DAMPIER TO BUNBURY NATURAL GAS PIPELINE

PROPOSED ACCESS ARRANGEMENT UNDER THE NATIONAL ACCESS CODE

RESPONSE TO COURT DECISION PUBLIC VERSION

Submission CDS#2: Substantive submissions concerning the Regulator's assessment of the Reference Tariff and Reference Tariff Policy

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1 Background

1.1 On 15 December 1999, Epic Energy (WA) Nominees Pty Ltd and Epic Energy (WA) Transmission Pty Ltd (together "Epic Energy") applied to the Independent Gas Pipelines Access Regulator for approval of a proposed Access Arrangement in relation to the Dampier to Bunbury Natural Gas Pipeline (**DBNGP**).

1.2 The Regulator considered Epic Energy's proposed Access Arrangement and delivered a draft decision on 21 June 2001, in which he did not approve the proposed Access Arrangement but instead stated amendments which would have to be made to the proposed Access Arrangement in order for him to approve it.

1.3 Epic Energy brought proceedings in the Supreme Court of Western Australia challenging the Regulator's decision not to approve its proposed Access Arrangement. Those proceedings sought prerogative relief to quash the Regulator's draft decision or, further or alternatively, declaratory relief.

1.4 The Full Court of Western Australia delivered its judgment on 23 August 2002: *Re Michael; Ex parte Epic Energy (WA) Nominees Pty Ltd*.[1] Although the Full Court held that Epic Energy had made good a case which in law could support the grant of prerogative relief quashing the Regulator's decision, the Court determined that the most appropriate course was to grant declaratory relief only. This was to allow the Regulator to continue assessing Epic Energy's proposed Access Arrangement, but in light of the principles set out by the Full Court, rather than requiring the Regulator to re-commence the assessment process.[2]

1.5 The Regulator has sought further submissions from Epic Energy as to the proposed Access Arrangement so that he may continue with his assessment process. The present submissions respond to the Regulator's requirement of further submissions. In the absence of a draft decision which complies with the Code, it is of quintessential importance that the Regulator should fully consider these submissions.

1.6 However, as the Full Court has not yet made final orders in the above proceedings, Epic Energy reserves the right to file further submissions after the final form of declaration is known. Further, as Epic Energy has not been provided with access to any information obtained by the Regulator pursuant to clause 41 of schedule 1 to the *Gas Pipelines Access (Western Australia) Act 1998* (WA) (the **Act**), Epic Energy also reserves its rights to make further submissions concerning this information when it obtains access to it.

[1] (2002) 25 WAR 511. ("Reasons").
[2] Reasons paras 218-222.

2 Regulator's Present Task

2.1 The Regulator's decision of 21 June 2001 was given pursuant to s.2.13 of the *National Third Party Access Code for Natural Gas Pipeline Systems* (the **Code**). The Code has force in Western Australia by virtue of the Act.

2.2 Section 2 of the Code sets out the process to be followed by the Regulator in assessing a proposed Access Arrangement. After issuing a draft decision pursuant to s.2.13, the Regulator must request submissions from persons to whom it provides the draft decision (s.2.14). There is also provision for a Service Provider to resubmit an Access Arrangement (s.2.15A), but Epic Energy has chosen not to do this.

2.3 After considering any further submissions made in response to his draft decision, the Regulator must issue a final decision. Where no revised Access Arrangement is submitted, the Regulator's final decision must either approve the proposed Access Arrangement, or alternatively not approve the proposed Access Arrangement and state amendments which would have to be made in order for the Regulator to approve it (s.2.16(a)).

2.4 As the Full Court has not quashed the Regulator's draft decision, the Regulator must now make a final decision concerning Epic Energy's proposed Access Arrangement, pursuant to s.2.16(a). However, that final decision is to be guided by the principles set out by the Full Court.[3]

2.5 The present submissions are contemplated by s.2.14(b). There are a number of associated papers filed in conjunction with these submissions, and Epic Energy also relies upon material previously provided to the Regulator. The new papers associated with the present submissions are as follows:

CDS#1	"Overarching Submission"
CDS#2	"Substantive submissions concerning the Regulator's assessment of the Reference Tariff and the Reference Tariff Policy"
CDS#3	"DBNGP Sale Process"
CDS#4	"The Deferred Recovery Account"
CDS#5	"Response to Draft Decision Amendments"
CDS#6	"Response to Third Party Submissions"

[3] Reasons para 220.

2.6 This submission has been prepared and finalised by Epic Energy in collaboration with KPMG, Mallesons Stephen Jaques and Counsel for Epic Energy (Chris Zelestis QC, Graeme Murphy and Joshua Thomson). It has been reviewed by them and they have confirmed that it accords in all respects with the views expressed by them during the collaborative process. To this effect, attached as **Attachments 1 & 2** are copies of letters from KPMG and Mallesons Stephen Jaques.

3 The Nature of the Assessment Process

3.1 The Regulator's final decision is governed by s.2.24 of the Code (as was his draft decision). That provides:

The Relevant Regulator may approve a proposed Access Arrangement only if it is satisfied the proposed Access Arrangement contains the elements and satisfies the principles set out in sections 3.1 to 3.20. The Relevant Regulator must not refuse to approve a proposed Access Arrangement solely for the reason that the proposed Access Arrangement does not address a matter that sections 3.1 to 3.20 do not require an Access Arrangement to address. In assessing a proposed Access Arrangement, the Relevant Regulator must take the following into account:

(a) the Service Provider's legitimate business interests and investment in the Covered Pipeline;

(b) firm and binding contractual obligations of the Service Provider or other persons (or both) already using the Covered Pipeline;

(c) the operational and technical requirements necessary for the safe and reliable operation of the Covered Pipeline;

(d) the economically efficient operation of the Covered Pipeline;

(e) the public interest, including the public interest in having competition in markets (whether or not in Australia);

(f) the interests of Users and Prospective Users;

(g) any other matters that the Relevant Regulator considers are relevant.

3.2 The nature of the assessment process which s.2.24 requires the Regulator to follow in making a final decision, whether to approve a proposed Access Arrangement, was carefully considered by the Full Court.

The Full Court held that:

(a) the Code establishes a single process of assessing a proposed Access Arrangement and deciding whether or not to approve it;[4]

(b) in that process, the Regulator is required by s.2.24 to take the stipulated factors into account and to give them weight as fundamental elements;[5]

[4] Reasons para 58.
[5] Reasons para 55.

(c) the process of assessment includes giving weight as a fundamental element to the s.2.24 factors in the consideration of s.3.1 to 3.20, including the consideration of s.8 as incorporated through ss.3.4 and 3.5;[6]

(d) consideration of ss.3.4 and 3.5 involves an evaluation and exercise of judgment and discretion, taking due account of inter-related matters;[7]

(e) assessing whether a proposed Reference Tariff and Reference Tariff Policy comply with s.8 principles does not involve the Regulator undertaking calculations producing fixed results and a fixed "yes" or "no" answer, but involves considering whether the proposed Reference Tariff and Reference Tariff Policy are consistent with the stated "principles" (not prescriptions) – the notion of compliance does not involve a single uniquely correct outcome, but a determination whether the proposal is reasonable within s.8;[8]

(f) in evaluating the application of ss.3.4 and 3.5 (ie, in considering compliance with the s.8 principles), the factors in s.2.24 are applicable and guide the Regulator in the exercise of the discretions contemplated by the last paragraph of s.8.1.[9]

3.3 Therefore, the correct approach to assessing a proposed Access Arrangement and deciding whether it should be approved may be explained as follows:

(a) there is a single, overall process of assessment, which involves inter-related components or elements – it does not involve a series of individual, final decisions which severally and mechanically produce an outcome;

(b) of necessity, the initial consideration of matters of detail under s.3.1 to 3.20 (including s.8) will be to an extent provisional in nature, for the proposal must be assessed overall and in an integrated manner, taking full account of the interaction between factors with proper weight being given to the s.2.24 factors, before final views are formed; and

(c) a central feature of the process is an evaluation of the proposed Access Arrangement, and the supporting case propounded by the service provider, having regard to the s.2.24 factors and the weight to be accorded to them as fundamental elements in the particular circumstances of the case.

[6] Reasons paras 61-69.
[7] Reasons paras 57-63.
[8] Reasons paras 64-68.
[9] Reasons paras 69, 203.

3.4 Further:

(a) the necessity to consider issues in some sequence should not obscure the nature of the assessment as a single, overall appraisal of a proposal which has been submitted for approval;

(b) the interrelationship between the ss.3.1 to 3.20 matters will be assessed according to the proper application of the s.2.24 factors (ie, according weight to them as fundamental elements);

(c) The Reference Tariff and the Reference Tariff Policy should be assessed for compliance with the s.8 principles, giving proper effect to the role of the s.2.24 factors through s.8.1 (last para) and proper breadth to the notion of compliance;

(d) in that regard there will be a consideration of whether the proposed Reference Tariff:

(i) has been designed to achieve the objectives in s.8.1, as applicable to the particular case and guided by s.2.24; and

(ii) satisfies the applicable principles and methodologies;

(e) the overall relationship between the ss.3.1 to 3.20 matters and the s.2.24 factors will be carefully evaluated;

(f) the process will yield a series of considerations some of which require weight as fundamental elements, and those will particularly affect both the overall decision whether the proposal should be approved and individual discretions exercised;

(g) the role of s.2.24 factors in guiding and being accorded weight as fundamental elements in the overall assessment of the proposed Access Arrangement, and in guiding the exercise of discretions under s. 8, through s.8.1 (last para), will inevitably ultimately produce a harmonious and consistent outcome; and

(h) overall, the correct process is more inductive than deductive.

3.5 Further argument before the Full Court on 28 November 2002, confirmed that the earlier judgment of the Full Court did not intend to exclude the possibility that s.2.24 might have relevance to the application of s.8 in some way not advanced before the Court when Epic Energy challenged the Regulator's decision of 21 June 2001. In particular, Parker J made a number of pertinent comments on 28 November 2002. In discussing various submissions with counsel for the Regulator, Parker J said that:

- *"…[the reasons come to the point that it was the Regulator's position that was erroneous,] in that 2.24 could and did reach into section 8, at least for the purpose there identified. Now, not in issue between the parties, it seems to me, and not then exhaustively analysed and considered was whether there might be some scope for any other operation of section 2.24 into section 8. What was demonstrated there was one position where it did appear to do that. There are passages in the reasons which suggest that nothing had appeared which would suggest that there was any other room for it to operate, but as neither party was approaching the case for its arguments on the basis that the court reached in paragraph 203, I would venture the view at the moment that it would be undesirable for the court to exclude the possibility that on full exploration of the issue as articulated in paragraph 203, that there might not be some other room for operation. I don't see myself that it was an issue that was directly faced by either party or that it was necessary to finally determine…"*[10]

- *"I think what I am putting to you is that a tentative position was reached [in the judgment of the Full Court], there was a firm position reached that the view taken in the draft decision was in error and a clear position reached that the submission advanced by the applicant in its full ambit was in error and that what was clear is that which is indicated in paragraph 203 [of the Full Court's reasons]. Now, there are potentially a myriad of factual situations in which any scope for the interrelationship of 2.24 and section 8 will, I suspect, in the future come to be explored. Certainly this particular case has not provided a factual basis to in any way exhaust those. My point that I put to you is that in the absence of that potential having been fully explored, it would be premature and imprudent for the court to make a declaration that appeared to absolutely finally determine that issue for all potential future factual situations, one or more of which may possibly arise in this very case if the matter is approached in the way in which the court indicates. There could be potential for some issue to arise in this case."*[11]

3.6 The response of counsel for the Regulator to these comments of Parker J was:

> *"We accept, with respect, what Your Honour is saying to the extent that there might be an attempt to articulate for all purposes the relationship between sections 2.24 and 8 of the code."*[12]

3.7 Consistently, in its judgment, the Full Court expressly rejected interpreting the three sentences in s.2.24 as independent and in effect sequential commands to the Regulator, and the view that the Regulator does not come to the stage of considering the factors in s.2.24(a)-(g) unless the requirements of ss.3.1-3.20 are satisfied. The Full Court held that the factors in s.2.24(a)-(g) are to be accorded

[10] Transcript pages 670-671.
[11] Transcript pages 671-672.
[12] Transcript page 673.

weight as fundamental elements in the assessment process and are to provide guidance to the Regulator in considering the elements and principles contained in ss.3.1-3.20, subject to the nature of these elements and principles indicating otherwise.[13]

3.8 In light of these principles, the sole question for the Regulator pursuant to s.2.16 is whether the proposed Access Arrangement should be approved. The task is not for the Regulator to calculate his own version of a Reference Tariff or Reference Tariff Policy or to determine his own version of a proposed Access Arrangement. Further, any attempt to segment the process of assessment and approval into sequential and component parts denies the fundamental nature of the process as a single one, and precludes attainment of the harmony and consistency which is achieved by a proper understanding and application of the s.2.24 factors. The Regulator's counsel accepted this form of analysis in argument on 28 November 2002.[14]

3.9 One other notable point from the Full Court's decision is that it did not hold that considerations of economic theory should be accorded any overarching significance in the assessment process. Rather, the Court emphasised that it is the factors in s.2.24(a)-(g) which are to be given weight as fundamental elements of the assessment process, and these may accommodate wider considerations than simply economic policy objectives, such as "embracing the protection of the interests of owners of pipelines", which may extend to "the assurance of fair and reasonable conditions being provided where [the] private rights [of pipeline owners] are overborne by a statutory scheme".[15]

[13] Reasons paras 57-62.
[14] Transcript p 699.
[15] Reasons para 134, see also for example, paras 130-133, 179-184, 205-206, 223.

4 Fundamental Elements: Factors in s.2.24(a)-(g)

4.1 As indicated, the starting point in the assessment process is s.2.24 and the factors which are accorded weight as fundamental elements of that process. These factors reflect in more precise context the general objectives of the Act and the Code.[16] Epic Energy therefore begins by identifying those factual matters which it submits should be recognised as having fundamental weight throughout the entire assessment process (subject to particular provisions of the Code) due to the operation of s.2.24.

4.2 This process of identifying the factual matters to be accorded weight as fundamental elements requires two steps. First, the meaning of each factor in s.2.24 must be interpreted. In this respect the Full Court has provided relevant guidance. Secondly, the correct interpretation of each factor must be applied to the facts which underpin the proposed Access Arrangement.

Section 2.24(a) - The Service Provider's legitimate business interests and investment in the Covered Pipeline

4.3 For the purposes of s.2.24(a) of the Code, the Full Court held that Epic Energy's legitimate business interests and investment in the DBNGP might properly extend to the recovery of all of $2.407 billion, at least over the expected life or operation of the DBNGP, together with an appropriate return on investment. The Full Court also said that it was not correct, in the context of the Code, that the recovery of monopoly prices or tariffs, above the level of economically efficient prices, should not be seen as "legitimate".[17]

4.4 The phrase "business interests and investment" contained in paragraph 2.24(a), is a compendious one. Broadly, there are two types of factual matters which must be taken into account under the rubric of Epic Energy's "business interests and investment". First, there is the process by which that investment came to be made in the DBNGP. This concerns the nature of the bidding process determined pursuant to the *Dampier to Bunbury Natural Gas Pipeline Act 1997* (**DBNGP Act**). Secondly, there is the amount of actual investment made by Epic Energy in the DBNGP. The factual matters relevant to this second aspect include the reasons for Epic Energy paying the amount it agreed and the reasonableness of this amount.[18]

4.5 Further, the concept of legitimacy incorporated into s.2.24(a) qualifies both aspects of the phrase "business interests and investment". This raises questions such as the appropriate level of return which Epic Energy should reasonably be allowed to recover upon the amount of its investment, and the future investment which may be required in order to expand the DBNGP.

[16] Reasons para 129.
[17] Reasons para 130.
[18] These factual matters are outlined in detail in Epic Energy's submission CDS#3.

Intention of Sale Process

4.6 The sale of the DBNGP was not a typical commercial transaction, but required legislative sanction. Part 2 of the DBNGP Act provided the legislative mechanism governing the sale process for the DBNGP. Section 6 of the DBNGP Act provided for a committee to guide the sale process. The Gas Pipeline Sales Steering Committee (**GPSSC**) fulfilled that role. The GPSSC was directly accountable to, and received directions from, the Minister. In turn, the terms of any direction made by the Minister had to be laid before, and be scrutinised by, each House of Parliament. Section 8 required the proceeds from the disposal of the DBNGP to be paid to the State Treasurer, to the extent that this was specified in a direction made pursuant to that section.[19]

4.7 The terms of reference for the GPSSC, prescribed by the Minister, were widely framed. Essentially, after considering a number of material issues and receiving guidance from the Minister, the objective was to negotiate with potential purchasers and develop a contract of sale for submission to the West Australian State Cabinet. The GPSSC kept the Minister for Energy and the Premier closely advised as to each stage in the sale process. This occurred through briefings and presentations. Ultimately, final approval for the sale of the pipeline was a matter which required the sanction of State Cabinet, which was granted on 3 March 1998.

