



## **DAMPIER TO BUNBURY NATURAL GAS PIPELINE**

### **PROPOSED ACCESS ARRANGEMENT UNDER THE NATIONAL ACCESS CODE**

#### **Additional Paper 3: Comments on AlintaGas's Fourth Submission to Regulator on Epic Energy's DBNGP Access Arrangement**

**8 September 2000**

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## 1. Introduction

- 1.1 On 20 April 2000, the Western Australian Independent Gas Pipelines Access Regulator (“the Regulator”) advised that four additional submissions relating to the proposed Access Arrangement for the Dampier to Bunbury Natural Gas Pipeline (“the DBNGP”) had been placed on the Office of Gas Access Regulation (“OffGAR”) web site. One of those submissions was Epic Energy Submission 1 (Public Version, dated 28 February 2000). That submission had, as an attachment, a report prepared by The Brattle Group describing the valuation method adopted for the DBNGP. The Regulator further advised that he would open another period for public submissions on issues raised in the four submissions.
- 1.2 AlintaGas subsequently made its *Fourth Submission to Regulator on Epic Energy’s DBNGP Access Arrangement* (“AlintaGas’s Fourth Submission”) addressing issues raised in Epic Energy Submission 1 and The Brattle Group valuation report. That submission was not available to Epic Energy for comment prior to the close of the further period for public submissions.
- 1.3 AlintaGas’s Fourth Submission deals with a number issues that are relevant to the case Epic Energy has made to the Regulator concerning its proposed Access Arrangement for the DBNGP. Furthermore, in the submission, AlintaGas has made a number of statements which Epic Energy believes are incorrect, or which could mislead another party seeking to understand the Access Arrangement and its proposed Reference Tariff.
- 1.4 Epic Energy indicated in its Submissions 4 - 9 that, where it was unable to provide detailed comment on issues raised, or had not provided comment in earlier submissions, it would endeavour to deal with those issues in further papers to the Regulator.
- 1.5 Epic Energy’s comments on some of the points raised in AlintaGas’s Fourth Submission are made in this Additional Paper 3. These comments deal with the following issues:
- the regulatory compact, and Epic Energy’s obligations to lodge an Access Arrangement for the DBNGP prepared in accordance with the requirements of the *National Third Party Access Code for Natural Gas Pipeline Systems* (“the Code”);
  - Epic Energy’s proposed initial Capital Base for the DBNGP and the deferred recovery account; and
  - the proposed Reference Tariff:
    - inclusion of prudent discounts;
    - an appropriate level for the tariff;
    - long term tariff expectations; and
    - firm service terms and conditions.
- 1.6 This document does not contain any information which Epic Energy is under an obligation of confidentiality to any person not to disclose or where it does Epic Energy has obtained all necessary consents and permissions for the publication of that information.

## **2. The regulatory compact and the Code**

2.1 Section 2 of AlintaGas's Fourth Submission argues that there was no regulatory compact of the type Epic Energy has asserted it had with the State (and AlintaGas) and, in particular, that:

- "AlintaGas did not agree to accept headline tariffs of \$1.00 per GJ and \$1.08 per GJ or any other headline tariffs"; and
- "AlintaGas did not agree to allow Epic Energy to use the DBNGP purchase price as the initial capital base in determining tariffs under the National Access Code, or any other Capital Base".

Furthermore, AlintaGas indicates that it was "aware that the State had no such agreements and had no such understandings with Epic Energy".

2.2 Epic Energy introduced the term regulatory compact in its confidential submission to the Regulator lodged with the DBNGP Access Arrangement on 15 December 1999. The term was retained in the version of the Confidential Submission subsequently released by the Regulator as Epic Energy Submission 1, and further elaborated on in Epic Energy Submission 4. Another additional paper ("Additional Paper 4: Regulatory Compact") filed by Epic Energy at the same time as this paper provides a further look at this concept. In particular Epic Energy Additional Paper 4 attaches a detailed report from Epic Energy's regulatory experts, The Brattle Group, which considers the regulatory compact concept developed by Epic Energy in relation to the proposed Access Arrangement for the DBNGP. That further report is complimentary to The Brattle Group's earlier report on the regulatory valuation model. Throughout, Epic Energy has sought to assign a clear meaning to the term regulatory compact, and to use it consistently in all of its submissions on the DBNGP Access Arrangement.

2.3 Epic Energy uses the term regulatory compact to describe the common understandings and expectations that developed between prospective purchasers of the DBNGP and the Government of Western Australia during the Pipeline sale process. These common understandings and expectations were understandings and expectations about the gas market in the State, about the Pipeline sale process, and about the way in which the DBNGP would operate after the sale. One of these common understandings was an understanding as to the level of gas transportation tariffs after the Pipeline sale.<sup>1</sup>

2.4 AlintaGas claims that there were no understandings, and there was no agreement between the State and Epic Energy, as to the future level of tariffs. Epic Energy concurs with AlintaGas on the point of there being no agreement between it and the State as to the level of tariffs.<sup>2</sup> Epic Energy has, throughout, maintained that the term regulatory compact does not refer to an agreement, although some aspects of the common understandings and expectations that developed between prospective purchasers of the DBNGP and the Government of Western Australia during the Pipeline sale process were subsequently recorded in the DBNGP Asset Sale Agreement.

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<sup>1</sup> For a short summary of the essential elements of the regulatory compact, see Section 2 of Epic Energy Additional Paper 4.

<sup>2</sup> Epic Energy has maintained throughout that there was not an agreement or guarantee for the tariffs set out in Schedule 39: see paragraph 2.3 of Epic Energy's Additional Paper 4 and the footnote to that paragraph.

- 2.5 Epic Energy does not accept AlintaGas's view that there were no understandings as to the future level of tariffs. Epic Energy's position on this matter – that there were understandings – has been set out in its earlier submissions.<sup>3</sup> Recent statements by the Minister for Energy, during a debate on a motion to appoint a Select Committee in relation to the sale of the DBNGP on 14 June 2000 ("14 June debate"), provide further support for Epic Energy's position. These statements are analysed in detail in Section 3 of Epic Energy Additional Paper 4.
- 2.6 The salient points made by the Minister during that debate were:
- the sale of the Pipeline was a "large and complex transaction";
  - a number of significant policy issues had to be dealt with, and these issues were matters for the Government, and for the Minister, who had overall control of the sale process;
  - gas transportation tariffs were critical;
  - given the uncertainty about the future level of tariffs and the impact that would have on the purchase prices bid along with a risk that the successful bidder might subsequently secure, through the regulatory arrangements of the Code, a higher tariff than the Government considered appropriate, the Government determined to provide certainty so bidders were only bidding on purchase price;
  - the tariff was, therefore, one of the policy issues the Minister sought to resolve as part of the sale process;
  - the bids underwent rigorous scrutiny by the Gas Pipeline Sale Steering Committee, to determine, in part, that:
    - the purchase price coupled with the proposed tariff and tariff path was sustainable;
    - the proposed tariff and tariff path were consistent with the Government's objectives in relation to the tariff; and
    - that the bidder would remain a viable business if its bid was accepted;
  - the Government would not have accepted a bid lower than \$1.00/GJ to Perth and would not have accepted a bid higher than contained in Schedule 39, namely \$1.00/GJ to Perth and \$1.08/GJ to south of Perth; and
  - the Minister personally considers Epic Energy's proposed Access Arrangement to be reasonable.
- 2.7 The Minister indicated the Government's preferred level of future tariffs was to be fixed initially by regulation.<sup>4</sup> Continuation of that level of tariffs, once that regulation lapsed, was secured by Clause 9 of Schedule 5 to the Asset Sale Agreement. That Clause advises that the tariffs and the tariff path of the bid provide the bidder with an acceptable return on investment, and permits AlintaGas to freely disclose those tariffs to any governmental agency, or in the course of any public inquiry or other determination process relating to tariffs. In the 14 June debate, the Minister acknowledged how important this was and indicated that the Epic Energy bid underwent rigorous scrutiny.<sup>5</sup>
- 2.8 The Government's policy was clear. It wanted tariffs of around \$1.00/GJ to Perth. It subsequently enshrined that by regulations promulgated on 31 December 1999 until an access arrangement was approved under the Code as implemented in Western Australia. Subsequently, tariffs would be set in accordance with the reference tariff principles of the

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<sup>3</sup> See Epic Energy Submission 1, Epic Energy Submission 3, Epic Energy Submission 4, the revised Access Arrangement Information and Epic Energy Additional Paper 4.

