



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

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

#### **Additional Paper 4: Regulatory Compact 8 September 2000**

**Epic Energy (WA) Transmission Pty Ltd  
ACN 081 609 190  
Level 7  
239 Adelaide Terrace  
PERTH WA 6000  
CONTACT: David Williams  
TELEPHONE: 9492 3823**

## **1. Introduction**

- 1.1 The regulatory compact is fundamental to the structure of the proposed Access Arrangement for the DBNGP.
- 1.2 The concept of a regulatory compact has, to date, been the subject of a number of explanations provided by Epic Energy.<sup>1</sup> The purpose of this paper is not to revisit them other than to provide, in section 2, a brief summary of the salient points of Epic Energy's argument.
- 1.3 Section 3 deals with statements made by the Minister for Energy during a debate in the Legislative Assembly held on 14 June 2000. A number of these statements have now been referred to in the amended Access Arrangement Information filed on 28 July 2000. The Minister's comments in the various passages referred to add considerable weight to the argument Epic Energy has been putting in support of the proposed Access Arrangement.
- 1.4 As foreshadowed in Epic Energy Additional Paper 3, filed at the same time as this paper, Epic Energy has obtained a further expert's report from The Brattle Group. This report, on the concept of the regulatory compact as it has evolved in the United States and the United Kingdom, is dealt with in Section 4. Two previous reports from The Brattle Group, both of which now form attachments to the Access Arrangement Information, dealt with the Regulatory Model, which shows the outworking of the regulatory compact, and the Cost of Capital.
- 1.5 These elements are brought together in section 5 to provide a further demonstration of the veracity of Epic Energy's arguments and, hence, of the appropriateness of the proposed DBNGP Access Arrangement. Unlike the various submissions made by interested parties, the arguments of this Additional Paper 4 are based on fact and the opinion of identifiable experts.
- 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.

---

<sup>1</sup> See Amended Proposed Access Arrangement Information dated 28 July 2000 at Section 3, Epic Energy Submission 1 dated 15 December 1999, Epic Energy Submission 3 dated 17 March 2000 at Section 4.3, Epic Energy Submission 4 dated 12 May 2000 and Epic Energy Submission 5 dated 12 May 2000 at Sections 2 and 3.

## 2. Summary of Regulatory Compact Concept

- 2.1 Set out below is a brief set of points outlining the regulatory compact between Epic Energy and the State of Western Australia. It is not intended to be a complete statement of the compact (reference should still be made to previous filings by Epic Energy), but is intended to present its key elements.

### Regulatory compact

- 2.2 “Regulatory compact” is a label used by Epic Energy to describe the common understandings and expectations which developed during the process in which it bid for, and purchased, the DBNGP. These common expectations and understandings now give rise to the justification for the proposed Access Arrangement filed by Epic Energy with the Regulator.
- 2.3 Epic Energy has not, and does not, suggest that the regulatory compact equates to an agreement or guarantee by the State that Epic Energy would be able to charge the tariffs set out in Schedule 39 of the DBNGP Asset Sale Agreement.<sup>2</sup>
- 2.4 The regulatory compact reflects the manner in which the State conducted the Pipeline sale process.
- In the time leading up to the sale, the National Third Party Access Code for Natural Gas Pipeline Systems (“the Code”) was being developed, and was only in draft form in WA. (The Second Reading of the Gas Pipelines Access (Western Australia) Bill did not take place until 18 June 1998, almost three months after the DBNGP had been transferred to Epic Energy, and the Act did not commence until 8 February 1999.) The DBNGP Asset Sale Agreement selling the DBNGP to Epic Energy was signed on 3 March 1998. Clearly there was a need to provide bidders with some certainty about the tariff for the DBNGP in the lead up to the sale if the State were to extract the maximum sale price.
  - The State was driven by maximising the sale price while matching it with an acceptable gas transmission tariff to be charged by the purchaser in the future. That fact was acknowledged in the sale process documentation<sup>3</sup>, it was acknowledged by the Minister for Energy, Colin Barnett, during the sale itself<sup>4</sup>, and it was subsequently acknowledged by both the Minister for Energy and the Premier<sup>5</sup>.
- 2.5 The regulatory compact comprises a number of “commitments”. These include, on Epic Energy’s behalf:

---

<sup>2</sup> See Epic Energy Submission 1 at page 14, and Epic Energy Submission 4 at paragraphs 2.1, 4.10 and 4.12.

<sup>3</sup> See sales process letter dated 8 September 1997 referred to in Epic Energy Submission 1 at page 5.

<sup>4</sup> See examples set out in Attachment 1.

<sup>5</sup> See examples set out in Attachment 2, and also see references in Section 3.

- a payment by Epic Energy of a purchase price of \$2.407 billion;
- a reduction in gas transmission tariffs to those outlined in Schedule 39;
- the future expansion of the DBNGP requiring capital expenditure of up to \$875 million based on forecasts made by the Government at the time of sale;
- the relocation of Epic Energy's head office to Perth.

The "commitments" include on the State's behalf:

- an acceptance that the tariffs proposed in Schedule 39 were the appropriate tariffs.

2.6 Much has been made, in submissions to the Regulator, about the use of the term "commitment" when referring to the regulatory compact. Yet that term has been used time and time again by the Minister for Energy, and by other members of the Government as well<sup>6</sup>.

2.7 The State has been the recipient of a number of benefits as a result of Epic Energy honouring the regulatory compact. These are dealt with more fully below.

### **\$1.00/GJ Environment**

2.8 The Minister for Energy, and the Gas Pipeline Sale Steering Committee ("the GPSSC"), which was effectively the agent of both the Minister and AlintaGas in the sale, made it quite clear in the lead up to the sale, and during the sale process, that a tariff of around \$1.00/GJ to Perth was expected.<sup>7</sup>

2.9 That expectation has been confirmed many times subsequently to the extent that, as a result of the Minister's statements, shippers on the DBNGP have developed a strong understanding that the tariff would be around \$1.00/GJ to Perth.<sup>8</sup>

2.10 As noted above, the Government sought to establish an environment in which it could extract the highest sale price, and to do this it was necessary to fix on a particular tariff in order to remove uncertainty. The Minister decided that a tariff of around \$1.00/GJ to Perth was an appropriate tariff, and did not attempt to drive the tariff down as this would have had the impact of lowering the purchase price. This has been acknowledged by the Minister in public<sup>9</sup>, and was implicit in the actions of the GPSSC leading to acceptance of the Final Bid for the DBNGP lodged by Epic Energy. It was also implicit in the fact that the Government did not take up Epic Energy's offer in its alternative bid.

