Court held that, regardless of the state of economic theory and practice, section 8.1(d) does not deny the "potential relevance of past investment decisions to the design of a reference tariff or a reference tariff policy".[154] It is not confined to looking at only "forward looking" costs and as disregarding past investments.[155]

(iv) In the Court's view, section 8.1(d) reflects a public interest that is broader than economic theory. It takes account of "wider political and social considerations" and reflects the scope and policy of the Act in respect of ensuring the provision of access terms and conditions that are fair and reasonable to pipeline owners and operators.[156] As such, the Court held that section 8.1(d) would allow the Regulator, "in an appropriate case", to take into account the actual investment of an owner in an Existing Pipeline when establishing the initial capital base.[157]

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149 *Supra* n. 2, para 148.
150 *Ibid*, para 149.
151 *Ibid*, para 150.
152 *Ibid*, para 151.
153 *Ibid*, para 152.
154 *Ibid*, para 151.
155 *Ibid*, para 148.
156 *Ibid*, para 153.
157 *Ibid*, para 154.

(v) However, the Court stated that:

> "This is not to suggest that reckless, mistaken or highly speculative investment decisions should be accepted for this purpose."[158] [Emphasis added]

(vi) In addition, the Court acknowledged the Regulator's concern in the Draft Decision that future investment decisions in pipelines might well be distorted:

> "were it the case that *any* price paid by a service provider to acquire a pipeline, no matter how uncommercial, mistaken or reckless, should automatically be recognised as the initial Capital Base...."[159] [Emphasis added]

This would encourage the payment of "excessive and unrealistic prices" to acquire a pipeline. Accordingly, the Court stated that the Regulator will need to evaluate carefully a purchase price for purposes of section 8.1(d) before the Code applies to it.[160]

(b) **Application of the law**

In its decision, the Court found that it was not apparent that the Regulator had given, in the Draft Decision, any consideration to Epic's investment decision for the purposes of section 8.1(d).[161] In line with that finding, the Regulator must, therefore, consider Epic's purchase price when taking into account section 8.1(d) for the purposes of making a final decision.

AlintaGas makes the following comments and submissions on section 8.1(d) in light of the Court's findings.

(i) **Scope of section 8.1(d)**

It is clear from the very wording of section 8.1(d) and the Court's decision that the Regulator must consider the objective of not distorting investment decisions in both:

- pipeline transportation systems; and
- upstream and downstream markets.

While the Court's decision focused on the effect of investment decisions in pipeline systems - that being the argument raised by Epic before the Court - the Regulator must also equally consider the impact on upstream and downstream markets. No significance can be attached to the fact that the Court addressed only one of these elements. And neither should that

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158 *Id.*
159 *Ibid*, para 155.
160 *Id.*
161 *Ibid*, para 212.

influence the weight that the Regulator gives to an element of this provision.

(ii) **Consideration of commercial soundness**

The error that the Court stated that it found in the Draft Decision was that the Regulator had not "given any consideration to the outcome of the investment decision of Epic".[162] In making that finding, the Court did not say anything about what the Regulator's consideration should be; it merely indicated that the Regulator should consider Epic's purchase price of $2,407 million.

Further, the Court's decision is such that the mere fact that Epic made an investment of $2,407 million is not sufficient to bring it within the scope of section 8.1(d), which is only concerned with investments that are sound when judged by the commercial circumstances at the time of the investment. Section 8.1(d) does not take into account reckless, mistaken or highly speculative investment decisions.

Consistently with this, AlintaGas submits that the Regulator should carefully evaluate the purchase price paid by Epic. This in itself is, of course, consistent with what the Court indicated that the Regulator should do.[163]

AlintaGas further submits that, consistent with the Court's findings in relation to section 8.10(c) and (j), the onus of establishing the commercial soundness of the purchase price falls on Epic.

There is an obvious relationship between the task that the Court indicated that the Regulator should undertake in relation to section 8.10(c) and this provision, section 8.1(d). To that end, the submissions that AlintaGas made under the following headings in this Submission in relation to section 8.10(c) are repeated *mutatis mutandis* in respect of section 8.1(d):

- 3.4(b)(iii) - Court's findings on commercial soundness and regulatory compact;
- 3.4(b)(iv) - Court's findings on purchase price - allowance for capital expenditure;[164] and
- 3.4(b)(v) - Supplementary observations on Epic's purchase price.

AlintaGas notes that the idea that certain investments do not come within the terms of section 8.1(d) is consistent with the public interest in users of pipeline services not being required to subsidise, through inflated tariffs, unsound, uncommercial or reckless investments.

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[162] *Id*.
[163] *Ibid*, para 155.
[164] The Court stated that the error concerning section 8.10(c) that is discussed under this heading had also been material to the Regulator's discussion of section 8.1(d): see *ibid*, para 211.

(iii) **The significance of past investment to future investment decisions in pipelines**

Even if the Regulator is satisfied that the purchase price that Epic paid for the DBNGP does fall within the scope of section 8.1(d), AlintaGas submits that it must be seen as just one factor that is to be taken into account when considering the distortion of investment decisions in pipeline transportation systems. Other factors include the considerable body of economic theory that was recognised by the Court which suggests that past investment decisions are sunk and generally will not influence future investment decisions.

AlintaGas acknowledges the "growing awareness" referred to by the Court of the need to balance the interests of owners who have made investments against the advantages of lower prices for consumers in the short term (as discussed above). However, AlintaGas submits that the Regulator should carefully consider the weight of any evidence of that growing awareness and its applicability to the case of the DBNGP. The Regulator should acknowledge that the Court went no further than stating that there was a "growing awareness" of that body of thought.

Section 8.1(d) requires the Regulator to make an assessment of the effect that a reference tariff and an initial capital base will have on investment decisions in pipeline transportation systems. It is, therefore, concerned with "pipeline transportation systems" generally, not just the DBNGP or pipeline transportation systems owned or operated by Epic.

In this regard, it is open to the Regulator to question whether the determination in relation to the DBNGP will have an effect on future investment decisions in pipelines. A number of points are relevant to this.