<sup>4</sup> See Hansard, 14 June 2000 at pages 7655 and 7656.

<sup>5</sup> See paragraph 3.7 of Epic Energy Additional Paper 4.

Code, but they would remain consistent with the Government's preferred level of future tariffs. If Epic Energy, as the successful bidder for the DBNGP, sought to secure higher tariffs through the regulatory arrangements of the Code, the Government had the information required for making a case to the Regulator that the tariffs it preferred were consistent with an acceptable return on Epic Energy's investment in the Pipeline. As the Minister for Energy stated, there was no lack of understanding on this matter. It was understood by the Government. It was understood by Epic Energy. Only AlintaGas appears not to accept this understanding as to the Government's policy on gas transportation tariffs developed during the DBNGP sale process.

- 2.9 Comments by the Minister for Energy during the 14 June debate also refute AlintaGas's claim that the State had no understanding with Epic Energy concerning the link between the price it paid for the DBNGP and the level of future tariffs. Again, Epic Energy fully agrees with AlintaGas that there was no formal agreement on the matter. There was, nevertheless, a clear understanding. The Government sought to ensure that bids were assessed on both compliance with its tariff policy and the bid price.<sup>6</sup>
- 2.10 Parliament was advised, in the 14 June debate, that both the Minister for Energy and the Gas Pipeline Sale Steering Committee were satisfied that Epic Energy's bid, and the tariffs and tariff path of Schedule 39, met the Government's criteria for tariffs and sustainability.<sup>7</sup>
- 2.11 The Minister also indicated that a bid with a tariff of less than \$1.00/GJ to Perth was not acceptable to the Government, as this would have meant changing the selection criteria which reflected the Government's policy decisions.<sup>8</sup> Nor was a bid with a tariff higher than that set out in Schedule 39 of the Asset Sale Agreement acceptable to the Minister.<sup>9</sup>
- 2.12 Epic Energy's bid for the DBNGP was clearly understood by the Minister. It was also understood by the Gas Pipeline Sale Steering Committee, which, as the Minister has indicated, scrutinised it to ensure that the purchase price was consistent with the proposed tariff and tariff path, and with the continued financial viability of the purchaser.
- 2.13 The DBNGP sale process put into place a set of common understandings in accordance with which:
- Epic Energy would make an initial investment of \$2,407 million in the DBNGP, and undertake to make further large investments in the Pipeline (expected to total about \$870 million) as demand for gas transportation services grew with the development of the Western Australian economy;
  - Epic Energy would make the initial investment, and undertake future investment, because the Government's preferred level of future tariffs would provide its shareholders with a return on investment commensurate with prevailing market conditions; and
  - the Government of Western Australia would achieve its policy objective with respect to the level of future gas transportation tariffs, and would secure its desired high price for the Pipeline, with which it would be able to repay State debt and undertake further health, education and infrastructure initiatives.<sup>10</sup>

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<sup>6</sup> See paragraph 3.7 of Epic Energy Additional Paper 4.

<sup>7</sup> See paragraph 3.9 of Epic Energy Additional Paper 4.

<sup>8</sup> See paragraph 3.9 of Epic Energy Additional Paper 4.

<sup>9</sup> See paragraph 3.9 of Epic Energy Additional Paper 4.

<sup>10</sup> See paragraph 3.10 of Epic Energy Additional Paper 4.

- 2.14 Epic Energy believes that these elements comprise the essential elements of a regulatory compact. The consistency of that with overseas thinking is dealt with in detail in paragraph 3.11 and Sections 4 and 5 of Epic Energy Additional Paper 4 and the further report from The Brattle Group attached to that paper.
- 2.15 AlintaGas proceeds, in section 2.1 of AlintaGas's Fourth Submission, to argue that Epic Energy's use of the term regulatory compact does not accord with its (AlintaGas's) understanding of the way in which that term is used in United States regulatory thinking. AlintaGas states that it has been advised that "the concept of regulatory compact, as it applies in the United States, is one in which the public and a utility have rights and obligations towards each other". AlintaGas concludes:
- “. . . a “regulatory compact” as envisaged within United States’ jurisdictions, is simply the process embodied by the application of the National Access Code. In consequence, AlintaGas submits, that the regulator should ignore any inference by Epic Energy that a “regulatory compact”, as Epic Energy utilises the term, is accepted practice in the United States. In any event the practice in the United States is irrelevant in the context of the National Access Code, which Epic Energy knew was to be applied to the DBNGP at the time Epic Energy purchased the DBNGP, . . . .“*
- 2.16 Epic Energy accepts that the Code is one element of the regulatory compact that developed during the DBNGP sale process. It was not, as AlintaGas seems to imply, the only element of the regulatory compact. The Code, in the context of the regulatory compact, is further discussed later in this Additional Paper 3.
- 2.17 Epic Energy's use of the term regulatory compact may not accord with AlintaGas's understanding of the way in which that term is used in United States regulatory thinking. AlintaGas has made a number of bald statements in this area apparently supported by some advice which it has not been prepared to disclose. Epic Energy suggests that AlintaGas's unnamed adviser has provided AlintaGas only with a description of the way in which the regulatory compact manifests itself in the particular circumstances of the United States. There is no reference in AlintaGas's Fourth Submission to the economic imperatives that give rise to and support, without the need for formal agreement, the terms of a regulatory compact. On the other hand Epic Energy has been quite open with who its adviser is and what they have advised.
- 2.18 AlintaGas's reasoning in section 2.1 of AlintaGas's Fourth Submission certainly does not support AlintaGas's conclusion that the Regulator should ignore Epic Energy's view that the concept of a regulatory compact is accepted practice in the United States.
- 2.19 Epic Energy maintains that the concept of a regulatory compact, and the way in which such a compact developed between Epic Energy and the State during the DBNGP sale process, is critical to understanding its proposed Access Arrangement for the DBNGP. Epic Energy fully agrees with AlintaGas that, in the context of the DBNGP sale process and application of the Code, specific practice in the United States is irrelevant. This being the case, the explication of the concept of the regulatory compact in the United States provided by AlintaGas is uninformative and potentially misleading. It totally ignores the way in which that practice has been shaped by economic imperatives, and by particular institutions, and, in consequence, does not provide informed comment on the regulatory compact that developed between Epic Energy and the State of Western Australia during the DBNGP sale process. Epic Energy and its advisers, The Brattle Group, have taken a far more



considered approach to an analysis of the United States position, which is set out in Epic Energy Additional Paper 4 and the report from The Brattle Group attached to it. The Brattle Group's report, is an explanatory paper setting out the concept of the regulatory compact, and the way in which that concept has been used in regulatory debate in the United States and the United Kingdom. (The Brattle Group has advised both regulators and regulated businesses in both jurisdictions.)