---

<sup>6</sup> See examples set out in Attachment 3.

<sup>7</sup> Again, see Section 3, and also the examples set out in Attachment 4.

<sup>8</sup> See examples set out in Attachment 5.

<sup>9</sup> See, in particular, Section 3 but also the examples in Attachment 6.

## **State's Benefits**

- 2.11 As noted above, the State received a number of benefits from the sale of the DBNGP to Epic Energy. These included the following.
- Receipt of \$2.407 billion from Epic Energy. This has been applied in retiring \$1.9 billion of State debt (including debt associated with the DBNGP), in placing \$100 million worth of computers in schools, in the construction of a convention centre expected to cost in excess of \$100 million, and in other uses not specifically identified.
  - A commitment from Epic Energy to expand the DBNGP by investing up to about \$870 million, based on the forecasts prepared at the time of sale. To date Epic Energy has spent around \$120 million on Pipeline expansion, honouring that commitment.
  - A commitment by Epic Energy to transfer its head office to Perth. That has been done and, as a result, since the acquisition of the DBNGP, approximately 50 new positions have been created in Perth outside of those of the employees who transferred across from AlintaGas. In addition there have been benefits to WA's service industries with Epic Energy now sourcing work from WA professional service firms and other service providers including lawyers, accountants, and engineers.
  - A guarantee to give the State's utilities, AlintaGas and Western Power, priority in the access to Pipeline capacity to serve residential and small business customers.
  - A reduction in gas transmission tariffs to around what the Government was seeking, namely \$1.00/GJ.

## **Structure of Epic Energy's proposed tariff**

- 2.12 There has been a lot of misinformation about the structure of Epic Energy's proposed Access Arrangement and its proposed reference tariff. Epic Energy has always made it clear that the proposed tariff derives from the commitments forming part of the regulatory compact, and not from the purchase price paid by it for the DBNGP.
- 2.13 The only role of the purchase price in the proposed Access Arrangement is ensuring that Epic Energy does not recover more than the purchase price over the remaining economic life of the assets it acquired. In other words it acts simply to cap the revenue that might be received by Epic Energy. If, for example, the volume of gas transported grew to an such an extent that it was likely that Epic Energy would recover more than the purchase price, tariffs would be lowered to ensure that this did not happen.
- 2.14 The proposed Access Arrangement adopts the tariffs set out in Schedule 39 (namely \$1.00/GJ to Perth and \$1.08/GJ to south of Perth) and those tariffs are locked in and escalated each year at less than the increase in CPI

(namely, at 67% of the increase in CPI) so that, over time, the tariffs charged by Epic Energy will decrease in real terms.

- 2.15 Within the revenue from that tariff path Epic Energy must absorb any future capital enhancements (including the current \$120 million Stage 3 expansion project), and the impact of any volume shortfall (this is discussed below).
- 2.16 Epic Energy has sought to honour its tariff commitment to the State, and has not made any ambit claim in relation to the tariff or the tariff path.
- 2.17 The tariff proposed by Epic Energy compares extremely favourably with tariffs sought by the other two major pipelines in WA, namely the Parmelia Pipeline and the Goldfields Gas Transmission Pipeline. In cents per GJ per 100 km of pipeline, the DBNGP tariff is about one half of that in the draft decision for the Parmelia Pipeline, and about one third of what CMS sought for the Parmelia Pipeline. It is less than one third of the tariff being sought for the Goldfields Gas Transmission Pipeline.
- 2.18 It is also interesting to note that, since 1995, despite the large reductions in the tariff for the DBNGP, there have been no reductions in published tariffs for customers of AlintaGas, and minimal reductions for customers of Western Power.
- 2.19 The significant aspect of the tariff and tariff path contained in the proposed Access Arrangement for the DBNGP is that Epic Energy must bear the volume risk associated with the forecasts upon which both the State and Epic Energy based the calculation of the tariff established at the time of Pipeline sale. This position is succinctly stated in Epic Energy Submission 3 at paragraph 4.13.16:

*“Because the reference tariff and the tariff path are fixed in accordance with the commitments Epic Energy has made to the State of Western Australia, Epic Energy’s shareholders, and not shippers, bear the risk of failure to recover, through the depreciation policy proposed, an initial capital base derived from the price paid for the DBNGP. Epic Energy’s shareholders bear the “volume risk” associated with the Pipeline until market growth permits full recovery of the initial capital base. If expected growth in the demand for gas transmission services materialises, shareholders will fully recover their investment, and real reductions in the reference tariff should be possible. If expected growth fails to materialise, reference tariffs follow the tariff path of the regulatory compact and Schedule 39 to the Asset Sale Agreement, and Epic Energy’s shareholders are unable to recover their investment in the Pipeline. A part of that investment will have been shown to be “imprudent”, and shareholders will not be compensated for it.”*

- 2.20 Epic Energy is already seeing the effects of a significant volume shortfall. The volume forecasts of the Access Arrangement for the regulatory period (through to 31 December 2004) demonstrate minimal growth. In the Information Memorandum for the Pipeline sale, the GPSSC referred to forecasts for annual gas sales in Western Australia growing from 246

petajoules (about 673 TJ/day) in 1998 to 425 petajoules (about 1,160 TJ/day) in 2006.<sup>10</sup>

- 2.21 Hence Epic Energy is already bearing a significant shortfall in the demand for capacity on the DBNGP relative to that which was forecast at the time of Pipeline sale. It is having to bear that shortfall and its associated shortfall in revenue without a compensating increase in tariffs. That in itself provides Epic Energy with a huge incentive to try to grow the demand for the DBNGP.

---

<sup>10</sup> *Dampier to Bunbury Natural Gas Pipeline Information Memorandum*, page 28.

