



DAMPIER TO BUNBURY NATURAL GAS PIPELINE

PROPOSED ACCESS ARRANGEMENT UNDER THE NATIONAL ACCESS CODE

RESPONSE TO DRAFT DECISION PUBLIC VERSION

Court Decision Submission CDS#4: The Deferred Recovery Account

16 December 2002

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1. Introduction

- 1.1 This submission is one of a number of submissions being made to the Regulator in response to the decision of the Full Court of the Supreme Court of Western Australia ("Court") on 23 August 2002 in relation to Epic Energy's legal challenge of the Regulator's draft decision issued on 21 June 2001 ("Court Decision").¹
- 1.2 In response to the Court's reasons for decision, the Regulator issued an Information Paper on 2 September 2002 which outlines the process the Regulator intends to follow in light of the Court's decision.
- 1.3 The Information Paper provides (as suggested by the Court Decision) that the regulatory decision making process should proceed in accordance with the Code subject to the Regulator allowing all interested parties a reasonable time to prepare and provide submissions to the Regulator which have regard to the reasons in the Court Decision and their effects on matters identified in the Draft Decision as being the reasons for requiring amendments to the proposed Access Arrangement.
- 1.4 As part of that process, the Regulator required all submissions to be provided to him by a specified date (being 8 November 2002).
- 1.5 The Regulator closed the public consultation period, notwithstanding the fact that the declaratory orders remained to be finalised.
- 1.6 Nevertheless, Epic Energy has elected to participate in the public consultation process because it is driven by expediency. It has proceeded on the basis that the Court's declaratory Orders will be as set out in paragraph 223 of the Court decision.
- 1.7 In doing so, Epic Energy has not had access to all the information which the Regulator has relied on to date. Furthermore, there is additional information which Epic Energy believes the Regulator should obtain but which Epic Energy has been unable to for one reason or another.
- 1.8 Therefore, because:
- (1) the Full Court has not yet made final orders in the above proceedings;
 - (2) the Regulator has not disclosed all information that he has relied upon or intends to rely upon; and
 - (3) Epic Energy has urged the Regulator to exercise his information collection powers under Schedule 1 to the Gas Pipelines Access (Western Australia) Act 1998 (WA) ("Act");

Epic Energy reserves the right to file further submissions after the final form of declaration is known and the information is released.

- 1.9 The new submissions associated with the present submissions are as follows:

¹ Re Dr Ken Michael AM; Ex parte Epic Energy (WA) Nominees Pty Ltd & Anor [2002] WASCA 231 16 December 2002

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Identifier	Submission Title
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

- 1.10 As a final introductory matter, Epic Energy requests that it be afforded an opportunity to meet with the Regulator to discuss aspects of the information contained in this and the accompanying submissions. In this respect, Epic Energy will contact the Regulator to arrange a mutually convenient time for this meeting.

2 Epic Energy's Legitimate Business Interests – the deferred recovery account

2.1 The proposed initial Capital Base for the DBNGP as at 1 January 2000 totals \$2,571.1 million. As Epic Energy has disclosed to the Regulator on numerous prior occasions, that represents the actual capital cost of the DBNGP (ie Epic Energy's capital investment in the pipeline) and it comprises two components:

- the cost Epic Energy incurred in acquiring the Pipeline - its purchase consideration, \$2,407.0 million, plus net costs incidental to the purchase, which amounted to \$42.5 million; and
- the capital costs of enhancement and expansion of the Pipeline after acquisition, which amounted to \$121.6 million for the period from 25 March 1998 to 31 December 1999.

2.2 The Court concluded that that investment and Epic Energy's legitimate business interests properly extend to the recovery of that price together with an appropriate return on an investment. Indeed, the Court concluded that Epic Energy's legitimate business interests might well extend much further.

2.3 However at paragraph 189 of the Court's reasons for its decision, it states:

*"It is for Epic to seek to justify to the Regulator that the price it paid represented market value at the relevant time and to establish its reasonable expectations under the previous regulatory regime. In this regard it is fair to say that the manner in which Epic sought to demonstrate that it paid market value for the DBNGP has shown itself, in the course of these proceedings, and in the Regulator's draft decision, to be well capable of being misunderstood in more than one material respect, namely the financial provision for future expansion of the capacity of the pipeline and the period over which it proposed it should recover its capital investment. That will be for Epic to seek to remedy, if it is so minded."*²

2.4 Accordingly this submission, together with the other submissions being lodged in response to the Court's decision, is an attempt to clarify Epic Energy's proposal and in turn demonstrate that it is in accordance with the proper construction and application of the Code.