- 2.20 AlintaGas's concern with Epic Energy's view of its regulatory compact with the State is made clear in sections 2.2.1, 2.2.2, and 2.2.3 of AlintaGas's Fourth Submission. AlintaGas sees the regulatory compact as implying an agreement between Epic Energy and the State to use the DBNGP purchase price as the initial Capital Base in determining tariffs under section 8 of the Code, in effect usurping the regulatory process. AlintaGas argues that "even if there was some form of regulatory compact between Epic Energy and the State, which AlintaGas understands there is not, the Regulator's independence means that it is not, and should not be, bound by any such compact". In AlintaGas's view, by the time Epic Energy submitted its final bid for the DBNGP, it knew that tariffs would be determined by an independent regulator, and not by or through an agreement with the State.
- 2.21 Epic Energy totally rejects the assertion that it has suggested the State agreed to Epic Energy using the DBNGP purchase price as the initial capital base for determining tariffs under the Code. Epic Energy has never made such a statement. The regulatory compact is about the tariffs and tariff path and the benefits and understandings the State derived from the sale of the DBNGP to Epic Energy. As such the setting of an initial capital base was to comply with the Code and not for the determination of the tariff and tariff path – they having already been set by the regulatory compact. The use of the purchase price as part of the initial capital base came as a result of advice from Epic Energy's regulatory experts, The Brattle Group, who, in short, said that that sum, along with some other amounts, was the most appropriate value for the capital base in the circumstances. Epic Energy does not intend to revisit that argument in this paper but simply refers the Regulator to Epic Energy Submission 1 filed on 15 December 1999.
- 2.22 Earlier in section 2 of its Fourth Submission, AlintaGas appears to accept the term regulatory compact as describing common understandings and expectations. However, that meaning of the term is lost as AlintaGas develops its arguments against Epic Energy's proposed DBNGP Access Arrangement in sections 2.2.1, 2.2.2, and 2.2.3 of AlintaGas's Fourth Submission. In these sections, AlintaGas's purpose appears to be best served by referring to an "agreement" between Epic Energy and the State.
- 2.23 To replace the term regulatory compact with "agreement" is misleading. There was, as AlintaGas rightly points out, no agreement between Epic Energy and the State. There was certainly no agreement regarding the value of the Capital Base Epic Energy would use for tariff setting under the Code. There was, however, a regulatory compact – a set of common understandings. Those common understandings included the understanding that the price Epic Energy paid for the DBNGP was consistent with the level of future tariffs the Government was seeking through the policy decisions it made at the time of Pipeline sale, and that the tariffs and the purchase price were consistent with Epic Energy's continued viability.
- 2.24 AlintaGas's Fourth Submission is at odds with the way the State saw the whole sale process and what it was seeking from bidders for the DBNGP. The State's position has been clearly demonstrated in the recent statements by the Minister for Energy referred to

above and in Epic Energy Additional Paper 4. Given that the Minister<sup>11</sup> and the Gas Pipeline Sale Steering Committee<sup>12</sup> were acting effectively as AlintaGas's agents in the DBNGP sale process, AlintaGas is now at odds with what actually happened in making such statements.

- 2.25 Epic Energy fully accepts AlintaGas's view that, if there was an agreement between Epic Energy and the State regarding the value of the Capital Base Epic Energy would use for tariff setting under the Code, and regarding tariffs, that agreement could not be binding on the Regulator.
- 2.26 AlintaGas notes, in section 2.7 of AlintaGas's Fourth Submission, that Schedule 39 of the Asset Sale Agreement ("Schedule 39"), the schedule setting out Epic Energy's proposed tariffs and future tariff path, was not contractual in respect of charges for a T1-equivalent reference service, although it did indicate that, in 1998, Epic Energy was of the view that the proposed tariffs and tariff path were sustainable at a purchase price of \$2.407 billion. Furthermore, according to AlintaGas, Schedule 39 was significant because it did not "refer to any "regulatory compact" with the State which gave Epic Energy a guarantee that the proposed tariffs could be implemented". It did not, AlintaGas argues, because it could not as "there was no such agreement". AlintaGas's statements about the importance of Schedule 39 are at odds with AlintaGas's statements elsewhere in its Fourth Submission and in AlintaGas's Second Submission regarding a T1 equivalent reference service (this aspect is commented on later in this Submission).
- 2.27 Epic Energy acknowledges that Schedule 39 was non-contractual in the way implied by AlintaGas. However, it provides a clear indication of the understandings and expectations about tariffs and the purchase price that had developed during the DBNGP sale process. Schedule 39, as AlintaGas rightly points out, did not refer to any regulatory compact. The regulatory compact is a concept representing the various understandings and expectations of which the content of Schedule 39 formed only part. It would not be expected to see any reference to the regulatory compact concept in that schedule. To suggest such shows that AlintaGas does not understand what the concept is all about.
- 2.28 The regulatory compact does not "usurp" the regulatory process as suggested by AlintaGas. It operates entirely consistently with it and, as Epic Energy has submitted in its various submissions, meets the principles under the Code that are required to be met.
- 2.29 Section 3 of AlintaGas's Fourth Submission describes, at some length, the process through which Epic Energy, as a potential purchaser of the DBNGP, was apprised of the Code's development through the course of the Pipeline sale process. It concludes: "there was no doubt that when Epic Energy submitted its bid for the DBNGP, it did so in full knowledge that from (it was then expected) 1 January 2000, tariffs for the DBNGP would be set either under the National Access Code, or under an equivalent access regime containing all key elements of the National Access Code". Section 3 contains AlintaGas's support for its earlier assertion that, by the time Epic Energy submitted its final bid for the DBNGP, it knew that tariffs would be determined by an independent regulator, and not by or through an agreement with the State.

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<sup>11</sup> As demonstrated through section 6(2) of the *Dampier to Bunbury Pipeline Act 1997* and the directions given by the Minister to AlintaGas pursuant to that provision on 6 January 1998 and 3 March 1998 (those directions are described on page 27 of AlintaGas's 1998 Annual Report).

<sup>12</sup> By virtue of section 6(3) of the *Dampier to Bunbury Pipeline Act 1997*, the direction given on 6 January 1998 and the manner in which the Committee acted during the sale process, the Committee was acting as the agent of AlintaGas in relation to the sale of the DBNGP.



- 2.30 Epic Energy acknowledges that, despite the fact the Gas Pipelines Access (Western Australia) Bill had not yet been introduced to the parliament, it was aware, by the time it submitted its final bid for the DBNGP, that future tariffs would be determined by the Regulator and not by, or through, agreement with the State. Whether Epic Energy, an “outsider” in relation to the governmental system in Western Australia, could have been as certain about the Code and its implementation as AlintaGas seeks to imply, is open to debate. However, Epic Energy has maintained and continues to maintain that the proposed Access Arrangement is consistent with the Code. It has never suggested that the regulatory compact overrides the Code. The regulatory compact is but one factor, although a very important one, which the Code requires the Regulator to take into account in determining whether to approve the proposed Access Arrangement. If Epic Energy had been suggesting that the regulatory compact overrode the Code and hence did not require Epic Energy to submit its proposed Access Arrangement “to scrutiny and approval of an independent regulator”, it would never have filed the proposed Access Arrangement with the Regulator. It is a matter of record that it has done so.
- 2.31 Epic Energy notes the words used by AlintaGas in parentheses at the bottom of page 9 of AlintaGas’s Fourth Submission – “*the uncertainty as to which code would apply was simply a matter of timing, and the need to be absolutely precise in the context of a major asset sale*”. This is exactly the point that was made by the Minister during the 14 June debate<sup>13</sup>, ie. that uncertainty had to be negated in order to have bidders concentrate just on the purchase price and so the Government took that uncertainty away by determining what that tariff should be.
- 2.32 The point that AlintaGas makes at section 3.4 of its Fourth Submission is agreed with by Epic Energy in the sense that that report was but one element of what was happening during the sales process. The State was clearly endeavouring to put some substance around the framework of tariff certainty. Epic Energy has never suggested otherwise in referring to the Price Waterhouse report. Epic Energy has not suggested that it has any greater significance than that.
- 2.33 Epic Energy accepts, without question, the independence of the Regulator in all matters to be dealt with under the Code. There was, as AlintaGas asserts, and as Epic Energy has previously stated, no formal agreement between Epic Energy and the State. Nevertheless, there was a regulatory compact, and the Regulator should, Epic Energy maintains, give consideration to the common understandings and expectations which comprise that compact in his approving the DBNGP Access Arrangement in accordance with the relevant provisions of the Code.