- First, if section 8.1(d) is concerned with investment decisions in relation to new pipeline systems, it is not clear that a decision on the ICB will be of relevance because section 8.16 of the Code provides that the initial capital base for a new pipeline will be its actual capital cost at the time it first enters service. It is questionable whether the particular and unique circumstances associated with the establishment of the ICB under section 8.10 can be relevant to the viability and attractiveness of investment in new pipelines.

- Second, if section 8.1(d) is concerned with the future acquisition of existing pipelines, it is not clear that a decision on the ICB will be of significant relevance to such acquisitions. AlintaGas understands that nearly all major pipeline systems are covered by the Code and have an established initial capital base. Accordingly, it would seem that any future acquisitions of existing pipelines would be undertaken in circumstances in which, in contrast to the acquisition of the DBNGP, the regulated asset base is already established.

- Third, if there is such an impact, it would presumably be to recognise that expecting the Regulator to allow more than the upper limit of the range of values suggested by the DAC and

DORC methodologies as an initial capital base is imprudent. It is not clear how this would "distort" future investment, as opposed to encouraging buyers to be efficient (rather than pay excessive prices).

- Finally, AlintaGas submits that the Regulator should consider the effect of establishing an ICB that is in excess of the level that reflects an economically efficient value (in particular, a DORC value), including the risk that doing so might distort investment decisions by encouraging the payment of "excessive and unrealistic prices" to acquire a pipeline.

In making these submissions, AlintaGas notes that there are sound economic reasons for the view that an investment decision will distort the wider economy (including upstream and downstream markets) if it does not reflect the investment decision that would have been made in a workably competitive market. A DORC value provides the best estimate of that investment decision.

(iv) **Distorting investment decisions in upstream or downstream markets**

As noted above, the Regulator must also consider the objective of not distorting investment decisions in upstream or downstream markets.

In AlintaGas's view, investment decisions in upstream and downstream markets will be distorted if a reference tariff is established based on an initial capital base that incorporates the value associated with any monopoly rent. This is consistent with the Hilmer Committee's concern that the ability of an essential facility owner to charge monopoly prices provides that person with the capacity to distort the operation of upstream and downstream markets.[165] A reference tariff will also distort upstream and downstream investment decisions if it contains any unsound, uncommercial or reckless component.

Accordingly, to avoid distorting investment decisions in upstream and downstream markets, it is necessary to determine a reference tariff that is derived, in part, from an initial capital base that reflects an economically efficient value. It will not include any component of monopoly rent.

The Regulator should carefully examine the impact on investment decisions in upstream and downstream markets of a reference tariff that is based on the different valuation methodologies considered under section 8.10. AlintaGas submits that the valuation methodology that is least likely to distort such investment decisions is the DORC methodology.

AlintaGas also repeats its previous comments on the prospect of the economically inefficient construction of a second pipeline. As noted above, higher tariffs will increase delivered gas prices and reduce gas demand,

[165] Independent Committee of Inquiry, *National Competition Policy Review*, AGPS, Canberra, 1993, p 240 to 241, and 251 to 253.

thereby distorting investment outcomes for both suppliers and potential gas users, such as energy intensive mineral processing.

(v) **Guidance from section 8.1(d)**

Section 8.1(d) guides the Regulator toward the establishment of an ICB for the DBNGP that is consistent with not distorting investment decisions in pipeline transportation systems or in upstream or downstream industries. In AlintaGas's view and consistent with the Hilmer Report principles explained above, from an economic perspective, this suggests that it is appropriate to use a value that does not include a component of monopoly rent and which does not contain any unsound, uncommercial or reckless component.

It also provides guidance in so far as it requires the Regulator to consider the purchase price of the DBNGP to the extent that it is sound, commercial and not reckless and to the extent that not permitting its recovery will distort investment decisions in pipeline transportation systems. There are, however, questions about whether the purchase price for the DBNGP falls within the scope of section 8.1(d) and as to whether non-recovery of the purchase price would, in any event, distort investment decisions in pipeline transportation systems.

In AlintaGas's view, section 8.1(d) guides the Regulator toward the use of a DORC valuation.

4.6 **Efficiency in the level and structure of the reference tariff**

(a) **The law**

Section 8.1(e) states that a reference tariff and a reference tariff policy should be designed with a view to achieving the objective of efficiency in the level and structure of the reference tariff.

In its decision, the Court did not deal with section 8.1(e) other than to note that "efficiency" appears to reflect the concept of economic efficiency as discussed above.[166]

(b) **Application of the law**

AlintaGas submits that the Court's decision does not directly impact on the level and structure of the reference tariff, although the ICB adopted will obviously have a significant impact on the eventual tariff outcome.

4.7 **Incentive to reduce costs and develop the market**

(a) **The law**

Section 8.1(f) states that a reference tariff and a reference tariff policy should be designed with a view to achieving the objective of providing an incentive to the

[166] *Supra* n. 2, para 156.

service provider to reduce costs and to develop the market for reference and other services.

In its decision, the Court did not deal with section 8.1(f).[167]

(b) **Application of the law**

AlintaGas submits that section 8.1(f), concerning, as it does, incentive mechanisms is not directly affected by the Court's decision.

4.8 **Analysis of 8.1 objectives**

The 8.1 objectives provide guidance to the Regulator in both the design of a reference tariff and reference tariff policy for the DBNGP and in the exercise of his discretions under sections 8.10 and 8.11 in relation to the establishment of an ICB. In particular, the 8.1 objectives provide guidance to the Regulator in relation to whether the ICB should be established at:

- a value equal to the DORC value of the pipeline ($1,234 million) or some other value of about that magnitude as suggested by other 8.10 factors (as discussed above) and within the range of values indicated by section 8.11 (being the DAC value of $874 million and the DORC value of $1,234 million); or

- a value that is adjusted to take into account the purchase price of the DBNGP of $2,407 million, provided that value meets threshold requirements such as being a price that can be properly considered under sections 8.10(c), 8.10(d), 8.10(j) and 8.1(d) (which AlintaGas believes is not supportable).

In summary terms, as discussed above, the 8.1 objectives provide the following particular guidance to the Regulator.

(a) The use of a DORC value will assist in achieving the objective of providing Epic with the opportunity to earn a stream of revenue that recovers the efficient costs of delivering its reference service over the life of the DBNGP (section 8.1(a)).