### 3. Recent Statements by the Minister for Energy

- 3.1 As indicated at the start of this paper, a significant debate was held in the Legislative Assembly of the Western Australian Parliament on 14 June 2000 concerning a motion put by the Leader of the Opposition, Dr Gallop, calling for the establishment of “a select committee to inquire into and report on whether or not the State Government gave assurances or guarantees to the purchasers of the Dampier to Bunbury natural gas pipeline about the level of tariffs to be charged for the future use of the pipeline”. Set out in this section is a discussion of statements made by the Minister during that debate which are pertinent to the proposed DBNGP Access Arrangement.
- 3.2 The regulatory compact, which Epic Energy maintains is fundamental to the structure of the proposed Access Arrangement for the DBNGP, evolved during the Pipeline sale process. As the Minister for Energy advised during the 14 June debate<sup>11</sup>, he was the person in control of the sale process for the DBNGP, and was the one making the policy decisions<sup>12</sup>. During his speech, he commented that the sale of the DBNGP was a “large and complex transaction”<sup>13</sup>. There was a significant degree of uncertainty about future tariffs due to the foreshadowed introduction of the National Access Code, an access regime which had not, at that time, been brought to the Parliament of Western Australia for consideration.
- 3.3 The Government knew that any uncertainty about tariffs could severely impact on the price that bidders would be prepared to pay for the DBNGP. In addition, there was also the risk to the Government that the purchaser might ultimately obtain a higher tariff than the Government had spent some time prior to the sale saying it was expecting.
- 3.4 The tariff was therefore one of the policy issues that the Minister had to resolve as part of the sales process. As the Minister said during the 14 June 2000 debate:

*“We sold [the DBNGP] subject to a range of policy issues designed to guarantee the business continued and to deliver a 20 per cent cut in tariff which was put in place by me by regulation. A host of matters were contained in a schedule that would guarantee protection for consumers. It was a sale that would guarantee other people multi-user third party access under the National Third Party Access Code for Natural Gas Pipeline Systems.”<sup>14</sup>*

- 3.5 The Government’s policy decision was quite clear – it wanted tariffs to be around \$1/GJ to Perth<sup>15</sup>.

---

<sup>11</sup> In the debate, the Minister for Energy, Colin Barnett, said “*The sale process was overseen by me, as minister, and reporting to me was a gas pipeline sale steering committee which consisted of the chief executive officers of Treasury, the Office of Energy and the Department of Resources Development.*” (Hansard, 14 June 2000, p. 7655.)

<sup>12</sup> See Hansard, 14 June 2000, p.7655, 7661 and 7662.

<sup>13</sup> Hansard, 14 June 2000, p.7655.

<sup>14</sup> Hansard, 14 June 2000, p.7655.

<sup>15</sup> See statements by the Minister for Energy in the debate on 14 June 2000:



- 3.6 The Government sought to ensure that bidders' bids were assessed on both price and compliance with the tariff policy. Bidders were required to set out their tariff structure in their bids, and this tariff structure then formed part of the Asset Sale Agreement as Schedule 39.
- 3.7 The GPSSC subjected each of the bids it received to close scrutiny to determine whether the proposed tariff structure and the proposed purchase price, along with the bidder's financing structure, were consistent with a viable pipeline business. As the Minister for Energy explained in the debate on 14 June 2000, Epic Energy's bid was understood by the Minister, and was subjected to such close scrutiny:

*"Epic Energy's proposed tariff would come down to \$1, so it complied with the policy position of the Government. There was no argument about that; it would be \$1 and that is why I regulated for \$1. It foreshadowed that it would be proposing tariff increases of two-thirds of the consumer price index in subsequent years. Two-thirds of CPI means that if inflation is 3 per cent, tariffs might go up 2 per cent. That is what it foreshadowed. With regard to a long-term price strategy that it 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. It had fallen 20 per cent by the sale process and it would continue to fall year after year by one-third of CPI, because its increase could be only two-thirds."*<sup>16</sup>

*"The sale process was conducted under closed tenders in the form of binding bids. All of the bids had to comprise a standardised form of asset sale agreement and had to indicate the full purchase price including stamp duty. The complying documentation contained only an indication by bidders of their proposed tariff schedule. In the case of Epic that was the famous schedule 39. Under schedule 5 of the asset sale agreement, bidders were required to provide and affirm indications of their proposed tariff rates and the path they would follow. They were required to do that to demonstrate to the gas sale steering committee that, given the price they bid and the price they proposed as tariffs, they would receive an acceptable rate of return on the asset. In other words, they had to demonstrate that they could not only buy the asset, but also operate it profitably and not expose*

---

*"There was therefore no secrecy, no confusion, and no lack of understanding of the policy commitments. I said through various Press announcement that there would be a declining tariff from \$1.20 to \$1 from the point of sale to 1 January 2000, and the regulator would be subject to the national access code . . . . That was stated consistently way back from 1997 right through the sale process."* (Hansard, 14 June 2000, page 7655)

*"The Government's position, which was reflected in various announcements and all the tender documentation, was that the price of gas transport should fall by 20 per cent at the point of sale from \$1.20 to \$1.11, then to \$1."* (Hansard, 14 June 2000, page 7656.)

*"As I explained, a number of policy matters during the sale process were reflected by the sale steering committee. The major policy matter was the decline in tariffs, which was subsequently regulated from \$1.20 to \$1."* (Hansard, 14 June 2000, page 7660.)

*"The Government's policy decision that bidders would bid on a set of conditions was put out to all bidders. The prime condition was that transport tariffs would fall to \$1 for the national access code."* (Hansard, 14 June 2000, page 7661.)