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<sup>13</sup> See commentary in paragraphs 2.6 to 2.8 above and in Epic Energy Additional Paper 4.

### 3. Capital Base and the Deferred Recovery Account

- 3.1 In section 4 of its Fourth Submission, AlintaGas submits that the Regulator should not allow use of a deferred recovery account in rolling forward the Capital Base of the DBNGP. AlintaGas's principal reason for this position appears to be that it sees the deferred recovery account as a means of sustaining an inappropriate Capital Base. AlintaGas argues:

*"In applying the deferred recovery concept to the DBNGP, Epic Energy is attempting to defer cost recovery on a fully loaded pipeline in which the capital base is set at the price Epic Energy chose to pay for the DBNGP. This price incorporates a considerable premium above the depreciated replacement cost of the DBNGP."*

- 3.2 AlintaGas further contends that Epic Energy misleads in putting forward the view, in the valuation report prepared by its (Epic Energy's) regulatory advisers, The Brattle Group, that the deferred recovery method is an accepted method in Australia and overseas. AlintaGas considers the use of a deferred recovery concept to be acceptable only "when it is applied to a new pipeline as a way of normalising the tariff structure while gas demand on the pipeline increases".
- 3.3 Epic Energy is of the view that AlintaGas's submission, in the way in which it deals with the Capital Base and the deferred recovery account, does not accurately reflect the proposals of the DBNGP Access Arrangement and the associated Access Arrangement Information.
- 3.4 Epic Energy's Capital Base for the DBNGP, and its use of the deferred recovery account, must be understood in the context of the reference tariff and the tariff path of the proposed Access Arrangement. The reference tariff and the tariff path proposed by Epic Energy are the tariff and the tariff path of the regulatory compact.
- 3.5 The tariff and the tariff path of the regulatory compact support the price Epic Energy paid for the DBNGP. Epic Energy made, at the time of Pipeline sale, an assessment of the price it was prepared to pay, given its understanding of the gas transportation tariff the Government of Western Australia had sought to establish as a matter of policy during the sale process. That purchase price was consistent with the Government's required tariff, and with a tariff path which would see the tariff increase at 67% of the increase in the Consumer Price Index over an extended period. Both Epic Energy's proposed tariff (namely \$1.00/GJ to Perth and \$1.08/GJ to south of Perth) and tariff path and its purchase price underwent rigorous scrutiny by the Gas Pipeline Sale Steering Committee on behalf of AlintaGas and the State.<sup>14</sup> The Minister has confirmed that the State considered the purchase price to be sustainable based on the proposed tariff and tariff path which the State considered was appropriate. Epic Energy notes the recent comment by the Minister for Energy on the tariff path:

*"With regard to a long term price strategy that [Epic Energy] might pursue, I have said publicly that I was comfortable with that, because it implied that the real cost of gas transport would continuously fall."*<sup>15</sup>

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<sup>14</sup> See paragraphs 2.6 and 2.7 above and paragraph 3.7 of Epic Energy Additional Paper 4.

<sup>15</sup> Hansard, 14 June 2000, page 7657.

- 3.6 The purchase price, and the tariff and tariff path, also reflected the substantial growth in gas transportation demand indicated by the Government's forecasts made available to prospective bidders during the sale process.
- 3.7 Epic Energy's bid for the DBNGP included a price at which it was prepared to purchase the Pipeline that reflected the present value of the revenue stream it expected, over a period of 20 years, given the level of the tariff and the proposed tariff path, the Government's forecast of gas transportation demand, and the future investment Epic Energy would have to make if it were to be able to satisfy the anticipated growth in demand.
- 3.8 With the tariff and the tariff path fixed, Epic Energy must, for consistency, use an economic, rather than an accounting, concept of depreciation in establishing the cost of service. Economic depreciation in any period is the difference between the revenue generated in that period and the sum of the operating costs and return on the capital base for the period. Economic depreciation may be negative in periods when the sum of operating costs and return exceeds the revenue generated. However, provided the tariffs used in determining revenue have been set to recover no more than the initial cost of the asset, plus expansion costs and operating costs, the accumulated economic depreciation will recover only the initial cost of the asset plus the expansion costs.
- 3.9 The use of economic depreciation:
- allows a tariff that changes in a manner consistent with efficient growth of the market (which may involve a substantial portion of depreciation in future periods);
  - permits the initial capital cost of an asset to be recovered over its economic life; and
  - involves depreciation of the asset only once.

These are the requirements for a method of depreciation that is acceptable under the Code.

- 3.10 Epic Energy's deferred recovery account does no more than record accumulated economic depreciation. It is a valid construct, irrespective of whether the pipeline for which it is used is an existing fully loaded pipeline, or an existing pipeline with fluctuating demand, or a new pipeline with an expectation of increasing demand. At the time Epic Energy purchased the DBNGP it had the expectation, as did the State (in fact it was a stated objective of the State to have a purchaser who would continue to expand the pipeline), that volumes, which did not then exist or were contracted, would eventuate. This was a not dissimilar way to that for new pipelines.
- 3.11 Economic depreciation and deferred recovery have been used, as AlintaGas points out, in tariff construction for new pipelines for which market growth is expected. This does not preclude their use in other contexts, provided Code requirements are satisfied. Epic Energy has used them in the case of the DBNGP. The DBNGP is currently close to being fully loaded, but further growth in gas transportation demand is expected. This is, however, irrelevant. Epic Energy maintains that the approach it has taken to capital recovery is consistent with the Code, and consistent with a regulatory compact in which its shareholders have reasonable expectations of recovering their investment.
- 3.12 As previously indicated (in Epic Energy Submission 5), Epic Energy believes the tariffs and the tariff path remain fixed for a period of at least 20 years from the date of its purchase of the DBNGP. The financial analyses undertaken to support the purchase price used a time horizon of 20 years. A shorter time horizon would have resulted in excessive weight being

placed on an uncertain residual. A longer time horizon would have required specific forecasts for increasingly uncertain events.