4.8 Therefore, while the GPSSC was responsible for the day to day operation of the sale process, the State Government prescribed and co-ordinated this process, and, through the operation of s.6 of the DBNGP Act and the Minister for Energy, was able to direct the whole process. As a consequence, the intention of State Cabinet, the Premier and the Minister for Energy, as disclosed in various public statements made by the Premier and the Minister for Energy (both in and out of Parliament), should be taken as reflecting the intention of the sale process.

4.9 The detail of the sale process, which was prescribed and co-ordinated by the GPSSC, occurred in four stages. These included identifying potential bidders, calling for the submission of non-binding bids prior to due diligence inquiries being made, and the submission of final bids by short-listed bidders.

4.10 The primary objective of this comprehensive sale process, which was given precedence over achieving the lowest possible tariffs, was to deliver the highest possible return to the State.[20] To the extent that the State extracted monopoly returns from the sale price, it follows that the State (through its control of the sale process pursuant to the DBNGP Act) must have anticipated and implicitly sanctioned the recovery of those returns by the successful bidder.

[19] Reasons, para 11.
[20] See Minister Barnett's statement in Parliament on 14 March 2000, Hansard, p 4962-3. See also Minister Barnett's second reading speech in relation to the Gas Corporation (Business Disposal) Bill, 1999, Hansard, 16 September 1999, p1324.

4.11 The sale process was conducted with the participation of a number of arms-length parties. The competitive bidding process was an integral part of the sale process, and was equivalent to the type of process adopted in the sale of any large asset by a commercial organisation.

4.12 Further, the natural market forces applying to bidders who engaged in the process, meant that the resulting price ought to have been within an appropriate range for a commercial transaction.

4.13 Therefore, one factual matter which must be accorded weight as a fundamental element of the assessment of Epic Energy's proposed Access Arrangement is that the sale process for the DBNGP was designed to achieve a competitive and commercial price in an arms-length transaction for the sale of the State's most significant infrastructure asset. In fact, the State is on record as having as its primary objective, the maximisation of the sale price. (See discussion below.) Further, the State was responsible for the design of the sale process and in fact created the very market in which the sale of the DBNGP occurred, thereby sanctioning (through legislative action) the reasonableness and appropriateness of the sale process and its outcome.

Design of the sale process and the "winner's curse"

4.14 The sale of an infrastructure asset may not always have the object of maximising the proceeds from the sale. The alternative is that there could be a form of auction for natural monopolies with the aim of resulting in the services being supplied at the lowest price to relevant users. In such a case the winning bidder is the bidder who offers to supply at the lowest price to users.

4.15 The competitive tender process for a new pipeline, set out in ss.3.21 to 3.35 of the Code, may be designed to achieve an auction of that type.[21] The winning bidder is to be the bidder who will deliver the lowest sustainable tariffs to users generally over the economic life of the proposed pipeline.

4.16 Nevertheless, the State Government did not seek to design an auction process designed to deliver the lowest tariffs, but instead sought to maximise the proceeds from the sale of the DBNGP. For this purpose, it adopted a two stage competitive bidding process, with a first-price sealed bid auction, which was consistent with that objective. In accordance with the sealed bid auction model, the State was extremely guarded in disclosing information from competing bids to other potential bidders. Moreover, every potential bidder was required to enter into a confidentiality undertaking.[22]

4.17 In a first-price sealed bid auction, each bidder submits a single bid - a price at which it will purchase the asset to be sold. Each buyer's bid is based on its

[21] See s 3.28(f)(i).
[22] See Minister Barnett's statement in Parliament, Hansard, 14 March 2000, pp 4962-3. Also a copy of the confidentiality undertaking is attached to Epic Energy's submissions CDs.

particular evaluation of the asset, which is an evaluation made without the bidder having access to the bids of others. By definition, the asset is sold to the bidder offering the highest price, and the "winner" pays its bid price. When bidders are risk averse, use of a first-price sealed bid auction is conducive to the seller achieving the maximum proceeds from the sale of the asset. A small increase in bid increases a bidder's probability of winning at the cost of a small reduction in the value of winnings. More aggressive bids are therefore likely to be received when bidders are risk averse and an auction is organised as a first-price sealed bid auction.

4.18 It may be suggested that such a model is not economically efficient, because it engenders a "winner's curse". This occurs in an auction where there is a common value, with each bidder having incomplete information. The winning bidder may not have taken into account the "bad news" implied in other (lower) bids, and may therefore pay more, on average, than the asset is worth. This paying more than the asset is, on average, worth by reason of only having limited information is referred to as the winner's curse. The winner's curse does not describe a person who bids too much because he or she takes too optimistic a view upon available information. Such a bidder is simply imprudent, not afflicted by a curse resulting from a flaw in auction design.

4.19 The significance of the winner's curse lies in its implications for bidding. Experienced bidders who know about the winner's curse will bid cautiously. Moreover, bidders who recognise that their lack of information makes them particularly vulnerable will be especially cautious because they are likely to win only when they have significantly overestimated the value of the asset. In auctions with common value components, rational bidders will adjust their bids downwards, thereby attempting to negate the effect of the so-called winner's curse.

4.20 The magnitude of the downward adjustment of a bid price in circumstances where the winner's curse is anticipated, depends on the number of competing bidders and amount of uncertainty over the common "true" value of the asset. Each bidder must bid more cautiously when the number of competing bidders is large than when it is small. Winning in these circumstances implies a greater winner's curse. This lowering of bids in response to the winner's curse can more than compensate for the increase in bids that is usually associated with a large number of, and greater competition among, bidders. Increasing the number of bidders may lower the expected proceeds for sale of an asset.

4.21 One way to ameliorate the effect of a possible winner's curse, is to introduce a two-stage competitive bidding process. In such a process, bidders are first invited to submit non-binding bid prices together with information about their prior experience in owning and operating an asset that is to be sold, their financial strength, and how they expect to finance a successful bid. At the conclusion of the first stage, bidders who do not have the necessary experience or the financial resources needed to complete the transaction are screened out. This screening

may also exclude those bidders with the necessary experience and financial resources whose initial bids are seen by the seller as being too low.

4.22 The screening of deficient bids leaves, at the second stage of the process, only those bidders with high bids who have the experience and financial backing needed to own and operate the asset. The result is a more credible auction among a smaller number of strong bidders with a lower dispersion of valuations. This should have the effect of reducing or ameliorating winner's curse effects, and should result in the seller obtaining a high price for the asset.

4.23 Therefore, judged against the Government's stated objective of maximising the proceeds of the DBNGP's sale, the two stage competitive tender process, through which the DBNGP was sold, was likely to have delivered a reasonable market valuation.

4.24 It is notable that the auction process adopted by the State Government, namely a first-priced sealed bid auction, has become increasingly common in the sale of infrastructure assets and other resources. The following table illustrates a number of privatisations of infrastructure assets carried out in the late 1990's and early 2000's where a sealed bid auction process was adopted by the relevant government.

YEAR	ASSETS
1995	Victorian electricity distribution assets – Eastern Energy
1995	Victorian electricity distribution assets – Powercor
1995	Victorian electricity distribution assets – Solaris
1995	Victorian electricity distribution assets – CitiPower
1995	Victorian electricity distribution assets – United Energy
1997	Victorian electricity transmission system – Powernet
1998	Victorian gas transmission system – TPA
1998	Victorian gas distribution assets – Westar
1998	Victorian gas distribution assets – Multinet
1998	Victorian gas distribution assets – Stratus
1999	South Australian electricity transmission assets – ElectraNet SA

1999	South Australian electricity distribution assets – ETSA Utilities
2002	Sydney Airport

4.25 Of these processes, all except the sales of the Victorian distribution companies to Powercor and Citipower involved two stages and all included no price disclosure. In the case of the asset sales to Powercor and Citipower, there was only a single stage sealed bid process but this was solely because all of the bidders had already participated in the previous processes to acquire the other distributors.

4.26 Also, such a bidding process has received the sanction of Federal Parliament by ss. 22A and 22B of the *Petroleum (Submerged Lands) Act 1967 (Cth)* in relation to the sale of an unique resource, namely exploration permits for offshore blocks of land.

4.27 As a result of the auction process being designed to deliver a reasonable market valuation, it is fair to say that the bid price paid by Epic Energy may be taken to be the market value for the DBNGP as obtained in the market created by the State Government for the purpose of the sale.

4.28 It follows that the DBNGP sale process itself provided the market valuation for the pipeline which was missing at the time when Price Waterhouse reported to the State Government concerning the possible regulatory value to be assigned to the DBNGP for the purposes of independent regulation. Therefore, the market valuation created by the sale process itself should primarily be considered in deriving an initial Capital Base, and a Reference Tariff, which will permit Epic Energy the opportunity to recover its investment in the DBNGP (provided that the growth and demand for gas transportation services, which were forecast at the time of sale, are realised). It will also allow Epic Energy to deliver to the State the tariff and tariff path sought by the Government at the time of sale, together with the enhancement of the DBNGP which the Government considered (at the time) to be essential to future economic development in Western Australia.

Reasonableness of Epic Energy's Actual Investment

4.29 The actual capital investment made by Epic Energy in the DBNGP (as at the date of lodging the proposed Access Arrangement) was $2.5711 billion. This amount comprised several components. First, there was the actual purchase price paid by Epic Energy, of $2.407 billion. Secondly, there were the transaction costs which were a direct result of entering into the agreement to purchase the DBNGP. The net amount of these was $42.5 million. Lastly, there was the amount of $121.6 million which Epic Energy has spent in enhancing and expanding the DBNGP after acquisition (prior to lodging the proposed Access Arrangement).

4.30 Of the total figure of $2.5711 billion, an amount of $1.91 billion was provided by debt funding arrangements provided by a consortium of leading national and

international banks.[23] A detailed list of the banks and their proportionate contribution to the facility follows. It should be noted that this is a list of the current members of the syndicate. Some of the original banks have assigned their interest.

[23] The lead banks in the consortium supporting Epic Energy are marked with an asterisk in the table. The other 23 banks are the syndicated banks. The original lead banks were Deutsche Bank AG, National Australia Bank Limited, Sumitomo International Finance Australia Limited, Toronto Australia Limited and Westpac Banking Corporation

Bank/Loan Certificate Holder	*Percentage*
[Deleted – Confidential]	

4.31 The remainder was equity capital invested by the members of the consortium behind Epic Energy, which in effect is as follows[24]:

Shareholder	Percentage
El Paso Corporation	33%
CNG International (which was acquired by Dominion Resources as part of a take over of CNG in 2000)	33%
AMP Custodian Services Pty Ltd and AMP Investment Services Pty Ltd	11%
Hastings Funds Management Limited (for the Australian Infrastructure Fund & the Utilities Trust of Australia	11%
Deutsche Asset Management (for the SAS Trustee Corporation)	11%

4.32 The amount paid for the pipeline (ie, $2.407 billion) should be a matter accorded weight as a fundamental element of the assessment process, to the extent that the Regulator concludes that the amount paid was reasonable. What is "reasonable" must be determined by reference to the circumstances existing at the time of the sale and by reference to the information known to the potential buyers. There are a number of factors which go towards demonstrating that Epic Energy's investment was a reasonable price in the circumstances of the sale process discussed above.

[24] It should be noted that this ownership structure differs slightly from that which existed at the time of sale.

4.33 Before turning to these factors, there are two aspects about the quantum and timeliness of information that was made available to bidders. First. the GPSSC placed strict controls on the information that was made available to bidders. There were two levels to this control. Bidders were not able to discuss the sale with the Minister or his department or with representatives from AlintaGas. In addition, the GPSSC made sure that any information that was made available to one bidder was also made available to all other bidders. This is particularly the case in relation to questions asked of the GPSSC by bidders. All answers given by the GPSSC were given to all potential bidders. The consequence of this is that it ensured that all potential buyers were placed on a level playing field, in assessing the commercial viability of operating the DBNGP after purchasing it. They all had access to the same, limited amount of information.

4.34 The second aspect relates to the manner in which information was disclosed by the GPSSC. There was limited information available from the State concerning the contractual arrangements with existing shippers using the DBNGP. Further, information concerning these contractual arrangements was released very late on in the bid process. (omitted – confidential). The consequence of this was that as potential buyers were aware of the restrictions upon the available material, this would (presumably) have influenced them to act cautiously in making bids. Both of these implications are relevant in mitigating the effects of the winner's curse.

4.35 The first indication of the reasonableness of Epic Energy's actual investment concerns the tariff projections which formed the basis of the bid. Those projections were based upon a tariff level of $1/GJ to be charged for the shipment of gas to Perth (at Kwinana), and $1.08/GJ for gas conveyed past Perth (at Kwinana) to more southern delivery points.

4.36 Epic Energy adopted those tariff levels based on consistent statements made by the Minister for Energy on behalf of the State Government of Western Australia throughout the time leading up to the sale that the tariff level to Perth from 2000 would be $1.00/GJ. Statements were also made by the GPSSC in a series of meetings with Epic Energy that the bids would be adjudicated by reference to the amount of the price bid, on the understanding that the tariff level was fixed. [omitted confidential] The nature of these statements, and the circumstances in which they were made, are outlined in the associated document summarising all of the factual contentions on which Epic Energy relies, which is provided in conjunction with this paper.[25] If the Regulator is in any doubt as to these statements, he should interview the members of the GPSSC and the representatives of CMS/AGL, Nova Corporation/UniSuper and PG&E Corporation who participated in the sale process (as well as other short-listed bidders).

4.37 Given that the State Government controlled the sale process, through the terms of s.6 of the DBNGP Act and directions given by the Minister for Energy, it was entirely reasonable for Epic Energy to rely upon statements by the Minister for

[25] See Epic Energy submission CD #3, s 4, confidential version.

Energy on behalf of the State Government in the time leading up to the sale. The Minister for Energy was the very person who designed the sale process to achieve the ends deemed by the Government to be appropriate to achieve its stated objectives. In this important respect, the statements by the Minister for Energy, given his position and the need for State Cabinet approval in relation to the DBNGP, must be taken as reflecting the State Government's assessment of the public interest which applied at the time of the sale.

4.38 This point is reinforced having regard to the circumstances in which the Code came into effect in Western Australia. At the time when the DBNGP was sold, the Code did not have legislative force and effect in WA, although the terms of the Code had been agreed by the Council of Australian Government. The State's position at the time of sale was that the Code would not be administered by a policy-driven competition body unaware of the particular circumstances applicable in Western Australia. Rather, the Government indicated that it would appoint a Regulator with local experience of the State's energy industry. By taking this position, the State signalled that it intended the Code should be administered and implemented in a way which would give effect to the particular public interest relevant to the Western Australian industry.

4.39 Epic Energy also made various projections concerning the volume of gas which was to be shipped along the DBNGP.[26] These projections were crucial in calculating a purchase price using the tariff level of $1/GJ to Perth, which appeared to have the official sanction of the Government.

4.40 [Deleted – confidential].

4.41 [Deleted – confidential].

4.42 [Deleted – confidential].

4.43 However, it should be noted here that the exclusion of the Kingstream project from the projected forecast did not have a significant impact on the calculation of the purchase price. The purchase price which was supportable was $2.407 billion. [deleted - confidential]. Further, the service to be provided to the Kingstream project, if it came online, was only a part-haul service, and did not extend the full length of the DBNGP. That factor also reduced the impact of the Kingstream project.

4.44 [Deleted – confidential].

4.45 [Deleted – confidential]. The fact that 29 leading international banks "signed off" on the decision to lend $1.91 billion to Epic Energy is compelling evidence of the

[26] Ibid.

reasonableness of Epic Energy's assumption in formulating the bid.[27] To the extent that Epic Energy is able to offer documents revealing the banks' assessment, it has included these in Epic Energy's submission CDS #3, provided with this paper. To the extent that Epic Energy has been unable to obtain certain confidential information from the banks, the Regulator may obtain this information by directly approaching the banks, who have indicated to Epic Energy (and, Epic Energy understands, to the Regulator) that they would be willing to assist the Regulator. Therefore, the financial analysis by Epic Energy and its independent bankers indicates the reasonableness of Epic Energy's bid at the time when that bid was made.

4.46 The next indication of the reasonableness of Epic Energy's bid comes from the other bids made in the sale process. [deleted - confidential].

4.47 [deleted confidential].

4.48 [deleted confidential].

4.49 To the extent that the Regulator is able, he should confirm Epic Energy's own understanding of the nature of the competing bids by the use of his compulsory powers, if he has any doubt over the terms of the competing bids.

4.50 [Deleted – confidential].

4.51 The other components of Epic Energy's actual investment, namely the transaction costs incurred by Epic Energy in purchasing the DBNGP and the subsequent expansion cost (of $121.6 million) were also reasonable costs and should be given effect in according weight to the amount of Epic Energy's actual investment. In relation to the transaction costs, these were the inevitable consequence of entering the agreement to purchase the DBNGP. In so far as there was further expenditure incurred for the expansion of the pipeline, this was legitimate and appropriate in the circumstances when that expenditure was incurred, particularly in the context of Epic Energy's undertaking to expand the DBNGP over a 10 year period at a cost of $875 million. There is no suggestion that Epic Energy was imprudent, reckless or speculative in the amount it paid for that expansion and enhancement of the DBNGP. This is proved by the fact that the extra capacity built by Epic Energy is now fully utilised.