<sup>16</sup> Hansard, 14 June 2000, page 7657.

anyone to an unforeseen risk of failure of the business or unanticipated demands for tariff increases.”<sup>17</sup>

*“In its requirements on bidders, the sale steering committee, through its information memorandum and whatever other documentation was involved, also required that people provide indications on such issues as tariff, expansion capacities and the like. The reason for that was to check the veracity and the robustness, if one likes, of the bid. The Government would not accept a bid which could not be sustained. Therefore, it would have to know what that bid implied, and the bidders would have to demonstrate a proposed scenario of tariffs which would stack up and demonstrate to the sales committee that such a scenario of tariffs would give a return which would enable the money, the \$2 407m, to be serviced. In other words, the Government was not about setting up the gas industry in this State for a shock. On gas tariffs, it wanted to be satisfied that the bidders' scenario was compatible with the price. It also wanted to be satisfied about capacity.”<sup>18</sup>*

- 3.8 The Government was quite definite that it was not interested in tariffs either lower or higher than the policy decision of \$1/GJ to Perth. As the Minister put it, they only wanted people bidding on price:

*“Mr BARNETT: And we made a decision to drop it to a dollar. That is the commitment. It was possible to bid a high price and a high transport charge or a low price and a low transport charge. Surely members opposite do not think I did not realise that in 1997. We did not want people bidding on price and transport; therefore, logically, the Government made a policy decision on the transport charge which was to go from \$1.20 to \$1. Members opposite could argue we should have made the charge 90¢. That would be a fair argument. Right or wrong I made a policy decision, supported by Cabinet, that we reduce the tariff from \$1.20 to \$1 and invited people to bid against that. We wanted them to bid against one area on price. We did not want them bidding on a range of criteria.*

*Mr Ripper: They would be expecting to earn a rate of return on their investment over a considerable period, so they would have understood that policy decision would last.*

*Mr BARNETT: Why does the member for Belmont think they were not challenged? That is why the sale steering committee required people to indicate a scenario, not a contractual issue, for tariffs. We wanted to ensure their bid was sustainable. These are not my calculations; they are based on Epic's financial modelling. Epic prepared a model of the value of the pipeline, its contracts and its prospects for growth, and fed in assumptions about the Australian dollar, interest rates and many other factors. It came up with a figure - I do not know whether it added to it - of \$2 407m based against a certain fall in tariff from \$1.20 to \$1.”<sup>19</sup>*

---

<sup>17</sup> Hansard, 14 June 2000, page 7655.

<sup>18</sup> Hansard, 14 June 2000, p.7660

<sup>19</sup> Hansard, 14 June 2000, p.7662

- 3.9 The Minister made it very clear that he and the GPSSC were satisfied that what Epic Energy put forward in Schedule 39 (namely \$1.00/GJ to Perth and \$1.08/GJ to south of Perth) met the policy criteria in relation to tariff and sustainability.<sup>20</sup> In fact, he went further and indicated that a bid of less than \$1/GJ to Perth was not acceptable to the Government, as it would represent a moving of the goal posts:

*"The Government's policy decision that bidders would bid on a set of conditions was put out to all bidders. The prime condition was that transport tariffs would fall to \$1 for the national access code. One does not, at the conclusion of a sale process, suddenly change the rules of the game. To entertain bids on a range of issues or criteria would have changed the rules of the game and would have aborted the sales process."*<sup>21</sup>

*"Mr Ripper: You are keeping secret the potential for having accepted a lower price for the pipeline and a lower transport tariff. You are not revealing the trade offers the Government had before it on this matter. Mr BARNETT: I was not conducting a sale process that was subject to alteration halfway through."*<sup>22</sup>

Furthermore, a bid including a tariff which was higher than the tariff set out in Schedule 39 of the Asset Sale Agreement was not acceptable:

*"Epic justified that to the sale steering committee based on a price scenario with which we were compatible. Had Epic said it would pay \$2 407m, but it would need to increase gas transport by 10 per cent a year, clearly, its bid would not have been accepted. That was the process."*<sup>23</sup>

- 3.10 These extracts confirm that a set of common understandings about tariffs, and about the linkage between the tariffs and purchase price, developed through the DBNGP sale process. These common understandings centred around Epic Energy, as the successful bidder for the Pipeline, delivering to the Government of Western Australia its preferred level of future tariffs, a purchase price of \$2.407 billion consistent with those tariffs, and an undertaking to further expand Pipeline capacity. As the Minister for Energy later explained:

*"The Government did not want to sell a pipeline that never expanded; . . ."*<sup>24</sup>

*"Attachments to the bid were included to be scrutinised so that the bidders could be questioned by the steering committee to ensure the bid*

<sup>20</sup> See the Minister for Energy's comments in the debate on 14 June 2000 quoted above, and also where he said, "[Epic] came up with a figure - I do not know whether it added to it - of \$2 407m based against a certain fall in tariff from \$1.20 to \$1. Epic justified that to the sale steering committee based on a price scenario with which we were compatible." (Hansard, 14 June 2000, page 7662.)

<sup>21</sup> Hansard, 14 June 2000, page 7661.

<sup>22</sup> Hansard, 14 June 2000, page 7662.

<sup>23</sup> Hansard, 14 June 2000, page 7662.

<sup>24</sup> Hansard, 14 June 2000, page 7656.

*stacked up; that is, the bid price was consistent with reasonable future tariff changes and the expanding capacity of the pipeline.”<sup>25</sup>*

3.11 These are the essential elements of a regulatory compact as described by Goldberg, and more recently by Sidak and Spulber, in the context of utility regulation in the United States, and by Newbery in the broader context of privatisation, restructuring and regulation internationally.<sup>26</sup> A government secures service provision at prices which are “fair and reasonable” for both users and service providers. The service provider makes the investment required for service provision confident that it has secure title to future returns, and that those returns are commensurate with the returns available from alternative investments of similar risk. Its confidence in securing these returns, in an environment in which investment decisions are difficult to reverse, involve large sunk costs, and expose investors to the risk of expropriation of their sunk capital through the power of the State subsequently being used to drive prices down to avoidable costs, rests ultimately upon the reputation of the government. A government’s failure to maintain the “terms” of the regulatory compact would ultimately limit new investment and the potential for future economic development. This argument is expanded on in Section 4 and in the attached report from The Brattle Group.

3.12 Epic Energy has sought with the Access Arrangement to do no more than was contained in Schedule 39 to the DBNGP Asset Sale Agreement (namely \$1.00/GJ to Perth and \$1.08/GJ to south of Perth), with some refinement coming from experience. The Minister for Energy himself indicated during the 14 June debate that he, himself, was comfortable with Epic Energy’s proposed Access Arrangement for the DBNGP, when he acknowledged:

*“I do not have any problem personally with what Epic proposes”<sup>27</sup>*

---

<sup>25</sup> Hansard, 14 June 2000, page 7656.