- 3.13 With the tariffs to follow a tariff path that is fixed for an extended period, Epic Energy will not recover the capital charges on its proposed initial Capital Base, and on the capital base in subsequent years, without realisation of the expected growth in the demand for gas transportation. If that growth occurs at a time later than the time assumed in the forecasts used in Epic Energy's financial analysis, the tariff is likely to be insufficient to recover both Pipeline operation and maintenance costs and the capital charges (return on and of capital). The shortfall in capital recovery is, as discussed above, treated as economic depreciation and added back to the Capital Base. The use of economic depreciation, and the deferred recovery account, allows deferral of recovery of a part of the Capital Base until that recovery is warranted by growth in demand for gas transportation services.
- 3.14 Sitting in front of that though, as mentioned above, is the regulatory compact which sets the tariff and tariff path, so that despite the growing deferred recovery account adding to the capital base, the tariff cannot exceed that tariff and tariff path.
- 3.15 AlintaGas asserts that the increase in the deferred recovery account balance (which is shown in Table 3.3 of the proposed Access Arrangement Information) is "an indication that Epic Energy's proposed initial capital base of \$2.45 billion is not sustainable under Epic Energy's tariff regime, despite such a tariff regime imposing considerably higher costs on users compared to existing tariffs".
- 3.16 Epic Energy refutes this assertion, and makes the following three points.
- 3.16.1 AlintaGas is misleading in its comment that the proposed tariff regime imposes considerably higher costs on users compared to the existing tariffs. Presumably, the "existing tariffs" to which AlintaGas refers are the tariffs currently applying for gas transportation in the DBNGP. As Epic Energy has indicated in previous submissions, any inference by way of comparison with the \$1.00/GJ currently applicable by virtue of the *Gas Pipelines Access (Privatized DBNGP System) (Transitional) Regulations 1999* (as amended) is totally inappropriate. The \$1.00/GJ was promulgated at 3.45pm on 31 December 1999 by the Government using the powers under the *Gas Pipelines Access (Western Australia) Act 1998* to amend the "repealed access regime". That tariff was set against Epic Energy's opposition and without its agreement or any consideration being given to Epic Energy's business position. Epic Energy continues to maintain that in doing that, the State has acted contrary to its expectations and understandings. AlintaGas was potentially one of the main recipients of the benefit of this arbitrary lowering of the tariff. The tariff that was applying at the time of filing the proposed Access Arrangement were \$1.09/GJ T1 full haul.<sup>16</sup> There were no tariffs published at that time to apply from 1 January 2000. In fact there is still a question mark over some shippers whether they are even entitled to the \$1.00/GJ tariff or are still on the GTR tariff of about \$1.18/GJ.
- 3.16.2 The increase in the deferred recovery account balance shown in Table 3.3 of the proposed Access Arrangement Information cannot, at the present time, be taken as indicating that the initial Capital Base is not sustainable under the proposed tariff regime. All that the increasing deferred recovery account balance indicates is that growth in the demand for gas transportation is not expected to be sufficient to allow

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<sup>16</sup> See regulation 35 of the *Dampier to Bunbury Pipeline Regulations 1998*.

full capital recovery during the five years for which forecasts are shown in Table 3.3. A conclusion that the initial Capital Base is not sustainable must be deferred until the demand forecast underlying the tariff, the tariff path and Epic Energy's purchase price for the DBNGP, is shown, by the facts, to have not been achievable. Epic Energy remains optimistic that the State's growth will in the future once again resume and the growth in transported capacity materialise as anticipated at the time of the acquisition of the DBNGP. The capital base, including the deferred recovery account, serves to cap the tariff and tariff path and will then ensure that Epic Energy cannot recover more than that investment over the economic life of the asset.<sup>17</sup>

3.16.3 The implications of the underlying demand forecast not being achieved must be clearly understood. If the growth in demand for gas transportation is less than expected, the tariff and the tariff path do not change. There is no review at the end of the proposed access arrangement period, or at the end of a subsequent period. Epic Energy assumes the "volume risk" associated with the demand forecast. If the demand for gas transportation grows in the way expected at the time of the DBNGP sale, Epic Energy will recover its investment in the Pipeline. If demand does not grow as expected, a part of the price paid by Epic Energy for the DBNGP will be shown to have been an imprudent investment for which Epic Energy shareholders will not be compensated. The deferred recovery account balance becomes, in these circumstances, a measure of the extent to which Epic Energy's shareholders have been "imprudent" in initially investing \$2,407 million in the DBNGP and in making further investments to expand Pipeline capacity, as the demand for gas transportation has grown.

3.17 Epic Energy notes that the use of economic depreciation and a deferred recovery account permit deferral of capital recovery at times when Pipeline utilisation is relatively low only if there is an expectation that higher utilisation at other times will allow the deferred amount to be recovered. In the absence of growth in gas transportation demand, there can be no deferral. AlintaGas's view that, through its use of economic depreciation and deferred recovery, Epic Energy is attempting to defer the costs of a fully loaded pipeline for which a considerable premium was paid, does not make much sense. There would be no value to Epic Energy in deferring capital recovery on a fully loaded pipeline. Given the tariff and the tariff path of the proposed Access Arrangement, if there is no possibility of expansion, there can be no subsequent recovery of any deferred amount. In these circumstances, whether the proposed initial Capital Base incorporates a considerable premium is of consequence only to Epic Energy's shareholders. If the initial Capital base incorporates a premium that cannot be recovered, shareholders, not Pipeline users, bear the cost.

3.18 AlintaGas's submission that the Regulator should disallow Epic Energy's use of a deferred recovery account is unsupported (and, in Epic Energy's view, unsupported). As Epic Energy has indicated above, its use of economic depreciation and a deferred recovery account are essentially technical adjuncts to its view that the tariffs and the tariff path of the proposed DBNGP Access Arrangement are fixed for an extended period in accordance with the regulatory compact developed at the time of Pipeline sale. It is, then, a matter for the Regulator to give consideration to the common understandings and expectations which comprise that compact in his approving the DBNGP Access Arrangement in accordance with the relevant provisions of the Code, including those provisions that deal with depreciation.

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<sup>17</sup> This is a very simplistic summation of that aspect of the regulatory model. The Regulator is referred to The Brattle Group report annexed to Epic Energy Submission 1 for a full analysis of this concept.



## **4. Proposed Reference Tariff**

4.1 In section 5 of AlintaGas's Fourth Submission, AlintaGas makes a number of comments surrounding the calculation of the reference tariff. Section 4 of this Additional Paper 3 deals with each of those propositions in turn.

### **4.2 Initial capital base**

AlintaGas has taken a very narrow approach in section 5.1 of its Fourth Submission. The issue of the principles of the Code and valuation methodologies for capital base is much broader than they have portrayed it. Epic Energy has made extensive submissions to the Regulator on these aspects and it is not proposed to revisit them in this paper.

### **4.3 Inclusion of prudent discounts**

4.3.1 AlintaGas proposes, in section 5.2 of its Fourth Submission, that Epic Energy offer, a discount for delivery of gas to the Wesfarmers LPG ("WLPG") plant at Kwinana. A discount for the transportation of LPG was prescribed under the earlier access regime of the *Gas Transmission Regulations 1994* ("GTRs") and, as AlintaGas notes, Schedule 39 of the Asset Sale Agreement contemplated that discount being continued in respect of Epic Energy's contractual obligations.

4.3.2 AlintaGas argues that there are sound economic reasons for such a discount, given that the energy densities of the propanes and butanes that comprise LPG are higher than the energy density of natural gas. These reasons were, according to AlintaGas, accepted by the Energy Implementation Group ("EIG") in its preparation of the GTRs, and by the Gas Transmission Consultation Committee ("GTCC") in its review of tariffs for the DBNGP following their redetermination in October 1997 for application from 1 January 1998.

4.3.3 Epic Energy understands, from those directly involved, that the EIG accepted the argument for a discount for LPG transportation, but was unable to establish an exact basis for its magnitude. There was a degree of arbitrariness in its determination of the 50% discount subsequently made available through Regulation 146 of the GTRs. In fact Epic Energy notes that AlintaGas neglected to point out that it enjoys that discount for gas used or lost in the WLPG plant, in addition to for the LPGs extracted in the WLPG plant, to which the argument of energy density does not apply.

4.3.4 As explained in paragraph 4.5.5 below, the GTCC had no role in reviewing the 1997 redetermination of gas transportation tariffs under the pricing provisions of the GTRs. Epic Energy is not aware of any views the GTCC may have held on a discount for the transportation of LPG. Epic Energy would have expected that AlintaGas would have strongly maintained its contractual right to such discount. In fact even if a change had been made to the discount appearing in GTR 146 as part of the amendments contained in the *Gas Transmission Amendment Regulations (No. 2) 1997*, which were the amendments resulting from such review, they would not have been effective as AlintaGas chose not pick up those amendments.