(b) The use of a DORC value will assist in achieving the objective of replicating the outcome of a competitive market (section 8.1(b)).

(c) It is unnecessary for the Regulator to establish the ICB above a DORC value to achieve the objective of ensuring the safe and reliable operation of the DBNGP (section 8.1(c)). The use of a DORC value will be sufficient for this purpose, particularly as the Draft Decision allows for operational, maintenance and forward capital expenditure. Further, the Regulator should thoroughly test Epic's claims to the contrary.

(d) The objective of not distorting investment decisions in pipeline transportation systems or in upstream or downstream markets guides the Regulator toward the use of a DORC value for the ICB (section 8.1(d)). The objective also guides the Regulator to carefully evaluate the purchase price of the DBNGP to ascertain whether it falls within the permissible scope of section 8.1(d) as set down by the

[167] *Id*.

Court (about which AlintaGas has raised questions) and to consider whether non-recovery of that purchase price will actually distort future investment decisions in pipeline transportation systems.

(e) As considered above and by the Court, the objectives in section 8.1(e) and (f) do not provide a material degree of guidance in relation to the establishment of the ICB.

In AlintaGas's view, the objectives in sections 8.1(a) and (b) clearly guide the Regulator to exercise his discretion to establish the ICB at a value that does not exceed the DORC value. Further, AlintaGas submits that sections 8.1(c) and (d) also guide the Regulator to that position, and that sections 8.1(e) and (f) do not materially touch on the issue. Therefore, the 8.1 objectives indicate that a DORC value should be used for the ICB.

This also means that the 8.1 objectives do not conflict in their application to a determination of the reference tariff for the DBNGP. Accordingly, it is not necessary for the Regulator to exercise his discretion under the last paragraph of section 8.1. That being the case, AlintaGas submits that under the Court's decision the 2.24 factors do not have a role in establishing the ICB. The Court held that it is only where the 8.1 objectives are in conflict and the Regulator's discretion must be exercised that the Regulator is to be guided by the 2.24 factors. [168]

However, AlintaGas also submits that, if the Regulator considers that the 8.1 objectives do conflict and it is necessary to obtain guidance from the 2.24 factors, he should take into account the discussion in the next part of this Submission.

5. FACTORS TO BE TAKEN INTO ACCOUNT - SECTION 2.24

5.1 Overview of this part of the Submission

As noted above, the 8.1 objectives, rather than the 2.24 factors, guide the Regulator in the exercise of his discretions under section 8. However, where the 8.1 objectives are in conflict and the Regulator is required to determine (in accordance with the last paragraph of section 8.1) the manner in which they can best be reconciled or which of them should prevail, the Regulator should take into account and be guided by the 2.24 factors. This part of the Submission therefore provides AlintaGas's views on the 2.24 factors if, despite the views expressed above, it is necessary for the Regulator to examine them.

Further, in every instance where the Regulator is required to take into account the service provider's legitimate business interests and investment in the pipeline under section 2.24 (a), he must also take into account those other factors in section 2.24(b) to (g) that are relevant to that issue.

5.2 Service provider's legitimate business interests and investment

(a) The law

Section 2.24(a) provides that, in assessing a proposed access arrangement, the Regulator must take into account the service provider's legitimate business interests and investment in the covered pipeline.

[168] *Ibid*, paras 85, 136 and 203. Also see para 223, third bullet point.

In its decision, the Court discussed section 2.24(a) and reached the following conclusions.

- The service provider's legitimate business interests and investment are directly relevant to that object of the Act that is concerned with the provision of access on terms and conditions that are fair and reasonable for the owners and operators of a pipeline.[169]

- Section 2.24(a) reflects the viewpoint of an owner and operator (as opposed to society as a whole).[170]

- Section 2.24(a) might properly extend to the recovery by Epic of the purchase price of $2,407 million, at least over the expected life or operation of the DBNGP, together with an appropriate return on that investment.[171]

- The recovery of monopoly prices or the exercise of monopoly power is not necessarily an illegitimate business interest, even though economic theory and parts of the Hilmer Report suggest that it is against the interests of society as a whole. However, there is scope for illegitimate business interests, such as a contravention of the *Trade Practices Act 1974* (Cth) or the avoidance of revenue charges.[172]

- There was no basis shown upon which Epic's interests in recovering its actual investment and a reasonable return should be categorised as other than a legitimate business interest for the purposes section 2.24(a).[173]

(b) **Application of the law**

This factor seeks to draw a clear distinction between a service provider's (in this case Epic's) *legitimate* business interests and investment and those which are not legitimate.

Clearly, a service provider could incur investments and business interests that are not legitimate and which should not be taken into account by the Regulator under section 2.24(a). It further follows that the Regulator should not allow illegitimate business interests to determine regulatory outcomes.

The key question for the Regulator in relation to section 2.24(a) is to what extent recovery of Epic's purchase price of $2,407 million is a legitimate business interest. AlintaGas submits that the Regulator must satisfy himself that the purchase price does not contain anything illegitimate according to the meaning given to that term by the Court.

AlintaGas also submits that there is a question about whether the Regulator can properly use Epic's legitimate business interests to exercise his discretion under the last paragraph of section 8.1. In particular, it is not clear that the Regulator can

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169 *Ibid*, para 130.
170 *Ibid*, para 133.
171 *Ibid*, para 130.
172 *Id.*
173 *Id.*

use section 2.24(a) to simply choose to adopt and apply a purchase price as the ICB. As the Regulator's discretion under the last paragraph of section 8.1 is to determine the manner in which to reconcile conflicting objectives in section 8.1, or which of them are to prevail, it is difficult to see how he could simply determine that Epic's legitimate business interests require that the ICB should be $2,407 million and then adopt that as the ICB. In AlintaGas's view, the Regulator's discretion would require that he merely take into account the fact that Epic has a legitimate interest in recovering its investment as required by the Court when trying to determine how to best balance the 8.1 objectives. He can go no further than that, particularly when there is no direct relationship between section 2.24(a) and any of the 8.1 objectives.