4.52 Consequently, for the preceding reasons, Epic Energy's actual investment of $2.5711 million must be given weight as a fundamental element in the assessment process, given the reasonableness of the amount paid by Epic Energy.

Observations of the Full Court on the Reasonableness of the Bid Price

[27] The lead banks in the consortium supporting Epic Energy are Deutsche Bank AG, National Australia Bank Limited, Sumitomo International Finance Australia Limited, Toronto Australia Limited and Westpac Banking Corporation. The other 23 syndicated banks are detailed at paragraph 4.30 of this submission.

4.53 The Full Court considered the question whether the price paid by Epic Energy for the DBNGP represented a sound commercial assessment of the value of the pipeline in the circumstances which prevailed at the time of the purchase and which were then reasonably anticipated, or reflected the reasonable expectations of Epic Energy under the regulatory regime that applied to the DBNGP prior to the commencement of the Code.[28]

4.54 The Court observed that the mere fact that the bid price was a price paid at public tender was not necessarily determinative of any of these questions. Parker J raised questions about whether Epic Energy may have erred in its assessment of value or had unreasonable expectations. Alternatively, he raised whether Epic Energy may have had reason to pay higher than the true market value. However, he was adamant that these were not matters for the Full Court to attempt to evaluate or to decide.

4.55 In taking the approach of not finally resolving these questions, Parker J was no doubt aware that the decision of the Full Court and the valid parts of the Regulator's draft decision would raise further factual issues which could not be properly addressed on the evidence before the Court. For example, the analysis of the design of the sale process (set out above) was not before the Regulator previously, or before the Full Court.

4.56 Moreover, Epic Energy contends that it did not advance the arguments in the way Parker J stated them. Parker J indicated his understanding of Epic Energy's argument by saying that Epic Energy sought to advance the view that it tendered on an understanding, induced by the tender terms and conditions and, in particular, the sale information memorandum and other accompanying information, inter alia that, under the Code after January 2000, the public interest would be served by a future gas tariff in the order of $1/GJ for the primary Dampier to Perth transmission service. Parker J said that these facts, by themselves, led to the argument put forward by Epic Energy that the Regulator should accept the purchase price paid by Epic Energy as representing the DBNGP's fair market value for the purpose of establishing the initial Capital Base under the Code.[29]

4.57 Crucially, Epic Energy's arguments were slightly different. They asserted error in the Regulator's approach by *not considering* whether the sale process produced a sound market value for the DBNGP. If that error was established, the Regulator's draft decision would be vitiated. Epic Energy did not say positively that the sale price was the market value of the DBNGP. In any event, Epic Energy now advances that argument based on a full analysis of all relevant facts and after examination of the design of the sale process.

[28] Reasons, para 188-100.
[29] Reasons, para 195.

4.58 Nevertheless, Parker J identified two points in respect of his statement of Epic Energy's argument, which Epic Energy now addresses. He said:

- "*A principal difficulty is that the tender process, including the information memorandum, on examination, appears to fall short of providing an adequate factual foundation for the submission*."[30]

- "*More fundamentally, it was made clear that a feature of the anticipated Code was that tariff levels were to be fixed by an independent Regulator. The fixing of tariff levels would then be out of the government's control*."[31]

4.59 In respect of the first matter identified by Parker J, he observed that the information memorandum appeared to have been directed to alerting tenderers that the existing tariff levels in 1997 could not be expected to be maintained and, by January 2000 when the introduction of the Code regime was expected, could well be down to $1/GJ to Perth. He considered that it was not apparent from the information memorandum (considered by itself) that a tariff level of $1 would apply under the Code, rather than by the anticipated time of the Code's advent.[32]

4.60 In relation to the second matter, Parker J referred to a report prepared by Price Waterhouse in 1997, who were retained by the GPSSC. He considered that this report could not form the basis for any reasonable anticipation by Epic Energy that the tariff levels advocated by the State would be applied by an independent Regulator.

4.61 In responding to the matters raised by Parker J, it is necessary to re-iterate that he dealt with these matters on a very limited factual basis. In fact, there is a wide range of factual material which is relevant to the propositions advanced by Epic Energy, and which should be considered by the Regulator.[33] Further, Epic Energy emphasises that Parker J was merely making tentative observations, not giving firm indications about how this matter should be considered by the Regulator when it was remitted for further consideration.

4.62 A powerful answer to the issues raised by Parker J is the approach adopted by the other bidders with whom Epic Energy has spoken, the public statements of various users of the DBNGP at the time of sale[34] and the banks which lent to Epic Energy and agreed to lend to the other (unsuccessful) bidders, as outlined above. These independent commercial organisations all accepted that bids for the purchase of for the DBNGP would be based upon a future tariff of $1/GJ to Perth. This goes to prove the reasonableness of Epic Energy's conduct and the commerciality of the resulting price. The position was that the State Government had to choose between accepting a bid which produced the highest price, or a bid

[30] Reasons, para 196.
[31] Reasons, para 197.
[32] Reasons, para 196.
[33] See Epic Energy's Submission CDS#3: DBNGP Sales Process, confidential version.
[34] See Epic Energy Submission CDS#3: DBNGP Sales Process, confidential version.

which produced the lowest tariff. These were the only two parameters which could be significantly varied in creating the relevant market in which bids for the DBNGP would be made. Therefore, it was of essential importance that the State Government effectively constituted the market on the footing that the highest bid, not the lowest tariff, would be accepted. This premise was universally accepted by bidders and was supported by the public statements of Minister Barnett, then Minister for Energy, who said:

"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."[35]

4.63 Further, it is not really to the point whether the State was committed to supporting the particular figure of $1/GJ to Perth before the Regulator. What is to the point is the basis upon which the State decided to sell the DBNGP (namely seeking the highest price, not lowest tariff) and on which it did obtain a very substantial benefit. Moreover, while the $1 tariff and schedule 39 of the Asset Sale Agreement could not directly bind the Regulator, because it did not have contractual force as between Epic Energy and the State, the $1 tariff is certainly relevant to the application of the Code and is a consideration which should be given significant weight in determining the application of s.2.24 to the facts of this case.

4.64 Moreover, Parker J's interpretation of the information memorandum may not be supportable by reference to the other statements made by the State Government. Parker J said that it was possible to interpret the information memorandum as saying that the Government predicted that a tariff level of $1/GJ to Perth might apply prior to the introduction of the Code, rather than by reason of the application of the Code. However, Minister Barnett said that the transitional tariff path set out pursuant to the DBNGP regulations was the lowest sustainable level which could be expected prior to the introduction of the Code.[36] Further, in August 1997, Mr Ian Baker, the then chairman of the GPSSC gave a presentation at a forum hosted by the WA Office of Energy on behalf of the Gas Transmission Consultation committee. Mr Baker presented the GPSSC view on its requirements of a tariff profile, in a slide reproduced below. This confirmed that the tariff of $1/GJ was to commence under the Code regime, and that Parker J was not correct in thinking that the information memorandum may have been suggesting that the relevant tariff path would have reached $1/GJ to Perth prior to the commencement of the Code.

Tariff Cap Progression (T1 - Full Haul - 100% Load) (illustrative)

	To 31.12.97	1.1.98 to	1.1.99 to	From 1.1.2000

[35] See Hansard, 14 June 2000, p 7662.
[36] See Hansard, 14 June 2000, pp 7660, 7665.

		31.12.98	31.12.99	
Dollars per GJ				
Reservation	1.03	0.97	0.85	?
Commodity	0.23	0.27	0.27	?
Total	**1.26**	**1.24**	**1.12**	**1.00?**
Basis	EIG Method	EIG Redetermination	Interpolate	Expected NAC (IGRT)*

* Indicative Global Reference Tariff
# National Access Code

4.65 As well, to the extent that it may be suggested (over and above Parker J's observations) that the tariff of $1/GJ was a starting point under the Code regime, which could be lowered as part of a further transitional process, it must be said that this ignores the commercial reality of the situation. The sale of the DBNGP was the privatisation of the largest infrastructure asset in Western Australia. The purpose of the sale process and the Code was to create a certain and stable environment within which the DBNGP could be operated by a private commercial operator. It is entirely contrary to that purpose to suggest that the tariff level promoted by the State Government on all occasions leading up to the sale of the DBNGP was the end point of a transitional phase, rather than the commencement of a long term independent period of regulation. Otherwise, the outcome of the sale of the DBNGP would have been entirely uncertain. That was not a result which was intended by the State Government, as is evident from the quote set out above from Minister Barnett.

4.66 Lastly, the GPSSC was required to evaluate all bids to ensure that, based on the price paid and the proposed tariffs, the bidders would receive an acceptable return on the DBNGP. In other words, bidders had to demonstrate that they could not only buy the DBNGP, but also that they could operate it, expand it and not expose anyone to an unforeseen risk of business failure or increased tariffs.[37]

4.67 The desire of the Government to foster the expectation of a stable regulated environment prompted it to obtain the report from Price Waterhouse concerning the possible outcomes of independent regulation of the DBNGP. This occurred at a time when the terms of the Code had not yet been finalised. The Price Waterhouse report was intended to provide independent justification and approval of the statements made by the Minister for Energy concerning the appropriate tariff levels which might apply under independent regulation.

4.68 The Price Waterhouse report itself acknowledges this. It says:

> *"In performing our work we have had to consider the implications of the present pricing regime on the gas transmission company's ability to*

[37] Minister Barnett. Hansard, 14 June 2000, p 7665.

> *achieve an appropriate level of return taking into account the likely financial and operating implications for a new pipeline operator. In addition, the objectives of complying with the Draft National Gas Code…as specified by the Office of Energy, and the significant reduction in gas transmission prices suggested by the Minister for Energy over a two year transition period will require a careful balance such that a purchaser of the DBNGP can be assured of acquiring an asset subject to stable regulation allowing the development of viable and stable business."*[38] [Emphasis added].

4.69 If the Regulator has any doubt about the purpose of the Price Waterhouse report, he should exercise his compulsory powers to obtain information concerning the reason why it was commissioned, from the relevant people involved in preparing the report, for example Mr Paul Baxter (PriceWaterhouseCoopers). Further, the Regulator should obtain the correspondence leading to the terms of reference for the preparation of the report, including the initial letter of engagement and the subsequent letter refining the initial terms of engagement (which Epic Energy understands was dated 8 July 1997).

Legitimacy of Epic Energy's return on its investment

4.70 The next matter is the legitimacy of Epic Energy earning a return upon its investment.

4.71 First, it may be legitimate for Epic Energy to recover monopolistic returns as part of its tariff. This follows from the Full Court's observation that it may be legitimate for Epic Energy to recover monopoly rent in setting tariff levels.[39] If the State extracted capitalised monopoly profits (which, after all accrued for the general benefit of all Western Australians) as part of the sale price, it is legitimate for Epic Energy to pass on this component of the cost to users. What is illegitimate is for Epic Energy to use its position of monopoly power through the ownership of an important infrastructure asset to extract *additional* monopoly rent (which it does not seek to do here).

4.72 The second aspect of Epic Energy's legitimate business interests is that it is entitled to earn a return which allows it sufficient profits to operate as a viable commercial business, to the extent that Epic Energy has made reasonable and appropriate forecasts as to future demand. Such a return is essential if private operators of infrastructure assets are to exist (as the Government clearly intended by the sale of the DBNGP to a private owner). Minister Barnett emphasised this as a key concern of the State in selling the DBNGP.[40] The appropriate level of profits to be allowed to Epic Energy is something which will be discussed below in relation to s.8 of the Code. However, at this stage, it is sufficient to note that a

[38] "Dampier to Bunbury Natural Gas Pipeline, Regulatory report on revenue requirement and future price path", August 1997 (Price Waterhouse) at page 4.
[39] Reasons paras 130, 154, 176.
[40] Hansard, 14 June 2000, pp 7660-7.

matter to be given weight in the assessment process is that Epic Energy should be allowed to earn an appropriate return on its investment to permit it to stay in business, and to provide a reasonable and appropriate return to its stakeholders.

4.73 The third aspect of Epic Energy's legitimate business interests is that it should be permitted to earn an appropriate level of return upon its ownership of the pipeline to allow it to invest in the expansion of the pipeline. This may be illustrated by reference to the looping and compression arrangements used for expansion of the pipeline. Epic Energy will shortly reach the limits of the existing pipeline's capacity through compression techniques, and will have to expand the pipeline's capacity using looping arrangements. This phase of the last bit of compression and the early-looping are significantly more expensive than the earlier phases of expansion. Epic Energy should be entitled to earn a sufficient return on its current infrastructure and investment to allow it to undertake such projects, which are also in the interests of the community. In this regard, it is important to note that in order to undertake expansion projects, Epic Energy will need to demonstrate its *overall* commercial viability in order to attract further funding to enable the expansion projects to be carried out.

4.74 Fourth, Epic Energy only seeks to be afforded the opportunity to recover its investment once-over. This, of course, is another aspect of the legitimacy of Epic Energy's return on its investment. This point is elaborated further below in relation to the discussion concerning depreciation and the cost of service approach prescribed by s.8.4 of the Code. If Epic Energy is not allowed to charge tariffs in accordance with Schedule 39 of the asset sale agreement (ie, tariffs at the rate contemplated in the proposed Access Arrangement), Epic Energy may well not be able to embark upon the proposed expansion program, and would need to consider revising the tariff path set out in the proposed Access Arrangement.

4.75 There is also a temporal aspect in judging the legitimacy of Epic Energy's return on investment. Taking, for example, the question of projected volumes and the increase in the DBNGP's capacity. At the time of purchase, the shareholders of Epic Energy were prepared to bear the risk that the forecast volumes would not materialise. Epic Energy now merely seeks the *opportunity* to recover its investment based on tariffs consistent with the expectation *during* the DBNGP sale process. If Epic Energy is not now given the opportunity to recover its purchase price, having regard to the reasonable expectations it formed at the time of the sale process, its shareholders will have substantially diminished incentives to further invest in the DBNGP and expand the pipeline capacity, and this will provide a further signal to Australian and international markets that Australian regulatory frameworks are generally detrimental to promoting the investment and efficient development of infrastructure. Neither of these potential outcomes is conducive to the further economic development of Western Australia (or, for that matter, Australia).

Conclusion on s.2.24(a)

4.76 In summary, the factual matters which Epic Energy contends should be accorded weight as fundamental elements of the assessment process due to paragraph 2.24 (a) of the Code are the following:

- the entitlement of Epic Energy to be afforded the opportunity to recover the actual amount of its initial Capital investment (ie, $2.5711 billion); and

- the entitlement of Epic Energy to be afforded the opportunity to recover an appropriate return on its actual initial capital investment, to allow it to operate at a reasonable level of profit, and also to expand the DBNGP as necessary and in accordance with the commitment it gave when purchasing the DBNGP.

Section 2.24(b) - Firm and binding contractual obligations of the Service Provider or other persons (or both) already using the Covered Pipeline

4.77 The Full Court did not extensively analyse this provision. However, the Court did consider that prices which have been contractually agreed by a Service Provider, even if they include monopolist rent or returns, must be taken into account pursuant s.2.24(b).[41]

4.78 There are two types of firm and binding contractual obligation which Epic Energy says should be taken into account under this provision. First, there are the contractual arrangements between Epic Energy and the banks, which provided the funding for Epic Energy's bid. Secondly, there are the arrangements which apply to charges levied by Epic Energy upon various users of the DBNGP.

Lending Obligations

4.79 The lending arrangements which have been entered between Epic Energy and its funding banks require Epic Energy to meet significant interest repayments, as well as repayments of principal. The reference tariff should be framed so as to allow Epic Energy to be in a position to meet these contractual obligations. Further, when the existing finance facility expires (omitted – confidential), Epic Energy's return should be sufficient to allow it to refinance the facility based on the DBNGP's operation, and without further capital injection by Epic Energy's owners, except to the extent that Epic Energy has mis-predicted the expansion of the DBNGP's throughput.

4.80 Detailed information concerning the financial arrangements has been provided in Epic Energy's Submission DDS#1: Financial Viability[42] and is further elaborated in Epic Energy's Submission CDS#3 to be provided with this paper. However, the critical aspects of these firm and binding arrangements may be summarised as follows.

[41] Reasons para 131.
[42] Epic Energy Additional Paper DDS1: Financial Viability, dated 20 September 2001, confidential version.

4.81 There was a primary facility of $1.91 billion provided by six foundation lenders. That was syndicated to a further 23 banks following the Sale. The total amount advanced was for two distinct purposes. $1.8 billion was used for the initial purchase price paid for the DBNGP, and the remaining $110 million was utilised for the initial expansion of the DBNGP. [deleted – confidential]. The facility was secured over the DBNGP only, and there is no prospect of the lending banks being able to have recourse to any other assets of the Epic Energy group or its owners.