4.3.5 Prior views on the appropriateness of a discount for the transportation of LPGs are now, however, largely irrelevant. Whether Epic Energy should provide such a discount, must be considered in the context of application of section 8.43 of the Code. Epic Energy would consider providing such a discount only if the Regulator were to permit, in accordance with section 8.43, the revenue foregone to be recovered from other users of the reference service. Before permitting recovery of the foregone revenue in this way, the Regulator must ensure that two conditions are satisfied:

- the consideration of the nature of the market in which the user of the reference service operates, and the price of alternative fuels available to the user, in the context of assessing whether the reference service would be used by that user at the nearest reference tariff; and
- the reference tariff calculated on the basis of the user not taking the service must be greater than the reference tariff calculated on the basis of the user taking the service and receiving a discount.

Epic Energy has not made any assessment of whether the conditions of section 8.43 of the Code might be satisfied in the case of a discount for the transportation of LPG.

4.3.6 In any event while Epic Energy will honour its contractual obligations under the transport contract with AlintaGas it acquired as part of the acquisition of the DBNGP, it is not convinced that the service which AlintaGas enjoys with respect to the WLPG plant should continue after the expiration or cessation of the AlintaGas contract. Even if that service were to be provided, there is a question as to what the appropriate charge for that service should be. Epic Energy regards the WLPG service to be a non-reference service due to its uniqueness and not one appropriate to be a reference service or to form part of a reference service.

4.3.7 The reference to a discount for the transportation of gas and LPGs in Schedule 39 is a reference to a contracted discount for WLPG. The discount referred to is not a prudent discount established in accordance with section 8.43 of the Code, but a continuation of the discount available to AlintaGas under its grandfathered transportation contract. Epic Energy notes, in this context, that the requirement imposed on Epic Energy to ensure that there is, in effect, at least 1.45 tonnes of LPGs per TJ of gas transported in the DBNGP ceases on 1 July 2005.

#### **4.4 An appropriate level for the tariff**

4.4.1 AlintaGas's representation of the reference tariff of Epic Energy's proposed Access Arrangement for the DBNGP is misleading. AlintaGas claims, in section 5.3 of its Fourth Submission, that:

*"Whilst Epic Energy is promoting its Firm Service as having a "headline" tariff of \$1.00 per GJ, AlintaGas submits that this does not reflect the costs that will be incurred by users of the DBNGP. There are a number of significant other costs that impose a considerable additional burden on users."*

- 4.4.2 Neither Epic Energy's proposed Access Arrangement for the DBNGP<sup>18</sup>, nor its proposed Access Arrangement Information<sup>19</sup>, promotes the Firm Service as having a headline tariff of \$1.00/GJ. The tariff for the Firm Service is zone-based, and varies between zones. Both the proposed Access Arrangement and the proposed Access Arrangement Information clearly indicate that the tariff for Firm Service transportation from a receipt point in Zone 1 to a delivery point in Zone 9 is \$1.00/GJ. The tariff for Firm Service Tariff for transportation from a receipt point in Zone 1 to a delivery point in Zone 10 is \$1.08/GJ. It is interesting to note that AlintaGas neglects to refer to the positives in this section such as rebateable revenue, which sees some revenue returned to shippers.
- 4.4.3 AlintaGas's statement that the \$1.08/GJ for gas transportation from Zone 1 to Zone 10 represents a "significant other cost" is either inaccurate, or a further attempt to support its unsubstantiated view that the tariff for transportation from a receipt point in Zone 1 to a delivery point in Zone 10 should be \$1.00/GJ. AlintaGas states in the submission that a tariff of \$1.00/GJ is acceptable but then says it should be based on an initial capital base no greater than DORC. The first and main part of AlintaGas's statement provides a clear indication that AlintaGas is not adversely impacted by the tariffs proposed. Given that in 1997 AlintaGas's tariff was approximately \$1.27/GJ, in 1998 it was \$1.18/GJ and in 1999 it was \$1.09/GJ, that is not surprising.
- 4.4.4 Epic Energy's proposed Delivery Point Charges are cited by AlintaGas as a second example of significant other costs that impose a considerable additional burden on shippers. However, AlintaGas does not indicate how these charges are a significant other cost, and how they become an additional burden. To what are they an addition? Certainly the Delivery Point Charges are additional to the Firm Service tariffs of \$1.00/GJ and \$1.08/GJ for Zones 9 and 10, respectively. But they are not unexpected additions. Schedule 39 of the Asset Sale Agreement clearly indicated additional charges for the recovery of capital invested in shipper facilities including metering stations. Nor are they significant additions. They would recover some \$3.25 million annually, or only about 1.5% of total revenue, and would add, on average, about 1.7 cents per GJ to transportation charges.
- 4.4.5 Epic Energy notes that the capital costs of some metering stations have already been recovered from shippers through "up front" capital payments. Furthermore, these shippers have in place contracts which require that Epic Energy reimburses a portion of the capital cost in the event of another party making use of the facilities. Those contracts provide that reimbursement without regard to the actual total revenue Epic Energy will receive from that new party. These prior arrangements will need to be reflected in contracts entered into in accordance with the DBNGP Access Arrangement. Furthermore, Epic Energy will require the means of recovering from new shippers, a portion of the capital costs of any metering facilities which have already been paid for by others. The Delivery Point Charges are, among other things, a means of effecting this recovery and, more importantly, imposing the recovery of those charges on an equitable basis.

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<sup>18</sup> See the Reference Tariff annexed as Annexure "A" to the proposed Access Arrangement. No where else in the proposed Access Arrangement document are any tariff amounts mentioned. In fact in paragraph 7.10(d) it is made quite clear what the various components of the tariff are including the Delivery Point Charge.

<sup>19</sup> Again the proposed Access Arrangement Information document is generally silent about actual tariffs. Where such are mentioned, as in section 2.5, there is clear reference to both the \$1.00/GJ for zone 1 – 9 and \$1.08/GJ for zone 1 – 10.

- 4.4.6 AlintaGas then makes a further comment on Epic Energy's reference to the August 1997 report prepared by Price Waterhouse, the Government's expert adviser on tariff and regulatory matters during the DBNGP sale process, including some oblique and non-specific references to escalation paths used by them. In the context of Epic Energy's quotation from the Price Waterhouse report, AlintaGas argues that "since Epic Energy proposes reference tariffs that escalate at 67% of CPI, AlintaGas submits that comparable tariffs, if Epic Energy is to be consistent with the Price Waterhouse conclusions it quotes, should be at the lower end of the range of tariffs determined by Price Waterhouse". Price Waterhouse indicated that tariffs for "firm full haul transmission capacity" could lie anywhere within the broad range of \$0.71/GJ to \$1.12/GJ, and values between \$0.88/GJ to \$0.98/GJ could be argued.
- 4.4.7 Again, AlintaGas misrepresents Epic Energy's argument. Epic Energy has never sought to compare its proposed reference tariff with the tariffs in the Price Waterhouse report, and has no reason to make its tariffs consistent with those put forward by Price Waterhouse. Epic Energy referred to the Price Waterhouse report in Epic Submission 1 only for the purpose of providing further support to its belief that, during the DBNGP sale process, the Government of Western Australia had formed a view that the tariff to Perth should be **about** \$1.00 per GJ. The reference was simply for the purpose of demonstrating the environment the State created for the sale of the DBNGP.
- 4.4.8 Irrespective of any view that might have been formed during the sale process, at its conclusion, the Government and its Gas Pipeline Sale Steering Committee fully understood that, in accepting a purchase price of \$2,407 million from Epic Energy, they were also accepting a bid based on tariffs - excluding delivery point charges - for Firm Service transportation from receipt points in Zone 1 to delivery points in Zone 9 of \$1.00/GJ, and to delivery points in Zone 10 of \$1.08/GJ. That position has been made quite clear by the Minister for Energy in the 14 June debate referred to in this paper and in Epic Energy Additional Paper 4.