AlintaGas submits that the Regulator cannot take into account and weight any of the 2.24 factors, including section 2.24(a), in a way that produces a result which is inconsistent with, or simply overrides the requirements of the Act and the Code (in so far as the initial capital base is concerned, as specified in the preamble to the Act, section 8.1, section 8.10 and section 8.11). The 2.24 factors can only guide or shape a result which is consistent with the policy and principles enunciated in the relevant provisions of the Act and Code.

5.3 Firm and binding contractual obligations

(a) The law

Section 2.24(b) provides that, in assessing a proposed access arrangement, the Regulator must take into account firm and binding contractual obligations of the service provider or other persons (or both) already using the covered pipeline.

The Court's decision did not deal with section 2.24(b), other than to note that the provision requires that the Regulator take into account prices that have been contractually agreed even though they may include "monopolist rents or returns".[174]

(b) Application of the law

AlintaGas and other users are already using the DBNGP and have firm and binding contractual obligations with Epic. AlintaGas submits that the Regulator should take these into account in his final decision whilst ensuring that the Access Arrangement does not infringe existing contractual rights

5.4 Safe and reliable operation

(a) The law

Section 2.24(c) provides that, in assessing a proposed access arrangement, the Regulator must take into account the operational and technical requirements necessary for the safe and reliable operation of the covered pipeline.

The Court's decision did not deal with this provision other than to note that expenditure necessary for this purpose must be taken into account "whether or not

[174] *Ibid*, para 131.

that would occur in a competitive market or according to theories of economic efficiency".[175]

(b) **Application of the law**

AlintaGas notes that section 2.24(c) requires the Regulator to take into account matters that are effectively the same as those raised under section 8.1(c). The comments set out above in relation to section 8.1(c) also apply *mutatis mutandis* to this provision.

5.5 **Economically efficient operation**

(a) **The law**

Section 2.24(d) provides that, in assessing a proposed access arrangement, the Regulator must take into account the economically efficient operation of the covered pipeline.

In its decision, the Court addressed section 2.24(d) and held as follows.

- Section 2.24(d) directs attention to the "economically efficient operation" of a pipeline. This refers to the concept of efficiency as generally understood by economists in the field of the regulation of essential infrastructure.[176]
- The concept of economic efficiency is concerned with the question of "how limited resources may be used to produce the goods and services that will best meet the needs of society as a whole".[177] It has at least three well recognised dimensions, being technical or productive, allocative and dynamic efficiency.[178]
- The notion of economic efficiency also involves specific views about costs such as capital investment. These costs are to be viewed from the perspective of society, which is a different viewpoint to that required by section 2.24(a).[179]
- It is for the Regulator to consider section 2.24(d) having regard to the scope and objects of the Act. Importantly, the Court said that "... section 2.24(d) most naturally relates to the objective in the preamble of the promotion of a competitive market and, perhaps, also the prevention of the abuse of monopoly power".[180]

(b) **Application of the law**

It is clear that the Regulator must interpret section 2.24(d) consistently with the Court's decision. However, it is for the Regulator to consider and apply the provision in this case.

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[175] *Ibid*, para 132.
[176] *Ibid*, para 133.
[177] *Ibid*, para 115.
[178] *Ibid*, para 139. For the Court's discussion on the concept of economic efficiency see paras 112 to 115.
[179] *Ibid*, para 133.
[180] *Id.*

AlintaGas makes the following comments and submissions in relation to section 2.24(d).

(i) The key issue for the Regulator concerns what is the "economically efficient operation" of the DBNGP. That requires that the Regulator examine what is economically efficient when viewed from the perspective of society as whole (rather than from just Epic's perspective) taking into account dimensions of allocative, productive and dynamic efficiency.

(ii) The achievement of the economically efficient operation of the DBNGP is consistent with a regulatory outcome that will result in more, rather than less, competition and which constrains the abuse of market power. In the context of establishing a reference tariff and an ICB for the DBNGP, this guides the Regulator toward the establishment of a reference tariff that replicates the economically efficient tariffs that would arise in a workably competitive market and establishing the ICB at a value that equals the DORC value.

(iii) The use of a DORC methodology provides the best indication of the upper limit of the range of values that would arise in a competitive market and is consistent with the concepts of allocative, productive and dynamic efficiency. It also results in tariff outcomes that replicate the economically efficient outcomes that a workably competitive market delivers. As such, the application of a DORC value is likely to result in reference tariffs that are consistent with economically efficient pricing and should limit opportunities for monopolistic pricing outcomes.

(iv) Equally, it would be inconsistent with the objective in section 2.24(d) to establish an ICB that promotes the inefficient construction of a competing pipeline. The duplication of natural monopoly infrastructure such as the DBNGP is an exception to the normal rule that competition is in the public interest. Setting a value for the ICB that encourages the construction of a second pipeline would be inconsistent with the principle of allocative efficiency because it would lead to a misallocation of capital within the economy. The use of a DORC value provides an estimate of the reproduction cost of replacing a pipeline. Generally, setting an initial capital base above a DORC value will provide economic signals that encourage users to reproduce a pipeline rather than use and pay for the services provided by the existing asset. Such an outcome will promote the inefficient construction of a competing pipeline, suggesting that it is inconsistent with section 2.24(d) to establish an ICB that exceeds the DORC value.

(v) As noted above, the Court indicated that section 2.24(d) is naturally related to paragraph (c) of the preamble to the Act, which indicates that an objective of the Act is the promotion of a competitive market[181] for gas, in which customers may choose suppliers, producers, retailers and traders. As the Hilmer Report recognised, a key factor in determining the extent of competition throughout the economy is the existence and operation of

[181] This means a workably competitive market: *ibid*, para 126.

"bottleneck" type infrastructure such as pipelines. AlintaGas submits that regard to this object of the Act when construing section 2.24(d) indicates that the Regulator should aim to achieve regulatory outcomes that ensure that prices in the bottleneck infrastructure are consistent with economically efficient prices and do not retard overall economic development. As discussed above, the implementation of Epic's proposed ICB would result in reference tariffs that exceed efficient pricing levels and which are inconsistent with the economically efficient operation of the DBNGP, impeding efficient energy use and harming the Western Australian economy. In contrast, for the reasons discussed above, a reference tariff that is based on an ICB that reflects a DORC value would be consistent with the promotion of a competitive market for gas in which consumers have choice and would achieve the objective of the economically efficient operation of the DBNGP.