<sup>26</sup> Goldberg, V.P., “Regulation and administered contracts”, *Bell Journal of Economics*, vol. 7, 1976: 426-448. Sidak, Gregory, and Spulber, Daniel, *Deregulatory Takings and the Regulatory Contract: The Competitive Transformation of Network Industries in the United States*, Cambridge University Press, 1997. Newbery, David M., *Privatization, Restructuring, and Regulation of Network Industries*, MIT Press, 1999.

<sup>27</sup> Hansard, 14 June 2000, page 7658.

## 4. The Brattle Group Report

- 4.1 Attached as Attachment 7 is a copy of a further report, *The Regulatory Compact and Asset Values after Privatisation: A Discussion Paper*, prepared by The Brattle Group.
- 4.2 In that report, The Brattle Group examines the concept of a regulatory compact as it has evolved in the particular circumstances of utility regulation in the United States, and as it is now evolving in the context of privatised and regulated utilities in the United Kingdom.
- 4.3 The report discusses the economic efficiency foundations for a regulatory compact. It notes that the existence of a regulatory compact does not require an explicit written contract between the state and a regulated utility. The terms of the compact are set out in statutes, regulatory commission precedents, adjudicatory decisions, rule makings, hearings on record, and other documents. These documents define obligations placed on the utility, obligations which depend on industry and circumstances, but which usually include provision of a “universal service”, or rights of access to facilities. In return for its accepting these obligations, the utility can expect to charge prices sufficient to provide its shareholders with a “fair return” on their investment.
- 4.4 In essence, the utility undertakes to provide a service which the state considers as being of benefit to the community. In exchange for its making the necessary investment and committing the specialised resources required for service provision, the state permits the utility to charge a price for the service which allows shareholders a fair return on investment and which, at the same time protects consumers from any abuse of market power by the utility. The regulatory compact has the form of a contract, but that contract is implicit, not explicit. An implicit contractual relationship derives from both the state and the utility conferring a benefit on each other conditional upon the receiving a benefit in return.
- 4.5 The regulatory compact between a utility and the state has received renewed prominence in the United States as utilities, and their regulators, have sought to resolve problems associated with the “stranding” of assets that has occurred with deregulation and industry restructuring. In resolving these problems, both governments and regulators have had to recognise investor expectations at the time investments were made in now stranded assets, and the actions of their predecessors in supporting those expectations. They have allowed investors to recover the costs of stranded assets, not because of any explicit legal obligations, but for reasons of economic efficiency and equity. Governments and regulators have had to explicitly recognise the regulatory compacts between investors and the state.
- 4.6 In the United Kingdom, there have been disputes over asset valuation in the operation of the new regulatory regimes that were imposed at the time of the privatisation of major state-owned enterprises in the 1980s. The resolution of these disputes has required recognition of the principle of maintaining consistency with investor expectations at the time of privatisation, and regulators have adopted the use of market or flotation value at the time of the

initial share sales in the resetting of prices and price controls in the gas, electricity and water industries. That is, the regulators have recognised the existence of the regulatory compacts between shareholders and the state that arose during the process of enterprise privatisation.

- 4.7 As Epic Energy has demonstrated in previous submissions, and reinforced in this Additional Paper 4, a regulatory compact of the type described by The Brattle Group developed between the Epic Energy and the State of Western Australia during the DBNGP sale process. As noted in Section 2 above, Epic Energy conferred benefits on the State in a number of forms, and the State, in turn, sought to ensure that its preferred level of future tariffs would provide Epic Energy's shareholders with a fair return on investment.



## 5. Conclusions

- 5.1 The regulatory compact developed between Epic Energy and the State of Western Australia during the DBNGP sale process is fundamental to the structure of the proposed Access Arrangement for the Pipeline. It is the basis of the reference tariff and the tariff path that have been proposed, and underlies the linkage of the tariff and the tariff path to the price paid for the Pipeline through Epic Energy's choice of initial capital base.
- 5.2 Epic Energy has proposed, as the initial capital base for the DBNGP, a value of capital assets comprising the Pipeline derived from its purchase price of \$2.407 billion. Deriving the initial capital base in the way proposed by Epic Energy is consistent with the requirements of the Code. Section 8.10(j) of the Code identifies as one of the factors that should be considered in establishing the initial capital base "the price paid for any asset recently purchased by the service provider and the circumstances of that purchase". Epic Energy maintains that, given the way in which the Government structured and executed the DBNGP sale process, the price Epic Energy paid for the Pipeline is the critical factor to be considered in establishing the initial capital base. To give precedence to any of the other factors of section 8.10 of the Code would lead away from the policy outcomes sought by the Government during the sale process, and away from the regulatory compact, a compact from which the State has now received the benefits it sought in a variety of forms.
- 5.3 The linkage of the tariffs and the tariff path to the price Epic Energy paid for the DBNGP is made explicit through the Regulatory Model for the Pipeline developed by The Brattle Group. In accordance with that model, by delivering the tariff and the tariff path proposed in Schedule 39 of the Asset Sale Agreement (namely \$1.00/GJ to Perth and \$1.08/GJ to south of Perth), as accepted by the Government of Western Australia after scrutiny by its Gas Pipeline Sale Steering Committee, Epic Energy's shareholders can reasonably expect to recover their investment in the Pipeline.
- 5.4 The Regulatory Model is not a model of tariff determination. The tariff and the tariff path derive from commitments forming part of the regulatory compact, and not from an initial capital base which derives from the price it paid for the DBNGP.
- 5.5 The regulatory compact and the Regulatory Model do not guarantee that Epic Energy's shareholders will recover their full investment in the DBNGP. They do no more than give Epic Energy the opportunity to recover that investment. That opportunity is underpinned by demand for gas transportation services in Western Australia, and the tariff and the tariff path of the regulatory compact. As Epic Energy had indicated, it expects to take any volume risk associated with forecasts of the demand for gas transportation services made at the time of Pipeline sale.
- 5.6 The tariff and the tariff path are now a matter for the State and the Regulator in accordance with the Code as it has been implemented in Western Australia. Section 2.24 of the Code requires that, in approving an access arrangement, the Regulator must take into account:

- the service provider's legitimate business interests and investment in the covered pipeline;
  - firm and binding contractual obligations of the service provider or other persons (or both) already using the covered pipeline;
  - the economically efficient operation of the covered pipeline;
  - the public interest, including the public interest in having competition in markets (whether or not in Australia); and
  - the interests of users and prospective users.
- 5.7 In approving the proposed DBNGP Access Arrangement in accordance with section 2.24 of the Code, Epic Energy maintains that the Regulator must implement the regulatory compact between Epic Energy and the State.
- 5.8 Only by implementing the regulatory compact, would the Regulator take into account Epic Energy's legitimate business interests and the investment its shareholders have made in the Pipeline. Were the Regulator not to implement the compact, Epic Energy's shareholders would not be provided with the opportunity to recover their investment and a return on that investment commensurate with prevailing market conditions. Moreover, the Regulator may well remove Epic Energy's financial capability to continue pipeline operation, and to deliver on its commitment to make the investments in the additional pipeline capacity required to support economic development in the State.
- 5.9 Were the Regulator to proceed in any other way, he would fail to take into account the way in which the DBNGP sale process was structured and executed by the Government of Western Australia to serve the wider public interest and, at the same time, to deliver lower gas transportation tariffs in the interests of shippers and prospective shippers. Were the State and the Regulator to now ignore the regulatory compact, Epic Energy's shareholders would be exposed to "asymmetric risk". That risk may significantly deter future private sector investment in infrastructure assets in Western Australia. Future potential investors would realise that they could be exposed to substantial financial loss while, at the same time, they had no prospect of securing the superior financial returns required to compensate for the risk of that loss.



## Regulatory Compact – Sales Process

### Extracts from Statements made by Colin Barnett, Minister for Energy

Media Statement, 22 May 1997

*"I am confident the sale will deliver a substantial return to WA taxpayers on their investment. The price at which the pipeline eventually sells will depend on its future earning potential as determined by prospective bidders."*

*"It is imperative the Government sells the pipeline to deliver the highest possible return to WA taxpayers who have owned this asset since it was built in 1984."*

*"Issues such as ensuring gas transport costs are kept down, the desire to increase gas supply to encourage further downstream processing projects, the need to protect long-term supplies and maintain prices for households and small business were all key points of consideration the Government had to take into account."*

*"These are all valid, but not necessarily consistent issues that have been weighed up before the final decision was made. I believe the Government has balanced these competing issues and come up with an equitable solution."*

Media Statement, 24 July 1997

*"I am confident the sale will deliver a substantial return to Western Australian taxpayers on their investment."*

*"The pipeline and associated assets have a current book value of more than \$1 billion. The price at which it eventually sells will largely depend on its future earning potential, as determined by prospective bidders."*

Media Statement, 7 September 1997

*"The sale of the Dampier-to-Bunbury Natural Gas Pipeline has the potential to realise the highest sale price for a State-owned asset in WA's history."*

*"It has a current book value of more than \$1 billion."*

*"I am confident the sale will deliver a substantial return to WA taxpayers on their investment. The price at which the pipeline eventually sells will depend on its future earning potential as determined by the prospective bidders which have registered their interest."*

### Regulatory Compact - Sales Process

#### Extracts from Statements by the Minister for Energy at time of, and subsequent to, DBNGP sale

Minister for Energy – Media Statement, 3 March 1998

*"For the past several months, the Gas Pipeline Sale Steering Committee has met with the three bidders on a regular basis and discussions have been held on a wide range of issues in order to ensure that the bidders all understood the conditions governing the sale."*

*"The GPSSC and the working group analysed, assessed and carefully examined the bids with a view to determining the bid that provided the greatest advantage to the State."*

*"This analysis established that Epic Energy Australia's complying bid was superior to any other bid. Significantly for WA gas consumers, the new owner has committed to lower gas tariffs, a condition of sale set down by the State Government."*

Minister for Energy – Debate on Gas Pipelines Access (Western Australia) Act  
Hansard, 16 September 1998

*"The Government realised for this State an enormous capital gain on that asset, and it realised a commitment that the price of transporting gas would fall by 20 per cent by 2000. We also realised an agreement that \$870m would be spent on progressively doubling capacity of that pipeline between now and 2007, and that process is already underway. . . . There was a glittering prize to be had. My view and the view of this Government was that that glittering prize – the extra \$1b – belonged to the people of Western Australia to repay debt; and in the case of the Education portfolio, to put 32 000 computers into government and non-government schools over the next four years, plus the other things that might happen with those proceeds. . . ."*

Mr Grill: *"The bottom line is that our gas prices continue to go up and the adverse differential between us and the Eastern States continues to widen."*

MR BARNETT: *"Okay . . . "*

Minister for Energy – Answer to question from Mr Ripper, Hansard 14 March 2000

*"I can explain the broad background to the sale and what occurred. The bidders, including Epic Energy, were asked to bid on a number of features. One obvious one and the most important component was price; a second related to service standards and the like; a third related to the price, not only what they would pay for it but the cost of the transport of gas; a fourth related to commitments to expanding pipeline capacity. Therefore the price paid for the pipeline was by far the most important criteria. However, there were three other components: The first was the bid of \$2 407m; the second was a*

*commitment to spend some \$875m on effectively expanding and duplicating the pipeline capacity over an eight-year period; and the third related to the transport tariff. At the time of the sale, the cost of transporting gas was \$1.19 per gigajoule to the south west. Under the bid put in by Epic, the price would fall from \$1.19 to \$1.10 to \$1, and that has happened; in other words, the bid was composed of price, top dollar, an expansion commitment on investment and a 20 per cent reduction in tariff . . . Yes, it is true that we could have traded off. We could have gone back to Epic and said that we would take a lower price for the State in exchange for giving transporters of gas a lower tariff.”<sup>28</sup>*

*“We made the judgment that a high price for taxpayers and the community of Western Australia was the first and most important component. If at the same time we doubled the pipeline capacity and delivered a 20 per cent cut in transport tariffs, it was a very good deal.”<sup>29</sup>*

---

<sup>28</sup> Hansard, 14 March 2000, page 4963, question no. 543.

<sup>29</sup> Hansard, 14 March 2000, page 4963, question no. 543.