² Court Decision, para 189, at page 80
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3. Epic Energy's legitimate business interests and investment in the DBNGP – Recovering Epic Energy's investment

Information already submitted to the Regulator

- 3.1 Epic Energy has consistently submitted to the Regulator that the reference tariffs being proposed in its proposed Access Arrangement coupled with the regulatory tariff model operate to provide Epic Energy with the **opportunity** of recovering **only** Epic Energy's actual investment in the pipeline (ie the purchase price (plus net acquisition costs) plus the costs of enhancing the capacity of the pipeline) together with an appropriate return on that investment.
- 3.2 Epic Energy's proposal:
- **does not guarantee** Epic Energy that it **will** recover its investment. It merely provides Epic Energy with the **opportunity** that it may recover its investment if sufficiently high levels of throughput materialises (ie those upon which the purchase price was derived);
 - will **prevent** Epic Energy from **increasing** reference tariffs at any stage over and above those being proposed (subject to the annual escalation proposed) if throughput does not materialise so as to allow Epic Energy to recover the purchase price over the life of the pipeline. If lower than anticipated throughput materialises, then, at the end of the pipeline's life, Epic Energy will have been judged to have made an imprudent investment in the pipeline (to the extent of the under recovery); and
 - will **require** Epic Energy to **reduce** its reference tariffs if throughput is high enough to put the DBNGP on a path to excess recovery. It will be required to reduce its reference tariffs to the extent of the potential over recovery.
- 3.3 Epic Energy's tariff model that was provided to the Regulator on 20 January 2000 (an amended version was provided on 8 September 2000) makes this clear. In addition, the report prepared by the Brattle Group, *Proposed Regulatory Model for the Dampier to Bunbury Natural Gas Pipeline* (October 1999) further explains it.
- 3.4 Epic Energy met with the Regulator on 8 September 2000 to further explain the model and its application. Following that meeting, on 24 November 2000, Epic Energy provided a further paper (Response to Information Request #6 – Application of the Regulatory Model) which responded to certain queries raised by the Regulator at the meeting.
- 3.5 Epic Energy provided further clarification of it in Additional Paper 5 – Code Compliance, filed with the Regulator on 25 October 2000. In particular, the

paper prepared by KPMG and attached to Additional Paper 5 further explained the concept.³

Draft Decision

- 3.6 Notwithstanding this detail provided to date, at page 137 of Part B of the Draft Decision, decision, the Regulator makes the following statement:

“As indicated in section 5.3.2 of this Draft Decision, Epic Energy supported the proposed valuation of the Initial Capital Base with an indication that the purchase price of the DBNGP is justified by being consistent with the net present value of cash flows given the future tariffs proposed at the time of the purchase, and a recovery of the invested capital over the physical life of the assets at the same future tariffs.

The Regulator is of the view that Epic Energy has not demonstrated that the purchase price is consistent with a net present value of cash flows from the assets, or consistent with a recovery of invested capital over the physical life of the assets. The primary reason for this view is that the calculations presented by Epic Energy were based on forecasts of throughput quantities that are substantially in excess of the current capacity of the pipeline system, and no allowance has been made in the calculations for the capital expenditure necessary to accommodate these quantities.....”

- 3.7 This issue is also raised at pages 95 to 100 of Part B of the Draft Decision, in particular pages 98 to 100.
- 3.8 Based on these comments, it is apparent that in reaching the conclusion that “Epic Energy has not demonstrated that the purchase price is consistent with a net present value of cash flows from the assets, or consistent with a recovery of invested capital over the physical life of the assets”, the Regulator has been under a fundamental misapprehension as to the nature of Epic Energy’s proposal. This paper therefore seeks to once again clarify Epic Energy’s proposal and in doing so to correct that misapprehension.

Calculations relied upon by Regulator to reach conclusion

- 3.9 It appears that the Regulator has relied primarily upon the calculations contained in the KPMG paper attached to Additional Paper 5⁴ in reaching the above conclusion. Of all the information that Epic Energy provided to the Regulator, this is the only document the Regulator specifically refers to in the Draft Decision reasoning on this issue.
- 3.10 However, it must be noted that the figures and calculations that the Regulator does refer to in order to support the conclusion (see pages B98 – 100 of Draft Decision) are not exactly the same as the figures and calculations used in the KPMG Paper. They differ in one important respect – in the tables contained

³ See attachment 3 of Epic Energy Additional Paper AP#5 – Code Compliance, dated 25 October 2000.

⁴ *ibid.*

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in the Draft Decision, the Regulator designated the volumes as being in millions of gigajoules. However, the figures and calculations contained in the KPMG paper were stated in arbitrary units and not in gigajoules.