#### **4.5 Long term tariff expectations.**

- 4.5.1 In section 5.4 of AlintaGas's Fourth Submission, AlintaGas argues that the tariff and tariff path of the proposed DBNGP Access Arrangement would impose "significant and unreasonable increases in costs on users". These "significant and unreasonable" increases are, in AlintaGas's view, in contrast to reasonable expectations that those users would have formed on the basis of the tariffs that would have been set under the pricing methods of the GTRs.<sup>20</sup> In support of this view AlintaGas purports to show, in the diagram on page 15 of AlintaGas's Fourth Submission, a significant divergence between the paths of future tariffs under the proposal of the Access Arrangement, and under the pricing methods of the GTRs.
- 4.5.2 AlintaGas advises that the diagram compares the path of the proposed Access Arrangement tariff (at a 100% load factor and over a period of 20 years) with the path of the full-haul tariff that would result if tariffs continued to be redetermined in accordance with the pricing provisions of the GTRs. In justifying this particular comparison, AlintaGas:

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<sup>20</sup> AlintaGas does not make clear how users could have formed reasonable expectations on the basis of the pricing methods of the GTRs when it was widely known that the access regime of the GTRs was to be replaced by the Code.

- submits that the DBNGP tariff, as determined in accordance with the GTRs, complies with the Code; and
  - notes that on the second occasion on which tariffs were determined in accordance with the GTRs, they were determined under the supervision and approval of the GTCC.
- 4.5.3 These statements by AlintaGas are simply not true, are without foundation and, Epic Energy would suggest, made knowingly with wrong or misleading information.
- 4.5.4 The first of these assertions is unsubstantiated. No case is made to support the view that the pricing methods of the GTRs, and tariffs determined in accordance with those pricing methods, would be acceptable to a regulator as being in accordance with the reference tariff principles of Section 8 of the Code, and as meeting the objectives of section 8.1 of the Code.
- 4.5.5 In respect of the second of these assertions, AlintaGas is either incorrect, or is seeking to imply a legitimacy to the GTR tariffs which they do not have. Under the pricing methods of the GTRs, gas transmission tariffs were to be re-determined by AlintaGas. However, regulation 151(4) of the GTRs permitted a matter arising out of a redetermination of a price to be referred, by the GTCC, to an expert for review. Other than in this way, and in its being able to initiate redetermination by AlintaGas, the GTCC had no role to play in price redetermination. Neither the *Gas Corporation Act 1994*, nor the GTRs, gave it any standing as a body with supervisory or approval functions in respect of tariffs. Tariffs were redetermined by AlintaGas in October 1997 and the GTCC was advised. No matter arose out of that redetermination that required, in the GTCC's opinion, referral to an expert for review.
- 4.5.6 The diagram shown on page 15 of AlintaGas's Fourth Submission shows, in the case of the proposed Access Arrangement, a tariff increasing in accordance with the tariff path of the proposed Access Arrangement. In the case of the GTR tariff, it shows a steady (or possibly very slightly increasing) tariff resulting from successive redeterminations in accordance with the GTRs, until the DBNGP is fully depreciated. After the Pipeline is fully depreciated, the GTR tariff falls. In commenting on the diagram, AlintaGas notes that the capital component of the tariff determined in accordance with the pricing methods of the GTRs is not escalated, resulting in very little increase in the nominal tariff. The tariff of the proposed Access Arrangement, in contrast, increases due to the CPI escalation of both its capacity and commodity components.
- 4.5.7 In making this comparison, AlintaGas has omitted to disclose a number of things:
- the GTR tariff could only be redetermined after a significant capital enhancement and then only after at least 3 years had elapsed after the last redetermination;
  - the GTR tariff was redetermined with effect from 1 January 1998 and for T1 full haul service that was \$1.18/GJ. Subject to the point on commodity charge escalation below, that price remains fixed until the next redetermination, which at the earliest could not occur until 1 January 2001. Hence the starting point of the line (not to mention the predeceasing tariff for 1999) are not correct;

- the Stage 3A enhancement has been completed and would need to be included in the capital base. It is not known whether that would lead to an increase or a decrease in that charge;
- it fails to consider the tariff implications of Pipeline capacity expansion. The tariff and the tariff path of the proposed Access Arrangement were sufficient to permit recovery of some \$870 million of additional investment in the Pipeline. Although AlintaGas does not discuss the issue in the context of the GTR tariff path, a tariff which does not vary over an extended period suggests that no account has been taken of capacity expansion in AlintaGas's redetermined GTR tariffs. As outlined above, under the GTRs the price would be redetermined to take into account such capital investment;
- under GTRs the commodity charges were subject to an annual escalation formula; and
- new delivery point facilities and other shipper specific facilities had to be funded up front by shippers.

4.5.8 It is difficult to take this any further as the GTR regime was quite a different regime from that which would apply under the Code. Epic Energy simply points out the above to illustrate the inappropriateness and unreasonableness of the AlintaGas assertion. However, it is important to note the following points.

4.5.9 Pipeline capacity expansion does not automatically imply an increase in tariffs. The marginal costs of some expansions are lower than the average cost of capacity. Those expansions result in a lowering of tariffs determined on an average cost basis (the average cost basis was used under the pricing methods of the GTRs). However, not all expansions have this desirable outcome. When a pipeline is fully compressed, additional capacity must be obtained by looping (duplicating sections of the line). Initial looping typically has marginal costs which exceed the average cost of capacity and, when undertaken, increases tariffs determined on an average cost basis.

4.5.10 The DBNGP is close to being fully compressed, and further expansion of the Pipeline's capacity will require looping. In fact the Stage 3A expansion, which is nearing completion, involved looping of the southern section of the Pipeline. No account appears to have been taken of the effect of this on the tariffs shown in AlintaGas's diagram. The tariffs of the proposed Access Arrangement recover a substantial investment in new capacity. The tariffs determined in accordance with the GTRs in the AlintaGas diagram do not – in fact they do not take account of even the current Stage 3A expansion. The tariff paths of the diagram are not comparable.

4.5.11 Not only are the tariff paths of the diagram not comparable, but AlintaGas's conclusion that, under the pricing methods of the GTRs, tariffs will reduce significantly once the existing assets have been fully depreciated, rewarding users with significantly lower costs, may not follow. Whether tariffs would be significantly lower depends on the pattern of growth in transportation demand, and on the least cost way of providing the capacity needed to meet that demand. AlintaGas also ignores necessary capital expenditure to replace equipment or assets that have come to the end of their useful lives. A conclusion that can be relied upon requires a great deal more analysis than AlintaGas has provided or, indeed, could have provided.



4.5.12 As if to ensure the validity of its conclusion, AlintaGas comments that the tariff path of the proposed Access Arrangement does not fully capture the costs to users because no allowance is made for load factor, penalty charges, delivery inflexibility, and Epic Energy's proposed deferred recovery account. AlintaGas notes:

*"The deferred recovery account is particularly insidious. It will result in an inexorable rise in the DBNGP capital base. This will ensure that tariff reductions that users would have reasonably expected to occur as the DBNGP is expanded at low marginal cost will not materialise. Instead, the cost benefits of expansion will be retained by Epic Energy as it attempts to recover an increasing Capital Base that is supporting the amount it chose to pay for the DBNGP."*

The language is emotive and without basis. To suggest that Epic Energy has been "insidious" or "treacherous"<sup>21</sup> is an unwarranted slur on Epic Energy.

4.5.13 Any allowance for load factor will have little effect on the comparison AlintaGas seeks to make. Penalty charges will be incurred only in extreme situations. They are unlikely to be incurred by the majority of shippers, and are irrelevant to the comparison. Epic Energy does not budget on receiving penalty charges as it expects that shippers, such as AlintaGas, will honour their contractual terms and conditions. Delivery inflexibility is also irrelevant. As Epic Energy has shown in previous submissions, arrangements under the proposed Access Arrangement are more flexible than arrangements under the current access regime.