## Regulatory Compact – “Commitments”

### Extracts from Statements by Minister for Energy

Media Statement, 3 March 1998

*“Significantly for WA gas consumers, the new owner has **committed** to lower gas tariffs, a condition of sale set down by the State Government.”*

*“Epic Energy Australia is **prepared** to spend \$874 million through to 2007 to double the capacity of the pipeline and has **guaranteed** priority rights, as set down by the State Government, for AlintaGas and Western Power on capacity to serve residential and small business customers.”*

*Mr Barnett said a number of AlintaGas employees were involved in the operation and maintenance of the DBNGP and that the sale conditions also included that the new owner **would employ** these employees.*

*“As well, Epic Energy Australia has also **committed** that with the success of its bid, it would establish Perth headquarters for its Australian operations.”*

Australian Financial Review, 6 March 1998

*He said while the pipeline sale agreement **foreshadowed** a price drop of 20 per cent – from \$1.19 to \$1.00 per gigajoule – by the year 2000, beyond that time any increases were required to be less than the CPI.*

...

*But he said real competition in the gas industry would come from more producers and consumers using the existing pipeline, with Epic **committed** to doubling its size by spending \$857 million over the next nine years.”<sup>30</sup>*

Debate on Gas Pipelines Access (Western Australia) Bill 1998, Hansard 16 September 1998

*“The Government realised for this State an enormous capital gain on that asset, and it realised a **commitment** that the price of transporting gas would fall by 20 per cent by 2000. We also realised an **agreement** that \$870m would be spent on progressively doubling capacity of that pipeline between now and 2007, and that process is already underway. ... There was a glittering prize to be had. My view and the view of this Government was that that glittering prize – the extra \$1b – belonged to the people of Western Australia to repay debt; and in the case of the Education portfolio, to put 32 000 computers into government and non-government schools over the next four years, plus the other things that might happen with those proceeds.”*

<sup>30</sup> “Gas price is right despite pipeline sale”, *Australian Financial Review*, 6 March 1998.

Debate on Gas Corporation (Business Disposal) Bill 1999, Hansard 16 September 1999

*"Last year the Dampier-Bunbury natural gas pipeline was sold for \$2.4b. That result was important, but it was also a noteworthy example of **why it is necessary to resolve policy issues prior to making decisions to sell or privatise assets**. In the sale of the Dampier-Bunbury pipeline a number of policy issues were thought out and implemented prior to the sale. From my perspective that was one of the keys to the success and the achievement of such a high price. Apart from the \$2.4b in proceeds, **the sale included a reduction in transport tariffs of 18 per cent over three years**. A decision was made to widen the easement from 30 metres to 100 metres to allow future gas pipelines to be constructed, and a **commitment** was made by the buyer of the pipeline to expend \$870m over the next 10 years in expanding the capacity and ultimately duplicating to a parallel pipeline system."*<sup>31</sup>

Hansard 14 March 2000

*"I can explain the broad background to the sale and what occurred. The bidders, including Epic Energy, were asked to bid on a number of features. One obvious one and the most important component was price; a second related to service standards and the like; a third related to the price, not only what they would pay for it but the cost of the transport of gas; a fourth related to commitments to expanding pipeline capacity. Therefore the price paid for the pipeline was by far the most important criteria. However, there were three other components: The first was the bid of \$2 407m; the second was a commitment to spend some \$875m on effectively expanding and duplicating the pipeline capacity over an eight-year period; and the third related to the transport tariff. At the time of the sale, the cost of transporting gas was \$1.19 per gigajoule to the south west. Under the bid put in by Epic, the price would fall from \$1.19 to \$1.10 to \$1, and that has happened; in other words, the bid was composed of price, top dollar, an expansion commitment on investment and a 20 per cent reduction in tariff. . . . Yes, it is true that we could have traded off. We could have gone back to Epic and said that we would take a lower price for the State in exchange for giving transporters of gas a lower tariff."*<sup>32</sup>

*"We made the judgment that a high price for taxpayers and the community of Western Australia was the first and most important component. If at the same time we doubled the pipeline capacity and delivered a 20 per cent cut in transport tariffs, it was a very good deal."*<sup>33</sup>

Hansard 16 March 2000

*"The tariff schedule put in by Epic included a proposal that the price of gas would fall from \$1.20 to \$1.10 to \$1. That was a schedule that was generally*

<sup>31</sup> Hansard, 16 September 1998, page 1322.

<sup>32</sup> Hansard, 14 March 2000, page 4963, question no. 543.

<sup>33</sup> Hansard, 14 March 2000, page 4963, question no. 543.

*put forward by government to all bidders as an expectation. That was the broad understanding.*<sup>34</sup>

Speech given at *Energy in Western Australia 2000 Conference*, 22 March 2000

*"The major event was the privatisation in 1998 of the Dampier to Bunbury Natural Gas Pipeline, purchased by Epic Energy in a scenario where the sale consisted of several components. The price, \$2.4 billion, a **commitment** which was foreshadowed by Government during the sale process that transport tariffs should fall from a \$1.20 down to around \$1.10 and then to \$1.00 and also one that involved a **commitment** by the purchaser to expand capacity spending some odd \$870 Million to 2007. That process has already begun."*

[Highlighting of words has been added by Epic Energy.]

---

<sup>34</sup> Hansard, 16 March 2000, page 5198, question no. 575.