Regulator's error

- 3.11 If it is the case that the Regulator has primarily relied upon the calculations contained in the KPMG paper to reach the conclusion referred to in paragraph 3.8 above, he has misinterpreted its purpose and the conclusion reached is flawed. This is so, even if one is to disregard the Regulator's misinterpretation of the units used in the KPMG paper.
- 3.12 The purpose of the KPMG paper was **not** to demonstrate:
- (1) how Epic Energy had actually determined the purchase price of \$2.407b which was paid for the pipeline; nor
 - (2) that the price Epic Energy paid for the DBNGP was consistent with a net present value of cash flows from the assets, or consistent with a recovery of invested capital over the physical life of the assets.
- 3.13 Rather, it was prepared for two principal purposes:
- (1) To demonstrate that, in conformity with the principles contained in s. 8 of the Code, a reference tariff could be determined, by invoking the concept of economic depreciation, so as not to lead to an over-recovery of capital if increased volumes were obtained.
 - (2) To demonstrate that, if volumes were subsequently lower than those forecast at the time of Pipeline sale, the revenue from the reference tariff would not recover the capital cost that represented that "lost demand", and the loss would be borne by Epic Energy's owners. Under Epic Energy's proposed reference tariff policy, users would not bear the loss through increases in the reference tariff.
- 3.14 As stated in the attachment to Additional Paper 5, KPMG's work was to be conceptual and explanatory, rather than an examination of specific details. This is demonstrated in the KPMG paper itself in 3 material respects:
- First, express reference of the paper's purpose is stated in bold and in an outlined box at the beginning of each spreadsheet that forms part of the KPMG paper.⁵
 - Second, the figures contained in the spreadsheets themselves are simply stated in arbitrary units and not in gigajoules.
 - Third, the calculations in the spreadsheets, including those at pages B99-100 of the Draft Decision, are over a 10 year period, being a shorter life than the actual life of the assets submitted by Epic Energy in the proposed Access Arrangement. They show no capital expenditure for pipeline expansion, because the calculations do not involve throughput volume above existing capacity.

⁵ It is important to note that the Regulator noted this in footnotes 59 & 60 of the Draft Decision but nonetheless appears to rely upon these calculations as the basis for reaching his conclusion.

- 3.15 The calculations of the KPMG paper show no capital expenditure because they were to show how the outcomes of the DBNGP sale process, the capital base, and the reference tariff proposed for the Pipeline were interrelated through the regulatory model. The omission was deliberate in order to keep the example simple and thus make the concept easier to pick up.
- 3.16 The demonstration of interrelationship was to be conceptual and explanatory, directed at providing an understanding of the critical relationships, rather than an examination of specific details. Including capital expenditure does not introduce any new element of interrelationship requiring explanation. This was noted on page 8 of the KPMG paper.
- 3.17 The KPMG paper was clear in respect of its purpose, and the Regulator appears to recognise this in footnote 56 of the Draft Decision. Even if the Regulator had not been clear on the purpose of the KPMG paper, the calculations taken from that paper and set out at B99-100 of the Draft Decision could not reasonably be construed as being indicative of the derivation of the purchase price. The DBNGP has a remaining life much longer than 10 years. It should generate cash flows for an owner over a period much longer than 10 years, and this would normally be taken into account in establishing a purchase price consistent with a net present value of cash flows either by forecasting those cash flows over the remaining life of the assets or, if cash flows are taken over a shorter period, including in the present value calculation a residual value which estimates the likely revenue beyond the period of the present value calculation. This was not done in the calculations set out at B99-100.

4. Further Clarification – Additional Note to Brattle Regulatory Model Report

- 4.1 **Attached as Attachment 1** is a further note from the Brattle Group which supplements their original report that Epic Energy submitted to the Regulator and provides examples that attempt to:
- correct the misapprehensions of the Regulator manifest in pages B 95 to 100 and 136 to 137 of the Draft Decision; and
 - further clarify the consistency and compliance of Epic Energy's proposal with the Code.
- 4.2 The note uses forecasts of revenues, operating and capital expenditure taken from Epic Energy's acquisition model that was used to derive the price paid by Epic Energy for the purchase of the DBNGP.
- 4.3 Once again, as has been the case on prior occasions, the note seeks to show that by running scenarios that adopt forecasts relied upon at the time of sale (or any forecasts for that matter), Epic Energy's proposal ensures the following:
- It commits Epic Energy to the reference tariffs that are no more than \$1.00/GJ to zone 9 and \$1.08 to Zone 10, increased annually as a percentage of the CPI;
 - If additional investment is required to expand the capacity of the pipeline, Epic Energy will make that investment up to a cost of \$875 million. Such investment up to this amount **will not result in an increase in the reference tariff.**
 - Based on the above tariff, the model allows Epic Energy the opportunity to recover its purchase price and additional investment if sufficiently high levels of demand materialise.
 - Under no circumstances can Epic Energy recover more than the purchase price and additional investment, even if throughput materialises which is high enough to put the DBNGP on a path to excess recovery; and
 - If throughput does not materialise that allows Epic Energy to fully recover its purchase price over the life of the pipeline, then 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.
- 4.4 This submission should be read in conjunction with Epic Energy's submissions CDS# 2 & 3 as they demonstrate the reasonableness of the forecasts and assumptions that Epic Energy relied upon to bid for the pipeline and of course purchase price paid to the State in 1998.

5. Deleted

5.1 Deleted

5.2 Deleted



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Attachment 1

Proposed Regulatory Model Additional Note by Brattle Group

See Attached