4.82 Presently, the principal amount currently outstanding is approximately [deleted – confidential].

4.83 [deleted – confidential]

4.84 What is important for the Regulator to understand is that the income generated by the tariffs under the transitional regime is significantly lower than that which Epic Energy expected for current volumes based on the tariff and tariff path proposed in Schedule 39.[43]

4.85 [deleted – confidential].

4.86 These obligations, which were incurred as a direct result of purchasing the DBNGP, should be accorded weight as a fundamental element of the assessment process, so as to allow Epic Energy to meet its repayment obligations. This consideration confirms what has already been said about Epic Energy's legitimate business interests and investment in relation to s.2.24(a).

Obligations to Shippers

4.87 In relation to Epic Energy's contractual arrangements with users, it is highly significant that Epic Energy has a special contractual arrangement with Alcoa concerning the tariff chargeable to Alcoa for shipping gas along the DBNGP ("Alcoa exempt contract"). [deleted – confidential]. Hence, the price charged to Alcoa will significantly affect Epic Energy's actual total revenue, and will have an impact upon the tariff level which should apply under the proposed Access Arrangement.

4.88 [deleted - confidential].

4.89 [deleted – confidential].

[43] A detailed history of the tariffs on the DBNGP is contained in an attachment to CDS#3, DBNGP Sales Process (confidential version), filed simultaneously with this submission.

Section 2.24(c) - The operational and technical requirements necessary for the safe and reliable operation of the Covered Pipeline

4.90 [Deleted – confidential].

4.91 [Deleted – confidential].

4.92 [Deleted-confidential].

Section 2.24(d) - The economically efficient operation of the Pipeline

4.93 Section 2.24(a) reflects the viewpoint of the owner and operator of a pipeline compared to s.2.24(d), which directs attention to the "economically efficient" operation of a pipeline. Section 2.24(d) reflects the notion of economic efficiency as generally understood by economists. The Regulator must consider both, having regard to the scope and objects of the Act.[44]

4.94 Epic Energy contends that the fundamental question in relation to the "economically efficient operation" of the DBNGP is whether the assets which comprise the DBNGP should be valued for regulatory purposes at the cost of the initial investment, or at the cost of rebuilding the facility at the present time.

4.95 The modern trend of regulation has been to adopt "forward looking cost rules", whereby the cost used to determine access prices are based on the current cost of rebuilding facilities to provide the existing service, using the best available technology. In this context it is important to distinguish between the forward looking valuation of assets and the use of "optimisation" in valuing assets. Optimisation is a process by which assets are written out of the firm's valuation by the Regulator on the grounds that a new entrant would not require them. While frequently used in conjunction with forward looking asset valuation, optimisation is neither required in order to determine the current cost of an asset, nor is it restricted to forward looking valuation problems.

4.96 It is sometimes argued that forward looking access charges are desirable because they do not allow firms to recover inefficient investment. Clearly, however, this will only be so if optimisation is used, and since optimisation can also be applied to backward looking access charges, there is nothing special about forward looking charges in this regard. Moreover, because in practice, optimisation requires numerous, often implausible, assumptions, its ability to eliminate inefficient investment is in any case overstated.

4.97 The proponents of forward looking access charges claim that competitors should not be stuck with an incumbent owner's high cost structure just because the incumbent invested at a time when cost was high. In contestable markets, it is argued, a firm that tries to recover historical costs which are more than a current

[44] Reasons para 133.

stand-alone cost of re-building an infrastructure asset, will be unable to do so. Thus, it is said that, to mirror contestable markets, the costs included in access prices should be based on current best practice.

4.98 However, this argument misses an important point. The reason these markets are not contestable is firms need to sink large amounts of money into irreversible investments. Given uncertainty over the future costs of such projects, it is critical that they face the right incentives to do so in the first place.

4.99 Epic Energy contends that it is appropriate, and economically efficient, to adopt a rule which bases its Reference Tariff upon the historical cost of purchasing the DBNGP (at least to a substantial extent). This is because of an important policy consideration. Backward looking rules, which set access charges depending on costs at the time of investment, are more successful at promoting investment. Like forward looking rules, they allow the firm to shift the cost of investing earlier onto its users, who enjoy the benefit of an investment which would not otherwise have been made. Unlike forward looking rules, they do not expose the firm to the risk of future movements of costs.

4.100 It follows that the objective of the economically efficient operation of the DBNGP accommodates, and positively suggests, a reference tariff based upon Epic Energy's reasonable historical cost of investment. The policy aim of ensuring that investment in infrastructure assets is not discouraged by adopting forward looking rules, based on DORC, has recently been emphasised by the Productivity Commission[45] and the Committee established by the Council of Australian Governments to review Australia's energy markets.[46]

4.101 Therefore, Epic Energy submits that a proper application of s.2.24(d) means that weight should be given to its reasonable past investment in the DBNGP as a fundamental element of the assessment process. Again, this is consistent with the matters discussed previously in relation to the preceding subparagraphs of s.2.24.

[45] Productivity Commission, Review of the Natural Access Regime, Inquiry Report No 17, 28 September 2001, pp 356-367.
[46] COAG, "Towards a truly National and Efficient Energy Market", November 2002.

Section 2.24(e) - The public interest, including the public interest in having competition in markets (whether or not in Australia)

4.102 Section 2.24(e) reflects the objective of promoting a competitive market, but the public interest at large will also extend to wider considerations such as protecting owners of pipelines, and the assurance of fair and reasonable conditions being provided where the private rights of pipeline owners are overborne by the statutory scheme.[47]

Competition in markets

4.103 The public interest in having competition in markets raises policy considerations which are largely equivalent to the matters already discussed in relation to s.2.24(d). If the DBNGP operates in an economically efficient fashion, this, in and of itself, will replicate the outcome of a competitive market.

4.104 It must be noted that the Court concluded that the concept of a "competitive market" is that which economists in [this] field would understand to be a workably competitive market.[48] The Court went on to say that the "expert evidence and writings tendered in evidence suggests that a workably competitive market may well tolerate a degree of market power, even over a prolonged period. The underlying theory and expectation of economists, however, is that with workable competition market forces will increase efficiency beyond that which could be achieved in a non-competitive market, although not necessarily achieving theoretically ideal efficiency."[49]

4.105 Further, to the extent that it must be considered whether the proposed Access Arrangement promotes competition in downstream markets for users of the DBNGP, it is also relevant that the proposed Access Arrangement does not discriminate between any particular types of user or different forms of market (eg residential as opposed to commercial) within each zone specified in the proposed Reference Tariff. Therefore, each downstream user, in whatever market the gas is supplied, is placed in the same position.

Other matters of Public Interest

4.106 As well, Epic Energy's proposed Access Arrangement specifies one tariff level for present and future users. A consequence of this is that future users pay the same price for extra capacity as present users, notwithstanding any incremental increase in cost (up to $875 million) to Epic Energy in providing extra capacity. Further, it also means that a new shipper who wishes to enter the market to compete for small volume users (eg residential customers), will be able to enter the market by purchasing small volumes of shipping capacity at the same price as

[47] Reasons para 134.
[48] Reasons para 126. See also paragraphs 7.1 to 7.5 of this submission
[49] Reasons para 128

if purchasing a large tranche of capacity.[50] This reduces a barrier for new shippers entering the market for supplying gas. Typically, without there being a single tariff for all users, smaller volume shippers (such as those just commencing business) would pay more to purchase shipping capacity. The policy behind the single tariff therefore accords with the purpose of s.38 of the Act, as a means of extending effective competition in the supply of natural gas to residential and small business customers. Put simply, there are no "second class" citizens under Epic Energy's proposed Access Arrangement.

4.107 This policy also has an important public interest component to it for larger users, particularly electricity generators. A significant growth market which was forecast at the time of the DBNGP sale was the electricity generation market. This was based upon the Government's proposed disaggregation of the electricity industry to promote entry of new participants into the electricity generation industry (among other areas) to compete with the State-owned monopoly, Western Power Corporation. Western Power is a major user of capacity on the DBNGP. To ensure that new entrants into this industry were able to operate on a level playing field, at least in terms of the cost of gas, Epic Energy considered its proposal would promote new entrants. It would also promote the uptake of gas, a cleaner fuel source than coal.

4.108 There are seven other public interest considerations which Epic Energy has identified as matters which should be given weight as fundamental elements of the assessment process.

4.109 First, the State of Western Australia received a significant lump sum of $2.407 billion. This was used to reduce the total net debt of the State to $4.8 billion, by applying $1.8 billion of the proceeds to discharging outstanding debt. The sale proceeds were also used for new capital works of $244 million, and to assist with educational needs by providing approximately 32,000 computers for schools at a cost of $100 million. This expenditure was of obvious benefit to every person in the State.

4.110 Secondly, the sale of the DBNGP itself achieved a significant reduction in the applicable tariff levels, as compared to the position prior to the sale. As a result of implementing the sale, generally all tariffs dropped by approximately 20%. Therefore, a substantial part of the (secondary) objective of selling the DBNGP was achieved immediately upon completion of the sale.

4.111 Thirdly, the State Government made a conscious decision to accept the highest bid for the DBNGP (on the basis of a tariff of $1/GJ to Perth) rather than to accept the bid offering the lowest tariff. This was due to the State Government's positive

[50] This is subject of course to the position that Epic Energy will expand its capacity in the most efficient manner and will not expand to meet very small and short term capacity requirements if to do so would be commercially unsound.

decision that it was of greater public interest to obtain a high bid, than to have a low tariff, so long as existing tariff, were reduced to the level of $1/GJ to Perth.[51]

4.112 Fourthly, it is significant that part of the sale arrangements require Epic Energy to expand the DBNGP's capacity, as required by the State, without increasing the tariff on an incremental basis. At the time Epic Energy foreshadowed that this may require expenditure of up to $875 million dollars for this purpose in the first 10 years. Epic Energy has already expended approximately $125 million of this already. Hence, Epic Energy has agreed to undertake a project of significant importance for the State's infrastructure without increasing its return on its initial investment.

4.113 Fifthly, a major source of funds provided by equity participants in the DBNGP purchase, was from superannuation trustees conducting business in Australia. Deutsche Asset Management holds its interest for the NSW State Superannuation Fund. In addition, AMP's interest is for the benefit of other superannuation funds. The State Government was aware of this fact. To the extent that the Regulator may decide to reduce the capital value of the DBNGP for the purposes of calculating a return on investment, the funds at most risk are those provided by the equity participants, ie people employed throughout Australia.

4.114 Sixth, Epic Energy committed to moving its head office to Perth as part of the sale. That move has now been completed. Not only has this ensured greater security of employment for those AlintaGas employees whose employment arrangements were assumed by Epic Energy as a result of the sale, it has also resulted in a significant national business being headquartered in Perth. Epic Energy's corporate activities and the daily control of all of its pipelines throughout Australia (valued at $3.6 billion) are coordinated from the Perth office. The State obviously considers it of significant importance to have large companies' corporate headquarters located in Perth. This is demonstrated by the requirement in the privatisation of AlintaGas for its headquarters to remain in Perth and for its CEO to also be based out of Perth, which is enshrined in legislation.

4.115 As a result of Epic Energy's size and corporate presence in Perth, this has led to the engagement of local consultancy firms assisting Epic Energy in not only matters pertinent to the DBNGP, but also matters of national importance. To date, Epic Energy has engaged the services of local consultancy firms practising in the fields of law, regulation, accountancy, information technology, economics, engineering, human resources recruitment and environmental science. Significant funds have been invested by Epic Energy to date in these firms, totalling over $3 million during 2001. It is more than likely that this investment in these Western Australian firms would not have occurred had Epic Energy not relocated its head office to Perth.

[51] Statement by Colin Barnett, Hansard, 14 March 2000, p4962-4963.

4.116 Seventh, given that Epic Energy's expansion commitment was a fundamental element of its bid for the purchase of the DBNGP as were the tariffs as set out in Schedule 39 of the Asset Sale Agreement, if the tariffs set out in Schedule 39 are not implemented, Epic would not consider itself bound by the expansion program Epic Energy committed to in its complying Final Bid.

Section 2.24(f) - The interests of Users and Prospective Users

4.117 The Full Court observed that the interests of users and prospective users are likely to be counterpoised to the service provider's legitimate business interests and investment. However, it also said that maximising pipeline use by third parties could well be to the benefit of users and prospective users, as well as the owner and operator, so there is at least some scope for those respective interests to find mutual accommodation.[52]

4.118 As discussed in relation to s.2.24(e) above, the interest of present and prospective users will be advantaged by the capacity of the DBNGP being expanded in accordance with Epic Energy's undertaking, without increasing the applicable tariff on an incremental basis.

4.119 Just as important is the risk faced by existing users of their transportation contracts being lost in the event of a decision by the Regulator that adversely impacts on Epic Energy's financial viability, particularly one that places Epic Energy in external administration. Such an outcome would place at risk these users' existing contracts and benefits. This concern was commented on by a number of existing users in submissions made following the Regulator's draft decision of 21 June 2001.

4.120 Moreover, many of the matters discussed previously in relation to other paragraphs will also be of general relevance here. This overlap between relevant factors for each sub-paragraph in s.2.24 is consistent with a harmonious and consistent interpretation of the Code.

Section 2.24(g) - Any other matters that the Relevant Regulator considers are relevant

4.121 It is significant that independent regulation of the DBNGP commenced for the first time immediately after the sale was complete. At the time when the sale was completed, while the terms of the Code had been finalised and agreed between the Council of Australian Governments[53]', it had not been enacted as a law of Western Australia.

4.122 One of the most fundamental reasons for addressing competition issues through regulation, rather than through legislation, is that a complete set of rules is very

[52] Reasons para 135.
[53] Intergovernmental Agreement on Natural Gas Pipeline Access, dated 11 November 1997.

difficult (if not impossible) to specify in advance and the costs of adapting pre-specified rules to change the circumstances through legislative amendment are considered to be greater than those of relying on regulatory decisions made within the terms of more open-ended standards. Thus, Regulators always have some important decisions entrusted to them. As a consequence, the outcomes from the future stream of regulatory decision-making processes cannot be predicted with certainty. This may be described as "regulatory uncertainty" because it is a direct consequence of regulatory discretion.

4.123 Firms need to form expectations about the outcome of future regulatory decisions in order to evaluate the business case for investment projects. In forming these expectations, a firm will look to any past history of any regulatory decision-making by the same people, and will update these expectations each time a new decision is observed. This learning process implies that regulatory uncertainty is highest early in the tenure of a new regime of regulation.

4.124 It therefore follows that the regulatory risk borne by Epic Energy, as the owner of the DBNGP in the initial phases of regulation, is at its highest level. The increased regulatory risk is something to be taken into account in assessing the appropriate level of return which should be allowed to Epic Energy upon its initial investment. For these reasons, Epic Energy says that its place as the first regulated owner of the DBNGP should be given weight as a fundamental element of the assessment process.

5 Section 3 and Reference Tariff Matters

5.1 By virtue of s.2.24, the Regulator is required to consider whether Epic Energy's proposed Access Arrangement contains the elements and satisfies the principles set out in s.3.1 - 3.20 of the Code. In considering this, the Regulator must take into account the matters identified in accordance with the last section of this paper, subject to the terms of ss.3.1 - 3.20 themselves.

5.2 As previously observed, the Regulator's task in considering s.3 is to assess whether Epic Energy's proposed Access Arrangement is within the range of outcomes which may be legitimately reached in accordance with the Code. It is not for the Regulator to determine the outcome he would prefer to reach and reject Epic Energy's approach if it does not match his own. That would not be regulation of the industry, but dictation of the terms upon which the industry may exist.

5.3 Section 3.3 provides that the proposed Access Arrangement must include a Reference Tariff for:

(a) *at least one Service that is likely to be sought by a significant part of the market; and*

(b) *each Service that is likely to be sought by a significant part of the market and for which the Relevant Regulator considers a Reference Tariff should be included.*

5.4 Epic Energy's proposed Access Arrangement includes provision for a Reference Tariff for the Reference Service - namely, Firm Service - with the following salient features:

- It includes three charges to be levied on a zonal basis:
  - the Pipeline Capacity Charge, that is payable for each pipeline zone between a Shipper's Receipt Point and Delivery Point (including the zones in which the Receipt Point and Delivery Point are located);
  - the Compression Capacity Charge, that is payable by a Shipper for each Compressor Station (other than Compressor Stations 1 and 2) located between the Shipper's Receipt Point and Delivery Point; and
  - the Compressor Fuel Charge, that is payable by a Shipper in respect of each Compressor Station (other than Compressor Station 1 and 2) located between the Shipper's Receipt Point and Delivery Point.

- The Reference Tariff applies to the delivery of gas across ten zones. In summary, however, the initial Reference Tariff has the following attributes:

  - for gas transportation from a receipt point in Zone 1 to a delivery point in Zone 9 (for a shipper with a load factor of 100%) the aggregate of the tariff component described above is $1.00/GJ as at 1 January 2000;

  - for gas transportation from a receipt point in Zone 1 to a delivery point in Zone 10 (for a shipper with a load factor of $100%) the aggregate of the tariff component described above is $1.08/GJ as at 1 January 2000; and

  - The tariff amounts are escalated annually by 67% of the annual change in the CPI and are not increased by reference to the incremental cost of providing additional (ie new) capacity to current or future users.