(vi) AlintaGas submits that a use of monopoly power will be detectable by the extent to which outcomes diverge from those that would occur in a competitive market. Another indicator of a use of monopoly power would be the recovery of asset values beyond those that a competitive market would sustain. As discussed above, the asset values that would be sustained in a competitive market would not exceed those suggested by a DORC value. AlintaGas, therefore, submits that establishing the ICB at a value equal to the DORC value would also satisfy objective (b) of the preamble to the Act by eliminating monopoly pricing and achieving the the economically efficient operation of the DBNGP.

In summary, section 2.24(d) requires the Regulator to look at the economically efficient operation of the DBNGP. In the context of exercising the discretion under the last paragraph of section 8.1 (if the Regulator is required to do so in determining which 8.1 objectives prevail in guiding him in forming opinions, exercising discretions and making judgements under sections 8.10 and 8.11), section 2.24(d) clearly guides the Regulator toward reconciling conflicting 8.1 objectives, or deciding which of them should prevail, so as to establish the ICB at a value that is consistent with a DORC value.

5.6 Public interest

(a) The law

Section 2.24(e) provides that in assessing a proposed access arrangement the Regulator must take into account the public interest, including the public interest in having competition in markets (whether or not in Australia).

In its decision, the Court briefly dealt with section 2.24(e) and made the following findings.

- The public interest in having competition in markets reflects the objective of the Act in the promotion of a competitive market.[182]

[182] *Ibid*, para 134.

- The public interest generally has regard to a wider range of interests. They may "extend to embracing the protection of the interests of the owners of pipelines and the assurance of fair and reasonable terms and conditions being provided where their private rights are overborne" by legislation.[183]

(b) **Application of the law**

AlintaGas makes the following comments in relation to section 2.24(e).

(i) **Promotion of competition**

The first aspect of public interest to be considered under section 2.24(e) - that of having competition in markets - is a reflection of the ethos of the Code and its antecedents and underlying principles. The central theme of the National Competition Policy, as reflected in the Hilmer Report, is that competition is almost always in the public interest. Competitive markets result in lower prices, increased efficiency and better service, all of which are demonstrably in the public interest. By contrast, restrictions on competition may favour the private interests of producers and tend to deliver lower innovation, high costs, poor service and decreased efficiency.

In AlintaGas's view, there can be no question as to whether there is a public interest in having competition in markets. Section 2.24(e) expressly establishes this for the purposes of the Code.

Consistent with this public interest, the Regulator should seek outcomes that maximise the public interest in competition throughout the economy. Clearly, maximum competition will come from outcomes that lower energy transport prices and thereby increase competition in gas supply and between competing energy sources.

As discussed earlier in this Submission, the maximisation of competition in markets requires the elimination of inefficient monopoly pricing. To the extent that such pricing results in a high initial capital base, there will be a negative effect on competition in markets.

In contrast, the establishment of a reference tariff that is based, in part, on an initial capital base that is consistent with a DORC value will deliver competition in markets. Accordingly, the use of a DORC value for the ICB is consistent with the achievement of the public interest in having competition in markets under section 2.24(e).

(ii) **Other public interest considerations**

The second aspect of the public interest test is wider. AlintaGas makes the following comments in relation to it.

[183] *Id.*

(A) **Scope and meaning**

While the Code itself provides no guidance as to what constitutes public interest, the term is widely used in other applications of competition policy, including the *Trade Practices Act* 1974 (Clth) and the *Competition Principles Agreement* 1995.

The National Competition Council's ("**NCC**") view of public interest may assist the Regulator in applying the concept of public interest. The NCC takes the view that the main purpose of the public interest test is to ensure that:

> "… all relevant factors [are] considered when deciding whether restrictions on competition are warranted. The test requires consideration of an array of public interest matters, including the environment, employment, social welfare and consumer interests as well as business competitiveness and economic efficiency."[184]

Thus, the NCC's view is that the public interest captures a wide range of issues and that a key function of the public interest test is to ensure "all relevant factors have been considered".

Under Part IIIA of the *Trade Practices Act* 1974 (Clth), a public interest test applies in determining whether the Australian Competition and Consumer Commission ("**ACCC**") should accept an access undertaking for non-declared services. In this context, the ACCC has noted that the public interest criterion looks beyond the immediate interest of service providers and potential third party users and explores the extent to which an access undertaking contributes to the improved welfare of other parties and the broader community.[185] In its publication, *Access Undertakings: A Guide to Part IIIA of the Trade Practices Act*[186], the ACCC explains that, in assessing the public interest criterion, it draws on four sources.

- The first is Part IIIA itself. This specifies that the ACCC must have regard to "the public interest, including the public interest in having competition in markets (whether or not in Australia)" (section 44ZZA). Notably, this is the same as section 2.24(e).

- The second is the objective of the *Trade Practices Act* 1974 (Clth). Section 2 of that Act provides that the "object of the Act is to enhance the welfare of Australians through the promotion of competition and fair trading and provision for consumer protection".

[184] NCC, *National Competition Policy: Some Impacts on Society and the Economy*, January 1999, p 20.
[185] ACCC, *Access Undertakings: A Guide to Part IIIA of the Trade Practices Act*, September 1999, pp 10-11.
[186] *Id*.

- The third is clause 1.3(c) of the *Competition Principles Agreement* 1995. This provides a list of matters to be considered in the evaluation of a course of action under the *Competition Principles Agreement* 1995. They are as follows:

    1. legislation and policies relating to ecologically sustainable development;

    2. social welfare and equity considerations;

    3. legislation and policies relating to matters such as occupational health and safety, industrial relations and access and equity;

    4. economic and regional development, including employment and investment growth;

    5. the interests of consumers generally or a class of consumers;

    6. the competitiveness of Australian businesses; and

    7. the efficient allocation of resources.