## \$1.00/GJ Environment – Sale Process

### Extracts from Statements

Minister for Energy – Media Statement, 22 May 1997

*“As well, new regulations would enforce a set of reference tariffs for the first two years of operation under private ownership, declining over the period 1998 to 2000. This would see transport costs decline from around \$1.25 per gigajoule at present to around \$1 per gigajoule by the year 2000.”*

Minister for Energy – Media Statement, 24 July 1997

*“This would see transport costs decline from about \$1.25 per gigajoule at present to about \$1 by the year 2000.”*

Minister for Energy – Media Statement, 7 September 1997

*“Based on preliminary work undertaken by AlintaGas and work independently commissioned by the Gas Pipeline Sale Steering Committee, it is currently anticipated that the cap on tariffs for a full haul firm service at a 100 per cent load factor will be \$1.24/GJ for 1998 and \$1.12/GJ for 1999. From the year 2000, the State is planning to adopt the National Access Code and tariffs could fall to around \$1/GJ.”*

Sale of the Dampier to Bunbury Natural Gas Pipeline Information Memorandum, August 1997

*The GPSSC has commissioned a detailed analysis to estimate the expected level of Reference Tariffs for a Reference Service that would be approximately equivalent to the full haul T1 service at 100% load factor currently offered on the DBNGP under the GTR, and which would be available to new and existing users of the DBNGP from 1 January 2000 when the Access Code is intended to be introduced (“Indicative Global Reference Tariff” or “IGRT”). The Indicative Global Reference Tariff has been calculated on the assumption that all loads are full haul. To the extent that a small proportion of the DBNGP loads are presently part haul, the Indicative Global Reference Tariff **understates marginally** a specifically calculated full haul T1 service at 100% load factor.*

*The IGRT analysis has involved a range of assumptions, including such matters as the manner in which tariffs would escalate over time. However, the Access Arrangement may utilise differing assumptions in respect of such matters which could also be acceptable to the Regulator.*

*The IGRT analysis has been based upon the Indicative Valuation [a DORC valuation of \$1.124 billion] and a rate of return **consistent with the***



***proposed requirements of the draft NAC. The IGRT analysis has considered a number of possible price paths that would support a tariff on a price capping basis of \$1.00/GJ, nominal at 1 January 2000. It is the Government's expectation that the tariff will be of that order at that time.***<sup>35</sup>

[emphasis added by Epic Energy]

Minister for Energy – Second Reading of Dampier to Bunbury Pipeline Bill 1997, Hansard 11 November 1997 p.7523-7524

*"Gas prices have also reduced in the south west and passage of this Bill will contribute to further economies. On 1 January 1995 it cost \$1.27 per gigajoule to transport gas at 100 per cent load factor to Perth. This will be reduced to less than \$1.24 per GJ on 1 January 1998 and will fall to less than \$1.12 per GJ on 1 January 1999 and to about \$1.00 per GJ on 1 January 2000. This is a reduction of 27 per cent in transmission costs, a major component of delivered gas prices."*<sup>36</sup>

---

<sup>35</sup> Information Memorandum, page 107.

<sup>36</sup> Hansard, 11 November 1997, pages 7523 – 7524.



## **\$1.00/GJ Environment – Confirmation**

### **Extracts from Statements**

Minister for Energy – Media Statement, 3 March 1998

*"This analysis established that Epic Energy Australia's complying bid was superior to any other bid. Significantly for WA gas consumers, the new owner has committed to lower gas tariffs, a condition of sale set down by the State Government."*

*"Under the transitional access regime, tariffs will fall 20 per cent from \$1.19 (nominal) in 1998 to \$1 (nominal) in 2000."*

Minister for Energy – Debate on Gas Pipelines Access (Western Australia) Act  
Hansard, 16 September 1998

*"The Government realised for this State an enormous capital gain on that asset, and it realised a commitment that the price of transporting gas would fall by 20 per cent by 2000."*

Minister for Energy – Debate on Gas Corporation (Business Disposal) Bill 1999,  
Hansard 16 September 1999

*"... the sale included a reduction in transport tariffs of 18 per cent over three years."<sup>37</sup>*

Minister for Energy – Hansard 14 March 2000, Answer to Question 543

*"At the time of the sale, the cost of transporting gas was \$1.19 per gigajoule to the south west. Under the bid put in by Epic, the price would fall from \$1.19 to \$1.10 to \$1, and that has happened; in other words, the bid was composed of price, top dollar, an expansion commitment on investment and a 20 per cent reduction in tariff."*

Minister for Energy – Hansard 14 March 2000, Answer to Question 546

*"I think the member is referring to schedule 36 which was the scenario that Epic, as part of its bid, put in what would happen for transport tariffs. That was the \$1.20 to \$1.10 to \$1.00 and that has happened. It was also to be two-thirds of the consumer price index in subsequent years, and there was more detail."*

---

<sup>37</sup> Hansard, 16 September 1999, page 1322.

Minister for Energy – Hansard 16 March 2000, answer to Question 575

*“As I explained yesterday, when the bids were received for the Bunbury to Dampier natural gas pipeline, people presented their bids on a number of criteria. That included the price, commitments to expanding capacity and a tariff schedule; in other words, what they would see as the price of transporting gas. The tariff schedule put in by Epic included a proposal that the price of gas would fall from \$1.20 to \$1.10 to \$1. That was a schedule that was generally put forward by government to all bidders as an expectation. That was the broad understanding.”*

## **\$1.00/GJ Environment – Choice of Tariffs**

### **Extracts from Statements**

Minister for Energy – Debate on Gas Pipelines Access (Western Australia) Act  
Hansard, 16 September 1998

*“The Government realised for this State an enormous capital gain on that asset, and it realised a commitment that the price of transporting gas would fall by 20 per cent by 2000. . . . There was a glittering prize to be had. My view and the view of this Government was that that glittering prize – the extra \$1b – belonged to the people of Western Australia to repay debt; and in the case of the Education portfolio, to put 32 000 computers into government and non-government schools over the next four years, plus the other things that might happen with those proceeds.”*

Mr Grill: *“The bottom line is that our gas prices continue to go up and the adverse differential between us and the Eastern States continues to widen.”*

MR BARNETT: *“Okay . . . ”*

Minister for Energy – Response to Question 543, Hansard 14 March 2000

*“Under the bid put in by Epic, the price would fall from \$1.19 to \$1.10 to \$1, and that has happened; in other words, the bid was composed of price, top dollar, an expansion commitment on investment and a 20 per cent reduction in tariff. . . . Yes, it is true that we could have traded off. We could have gone back to Epic and said that we would take a lower price for the State in exchange for giving transporters of gas a lower tariff.*

*. . .*

*We made the judgment that a high price for taxpayers and the community of Western Australia was the first and most important component. If at the same time we doubled the pipeline capacity and delivered a 20 per cent cut in transport tariffs, it was a very good deal.”*

**The Brattle Group Report**  
**On**  
**The Regulatory Compact and**  
**Asset Values after Privatisation:**  
**A Discussion Paper**