5.5 Epic Energy's proposed Reference Tariff was not determined through a competitive tender process under the Code. Accordingly, it must be evaluated by the Regulator to determine whether it complies (by falling within an acceptable range of outcomes) with the Reference Tariff Principles described in s.8. See s.3.4 of the Code. Also, Epic Energy's proposed Access Arrangement must include a policy describing the principles that are to be used to determine a Reference Tariff, which is known as a Reference Tariff Policy. A Reference Tariff Policy must also comply with the Reference Tariff Principles described in s.8.

5.6 The effect of ss.3.4 and 3.5 of the Code is as though the Reference Tariff Principles in s.8 were set out fully in each of those subsections. Further, ss.3.3, 3.4 and 3.5 of the Code involve much scope for discretion in the assessment of interrelated matters which may bear directly on a proposed Reference Tariff.[54]

5.7 As ss.3.4 and 3.5 incorporate s.8 by reference, it is necessary to examine the provisions of that section and how they apply to the present case. It is then necessary to return to ss.3.3, 3.4 and 3.5 and to consider the inter-relationship of the matters arising from a consideration of s.8.

[54] Reasons paras 66, 67.

6 Assessing Compliance with s.8 factors

6.1 As emphasised before, the Full Court concluded that Regulator's task under s.3.4 (relevant to this part of the assessment process) is to form an opinion whether the reference tariffs in the proposed Access Arrangement comply with the Reference Tariff Principles described in s.8 of the Code.[55]

6.2 The s.8 principles include[56] a consideration of:

(a) whether the proposed Reference Tariff has been designed to achieve the objectives in s.8.1 of the Code ie, a consideration of the *effect or outcome* of the proposed Reference Tariff against specified objectives;

(b) whether the proposed tariff has been established in accordance with certain principles and methodologies[57] ie, a consideration of the *processes* by which the tariff has been established.

6.3 In assessing the outcome or effect of the proposed tariff against the list of objectives in s.8.1, to the extent that those objectives conflict, the Regulator must consider the manner in which they can best be reconciled or, if irreconcilable, which should prevail.[58]

6.4 In undertaking that consideration (ie, reconciliation of the objectives or the formation of the opinion as to which is or are to prevail), the Regulator must take into account the factors in s.2.24 and give them weight as fundamental elements to his decision.[59] Moreover, in circumstances where the same factual matters are identified as relevant for the purposes of both ss.2.24 and 8.1, this serves to give particular weight to those factors in a harmonious interpretation of the Code as it applies to the facts of the present case.

[55] Reasons para 70.
[56] Sections 8.1 and 8.2 of the Code.
[57] Section 8.2 of the Code.
[58] Section 8.1, Reasons para 85.
[59] Reasons para 55, 85, 136.

7 Interpreting the s.8.1 objectives

Section 8.1(a) - Providing the Service Provider with the opportunity to earn a stream of revenue that records the efficient costs of delivering the Reference Service over the expected life of the assets used in delivering that Service.

7.1 The Full Court said that the objective is to provide the Service Provider with an opportunity to earn a stream of revenue over the expected life of the assets used. It looks at the life of the asset in which the investment has been made. The revenue referred to in this objective is not the "Total Revenue" which is determined for the period of the Access Arrangement under ss.8.2(a) and 8.4 of the Code.[60] As the focus is on the life of the asset, the objective is not concerned with whether and how the revenue is spread between current and future users.

7.2 The opportunity to be given to the Service Provider is for the recovery of its "efficient costs" in delivering the service. The word "efficient" costs in this context refers to the economic theory of "efficiency".[61] However, in economics, there is no uniform accepted or certain meaning of the phrase "efficient costs".[62]

7.3 In economics, efficiency has at least three dimensions – technical or productive efficiency, allocative efficiency and dynamic efficiency.[63] Whilst there is some support, on a narrow approach to strict economic theory, for the view that only capital costs calculated on a "forward looking" basis would be relevant to the notion of economic efficiency[64], the concept of "efficient costs", like the related notion of "the outcome of a workably competitive market", is based on many assumptions and is incapable of precise or certain calculation.[65]

7.4 The Court said that a workably competitive market, for competition within a market, is a market where no firm has a substantial degree of market power.[66] A workably competitive market is itself a variable and varying state of things - or rather it is a process. It is not a fixed and immutable condition with any absolute or precise qualities, but a process which involves rivalrous market behaviour. As such a workably competitive market will react over time and according to the nature and degree of various forces that are happening within the market. There may well be a degree of tolerance of changing pressures or unusual circumstances before there is a market reaction. The concept of a workably competitive market may well tolerate a degree of market power, even over a prolonged period. The underlying theory and expectation of economists, however, is that with workable competition, market forces will increase efficiency beyond that which could be achieved in a non competitive market, although not

[60] Reasons para 141.
[61] Reasons para 137-139.
[62] Reasons para 106.
[63] Reasons para 11. See also para 91.
[64] Reasons para 141.
[65] Reasons para 143. See also para 126.
[66] Reasons para 125.

necessarily achieving theoretically ideal efficiency.[67] The object of s.8.1 of the Code is to replicate the outcome of a workably competitive market in circumstances where there is competition for a market, as opposed to competition within a market.[68]

7.5 In a workably competitive market, past investments and risks taken may provide justification for prices above the theoretically efficient level.[69] Economics offers no clear answer, and has not come to a settled view, as to the appropriate balance between the competing considerations of providing consumers with low prices and allowing a service provider higher prices, including monopoly rents.[70] There is, however, in economics, an emerging awareness of the disadvantages of securing too low prices for consumers without due regard to the interests of the service provider both in recovering higher prices generally and in recovering its investment in particular.[71] Recently, the Productivity Commission found that inappropriate regulation is detrimental to efficient investment in essential infrastructure facilities. The Commission Chairman has stated that regulation may pose a significant risk for investment:

> "*However, the major risk associated with the regulation of essential infrastructure is that setting prices too low could deter new investment in the facilities themselves. At a conceptual level it is clear that access and price regulation involve a significant intrusion into the property rights of facility owners and can distort their investment behaviour. While available evidence of adverse impacts on past investment is largely anecdotal and difficult to verify, the potential risk of adverse consequences from regulatory action appear to be looming larger."*[72]

7.6 The concept of a workably competitive market in the circumstances of this case, for the purpose of s.8.1(a), is not concerned with the efficient functioning of the Australian market in natural gas. The focus in s.8.1(a) is much narrower, and is on the transportation of gas by the Service Provider's assets.[73] Accordingly, broader concepts of efficiency in an overall gas market have no part to play at this point. Moreover, it would be wrong to construe s.8 as providing an "overriding" requirement that reference tariffs be based on efficient costs. [74]

7.7 Accordingly, in light of the Full Court's findings and reasons, it would be erroneous to confine the operation of s.8.1(a), as a matter of construction, to "forward looking" capital costs.

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[67] Reasons para 126,128.
[68] Compare reasons para 126, 127 and 143.
[69] Reasons para 144.
[70] Reasons paras 144 and 145.
[71] Reasons para 145. Also paras 92-95.
[72] Gary Banks, Chairman, Productivity Commission, "The Baby and the Bathwater": Avoiding efficiency mishaps in regulating monopoly infrastructure" - speech to IPART, 5 July 2002, pages 6-7. See also Productivity Commission, *Final Report into the National Access Regime*, pages 75-83, Council of Australian Governments, "Towards a truly national and efficient energy market" chapter 7. Compare Reasons paras 150-151.
[73] Reasons para 141.
[74] Reasons paras 159 and 160.

7.8 In any event, on any view of the notion of "efficient costs", it is important to note that the objective in s.8.1(a) is not to be read so as to limit or confine the Service Provider's opportunity for recovery to no more than efficient costs.[75] Thus if the proposed tariff provides both for the recovery of efficient costs, plus additional costs, the s.8.1(a) objective will be fulfilled by reason of its former aspect, but the inclusion of the latter aspect will not infract the provisions of that section or derogate from the fulfilment of its objective. So, for example, if (contrary to Epic Energy's primary submissions below) economic depreciation is not counted as an "efficient costs", s.8.1(a) would still allow Epic Energy to recover this cost.

Section 8.1(b) - Replicating the outcome of a competitive market

7.9 Section 8.1(b) is also concerned with a workably competitive market.[76] As noted above, past investment and risks are relevant and may provide justification for price above the efficient level.[77] This flows, in part, from the growing awareness amongst economists of the long-term disadvantages caused by pricing without due regard to the interests of the service provider in recovering its investment, and in recovering higher prices generally.[78]

7.10 The matter which is to be given fundamental significance by reason of s.8.1(b) is, in its application to the present case, materially identical to the considerations already discussed in relation to ss.2.24(d) and s.8.1(a) above. In substance, the point is that, in a workably competitive market, past investments and risks taken may provide justification for prices above the theoretically efficient level.[79]

Section 8.1(c) - Ensuring the safe and reliable operation of the Pipeline

7.11 This objective requires revenue to be sufficient to meet safety and reliability needs as and when that is necessary. This consideration is independent of what economic theory may otherwise require.[80] The factual matters to be given weight by reason of this provision are identical to the matters discussed previously in relation to s.2.24(c).

Section 8.1(d) - Not distorting investment decisions in Pipeline transportation systems or in upstream and downstream industries

7.12 This objective "is of particular significance in the present case".[81] As the Hilmer Report[82] observed, any consideration of public interest "would need to place special emphasis on the need to ensure access rights did not undermine the

[75] Reasons para 142.
[76] Reasons para 143.
[77] See also the discussion concerning s8.1(d) below.
[78] Reasons paras 144-145.
[79] Reasons para 144.
[80] Reasons para 146.
[81] Reasons para 147.
[82] Report to the Heads of Australian Government – National Competition Policy Review, dated August 1993.

viability of long-term investment decisions, and hence risk deterring future investment in important infrastructure projects".[83]

7.13 In interpreting this provision the Full Court suggested that there may be some tension between economic theory and practice.[84] The Full Court thought that there was general acceptance of the view that, as a matter of theory, economic efficiency required that actual past investment decisions be ignored. They said this because, the Full Court thought, that actual past investment decisions might be based on an expectation of recovering monopoly profits. On the material before the Full Court it appeared that the economists seemed to accept that, as a matter of economic theory, where a significant infrastructure asset, such as a pipeline, becomes the subject of regulation, the price of obtaining improved economic efficiency might be that the owner would be forced to vacate the market. The view in economic theory was that another party would no doubt enter the market to acquire the right to operate the asset, so that the services provided by the asset would continue. Failing that, economic forces would lead to a replacement of the services by some other means, at least if there was a sufficient demand for them. However, the Full Court also recognised that some of the expert evidence before it, and the writings tendered to the Court, revealed a growing awareness that such an outcome, although offering the advantage of lower prices for consumers in the short term, could be contrary to public interest in the long term, because of the adverse effect on necessary future investment in such assets of any adverse outcomes of past investments.[85]

7.14 In truth, the tension identified by the Full Court between practice and theory, assumes that the theoretical approach takes a narrow view of economic efficiency. If a properly wide view is taken of that concept, including allocative and dynamic efficiency, the perceived tension dissolves. If the long run decision-making process favours recognition that past investment decisions should be given proper weight in order to encourage future investment, then economic theory accords with the growing awareness identified by the Full Court. For the reasons outlined in relation to s.2.24(d) above, Epic Energy contends that the proper approach is, in economic terms, to give full consideration to past investment decisions because of the potential ramifications they have for future investment.

7.15 Hence, s.8.1(d) is not confined to "forward looking" costs. To prevent the distortion of investment decisions, the actual historical capital cost of the DBNGP should be taken into account pursuant to this provision, and given weight as a fundamental element of the s.8 process, except to the extent that the Regulator may conclude that some portion of the purchase price was reckless, mistaken or highly speculative (for example, because unrealistic demand forecasts were

[83] Reasons paras 92, 149.
[84] Reasons para 152.
[85] Reasons para 150-151.

made). For the reasons outlined in relation to s.2.24(a) above, such a conclusion could not reasonably be reached in this case.

7.16 In particular, Epic Energy puts emphasis upon the decision of the banks providing debt funding for the purchase. These banks independently evaluated the risks attached to Epic Energy's bid and concluded that the bid price was justified. Any suggestion that Epic Energy's historical costs in purchasing the pipeline cannot be substantially recognised will undermine the viability of Epic Energy's reasonable and warranted earlier investment decision. If, and to the extent that, Epic Energy is not entitled to charge a tariff to give it the opportunity to recover or substantially recover the actual historical cost of purchasing the DBNGP, this will have a significant distorting effect on future investment decisions concerning this pipeline, other pipelines and regulated infrastructure in Western Australia generally.

7.17 Further, any bank which may have its investment decisions, arrived at in an arms-length commercial transaction, "second-guessed" and undermined by a Regulator applying a narrow view of economic theory, will be heavily reluctant to provide further funds for the purchase of other infrastructure, investment in new infrastructure or even the expansion of existing infrastructure, particularly the DBNGP. [Deleted – confidential].

7.18 Such a result was not contemplated by the State at the time of sale. Minister Barnett told Parliament that:

> *"They were required to do that to demonstrate to the [GPSSC] that, given the price they paid 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."*[86]

7.19 Consequently, when establishing the Initial Capital Base this objective requires the Regulator to accept, or take into account and give weight to as a fundamental element the actual investment made by the Service Provider in the pipeline prior to the Code coming into effect. Such an investment, even if it anticipated some "monopoly" profits, would be relevant to this objective, except to the extent that any part of the investment was reckless, mistaken or highly speculative.[87] Whether the investment decision by a Service Provider falls into those categories should be assessed by, inter alia, reference to the conduct of other potential investors in relation to the sale of the pipeline at the time.[88] Accordingly the purchase price requires careful evaluation.[89] In this regard, Epic Energy refers to the discussion above and Submission CDS#3, provided with this paper.

[86] Hansard, 14 June 2000, p7655
[87] Reasons paras 154-155.
[88] Reasons para 154.
[89] Reasons para 155.

7.20 Importantly, this analysis of s.8.1(d) is consonant with s.2.24(a) and (d), and ss.8.10(c), (d), (f), (g) and (j).[90]

7.21 A specific example of the application of these points in relation to the DBNGP arises in respect of the Alcoa exempt contract.

7.22 [Deleted – confidential].

7.23 [Deleted – confidential].

7.24 [Deleted – confidential].

7.25 Epic Energy's bid for DBNGP explicitly recognised the obligations that the Alcoa contract would impose on it, and Epic Energy proposed a reference tariff consistent with its acceptance of those obligations.

7.26 Consideration of economic efficiency - in particular, the dynamic aspect of efficiency - requires that recognition be given to the way in which Epic Energy accepted and dealt with the obligations of the Alcoa contract. Not to do so would have the effect of discouraging the efficient transfer of infrastructure assets from one owner to another and this would, in turn, act as a disincentive to the transfer of those assets to their most efficient users. It would also "chill" any impetus on the part of substantial users to act in the future as foundation customers in the same manner as Alcoa.

Section 8.1(e) - Efficiency in the level and structure of the Reference Tariff

7.27 The Full Court did not consider the interpretation of this provision.[91] However, Epic Energy contends efficiency in the level and structure of the reference tariff must be assessed in the light of the Full Court's findings and reasons that references to efficient costs, from which the reference tariff might otherwise be derived, are not to be read as limiting or confining the Service Provider's opportunity for recovery to no more than efficient costs.

7.28 As noted above, the Full Court saw consideration of past investment and risks as necessary to efficiency. To prevent distortion of future investment decisions, the price Epic Energy paid for the DBNGP (and not forward looking costs) should be taken into account, and given weight as a fundamental element in the determination of the reference tariff in accordance with the provisions of s.8 of the Code. Furthermore, this past investment, and the risks associated with it, provide justification for a reference tariff above the level which would result from strict application of the principles of economic efficiency.

[90] Reasons para 153.
[91] Reasons para 156.

7.29 Epic Energy has sought to achieve efficiency in the structure of its proposed reference tariff by:

(a) dividing the DBNGP into ten zones for cost allocation and pricing purposes; and

(b) adopting a multi-part tariff.

7.30 With zone-based pricing, a shipper pays a charge for each pipeline zone between its receipt point and delivery point, through which gas is transported.

7.31 Epic Energy's proposed multi-part tariff comprises:

- a gas receipt charge;
- a pipeline capacity charge;
- a compression capacity charge;
- a compressor fuel charge; and
- a delivery point charge.

7.32 The gas receipt charge is to be payable by all users of the DBNGP. It recovers costs which are not specifically attributable to segments of pipe or to individual compressor stations. These costs, which include the costs of system operation, marketing costs, head office costs, and allocated corporate overheads, are semi-fixed costs. They do not vary directly with Pipeline throughput, or with the distance over which gas is transported.