- The fourth is a published list of factors recognised by the ACCC and the Australian Competition Tribunal as "public benefits" for the purposes of authorising anti-competitive arrangements under the *Trade Practices Act* 1974 (Clth). It includes the following:

    1. promotion of competition in industry;

    2. fostering business efficiency, especially improved international competitiveness;

    3. expansion of employment or prevention of unemployment in efficient industries and employment growth in particular regions; and

    4. improvements in the quality and safety of goods and services and expansion of consumer choice.

Notably, each of the four sources listed above emphasise the importance of economic efficiency and competition in markets. However, it is also clear that the public interest covers a broad range of other issues, focusing on economic efficiency and competition, but also covering subjects such as equity, consumer interests and safety.

The ACCC's approach also reflects past decisions of the NCC in relation to the issue of whether or not the declaration of a service under Part IIIA of the *Trade Practices Act* would be contrary to the public interest. In this regard, the NCC has repeatedly expressed

the view that, while other factors will be considered, a key consideration is economic efficiency.[187]

A further key point is that the public interest is not, by definition, private interest (although private interest may be relevant in making an overall assessment of the public interest), particularly where that private interest has been considered under other factors. The interests of the service provider and users are considered elsewhere, in sections (a), (b) and (f), and do not constitute the public interest. While it may be in the interests of a monopolist to obtain high prices, it is difficult to argue that monopoly pricing is in the public interest. Accordingly, the interests of the service provider and users do not fall for consideration under section 2.24(e).

(B) **Some public interest factors to consider**

AlintaGas encourages the Regulator to consider the range of public interest factors identified above.

AlintaGas also submits that the Regulator should consider the outcome for *the community as a whole* in considering access to the DBNGP. From this perspective, it is clear that the public interest, including but not limited to the NCC's key public interest areas of the environment, employment, social welfare, consumer interests, business competitiveness and economic efficiency, are best served by reconciling any conflicting 8.1 objectives, or deciding which of them should prevail, so that the reference tariff and the ICB for the DBNGP reflect as closely as possible an economically efficient level of prices. In particular, the public interest areas will not be well served by an outcome under which the ICB is established at a value that sets it equal to Epic's purchase price for the DBNGP.

A regulatory outcome delivering sustainably lower prices will represent a boost to the following key public interest factors.

- **The environment** – Keeping the delivered cost of gas at efficient levels will enhance gas use in preference to less environmentally friendly fuels. Gas averages around 51 kg of CO_2 per GJ compared to 93 kg of CO_2 per GJ for coal, an environmental advantage heightened by the greater efficiency of gas in electricity generation.[188]

- **Employment, business competitiveness and economic efficiency** – In an energy intensive economy such as Western Australia's, lower delivered energy prices and increased competition between fuels will boost economic efficiency and activity and hence employment. Energy intensive investment in the State competes with the rest of

[187] *Re Specialised Container Transport* (1997) ATPR (NCC) 70-004 & *Re NSW Minerals Council Limited* (1997) ATPR (NCC) 70-005.
[188] Australian Bureau of Agricultural and Resource Economics cited in Office of Energy, *Energy Western Australia 2000*.

the world based on delivered energy prices. The lower the tariffs on the DBNGP, the more competitive the State's economy becomes for such investment. Economic research has found significant economic benefits from productivity improvements in energy – improvements that are consistent with greater energy competition.[189]

- **Social welfare and consumer interests** – As an essential service, the lower the price of delivered gas, the better these factors are served.

(C) **Section 38 of the Act**

Section 38 of the Act applies where the Regulator is assessing a proposed access arrangement to determine whether it should be approved and, for that purpose, is required to take into account the public interest. When it applies, the provision requires the Regulator to:

> "take into account the fixing of appropriate charges as a means of extending effective competition in the supply of natural gas to residential and small business customers". (section 38(2))

The reference to appropriate charges is a reference to charges for the use of a pipeline to transport small quantities (currently, less than 1 TJ/a at single metered connection to the pipeline concerned) of natural gas for supply to residential and small business consumers.

Section 38 clearly identifies that there is a public interest in fixing appropriate charges as a means of extending effective competition in the supply of natural gas to residential and small business consumers. AlintaGas therefore submits that the Regulator should, in considering the public interest, take section 38 into account on the basis that it has direct application to the DBNGP or as an additional public interest factor that is of general application. Consideration of this factor requires a regulatory outcome that delivers sustainably lower tariffs on the DBNGP and, therefore, an ICB that is not over-valued.

(D) **Application of sale proceeds**

The Court's decision and Epic seem to suggest[190] that the public interest test is relevant to the purchase price of the DBNGP because the net proceeds of the sale were largely used by the State for debt retirement with consequential benefits for the State budget and taxpayers. Hence, it is argued that the use of the purchase price as the ICB can been validated by the public interest.

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[189] K W Clements, *The Great Energy Debate*, UWA Press, 2002.
[190] Epic Energy, *Fact Sheet*, p 3.

It may well be the case that there was a net public benefit in how the privatisation proceeds were applied. However, this is a function of how the proceeds were spent, rather than the actual transaction. There is no logical link between the source of the funds and what was done with them. It is possible for there to be a transaction which demonstrably is not in the public interest, but which nonetheless has a beneficial result in disposal of the proceeds. Alternatively, a transaction could be unquestionably in the public interest but the proceeds could be squandered by Government in unproductive and wasteful ways. In neither case would the Government's use affect the public interest assessment of the underlying transaction.

AlintaGas submits that the DBNGP privatisation should be assessed taking this important consideration into account, and that the public interest test in this case is limited to examining the regulatory arrangements surrounding the sale of the DBNGP - not the Government's use of the proceeds.

(E) **Inefficient construction**

One of the key public benefits offered by an effective third party access regime is that it removes incentives for access seekers to replicate natural monopoly assets by allowing access on fair and reasonable terms. As discussed earlier, a risk of setting the ICB too high is the incentive for inefficient construction of a second pipeline. As this would divert scarce resources from more productive uses, it would not be in the public interest.

(F) **Public interest in the protection of private interests**

The Court stated that the public interest may extend to embracing the protection of the interests of the owners of pipelines and the assurance of fair and reasonable conditions where their private rights are overborne by a statutory scheme.[191]

AlintaGas submits that this argument ought to be considered by the Regulator in the light of the following factors.