4.5.14 AlintaGas's concern over the deferred recovery account appears to be based on the assumption that future expansion of the DBNGP will always be at marginal costs which are lower than the average cost of providing capacity. As explained in paragraphs 4.5.9 to 4.5.11 above, this will not be the case. Some expansions will be at marginal costs that are higher than the average cost of capacity and, under the pricing arrangements of the GTRs, tariffs would have risen. Under the proposed Access Arrangement that tariff path is smoothed over an extended period. That initial tariff and the tariff path are not subject to review, and AlintaGas's contention that the cost benefits of expansion will be retained by Epic Energy as it attempts to recover an increasing Capital Base is simply not correct. As has been explained elsewhere in this paper and in Epic Energy Submission 1, the fact that the capital base rises due to an increasing deferred recovery account, does not in itself lead to a rise in tariffs.

## **4.6 Firm service terms and conditions**

4.6.1 In the final section of its Fourth Submission, AlintaGas raises again the issue of a T1-equivalent reference service. AlintaGas argues that Epic Energy has confused the situation over the nature of the reference service to be provided in the DBNGP Access Arrangement, by casting doubt on the service that was contemplated by Schedule 39 of the Asset Sale Agreement. In so doing, AlintaGas argues, Epic Energy has been able to put forward a service "stripped of many of the elements of the T1 service". It has been able to put forward "substantially degraded services in place of the balanced service it was previously providing".

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<sup>21</sup> See Concise Oxford Dictionary definition of "insidious".



- 4.6.2 AlintaGas argues that there could be no doubt about the nature of the service that was to be provided - all discussions at the time of the DBNGP sale were based either explicitly or implicitly on the T1 service, simply because that was the only service provided to third party users at the time. Furthermore, in Schedule 39 of the Asset Sale Agreement, AlintaGas suggests, Epic Energy explicitly proposed offering a T1-equivalent reference service, and clearly indicated that its tariff proposals were based on provision of such a service. This was, according to AlintaGas, acknowledged by Epic Energy in Epic Submission 3.
- 4.6.3 In Epic Submission 8, Epic Energy advised that it did not agree with AlintaGas's view that the Firm Service of the proposed DBNGP Access Arrangement is materially different from the T1 service of the access regime of the GTRs, and the transitional access regime. Nevertheless, Epic Energy acknowledged that there are some differences. These differences are due primarily to the fundamental difference of the Access Arrangement proposals not adopting a tranche structure for capacity. A shift away from the tranche structure of earlier access regimes was clearly signalled in the Tariff Principles of Schedule 39.
- 4.6.4 Epic Energy Submission 8 goes into quite some detail on the need to provide a T1 equivalent service. It deals with the types of argument put up by AlintaGas in this section. It is not proposed to revisit those arguments again in this paper, suffice to say, Epic Energy does not accept that it ever suggested that its reference service would replicate the T1 service under the *Dampier to Bunbury Pipeline Regulations 1998* and the associated Access Manual. A close study of Schedule 39 will reveal a number of significant differences in key terms were proposed, not the least of which was the abandonment of the tranche methodology.<sup>22</sup>

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<sup>22</sup> See page 2 of Schedule 39 under "Tariff Principles".

## **5. AlintaGas's Conclusions**

- 5.1 At the end of AlintaGas's Fourth Submission AlintaGas sets out eight conclusions which, AlintaGas indicates, follow from the arguments of that submission, and from the arguments of the three previous submissions it has made to the Regulator.
- 5.2 Epic Energy has dealt with issues relating to the initial Capital Base for the DBNGP in Epic Energy Submission 1, Epic Energy Submission 3 and Epic Energy Submission 5. Epic Energy has argued that, in the matter of the initial Capital Base, the Code is indicative not prescriptive, and does not mandate an initial capital base between the valuation method set out in section 8.10(a) of the Code and DORC. AlintaGas has not (and, indeed, cannot) provided support for a DORC valuation which is in the vicinity of \$1.0 billion. Irrespective of the DORC valuation of the DBNGP, Epic Energy maintains that neither a section 8.10(a) valuation, nor a DORC valuation, is necessary to understanding the proposed DBNGP Access Arrangement and its reference tariff. Nevertheless in response to the Regulator's direction, the proposed Access Arrangement Information has been revised and resubmitted with estimates of these valuations included.
- 5.3 Epic Energy's Firm Service proposal has been discussed in Epic Energy Submission 3 and Epic Energy Submission 8. Epic Energy Submission 8 effectively refutes the argument that the proposed Firm Service is not an appropriate Reference Service. Epic Energy acknowledges that there may be future circumstances in which AlintaGas will pay a higher tariff than might otherwise have been the case, but finds the claim that AlintaGas's costs will double to be exaggerated.
- 5.4 Epic Energy's proposed Firm Service cannot be identical to the T1 service of prior access regimes because the tranche structure of capacity in those regimes will not be used in the future. This was clearly signalled in Schedule 39 of the Asset Sale Agreement. This point is dealt with in detail in Epic Energy Submission 8.
- 5.5 Rate of return issues have been discussed in Epic Energy Submission 5. As noted in that Submission, AlintaGas has failed to provide any justification for its assertions that the DBNGP is exposed to relatively little risk and that, in consequence, the rate of return should be less than that used in other jurisdictions.
- 5.6 Epic Energy's arguments supporting a regulatory compact with the State of Western Australia have been developed in Epic Energy Submission 1, Epic Energy Submission 3 and Epic Submission 4, and have been further supported in this Additional Paper 3 and in Epic Energy Additional Paper 4. Epic Energy totally rejects the view that there was no regulatory compact. There was a regulatory compact, but it did not (and could not) bind the Regulator in itself. Nevertheless, Epic Energy maintains that the Regulator should give consideration to the common understandings and expectations that comprise the regulatory compact in his approving the DBNGP Access Arrangement in accordance with the relevant provisions of the Code.
- 5.7 Epic Energy has stated in this Additional Paper 3 that it broadly agrees with AlintaGas's view that, at the time bids were submitted for the DBNGP, it (Epic Energy) would have to submit an Access Arrangement for the Pipeline which would comply with the Code, and which would be approved by the Regulator. Whether Epic Energy, as an "outsider" to the

governmental system in Western Australia, could have been as certain about the Code and its implementation, as AlintaGas seeks to imply in its Fourth Submission, is open to debate. Nevertheless what is relevant is what the Minister for Energy has said in the 14 June debate, as dealt with in this Additional Paper 3 and in Epic Energy Additional Paper 4, it was an uncertainty the Government did not want to persist and impact on the purchase prices bid for the DBNGP so the Government worked to provide tariff certainty.

- 5.8 Epic Energy has sought to explain its use of economic depreciation and the deferred recovery account through its making public The Brattle Group's valuation report, and through discussion of the concepts in Epic Energy Submissions 3 and 5, and in this Additional Paper 3. Use of economic depreciation and a deferred recovery account are, Epic Energy believes, consistent with Code requirements in respect of depreciation. They are not, as AlintaGas claims, inappropriate. Epic Energy's use of economic depreciation and a deferred recovery account are essentially technical adjuncts to its view that the tariffs and the tariff path of the proposed DBNGP Access Arrangement are fixed for an extended period in accordance with the regulatory compact developed at the time of Pipeline sale. It is a matter for the Regulator to give consideration to the common understandings and expectations which comprise that compact in his approving the DBNGP Access Arrangement in accordance with the relevant provisions of the Code, including those provisions that deal with depreciation.
- 5.9 AlintaGas's view that the proposals of the DBNGP Access Arrangement will impose significant and unacceptable additional costs in an environment where it is reasonable for users to expect a declining tariff path as the benefits from expanding the DBNGP at low marginal capital costs materialise is unsubstantiated. As discussed in this Additional Paper 3, AlintaGas has no basis for claiming that future Pipeline expansion will be at low marginal capital costs, in fact it is likely to be quite the opposite.