7.33 The pipeline capacity charge recovers from each user, the costs of the segments of the pipe through which gas is transported for that user. These costs comprise the return and depreciation on each pipe segment, and the cost of maintaining the segments. They are fixed costs; they do not vary with Pipeline throughput.

7.34 Similarly, the compression capacity charge recovers from each user, the costs of providing the compression facilities required between its delivery point and receipt point. These costs are also essentially fixed.

7.35 Compressor fuel costs are the only variable costs associated with DBNGP operation. They are recovered from each user on the basis of the quantity of gas transported through each compressor station for that user.

7.36 Finally, the delivery point charge recovers the capital costs of facilities at each delivery point. It is a fixed charge payable by each shipper using a particular delivery point.

7.37 When combined with a multi-part tariff of the type proposed by Epic Energy, zone based pricing ensures that a user pays only for those Pipeline facilities used to transport gas from its receipt point to its delivery point.

Section 8.1(f) - Providing an incentive to the Service Provider to reduce costs and to develop the market for Reference and other Services.

7.38 The Full Court did not need to provide any guidance about the proper interpretation of this provision.[92] However, in so far as this subparagraph provides for Epic Energy to have an incentive to develop the market for Reference Services, it is relevant that Epic Energy has already undertaken to expand the DBNGP significantly over a 10 year period, without increasing the tariff on an incremental basis. That will necessarily develop the market for Reference Services. It will also provide an incentive for Epic Energy to develop the market for all Services, as the next few stages of enhancement of capacity on the DBNGP will be more expensive on an incremental basis than the average cost of the current capacity of the pipeline, whereas the following stages of enhancement will be cheaper on an incremental basis. It is in Epic Energy's interest to ensure that the market grows to allow it to provide access to cheaper incremental capacity.

7.39 In order to provide an incentive for Epic Energy to follow through on its expansion commitment, and indeed to make it commercially viable for Epic Energy to give effect to that commitment, the Reference Tariff should be structured in a way which allows Epic Energy to recover a return upon the actual cost of its proposed investment.

7.40 It is important to note the position which would apply if Epic Energy charged on an incremental basis for future expansions, as opposed to accepting a fixed tariff path which increases at 67% of CPI. For example, if the DBNGP is expanded to provide an extra 41 terajoules of capacity, as is anticipated in 2005, the incremental costs of expansion which would be charged to a shipper taking gas to Zone 10 would be around an extra $0.48/GJ over and above the firm tariff to Perth set by the Regulator in the Draft Decision. The corollary is that Epic Energy's only means of recovering the extra costs of expansion is to develop the market for shipping to Zone 10. This has been outlined in Epic Energy's Additional Paper DDS#2: Second Class Citizens, and is elaborated on in Epic Energy's submission CDS#3.

[92] Reasons para 156.

8 Interpreting the Code provisions for the process of establishing the proposed Reference Tariff, including s.8.10

8.1 The methodologies and principles to be applied in the process of establishing a reference tariff include the calculation of "Total Revenue" by reference to the "Cost of Service" methodology.[93] This in turn includes the establishment of an Initial Capital Base.[94]

8.2 Section 8.10 of the Code stipulates that when a Reference Tariff is first proposed for a Reference Service provided by a Covered Pipeline that was in existence at the commencement of the Code, as was the DBNGP, certain factors should be considered in establishing the Capital Base for the Pipeline. The factors which need to be considered for present purposes are:

> *(a) the value that would result from taking the actual capital cost of the Covered Pipeline and subtracting the accumulated depreciation for those assets charged to Users (or thought to have been charged to Users) prior to the commencement of the Code;*
>
> *(b) the value that would result from applying the "depreciated optimised replacement costs" methodology in valuing the Covered Pipeline;*
>
> *(c) the value that would result from applying other well recognised asset valuation methodologies in valuing the Covered Pipelines;*
>
> *(d) the advantages and disadvantages of each valuation of each valuation methodology applied under paragraphs (a), (b) and (c);*
>
> *(e) international best practice of Pipelines in comparable situations and the impact on the international competiveness of energy consuming industries;*
>
> *(f) …the economic depreciation of the Covered Pipeline…;*
>
> *(g) the reasonable expectations of persons under the regulatory regime that applied to the Pipeline prior to the commencement of the Code;*
>
> *(h) the impact on the economically efficient utilisation of gas resources;*
>
> *(i) …*
>
> *(j) the price paid for any asset recently purchased by the Service Provider and the circumstances of that purchase;…*

[93] Sections 8.2, 8.4 of the Code.
[94] Sections 8.4, 8.8 of the Code.

8.3 Economic efficiency is but one of the factors in s.8.10 of the Code and there is no justification for regarding it as in any way a dominant consideration.[95] In s.8 (and elsewhere), the Code accommodates the position of a service provider who has purchased a pipeline on the market before the introduction of the Code, even where the market price includes the capitalisation of some monopoly returns.[96] Economic theory aside, such an investment by a Service Provider has significant social political and public interest dimensions[97] and any exclusion of such interests would, in relevant cases, infringe seriously on established and legitimate rights, interests and expectations.[98]

8.4 Section 8.10(f) and (g) reflect that part of the general objective of the Act and Code that rights of access to third parties would be on conditions that are fair and reasonable for the owners and operators of pipelines, and are consistent with the more precise expression of that general objective to be found in s.2.24(a). The existence of s.8.10(f) and (g) preclude the view that the Code is concerned only with forward-looking considerations in respect of the establishment of the initial Capital Base.[99]

8.5 Other methodologies apart from DAC and DORC (which are the methodologies prescribed in s.8.10(a) and (b)) must be considered on their merits and are not to be weighed only according to economic theory.[100] Nothing in s.8.10 excludes a valuation methodology which has regard to the net present value of anticipated net returns, including monopoly returns. Such monopoly returns may form part of the Service Provider's reasonable expectations under s.8.10(g), or form part of the purchase price of a pipeline referred to in s.8.10(j).[101] Similarly, the factors in s.8.10(f) have potential relevance to past investments, particularly where, as here, there has been a sale of the pipeline before the Code.[102]

8.6 In considering market price under s.8.10(c), and purchase price under s.8.10(j), attention is directed to the price paid, in this case the $2.407 billion (plus associated capital costs), as well as the circumstances of purchase.[103] The latter aspect includes an examination of the price paid "according to the standards of reasonable commercial judgment as to value".[104] The relevant standards, at least in an arms-length commercial transaction, are to be judged "in the circumstances then prevailing and anticipated" at the time of sale.[105] The Full Court held that, for the purposes of s.8.10(j) of the Code, there was no error by the Regulator in his

[95] Reasons para 176.
[96] Reasons paras 175, 176 and 178.
[97] Reasons para 178.
[98] Reasons para 179.
[99] Reasons, para 169.
[100] Reasons para 176.
[101] Reasons paras 169, 176, 179.
[102] Reasons para 168.
[103] Reasons paras 172 and 173.
[104] Reasons para 172.
[105] Reasons para 179.

previous decision in regarding the whole of the DBNGP as an asset recently purchased.[106]

8.7 Further, the nature and conditions of the tender process by which the State sold, and Epic Energy purchased, the DBNGP are circumstances which might properly be considered under s.8.10(j). As well, the circumstances of the purchase are also relevant under s.8.10(c) and (d), as Epic Energy advances the purchase price as reflecting the market valuation of the DBNGP.[107]

8.8 The presence of s.8.10(c), (d), (g) and (j) reflect a consistency with s.2.24(a) and the general policy objective of the Act for providing access rights to third parties that are fair and reasonable for service providers.[108]

8.9 One way to put the valuation methodologies in s.8.10 into perspective is to consider the minimum initial Capital Base which would generate a tariff of $1/GJ to Perth, assuming that all other variables and methodologies specified in the Regulator's draft decision dated 21 June 2001 are accepted. The result is that a tariff of $1/GJ to Perth would result if an initial Capital Base of $[deleted – confidential][109] is selected.

8.10 Alternatively, another relevant way of putting the matter into perspective is to consider what tariff would be generated by adopting an initial Capital Base based on the actual capital cost to Epic Energy in purchasing the DBNGP, again assuming that all of the other variables and methodologies determined by the Regulator in his draft decision dated 21 June 2001 are adopted. In that case, applying the cost of service methodology used by the Regulator and a 100% load factor, tariff levels significantly in excess of those allowed by the Regulator would be reached. The applicable tariffs would be $[deleted – confidential] in Zone 9. For Zone 10, the relevant figure would be $[deleted – confidential].

8.11 Moreover, it is important that, presently, energy prices in Australia are amongst the lowest levels in the industrialised western world.[110] Further, Epic Energy has performed a comparison with the most closely similar pipeline it can find internationally, the Kern River Pipeline in the United States of America. The tariff proposed by Epic Energy for the DBNGP compares favourably with the tariff applied to the Kern River Pipeline on a dollar per GJ kilometre basis. The detail of this is contained in Submission 3 filed with the Regulator in March 2000, but it is notable that on a dollar per GJ kilometre basis the tariff applied in relation to the Kern River Pipeline is approximately 13% higher than the tariff proposed by Epic Energy for the DBNGP. Lastly, in its proposed Access Arrangement, Epic Energy has reduced the DBNGP reference tariff to a level below the levels of previous tariffs for this pipeline; has reduced the DBNGP reference tariff to a level that is

[106] Reasons para 171.
[107] Reasons paras 171 - 173.
[108] Reasons para 177. Also para 130.
[109] In dollar terms in 2000.
[110] See Council of Australian Government, "Towards a Truly National and Efficient Energy Market", Executive Summary, page 1.

significantly lower than the reference tariff proposed for other Western Australian pipelines (on a $/GJ km basis); and has reduced the DBNGP reference tariff to a level consistent with the tariffs of other major comparable transmission pipeline systems throughout the world. These considerations are all relevant and should be given weight as fundamental elements in assessing the proposed Reference Tariff for the purposes of s.8. See s.8.1(e).

9 Application of Code provisions to the process of establishing Epic Energy's proposed reference tariff, including establishment of the Initial Capital Base under s.8.10

9.1 The reference tariff proposed by Epic Energy is justified on a Cost of Service basis in accordance with s.8.4 of the Code. That provision describes the Cost of Service methodology in the following terms:

The Total Revenue is equal to the cost of providing all Services (some of which may be the forecast of such costs), and with this cost to be calculated on the basis of:

*(a) a return (**Rate of Return**) on the value of the capital assets that form the Covered Pipeline (**Capital Base**);*

*(b) depreciation of the Capital Base (**Depreciation**); and*

(c) the operating, maintenance and other non-capital costs incurred in providing all Services provided by the Covered Pipeline (**Non-Capital Costs**).

Derivation of Initial Capital Base

Establishing ICB

9.2 The Initial Capital Base has been established by reference to the purchase price paid for the pipeline by Epic Energy to the State. As explained, the Regulator's task is to assess the acceptability of Epic Energy's proposed Reference Tariff, rather than to determine its own Reference Tariff and then compare that to Epic Energy's proposed tariff. So, in argument before the Full Court on 28 November 2002, Parker J, when speaking to counsel for Epic Energy, said: "*In simple terms, Mr Zelestis, section 8.10 is initially speaking to your client*." This observation was adopted, in substance, by counsel for the Regulator who said: "*So with respect to my learned friend, there is a peculiar nature in respect to the Capital Base…there is here an openness about the question that means that there might be a number of alternatives within the range of discretion available to be found*."[111]

9.3 The purchase price paid by Epic Energy has its foundation in the factors enumerated in sub-paragraphs (c), (d), (f), (g), (h) and (j) of s.8.10 of the Code. All of the relevant factual matters for this purpose have already been discussed in respect of ss.2.24 and 8.1. (The detail of these factual matters is elaborated in Epic Energy's submission CDS#3 (confidential version), provided with this paper.)

[111] Transcript pages 697, 699.

9.4 While CDS#3 contains an extensive analysis of the pertinent facts, in summary the relevant factual matters for the purposes of s.8.10(c), (d), (f), (g), (h) and (j) are as follows:

(a) the sale process for the DBNGP was designed and sanctioned by the State Government and the Minister for Energy to achieve a competitive and commercial price in an arms-length transaction for the sale of an infrastructure asset, in respect of which there was no existing market structure to facilitate a sale;

(b) the bid price represented a sound commercial assessment of the value of the pipeline in the circumstances then prevailing and anticipated;

(c) judged by reference to the conduct of other potential investors in the market for the pipeline, the price paid by Epic Energy could not be regarded as reckless, mistaken or highly speculative. Moreover, the independent commercial assessment of the banks financing Epic Energy justifies the commercial reasonableness of Epic Energy's bid price. At the very least, the price paid by the second highest complying bidder, which Epic Energy believes was [deleted – confidential], must represent the fair market value of the DBNGP, assuming they were bid on the same or similar basis as to tariff and tariff path;

(d) [deleted confidential];

(e) [deleted – confidential];

(f) The principal users of the pipeline are Alcoa, AlintaGas (now itself privatised) and Western Power. The expectations of these users prior to commencement of the Code,[112] were that tariffs would be and remain in the order of $1/GJ;[113]

(g) the State Government made a conscious decision to accept the highest bid for the DBNGP, based on a tariff of $1/GJ applying from Dampier to Perth, rather than to accept the bid offering the lowest tariff. [deleted – confidential];

(h) it is legitimate for Epic Energy to pass on to shippers any capitalised monopoly profits charged by the State to Epic Energy as part of the bid price;

(i) Epic Energy should be allowed to earn an appropriate return on investment to permit it: (i) to stay in business; (ii) to ensure the safe and reliable operation of the pipeline; (iii) to take account of regulatory risk and the fact that the DBNGP came under independent regulation for the first

[112] Which are also relevant under s 8.10(g) - Reasons para 169.
[113] See s 8 of CDS#3, Confidential version.

time immediately after the sale; (iv) to provide a reasonable and commercial return to Epic Energy's funders; and (v) to provide Epic Energy's owners with the incentive to advance further equity to expand the DBNGP;

(j) the price paid by Epic Energy, in the circumstances outlined in subparagraphs (a) to (i) above, could not be regarded as reckless, mistaken or highly speculative;

(k) [deleted – confidential];

(l) [deleted – confidential];

(m) historically, significantly high tariff levels applied when the DBNGP was owned by the State, and the direct consequence of its sale was a reduction in tariff levels by approximately 20%;

(n) the undertaking by Epic Energy as part of its purchase to expand the DBNGP's capacity at a cost of $875 million over ten years, subject to demand, without increasing the tariff on an incremental basis;

(o) Epic Energy's expectations were, in fact, that it would be given the opportunity to earn a stream of revenue to recover the capital costs of the acquisition over the expected life of the pipeline and an appropriate return. Those expectations were reasonable given:

(i) it was not a feature of the regulatory regime under the Code (to the extent it was then in prospect) that only "efficient" capital investment should be considered or that only "regulated" revenues would be recovered;[114]

(ii) the legitimate business interests of a service provider were to be taken into account under the Code as a fundamental factor in the assessment of an access arrangement and those interests could include monopoly returns; and

(iii) the price it paid was reasonable in all the known and anticipated circumstances and was the subject of an arms-length transaction with the State, which was the vendor;

(p) Epic Energy's proposed reference tariff is comparable to, or below, the tariff levels which apply to comparable pipelines throughout Australia and the rest of the world.

9.5 An assessment, in light of the s.8.1 objectives, of Epic Energy's proposed reference tariff as determined in light of the establishment of an Initial Capital

[114] Reasons paras 204-207.

Base by reference to purchase price, is considered below. However, before that, it is appropriate to observe that there is nothing which would commend the selection of a DORC value in this case at the point of the s.8.10 factors. The unsuitability of DORC at the point of a consideration of the s.8.10 factors is discussed next. That conclusion is reinforced when a tariff based on DORC value is measured against the objectives in s.8.1(a) and those objectives are considered in light of the s.2.24 factors.