- "Fair and reasonable" refers to a balancing of interests between the pipeline owner and users; it does not refer to just the owner's interests.

- The owner's interests are only one component of the public interest and one which needs to be assessed against the myriad public interest factors discussed above. It must also be considered that little weight ought be given to this public interest factor because the very scheme, objects and scope of the Act are designed to provide the protection of the private

[191] *Supra* n. 2, para 134.

interests referred to by the Court. In particular, Epic's legitimate business interests and investments are covered by section 2.24(a).

- Further, little weight ought be given to this point because it is hardly a case in which an owner of private property rights simply had those property rights overborne by the statutory scheme. As recognised by the Court in its decision and as discussed above, Epic was made aware by the State at the time of acquiring its private property rights that a new statutory scheme would come into effect from 1 January 2000 which would directly affect the prices that Epic could obtain from that date.

(G) **Guidance from this aspect of the public interest**

AlintaGas submits that the general public interest factor in section 2.24(e) guides the Regulator in the exercise of his discretion under the last paragraph of section 8.1 toward reconciling conflicting 8.1 objectives, or determining which of them should prevail, so that the reference tariff and ICB for the DBNGP are lower, rather than higher.

5.7 **Interests of users and prospective users**

(a) **The law**

Section 2.24(f) provides that, in assessing a proposed access arrangement, the Regulator must take into account the interests of users and prospective users.

In its decision, the Court observed that the interests of users and prospective users are "likely to be counterpoised" to a service provider's legitimate business interests and investment.[192] However, the Court also said that there is some scope for those interests to find mutual accommodation in so far as maximising the use of a pipeline by virtue of third party use could be of benefit to users, prospective users and an owner and operator.[193]

(b) **Application of the law**

The interests of users and prospective users are likely to be counterpoised to the interests of Epic because the interests of users and prospective users are to obtain a low reference tariff, whereas Epic seeks to establish a high ICB. This is amply demonstrated by this Submission, which argues for the establishment of the ICB at an economically efficient DORC value of $1,234 million in response to Epic's previous proposals to establish an ICB, based on its purchase price, of $2,570 million.

It might be thought that it is in the interests of users and prospective users for prices for access to the DBNGP to be as low as possible. However, AlintaGas

[192] *Ibid*, para 135.
[193] *Id*.

submits that it is inconsistent with its interests for tariffs to be unreasonably low. For that reason, AlintaGas has accepted that it would not be reasonable or consistent with its interests to establish the ICB at or below the DAC value.

AlintaGas submits that proper consideration of section 2.24(f) requires the Regulator to minimise decisions taken that would damage the interests of existing and prospective users and that this requires an outcome delivering low sustainable tariffs. This is in marked contrast to the case advanced by Epic, which cannot be seen as anything other than significantly prejudicial to the interests of existing and prospective users.

AlintaGas submits that section 2.24(f) unequivocally guides the Regulator in the exercise of his discretion under the last paragraph of section 8.1 toward reconciling any conflicting 8.1 objectives, or determining which of them should prevail, (if he requires guidance under section 8.1 in taking into account and weighting the factors in sections 8.10 and 8.11 in establishing an initial capital base), so that the reference tariff and the ICB are established at economically efficient levels. Further, it specifically guides the Regulator toward the establishment of an ICB that is no higher than, but potentially less than, a DORC value.

In making these submissions, AlintaGas notes the Court's comments about maximising the use of the DBNGP. Of course, users will benefit if there are more parties using the DBNGP across which the costs of the DBNGP can be distributed. In addition, that would also be in Epic's legitimate business interests because capacity utilisation would be maximised. However, the approval of high reference tariffs and a high ICB, or the prospect of that occurring, will tend to discourage additional third party users.

AlintaGas also notes that Epic has argued[194] that the interests of prospective users requires an increased tariff, otherwise expansion of the DBNGP, which is close to capacity, cannot be funded on an equitable basis. This would require new users to pay considerably more, creating – in Epic's words - "second class citizens". AlintaGas and other existing DBNGP users have already provided a joint submission to the Regulator demonstrating that the creation of "second class citizens" is unnecessary. The submission shows there is ample scope under the Code for the DBNGP to be expanded on a basis that treats existing and prospective users equitably.

5.8 Other matters the Regulator considers relevant

(a) The law

Section 2.24(g) provides that, in assessing a proposed access arrangement, the Regulator must take into account any other matters that the Relevant Regulator considers are relevant.

The Court did not deal with this provision in its decision.

[194] Epic Energy, *Position on the Draft Decision*, p 1.

(b) **Application of the law**

The purpose of section 2.24(g) is to ensure that the Regulator is not precluded from taking into account matters that are relevant to exercising his discretion in achieving the objectives of the Code but which are not otherwise covered under sections 2.24 (a) to (f). AlintaGas is not aware of any additional factors that should be considered.

AlintaGas notes that Epic has argued[195] that the implementation of the Draft Decision would "create severe financial distress". AlintaGas submits that this issue is relevant to neither section 2.24(f) nor the public interest tests in the Code, concerning as it does the private interests of Epic, its financiers and shareholders. A key feature of a competitive market is that the risk of mistaken business decisions is borne by the companies concerned, rather than being shifted elsewhere. AlintaGas submits that the Regulator should, consistent with the notion of replicating the outcomes of a competitive market, dismiss any issue of possible distress to Epic when assessing section 2.24(g). Further, AlintaGas submits that Epic's interest in recovering its investments is already covered by section 2.24(a) and that it is not necessary to canvass it under any other factor.

5.9 **Analysis of 2.24 factors**

To the extent that it is necessary for the Regulator to exercise his discretion under the last paragraph of section 8.1, the 2.24 factors provide the following guidance to the Regulator.

(a) Epic's interest in recovering its investment of $2,407 million and a return on that interest should be taken into account to the extent that it is a legitimate business interest and investment (section 2.24(a)). This consideration guides the Regulator to exercise his discretion under section 8.1 toward adopting a higher, rather than lower, reference tariff and ICB. However, AlintaGas submits that it is not clear that the Regulator can properly use section 2.24(a) to simply choose to adopt and apply Epic's investment as the ICB. The Regulator's discretion under section 8.1 is to take into account as a fundamental element the fact that Epic has a legitimate business interest in recovering its investment and does not provide the Regulator with a warrant to over-ride the considerations raised by the 8.10 factors as guided by the 8.1 objectives.

(b) AlintaGas and other users are already using the DBNGP and have firm and binding contractual obligations with Epic that should be considered (section 2.24(b)).

(c) The Regulator must take into account the operational and technical requirements necessary for the safe and reliable operation of the DBNGP (section 2.24(c)). AlintaGas submits that this consideration does not provide material guidance to the Regulator in the exercise of his discretion under section 8.1. AlintaGas also notes that it is unnecessary for the Regulator to exercise his discretion under the last paragraph of section 8.1 so as to establish the ICB above a DORC value. The Draft Decision already provides for operational, maintenance and forward capital expenditure. The use of a DORC value will be sufficient for the purposes of

[195] *Id.*

section 2.24(c). In addition, the Regulator should thoroughly investigate any claims by Epic to the contrary.

(d) The Regulator must take into account the economically efficient operation of the DBNGP (section 2.24(d)). This objective clearly guides the Regulator toward exercising his discretion under the last paragraph of section 8.1 so as to establish the ICB at a value that is no higher than a DORC value.

(e) The Regulator must also take into account the public interest, including the public interest in having competition in markets (section 2.24(e)). The public interest in having competition in markets requires that the Regulator exercise his discretion under the last paragraph of section 8.1 so as to establish the ICB at a value that is no higher than a DORC value. The public interest that is the subject of section 38 of the Act in fixing appropriate charges as a means of extending effective competition in the supply of natural gas to residential and small business consumers requires the same. Other public interest considerations also guide the Regulator to exercise his discretion so as to establish a reference tariff and an ICB that are at economically efficient levels.

(f) The interests of users and prospective users must also be taken into account by the Regulator (section 2.24(f)). Those interests are in the establishment of sustainably low prices for access to the DBNGP and an economically efficient value for the ICB. This unequivocally guides the Regulator toward exercising his discretion under the last paragraph of section 8.1 so as to establish an ICB that is possibly lower than a DORC value.

(g) The Regulator must take into account any other matters that he considers relevant. AlintaGas is not aware of any other relevant matters that should be considered (if they are at all relevant to that exercise (which AlintaGas disputes)).

In AlintaGas's view, all of the 2.24 factors, with the exception of section 2.24(a), guide the Regulator to exercise his discretion so as to establish a reference tariff and an ICB that are at economically efficient levels. More particularly, the 2.24 factors other than section 2.24(a) indicate that the ICB should not be established at a value in excess of the estimated DORC value. The factors which provide this guidance include those that take into account the economically efficient operation of the DBNGP, the public interest and the interests of users and prospective users.

In contrast, section 2.24(a) indicates that Epic has a legitimate business interest in recovering its investment in the DBNGP to the extent that it represents a sound commercial valuation. Thus, section 2.24 guides the Regulator to exercise his discretion under section 8.1 toward adopting a higher, rather than lower, reference tariff and ICB for the DBNGP. However, as noted above, it does not mean that the Regulator can simply determine that the purchase price should apply as the ICB.

To resolve the tension between the competing 2.24 factors it is necessary for the Regulator to exercise a discretion that must be guided by the scope and objects of the Act and the Hilmer Report. In AlintaGas's view, any consideration that takes those things into account

must lead to the conclusion that it would be inconsistent to establish an ICB that exceeds the DORC value of $1,234 million.[196]

The establishment of an ICB for the DBNGP in excess of a DORC value will not facilitate the development and operation of a national market for natural gas contrary to objective (a) of the Act. Further, it will not prevent the abuse of monopoly power, contrary to objective (b), and it will not promote a competitive market for natural gas in which customers may choose suppliers, contrary to objective (c).

Just as importantly, it would run counter to the fundamental objectives of the Hilmer Report and be incongruent with the provision of access on terms and conditions that are fair and reasonable, contrary to objective (d). Importantly, objective (d) means fair and reasonable not only from the perspective of the owner and operator of the DBNGP, but also from the perspective of "persons wishing to use the services of" the DBNGP. For the reasons set out in this Submission, it is not fair and reasonable to ask the users and prospective users of the DBNGP to pay in excess of the economically efficient value of the DBNGP on the ground that Epic has a legitimate business interest in recovering what it paid for the pipeline.

As such, AlintaGas submits that, to the extent it is necessary to obtain such guidance, the 2.24 factors guide the Regulator to exercise his discretion under the last paragraph of section 8.1 so as to establish an ICB that is economically efficient and certainly no higher than a DORC value of $1,234 million.

6. CONCLUSION

In conclusion, AlintaGas submits that after:

- taking into account and weighting the factors specified in sections 8.10, 8.11, 8.1 and, to the extent it is necessary to do so, section 2.24;
- considering the price paid by Epic for the DBNGP in the circumstances that prevailed at the time of the sale and which were then reasonably anticipated or reflected Epic's reasonable expectations; and
- having regard to the reasons in the Court's decision and their effects on the matters identified in the Draft Decision as being the reasons for requiring amendments to the Access Arrangement,

the Regulator should not approve the establishment of an ICB at a value greater than the DORC value set out in the Draft Decision.

There is no reason, therefore, for the reference tariff to be changed from the indicative reference tariff set out in the Draft Decision.

In particular, AlintaGas submits that applying the sale price as the ICB would be unacceptable and inappropriate for a range of reasons. For example, it would:

[196] It also requires the rejection of any device, including a deferred recovery mechanism, that is used to attempt to justify a proposed ICB that is over $1,000 million in excess of all other estimates of the value of the assets that comprise the DBNGP.

- be contrary to the public interest and the promotion of the competition objectives of the Code;

- ignore the well established fact that purchase prices for regulated assets often include regulatory premiums over regulated asset bases; and

- not take account of the apparently incorrect assumptions used by Epic in calculating the price at which it acquired the DBNGP.

AlintaGas, therefore, submits that in considering the matters identified by the Court as requiring further attention, including the requirements of the Code and the circumstances of the DBNGP sale, the Regulator can and should legitimately maintain the position established in the Draft Decision.