DORC value not appropriate under s.8.10

9.6 As the Full Court's reasons make clear, there is nothing, on the proper construction of the Code, which would compel the conclusion that a DORC value should be selected for the establishment of the Initial Capital Base. The Regulator's selection of DORC on the last occasion, as revealed in the Draft Decision, reflected a misconstruction of the Code and a "significant misapprehension" of his statutory function.[115]

9.7 Another of the reasons advanced by the Regulator on the last occasion to reject purchase price in favour of a DORC value, viz the question of Epic Energy's allowance for capital expenditure to accommodate increased quantities, has been shown to be in error.[116]

9.8 The final reason advanced by the Regulator on the last occasion for adopting a DORC value was that he purported to attribute to Epic Energy an expectation that an amount in excess of DORC would not be allowed under the Code.[117] As the Court noted, however, the basis for attributing that expectation to Epic Energy could not be sustained:

(a) first and foremost, this was because it involved the Regulator attributing to Epic Energy his own serious misapprehension of the effect of the Code and its proper interpretation;

(b) secondly, a DORC valuation could not be supported on the reasoning of the Draft Decision. At one point, the Regulator had said that the Information Memorandum in the sale "would have" led to such an expectation. In other parts, he said it only "may have". The latter statement was inconsistent with the former and provided no basis for the conclusion that Epic Energy in fact held such an expectation;[118] and

(c) thirdly, it is clear that the Court regarded the Information Memorandum as providing an insufficient basis for concluding that Epic Energy held an expectation of the kind which the Regulator attributed to it. In this regard the Court observed that Price Waterhouse's brief was confined to valuing

[115] Reasons paras 204-207.
[116] Reasons paras 208-211. This is the subject of a further submission by Epic Energy – CDS#4.
[117] Reasons para 213.
[118] Reasons para 213.

the pipeline using DAC and DORC methodologies, that they went on to express the view that a DORC type valuation "would be supportable" under the Code, and that all such information was in any event the subject of clear and express disclaimers.[119] Just as the Court found that those materials alone did not warrant a finding that Epic Energy reasonably expected a tariff of $1/GJ under the Code, it is equally clear that the Court rejected the suggestion that those matters provided evidence from which to conclude that Epic Energy must reasonably have expected the pipeline to be valued at no more than DORC.[120]

9.9 To the extent that it may be relevant, the true position was that Epic Energy expected a Reference Tariff which would be $1/GJ to Perth, based on the official statements of Minister Barnett and representations made by the GPSSC.

9.10 The Full Court concluded that there was no basis, on the materials before the Regulator on the last occasion, for saying that Epic Energy had failed to provide for the costs of increasing the capacity of the pipeline, while at the same time anticipating revenue from increased throughput capacity for the DBNGP.[121] This error was the primary reason given by the Regulator for the critical decision not to accept that the price paid by Epic Energy for the DBNGP represented a reasonable market valuation of the pipeline. A further direct consequence of this error was that the Regulator was unpersuaded that a reasonable market valuation for the DBNGP was in excess of DORC valuation.[122] Hence, that finding coupled with the absence of any other material (at least which has been provided to Epic Energy) to support a DORC valuation, means that it would again be an error for the Regulator to adopt a DORC valuation in reaching his final decision.

9.11 In summary it is clear that none of the Regulator's reasons for preferring DORC, over the DBNGP's purchase price, in the proposed establishment of the Initial Capital Base under s.8.10, were valid. No other reasons were suggested or claimed by the Regulator on the last occasion for adopting a DORC methodology. Once the Regulator's original reasons are seen to be invalid, and there are no other reasons justifying a DORC valuation exist, and where a number of factors under s.8.10 point to adopting the purchase price, there is no basis for confining the initial Capital Base to a value derived by a DORC methodology. The insistence on DORC in those circumstances would serve to elevate the theory of economic efficiency to a position of paramountcy, which it does not have under the Code, and would reflect a repetition of the serious misapprehension under which the Regulator laboured in reaching the Draft Decision.

9.12 The conclusion that DORC is not the appropriate valuation methodology for establishing the Initial Capital Base is confirmed when regard is had to the objectives in s.8.1 and the s.2.24 factors, which must be accorded weight as

[119] Reasons paras 198 and 213.
[120] See generally Reasons, paras 198-200 and 213.
[121] Reasons para 211.
[122] Reasons para 211.

fundamental elements of the assessment process. The relevant factual matters to be given weight by reason of these objectives are discussed below, and all point towards using the DBNGP's actual purchase price (and associated capital costs) for its Initial Capital Base.

Assessment of the outcome or effect of Epic Energy's proposed reference tariff in light of the s.8.1 objectives

9.13 The reference tariff proposed by Epic Energy will allow it the **opportunity** to recover its actual purchase cost over the life of the pipeline. As, the Full Court's decision was to the effect that s.8.1(a) is not confined to "forward looking" costs, it is clear that the proposed tariff will achieve the objective in s.8.1(a). On the other hand, a tariff based on a DORC valuation methodology would not achieve that objective, as it would make no allowance for past investment.

9.14 If, on the other hand, s.8.1(a) were to be regarded as confined to "forward looking" costs, the tariff would still meet this objective, because such "efficient" costs are less than the costs of the investment and so any tariff designed to cover the latter, would also necessarily cover the former. The fact that costs greater than "efficient" costs would be recovered does not alter or impede the fulfilment of the objective, because s.8.1(a) does not purport to limit or confine recovery to "efficient" costs.

9.15 The question of whether the proposed tariff fulfils the objective in s.8.1(b) depends, in part, on whether past costs are comprehended within the meaning of this provision. For the reasons discussed above, in assessing the fulfilment of this objective, cognisance should be taken of the Court's finding of a growing awareness amongst economists of the long-term disadvantages of setting pricing for infrastructure below that which would permit recovery on the actual investment.

9.16 Again, to the extent that pricing in a workably competitive market can take account of past investments, the tariff proposed by Epic Energy fulfils the objective in s.8.1(b), whereas a tariff based on a DORC value would not.

9.17 If and to the extent that the reference to a competitive market in this provision were to be regarded as confining its operation to "forward looking costs" (contrary to Epic Energy's primary position), the resolution of whether and to what extent the fulfilment of this objective should affect the fulfilment of other objectives will depend upon a reasoned application of the s.2.24 factors to the facts of the case. If this stage is reached, the analysis in the next section of this paper shows that the proper outcome would still be to fix the DBNGP's Initial Capital Base by reference to Epic Energy's actual capital costs of acquiring the DBNGP.

9.18 Section 8.1(c) directs attention to the safety and reliability of the operation of the pipeline. If Epic Energy is financially constrained by a low reference tariff, this will lead to it being unable to carry out necessary maintenance upon the DBNGP. In

turn, that will have the flow-on effect of reducing the reliability, and thereby the capacity of the DBNGP. There could be no confidence that the objective in s.8.1(c) could be fulfilled if a tariff was established by reference to an amount which did not substantially accord with the purchase price. A low reference tariff would create the risk of putting Epic Energy out of business, which would be seriously disruptive of all aspects of the management of the pipeline, including safety and reliability matters.

9.19 Section 8.1(d) was the objective which the Court regarded as being "of particular significance in the present case".[123] This objective is fulfilled by the adoption of Epic Energy's proposed Reference Tariff. On the other hand, a reference tariff established on the basis of a valuation of the pipeline substantially less than the purchase price, would clearly not achieve that objective. In the most far-reaching and serious way it would undermine the viability of the earlier investment decision.

9.20 As the Court observed, it is a significant aspect of the public interest that investment be maintained and encouraged in essential infrastructure, and potential investors need to have confidence that decisions which were sound according to the commercial circumstances of the time, are not rendered loss-making or do not result in corporate liquidation, by virtue of future governmental action.[124] Yet liquidation would be the very result if tariffs were set by reference to a valuation of the DBNGP substantially less than the bid price.

9.21 The proper interpretation and application of s.8.1(e) was discussed above. Epic Energy contends that efficiency in the level of the Reference Tariff must be assessed in light of the Court's findings and reasoning that references to efficient costs, from which the reference tariff might otherwise be derived, are not to be read as limiting or confining the Service Provider's opportunity for recovery to no more than efficient costs. The Court saw consideration of past investment and risks as necessary to considerations of efficiency. Investment, and the associated risks, must be taken into account to prevent distortion of future investment decisions. Accordingly, the price Epic Energy paid for the DBNGP (and not forward looking costs) should be given weight as a fundamental element in the determination of the reference tariff in accordance with the provisions of s.8 of the Code. Moreover, this past investment, and the associated risks, provide justification for a reference tariff above the level which would result from strict application of the principles of economic efficiency.

9.22 Efficiency in the structure of the Reference Tariff is, in Epic Energy's view, to be achieved through a tariff design which ensures that a shipper pays only for those facilities used in providing it with the Reference Service. Epic Energy has sought to secure this outcome through a multi-part tariff and zonal based pricing. With such a tariff, a user pays for the provision and operation of only those parts of the

[123] Reasons para 147.
[124] Reasons para 148-149.

pipeline, compression, delivery point and other facilities used to provide it with the Reference Service.

9.23 The Full Court did not provide any guidance on s.8.1(f) of the Code, the section requiring that the Reference Tariff be designed with the objective of providing an incentive to the service provider to reduce costs and to develop the market for reference and other services. However, Epic Energy contends that the Reference Tariff should be framed so that Epic Energy's expansion of the pipeline in line with the commitment it gave at the time of purchase, is commercially viable. Commercial viability will not be demonstrated to potential finance providers for pipeline expansion if Epic Energy is unable to have the opportunity to earn a return on an initial Capital Base established from the actual cost incurred by Epic Energy in purchasing the DBNGP.

9.24 Subject to a possible qualification, it is apparent from the foregoing that the tariff proposed by Epic Energy fulfils the relevant s.8.1 objectives. Moreover, the factors in s.2.24 confirm the conclusions to be drawn from s.8. The potential qualification to this is that if, and in so far as, s.8.1(b) is confined to "forward looking" costs (contrary to Epic Energy's primary contentions above), there is a tension to be resolved between the fulfilment of that objective and, the objective in s.8.1(d). The resolution of that matter is discussed below, by particular reference to the s.2.24 factors.

The application of the s.2.24 factors

9.25 At the outset, it is to be recalled, that the Court regarded s.8.1(d) to be of particular significance in this case. As the Court noted, it is a reflection of the general scope and policy of the Act which requires access to be fair and reasonable from the perspective of owners and operators.[125] The Court also referred to the Hilmer Report's reference to the need to place special emphasis on an objective of this kind, to ensure access rights did not undermine the viability of long-term investment decisions, and hence risk deterring future investment in important infrastructure projects.[126]

9.26 In so far as the s.2.24 factors are concerned, it is clear that the legitimate business interests and investment of the service provider, under s.2.24(a), would require precedence to be given to the s.8.1(d) objective. The wider public interest identified in s.2.24(e) would also compel that conclusion. Again both of those matters were regarded by the Full Court as having particular significance in this case.

9.27 Section 2.24(d) and the narrower aspect of s.2.24(e) relate to economic theory, however they suffer from the same difficulty as s.8.1(b) itself. There is evidence, in economic theory, that in a workably competitive market, past investments and

[125] Reasons para 153.
[126] Reasons para 92.

risks taken provide some justification for prices above the "efficient" level (in a narrow sense) and that competing economic evidence indicates an "unresolved tension" in this area.[127] Accordingly these provisions themselves are inherently incapable of assisting in the resolution of any competing considerations which emerge from the objectives in s.8.10(b) and s.8.10(d).

9.28 Prior to the commencement of the Code, shippers' expectations (eg AlintaGas) were in fact consistent with a proposed tariff of $1/GJ to Perth. This has subsequently been confirmed in a number of public submissions and comments.[128] Moreover they had historically paid much higher tariffs. As well, the interest of existing users requires that Epic Energy should continue to operate as a commercially viable enterprise. This preserves the benefits of existing contractual arrangements with Epic Energy, in particular the benefits accruing to Alcoa under its exempt contract.[129] Certain other existing users also enjoy the benefit of transitional (but exempt) contracts and have accrued rights and privileges under those contracts. These accrued rights include significant rights to capacity based on previous use. All of these rights would be lost if Epic Energy was forced into external administration. These matters are also consistent with giving weight to the factors identified in accordance with s.2.24(b).

9.29 By contrast, there is no evidence that a user would be forced into liquidation if Epic Energy's proposed tariff is adopted and the objective in s.8.1(d) is fulfilled. Nor is there any evidence that the proposed tariff would act so as to deter prospective users from purchasing gas.

9.30 In this context it is also appropriate to consider the effect of the tariff proposed by Epic Energy upon end-users. By way of example it is informative to examine the position of AlintaGas, one of the major users of the DBNGP:

- it may be reasonably expected that AlintaGas would pass an increase in any DBNGP gas transportation charges to its contract customers by requiring them to pay a higher price for delivered gas if Epic Energy's proposed Access Arrangement is approved, compared to the case if the tariff prescribed by the *Gas Pipeline Acts (Privatised DBNGP system) (Transitional) Regulations 1999* continues to apply;

- however, in relation to AlintaGas's residential and small business customers, the *Energy Co-ordination (Gas Tariff) Amendment Regulations 2002* caps the tariffs applicable to sales of gas to residential and small business consumers, permitting those tariffs to increase at no more than a year-on-year increase in CPI plus 2%. Recent government announcements state that the tariffs will only be increased at CPI. These regulations effectively preclude any increase in the DBNGP transportation

[127] Reasons paras 144 and 150.
[128] These are outlined in s 8 of CDS#3, confidential version.
[129] Alcoa is an "User" within the meaning of Code as it is a person who has a current contract for a Service, ie a service provided by means of a Covered Pipeline such as a haulage service. See s 10.8 of the Code.

tariff paid by AlintaGas being passed through to residential and small business consumers; and

- not only does the retail price capping scheme of these regulations preclude tariff increases being passed through to residential and small business consumers, it also has the effect of ensuring that, if the Regulator were to apply a reference tariff which was lower than $1/GJ to Perth (appropriately escalated), the benefit of this lower tariff would not necessarily flow through to gas consumers. It would almost certainly accrue, in the form of increased profits, to the shareholders of AlintaGas and of any other gas retail business supplying residential and small business consumers. This is what has occurred in practice since the introduction of the transitional tariffs as of 1 January 2000 and there is no indication from AlintaGas that anything will change in the future.

The operation of s.8.11

9.31 Section 8.11 provides that in a case such as the present, where an existing pipeline has become the subject of the Code, the Initial Capital Base "normally should not fall outside the range of values" determined by the DAC or DORC methodologies provided in s.8.10(a) and (b).

9.32 Section 8.11 is to be accepted for what it says. In a case where there has been an acquisition of a pipeline on the open market before the commencement of the Code, that circumstance may take the application of s.8.10 outside of what is normal within the meaning of s.8.11, because a sale at market value may well involve the capitalisation of some monopoly returns. These will have been paid to the original owner by the new purchaser. While some economic theory would turn its face against such a market value, a sale in these circumstances introduces, as an additional factor, the legitimate investment and business interest of the new purchaser, which at the time of the commencement of the Code, is the Service Provider. (See in particular s.2.24(a).) At least in cases where investment in a pipeline before the Code applied is made in the course of an arm's-length commercial transaction, and is based on a sound commercial assessment of the value of the pipeline in the circumstances then prevailing and anticipated, it is not apparent from the terms of the Act and the Code that the intention is automatically and necessarily to preclude operation of the investment, or the interest of the Service Provider, in recovering it together with a reasonable return, or the reasonable expectations under the preceding regulatory regime of such a Service Provider.[130]

9.33 This conclusion follows from recognition that, in interpreting the word "normally" in s.8.11, economic efficiency is but one of the factors identified in s.8.10 and there is no sufficient justification in that provision for regarding it as in any way a dominant consideration. Therefore, while the DAC and DORC methodologies

[130] Reasons, para 178-179.

have an acceptability for the purposes of economic efficiency, it is clear from s.8.10(c) that other well-recognised asset valuation methodologies are to be considered; and from s.8.10(d) that the advantages and disadvantages of each of them are to be weighed. It is not provided that they are to be weighed only according to the economic theory of economic efficiency; they are to be considered and evaluated on their merits. There is no reason, implicit or explicit, why a valuation methodology which had regard to the present value of anticipated net returns, including monopoly returns, should necessarily be excluded for these purposes. Nor should there be excluded the expectations of Service Providers of monopoly returns where those expectations were reasonable under the regulatory regime that applied to the pipeline before the commencement of the Code. See s.8.10(g) and (j).[131] Therefore, normality for the purposes of s.8.11 does not reflect an overriding intention of the Code to achieve an outcome for the Initial Capital Base that is consistent with the principles of economic efficiency and a competitive market. As well, there is no overarching requirement which mandates a presumption in favour of the DAC or DORC values.

9.34 In the present case Epic Energy says that it purchased the DBNGP in an arms-length, State approved commercial transaction, based on a sound commercial assessment of the value of the pipeline in the circumstances then prevailing and anticipated. Therefore, it should not be deprived of an opportunity of recovering a return on the whole, or substantially the whole, of its actual bid price, by reason that a narrow view of pure economic theory might presume the application of the DAC or DORC valuation methodologies. Section 8.11 does not require that conclusion to be reached on its proper interpretation.

Conclusion on Initial Capital Base

9.35 Epic Energy's proposed reference tariff has been established in conformity with the *process* outlined in the Code and, in terms of its *effect or outcome*, fulfils the objectives in s.8.1 of the Code based on an Initial Capital Base reflecting Epic Energy's actual capital costs. There is no occasion, on the facts of this case, to select DORC as the appropriate methodology for deriving the Initial Capital Base for the purposes of s.8.10. Moreover the application of a DORC value would produce a tariff which failed to meet the s.8.1 objectives.

Derivation of Rate of Return

9.36 Section 8.30 and 8.31 of the Code apply to the process of deriving a rate of return. Importantly, the following principles apply:

- the rate of return should provide a return which is commensurate with prevailing conditions in the market for funds and the risk involved in delivering the Reference Service;

[131] Reasons, para 175-176.

- in general the weighted average of the return should be calculated by reference to a financing structure that reflects standard industry structures for a going concern and best practice;

- however, other approaches may be adopted where the Regulator is satisfied that to do so would be consistent with the objectives contained in s.8.1.

9.37 The considerations outlined above are entirely consistent with the analysis which Epic Energy has advanced in relation to the proper interpretation of s.8.1, and in particular s.8.1(a), (d) and (e). As well, these principles are consistent with the considerations mentioned in s.2.24, and in particular 2.24(a), (b), (d) and (e).

9.38 The rate of return which Epic Energy sought in its proposed Access Arrangement was 8.5% (pre-tax real).

9.39 The Regulator's approach to the question of the appropriate rate of return in his draft decision dated 21 June 2001 was to assess the rate of return which he considered appropriate, and reject the rate proposed by Epic Energy as it did not match his own determination. That approach is flawed. As previously emphasised, the approach that the Regulator ought to adopt, as was made clear by the comments of Parker J on 28 November 2002, is to ask himself the question whether the rate of return proposed by Epic Energy is outside the legitimate range which could reasonably be allowed. It is beside the point if the Regulator himself might favour another outcome within the legitimate range. He can only reject the proposed rate of return advanced by Epic Energy if he can demonstrate that it is commercially unreasonable or unjustified. Quite apparently, the draft decision does not set out to address that question.

9.40 Furthermore, the date at which the rate of return is assessed should be the date of the commencement of the access arrangement period. Epic Energy should not be prejudiced from any movements over time in the market variable elements of the rate of return calculation just because of a delay in the regulatory approval process. This is consistent with both the task of the Regulator in assessing a service provider's access arrangement and with the need to promote regulatory certainty over set periods.

9.41 Not only can the Regulator not demonstrate that Epic Energy's proposal is commercially unreasonable, but the Regulator has adopted an approach which itself is not correct. That is to do with the issues of capital structure and dividend imputation.

Capital Structure

9.42 Epic Energy's derivation of the rate of return used a capital structure comprising 55% debt and 45% equity. This capital structure was, in the view of Epic Energy's expert adviser on rate of return, The Brattle Group, consistent with

evidence from Australia and overseas on the capital structures of comparable companies. Gearing ratios (levels of debt to total assets) for those companies, summarized in The Brattle Group's report, were in the range 50% to 60%.[132]

9.43 In his Draft Decision, the Regulator required the use of a capital structure comprising 60% debt and 40% equity. No evidence supporting the use of this capital structure was provided, and no argument was presented that Epic Energy's proposal was commercially, or otherwise, unreasonable.

Dividend Imputation

9.44 Epic Energy proposed that the value of franking credits available to shareholders under the dividend imputation provisions of the Australian taxation system be recognized through use of a value of GAMMA of 44% in its derivation of the rate of return. The parameter GAMMA measures the ratio of utilized franking credits to corporate tax paid on income paid out of dividends.

9.45 At the time Epic Energy submitted its proposed Access Arrangement to the Regulator (December 1999), allowance for dividend imputation in the derivation of the rate of return was still relatively new and somewhat contentious. No allowance had been made for it in the tariff analysis undertaken by Price Waterhouse, for the Government of Western Australia, in August 1997, and later made available, in the sale data room, to bidders for the Pipeline.[133] Epic Energy's expert advisor on rate of return, The Brattle Group, sought to estimate GAMMA as the product of a franking credit utilization factor (the proportion of franking credits that are redeemed) and a franking ratio (the ratio of franked dividends to total dividends). Values for the franking credit utilization factor, and for the franking ratio, were obtained from a number of studies by Australian finance academics. These studies indicated a utilization factor of 55%, and a franking ratio of 80%. Accordingly, The Brattle Group's estimate of GAMMA was 44% (55% x 0.80). In applying this estimate, an adjustment was made for the dividend payout ratio (estimated to be 0.70), so that the effective value of GAMMA in The Brattle Group's derivation of a rate of return for the DBNGP was 30.8% (0.70 x 44%).

9.46 In his Draft Decision, the Regulator refers to a more recent study that indicates a higher value for the franking ratio, and that consistent application of the Capital Asset Pricing Model in the derivation of a return on equity requires the assumption that all investors are Australian and can fully utilize franking credits. According to the Regulator, these two factors suggest a franking credit utilization factor higher than the 55% assumed by Epic Energy. Further arguments are advanced by the Regulator which purport to show that the transformation method used by Epic Energy (and by the Regulator) to account for the effects of taxation requires assumption of a higher rather than a lower value for GAMMA. On the

[132] "The Cost of Capital for the Dampier to Bunbury Natural Gas Pipeline", October 1999, page 15.
[133] Reference: Price Waterhouse report, August 1997.

basis of the additional evidence, and these more theoretical arguments, the Regulator concludes that the appropriate value for GAMMA is that which has been assumed for other regulatory decisions in Australia.

9.47 There appears to be no basis for this conclusion, other than the fact that other regulatory decisions have assumed (without justification) a value of GAMMA of 50%, which is higher than the estimate used by Epic Energy.

Depreciation Method

9.48 Section 8.33 of the Code sets out the objects to be achieved by a Depreciation Schedule. This Schedule should be designed:

(a) *"so as to result in the Reference Tariff changing over time in a manner that is consistent with the efficient growth of the market for Services provided by the Pipeline (and which may involve a substantial portion of the depreciation taking place in future periods, particularly where the calculation of the Reference Tariffs has assumed significant market growth and the pipeline has been sized accordingly);*

(b) *so that each asset or group of assets that form part of the Covered Pipeline is depreciated over the economic life of that asset or group of assets;*

(c) *so that, to the maximum extent that is reasonable, the depreciation schedule for each asset or group of assets that form part of the Covered Pipeline is adjusted over the life of that asset or group of assets to reflect changes in the expected economic life of that asset or group of assets; and*

(d) *… so that an asset is depreciated only once…(that is, so that the sum of the Depreciation that is attributable to any asset or group of assets over the life of those assets is equivalent to the value of that asset or group of assets at the time at which the value of that asset was first included in the Capital Base, subject to such adjustments for inflation (if any) as is appropriate given the approach to inflation adopted pursuant to section 8.5(a)).*"

9.49 The Depreciation Schedule which Epic Energy submitted uses economic depreciation. Economic depreciation, in each year, is determined as the difference between the revenue expected given the Reference Tariff and tariff path of the proposed Access Arrangement, and the sum of return on the capital base (the assets which form the DBNGP), and the non-capital costs, in that year.

9.50 In circumstances, such as those anticipated by Epic Energy at the time it purchased the DBNGP, where future growth in the demand for gas transmission

service is expected, a depreciation schedule constructed using economic depreciation has the effect of initially deferring the recovery of a part of the capital base. When service demand is growing, economic depreciation is initially negative, deferring a part of the capital base until it can be recovered through higher revenues, derived from higher levels of service provision, without requiring an increase in the level of the Reference Tariff beyond that allowed by the tariff path. With growth in service demand, the additional revenues (determined using the reference tariff and tariff path of the proposed Access Arrangement) provide for both the recovery of the current capital base, and recovery of that part of the capital base deferred from previous years.

9.51 The deferred recovery account not only deals effectively with the non materialisation of throughput but it also deals effectively with the fluctuating tariffs that would otherwise occur with incremental expansions had Epic Energy not proposed a levelised tariff approach for future expansions over the first 10 years of ownership. Given that the next stages of expansion will be incrementally more expensive than the average cost of capacity, the deferred recovery ensures that Epic Energy will have the opportunity to earn a return on any "lost" revenue that Epic Energy would otherwise have gained had it charged the incremental tariff.

9.52 If the proposed tariff path had allowed the Reference Tariff to increase at the rate of inflation, the effect would be to ensure that each generation of shippers paid the same price per unit for gas transmission service. The Reference Tariff would remain unchanged, but the portion of the capital base recovered would increase year by year consistent with the growth in the market, as required by s.8.33(a) of the Code. (In fact, the proposed tariff path allows the Reference Tariff to increase at only 67% of the increase in the general level of prices, resulting in a small but important real reduction in the Reference Tariff over time.

9.53 Epic Energy has divided its (economic) Depreciation Schedule into two parts. One part is depreciation of the physical assets which comprise the DBNGP. Epic Energy refers to this part as the physical asset depreciation. The physical asset depreciation has been determined using the annuity method for calculating depreciation.

9.54 For the purposes of applying the annuity method, and determining the physical asset depreciation, Epic Energy has allocated each of the assets that form the DBNGP to one of four groups of assets. Those four asset groups are pipeline assets, compressor station assets, metering assets, and other assets.

9.55 Each group of assets has been depreciated over the economic life of the assets in the group as required by s.8.33(b) of the Code.

9.56 Epic Energy refers to the second part of the (economic) Depreciation Schedule as depreciation of the deferred recovery account. An increase in the deferred recovery account balance (negative depreciation of the deferred recovery account) is a deferral of a part of the capital base for recovery in subsequent

years when the market for gas transmission service has grown. With growth in the demand for transmission services, depreciation of the deferred recovery account is positive, effecting a recovery of that part of the capital base deferred in previous years, and reducing the deferred recovery account balance.

9.57 If the market for gas transmission services grows in the way that was expected at the time Epic Energy purchased the DBNGP (and if the reference tariff and tariff path are those which supported Epic Energy's purchase price), negative depreciation of (additions to) the deferred recovery account in early years of Epic Energy's ownership of the Pipeline will be exactly offset by positive depreciation of (reductions in) the deferred recovery account balance in later years. That is, if expectations are realised, accumulated deferred asset recovery will be zero.

9.58 In consequence, the Depreciation Schedule which Epic Energy submits will have the effect of charging to shippers, over the remaining economic life of the DBNGP, only the depreciation of the physical asset base. Each group of assets comprising the physical asset base will be (as noted above) depreciated over its economic life. Furthermore, over the economic life of the Pipeline the accumulated depreciation of the deferred recovery account will be zero, and the physical and deferred recovery assets which form the DBNGP will be depreciated only once as required by s.8.33(d) of the Code.

9.59 At this time (prior to approval of the first Access Arrangement for the DBNGP), Epic Energy has no need to consider the possibility that its expectations concerning the economic lives of the groups of physical assets that form the Pipeline are inappropriate, and should be adjusted. Accordingly, at this time, s.8.33(c) of the Code has no role to play in the design of Epic Energy's Depreciation Schedule.

9.60 If Epic Energy's expectations are not realised – that is, if the market for gas transmission service fails to grow in the way expected at the time Epic Energy purchased the DBNGP – the deferral of recovery of the capital base will have the effect of "insulating" shippers from increases in the reference tariff. Shippers will continue to pay the tariff established by the reference tariff and tariff path of the proposed Access Arrangement. If, at the end of the economic life of the Pipeline, the market for gas transmission services has not grown as originally forecast, a part of the deferred asset value will remain unrecovered. The amount of this unrecovered asset value is a measure of the extent to which the original investment in the Pipeline, by Epic Energy's shareholders, is shown, by subsequent events, to have been imprudent.

9.61 Should the market for gas transmission services grow at a greater rate than was expected at the time Epic Energy purchased the DBNGP, the deferred recovery account balance will be reduced to zero before the end of the economic life of the Pipeline. The tariff derived from the reference tariff and tariff path of the proposed Access Arrangement would, then, if they continued to apply in subsequent years, recover more than the value of the physical assets which form the DBNGP.

Should these circumstances arise, the regulatory model proposed by Epic Energy ensures that it recovers no more than its original investment.

9.62 The discussion in the preceding paragraphs assumes that the rate of return Epic Energy is allowed to earn on its investment in the DBNGP is equal to the rate implicit in its tariff calculation at the time of sale. Epic Energy's use of economic depreciation has the further implication that if the rate of return Epic Energy is allowed to earn on its investment is more than the rate implicit in its tariff calculation at the time of sale, the additional revenue from a reference tariff that is now higher than necessary to earn the current rate of return, is explicitly recognized as a return of capital. In these circumstances, the deferred recovery account balance will be reduced to zero before the end of the economic life of the Pipeline. Epic Energy will then reduce the reference tariff to the extent necessary to ensure that depreciation over the economic life of the Pipeline recovers no more than its original investment, and that it earns only the regulated rate of return on that investment.

9.63 Furthermore, should the rate of return Epic Energy is allowed to earn on its investment be less than the rate implicit in its tariff calculation at the time of sale, the shortfall in revenue from a reference tariff that is now lower than necessary to earn the current rate of return, may result in a part of the deferred asset value remaining unrecovered at the end of the economic life of the Pipeline. Should this occur, the unrecovered asset value will again be a measure of the extent to which the original investment in the DBNGP, by Epic Energy's shareholders, is shown, by subsequent events, to have been imprudent. The investors will be shown to have expected a higher return than is provided by the regulatory regime under which the Pipeline operates.

9.64 Epic Energy's use of economic depreciation is equivalent to the expression of an NPV (or IRR) approach to total revenue determination in terms of a cost of service methodology. The use of NPV and IRR methodologies in establishing tariffs (given asset values), or in establishing asset values (given tariffs) is a matter of normal commercial practice. Some submissions made to the Regulator have sought to argue that these methodologies are applicable only in the case of greenfields pipeline developments. This is not the case. They are applicable in the determination of tariffs wherever a transaction or transactions have established the value of an asset, irrespective of whether that asset is a greenfields development or an established pipeline.

9.65 Through the DBNGP sale process, Epic Energy acquired an established pipeline. Furthermore, it undertook, as part of commitments given at the time of purchase, to spend up to $875 million on expanding the DBNGP's capacity to assist the future development of the Western Australian economy. Epic Energy's ability to expand the gas transmission capacity of the DBNGP is supported by the Reference Tariff and tariff path of the proposed Access Arrangement, and these are implemented though the Depreciation Schedule which Epic Energy submits.

Derivation of Non-Capital Costs

9.66 The Code provides that Non Capital Costs are the operating, maintenance and other costs incurred in the delivery of the Reference Service. They may include, but are not limited to costs incurred for generic market development activities aimed at increasing long-term demand for the delivery of the Reference Service. See s.8.36. Further, consistently with the objectives of the Code concerning recovery of all costs which are not imprudent, s.8.37 states that a Reference Tariff may provide for the recovery of all Non Capital Costs except for any such costs that would not be incurred by a prudent Service Provider, acting efficiently, in accordance with exceptionally good industry practice and to achieve the lowest sustainable cost of delivering the Reference Service.

9.67 The Non Capital Costs which Epic Energy will incur in the operation of the DBNGP are set out with particularity in the proposed Access Arrangement. They are costs which are consistent with accepted and good industry practice, and there can be no question that a prudent Service Provider would incur such costs. These costs are justified in the associated material provided with this paper. The appropriateness of these costs was acknowledged, with some limited exceptions, by the Regulator in the Draft Decision.

10 Conclusion

10.1 The above analysis of the relevant provisions of the Code results in a consistent and harmonious interpretation of the Code as it is applied to the facts of the present case. At each point the same factual matters are given appropriate weight in each section of the assessment process.

10.2 Overall, an application of these factors produces a result which strongly favours adopting the Reference Tariff and Reference Tariff policy proposed by Epic Energy. There are no compelling contrary reasons which would justify a lower Reference Tariff. No form of economic theory has been, or could be, advanced which would justify basing the Reference Tariff on anything less than substantially the full amount of Epic Energy's bid price and associated capital costs. Each and every one of the reasons advanced by the Regulator in his draft decision dated 21 June 2001, for a Reference Tariff based on a significantly discounted initial Capital Base, was considered and specifically rejected by the Full Court. Many public interest factors, as well as principles of fairness and justice to Epic Energy itself, require the conclusion that the proposed Reference Tariff ought to be approved.

10.3 The consequences of adopting a Reference Tariff which is less than the tariff proposed by Epic Energy are that, most likely, Epic Energy would be forced into an external administration with grave consequences for the State, existing users of the DBNGP, and any investors interested in assisting in or facilitating the purchase of infrastructure assets in Western Australia at any point in the future.

10.4 If the Regulator identifies any possible reasons why Epic Energy's proposed tariff ought not to be approved, Epic Energy seeks the opportunity to address those reasons specifically. Further, to the extent that the Regulator has obtained material which supports Epic Energy's position, through the exercise of his compulsory powers or otherwise, Epic Energy seeks access to that material for purposes of elaborating and elucidating upon it, if the Regulator is proposing to make a decision adverse to Epic Energy. Finally, to the extent that the Regulator disagrees with any aspect of this submission or requires further information or detail to verify statements of fact, Epic Energy requests that it be provided with a reasonable opportunity to address the Regulator on those issues *before* the Regulator issues any papers for comment or issues a Final Decision.

11 Deleted

11.1 Deleted

11.2 Deleted

Attachment 1

Mallesons Stephen Jaques Letter to Epic Energy dated 11 December 2002

See Attached

Attachment 2

KPMG Letter to Epic Energy dated 11 December 2002

See Attached